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LEGAL UPDATES AND NEWS

Proposed Supplemental Capital Legislation

The Capital Access for Small Business and Jobs Act, H.R. 3993, was recently introduced by Rep. Peter King (R-NY) and co-sponsored by 18 congressmen, including the leading Democratic sponsor, Rep. Brad Sherman (D-CA). The purpose of this legislation is to allow credit unions to accept additional forms of capital, provided it does not alter the cooperative ownership structure of credit unions.

Overview

Under current NCUA regulations, credit unions, with the exception of low-income credit unions and corporate credit unions, may only use their retained earnings to meet their capital requirements. Under H.R. 3993, natural person credit unions (other than low-income credit unions) would be able to accept non-share capital accounts that do not alter the cooperative nature of the credit union. The non-share capital accounts must be uninsured, subordinate to all other claims against the credit union and subject to maturity limits, as determined by the NCUA. Additionally, the NCUA would first have to determine that the credit union is sufficiently capitalized and well-managed before a credit union could take advantage of this supplemental capital.

Terms such as “well-managed” and “sufficiently capitalized” are not defined in the bill, but would be determined by the NCUA through rule promulgation at a later date. One would expect that “well-managed” would mean a credit union with a CAMEL rating of “1” or “2” and “sufficiently capitalized” would mean that the credit union is at least “adequately capitalized,” as defined in NCUA regulations. Since low-income credit unions already have a mechanism that allows them to raise supplemental capital, they are not covered by the legislation.

As of March 8, 2012, H.R. 3993 has been referred to the House Committee on Financial Services, which referred the bill to the Subcommittee on Financial Institutions and Consumer Credit. Hearings have not yet been scheduled.

Existing Requirements for Supplemental Capital

Under current NCUA regulations, supplemental capital may only be raised by corporate credit unions and low-income credit unions. To count as capital for low-income credit unions the capital instrument must (1) have at least a five year maturity, (2) be subordinated to the claims of all other creditors, the members and the NCUSIF, (3) be established as an uninsured secondary capital account and (4) be approved by the NCUA. In addition, the capital may only be purchased by non-natural members and non-members. Any redemption of the capital must be approved by the NCUA. The application to the NCUA must contain a “secondary capital plan” that must provide, among other things, supporting pro forma financial statements, the planned uses of the secondary capital and how it will be repaid.

It seems likely that the requirements that would be adopted for this new form of capital would have similar application requirements with any additional requirements that the NCUA believes may be relevant.

Potential Investors

The proposed legislation does not specify who the purchasers or investors may be for this new form of capital. Obviously, having the widest potential source of investors will increase the likelihood of success. Since an investor will not become a member by purchasing the debt instrument, there should not be concern that the "purity" of the membership base will be diluted if the capital may be offered to members as well as the general public.

Disclosure and Securities Law Compliance

A secondary capital instrument is a security and carries with it many of the same risks as any other debt security. We believe the credit union industry has not adequately considered the administrative burden that will apply to the issuance of these securities. Unless the capital is only being issued to "accredited investors" (meaning sophisticated investors as defined by the SEC), considerable financial disclosure will likely be required as in the case of a stock offering by a public company. Further, there may be ongoing disclosure requirements for the credit union. Since the NCUA and other state credit union supervisors are not experienced securities regulators, the jurisdiction may fall to the SEC. The legislation does not address this question.

Historical Perspective

In the 1980's, a number of savings institutions issued subordinated debt that counted as regulatory capital. Many mutual institutions offered the debt at branch locations in small denominations to their members. When the savings and loan crisis occurred, many institutions failed, including *Lincoln Savings* in California. When customers came forward and requested their money, they were told, much to their surprise, that they had purchased an uninsured investment and not a certificate of deposit.

Conclusion

The prospect for passage of this legislation is uncertain. One thing that is certain, however, is that the bank trade groups will vigorously oppose the legislation since it eliminates one more difference between banks and credit unions.

Under current law, the only real viable option for credit unions to raise capital is to first convert to a mutual savings bank and then convert to a mutual holding company and issue stock or convert to a full stock institution. Our law firm has completed about one-half of the charter conversions that have been completed and raised more capital for former credit unions than any other firm. We would be pleased to speak with you regarding methods to augment your credit union's capital position. In addition, if you would like a copy of our summary of the NCUA's white paper on supplemental capital, we can provide you with one. Please do not hesitate to contact any of the following attorneys if you have any questions.

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