

## Capital Issues Leave Even Well-Managed Credit Unions Completely Defenseless

By Peter Duffy

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Restrictive capital requirements combined with the inability to raise secondary capital has left even well-managed CUs completely defenseless to the first-lien the system has on their capital. (Restrictions include asset-risk weighting and the minimum requirement that is 40% higher than banks). The NCUA has the statutory authority via the deposit insurance fund to use every credit union's entire net worth to pay for problems in the system. While the trade association proposal to allow for secondary capital is an attempt at a solution, the practical reality is that in current form, the risks outweigh any remote benefit. Meanwhile, risk to current capital is looming.

Central to the competitive disadvantage of CUs compared to banks is the fact that banks don't have a corporate credit union bail out, the cost of which appears significant considering that the \$21 billion in unrealized losses represents approximately 300% of the NCUSIF.

Competitive considerations also include that the well-managed bank, unlike the well-managed CU, has layers of protection for its capital, such as risk-based FDIC premiums; access to the capital markets and TARP; greater earnings due to more flexible regulations; allowing private equity firms to invest capital in banks; encouraging foreign banks to acquire troubled U.S. banks; the first joint transaction with an outside firm to remove troubled assets from a bank. The FDIC defends both its fund and the capital of well-managed banks while also dealing with troubled banks.

Secondary capital serves as a buffer to the insurance fund by allowing outside funds to bolster capital. Legislation allowing CU-to-CU capital infusion serves to increase the interconnected risk to the system and therefore is unlikely to be approved. The corporate meltdown provides a real-life example of this interconnected risk.

Even if approved, it is highly unlikely that CUs will be able to access traditional forms of secondary capital. This is because investors are looking for a high degree of transparency on a potential investment's asset quality and performance ratios. Well-informed investors will likely expect this degree of transparency.

Publicly traded banks with assets of \$15 billion or higher are able to access debt. The cost of such debt is also prohibitive. A \$15 billion publicly traded bank should expect to pay the investor a coupon rate of 10%-12%, which would create a negative arbitrage to the average yield on earning assets of the typical CU.

Outside investors are also unlikely to invest in a CU to plug a hole made by bad loans.

Current discussions propose that CU secondary capital come only from members. CUs seeking secondary capital to plug a hole due to deteriorating asset quality face a daunting task of disclosure should this option be approved. Among other things, the CU has not only a legal but a moral responsibility to disclose the use of funds as well as the lack of federal guarantee and potential for loss. What's more, the member should be advised that the CU system has a call on the CU's capital that comes before the secondary capital investment. The member should be apprised of the CU's financials and compare those to peers.

Well-run CUs with no asset problems but seeking capital to fund growth programs have the same disclosure requirement. The investing member (or SEG) will need to be informed of the first lien the system has on the CU's capital, among other risks. This disclosure decreases the likelihood of investor

willingness and quite possibly could lead to the further disclosure of the true risk in the system, including, but not limited to, the risk in the corporates' bond portfolios and the NPCU loan portfolios. The disclosure should appropriately include the differences between the two insurance funds, the FDIC and the NCUSIF. CUs can visit the FDIC at [http://www.fdic.gov/about/strategic/corporate/cfo\\_report\\_2ndqtr\\_09/balance.html](http://www.fdic.gov/about/strategic/corporate/cfo_report_2ndqtr_09/balance.html) to see both the fund balance but also the billions in contingent liabilities (reserves).

Regulatory capital requirements are changing. The minimum requirement may be increasing for both banks and CUs. Also, there's a lot of discussion that the quality Tier 1 capital is headed away from debt and toward reliance more on undivided earnings and common equity (with voting rights and hybrid debt that converts to equity). Undivided earnings and equity are in a first-loss position and protect the insurance fund.

Strong CUs are in a position to make a difference in their local markets but the capital constraint of regulations, including the lack of secondary capital, combined with the apparent capital drain from the system's credit problems, may unduly restrict CUs' contributions. The only secondary capital solution available is for a strong CU to convert into a mutual savings bank and then achieve member approval to issue stock. (With a minority offering, the institution is still a member-owned cooperative and the member retains voting rights).

Charter due diligence is but one of a number of considerations in strategic planning, but it is growing in importance, given the weakness of capital rules and the risk to current capital. Mergers, collaboration for cost savings and earnings enhancements are also on the radar.

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