THE OFFICE OF SMALL CREDIT UNION INITIATIVES
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FOCUS e-newsletter: Consulting

UNDERSTANDING SECONDARY CAPITAL

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Recently, the number of credit unions approved by NCUA as low-income designated (LID) has increased tremendously. Credit unions that have a majority of members who are low-income are eligible for the designation, regardless of asset size. Benefits to a credit union of having the designation include:

Primary benefits – eligible to:

- ✓ Accept non-member deposits from any source.
- ✓ Offer and accept secondary capital accounts.
- ✓ Receive exemption from the aggregate loan limit for members business loans (MBLs).
- ✓ Apply for grants and low-interest loans from NCUA.

Additional benefits – eligible to:

- ✓ Receive consulting service from NCUA through OSCUI.
- ✓ Lower barrier access to resources of other federal government agencies and non-profits.

Secondary capital

To help you better understand the primary benefit of the LID status, over the next three months, we'll dedicate this column to providing instructions on secondary capital. This month will feature general information; in May we'll address proper accounting treatment; and in June, we'll address prompt corrective action (PCA) consideration.

Secondary capital is uninsured, subordinated, convertible debt – in other words, a loan, which counts toward the net worth of a LICU. It must take the form of subordinated debt – a borrowing transaction that must be repaid over time, if the funds are not used to cover operating losses. Subordinated" means the secondary account holder's claim must come AFTER any other claims from shareholders, creditors or the NCUSIF.

Regulatory origin

NCUA first approved LID credit unions (LICUs) to offer and accept secondary capital accounts in 1996. The regulation allowed such credit unions to secure a new form of capital from institutional investors to enable them to do what they do best – extend credit and provide quality financial services to underserved individuals. The secondary capital helps build a LICU's net worth while it grows and offers more and better services to its members of modest means.

Key regulatory requirements

Borrowing limit: A requirement often overlooked regarding secondary capital is the borrowing limitation for federal credit unions stipulated in the Federal Credit Union Act. Since secondary capital is a loan, credit unions accepting it must comply with Section 107(9) of the Union Act. This provision limits borrowings to less than 50 percent of a credit union's paid-in and unimpaired capital and surplus. The amount held in secondary capital accounts by LICUs must be included in total borrowings for the purpose of this limitation. Paid-in and unimpaired capital and surplus is defined in NCUA Rules and Regulations, Section 700.2(f) as shares plus post-closing, undivided earnings. Regular reserves or special reserves required by law, regulation or special agreement between the credit union and its regulator or share insurer are excluded.

Additional requirements: The following requirements are contained in Section 701.34(b) of NCUA Rules and Regulations:

- LICUs can only accept secondary capital accounts from non-natural person members/nonmembers. Thus, the lender cannot be an individual.

- Before accepting secondary capital, a LICU must adopt and obtain NCUA approval of a written ''Secondary Capital Plan''. NCUA Regional Directors have authority to approve such plans. The regulation outlines the requirements for a secondary capital plan.

- Pro-forma financial statements covering a minimum two-year period must be included in the secondary capital plan. However, a LICU will need to provide projections out as far as the term of the secondary capital loan and show the interest expense on the funds.

- The secondary capital must be established as an uninsured secondary capital account or other form of non-share account. The account will not be insured by the National Credit Union Share Insurance Fund (NCUSIF).

- The secondary capital account investor's claim against the LICU must be subordinate to all other claims including those of shareholders, creditors and the NCUSIF.

- Funds deposited into a secondary capital account, including interest accrued and paid into the secondary capital account, must be available to cover operating losses realized by the LICU that exceed its net available reserves, exclusive of secondary capital and allowance accounts for loan and lease losses.

  Also, to the extent funds are so used, the LICU may not restore or replenish the account under any circumstances. This means that the funds in the account must be available to cover losses, after the credit union's Undivided Earnings, Other Reserves, and Regular

Reserve are depleted, but prior to liquidation. Accordingly, it is critical to note that if a LICU has secondary capital and has to tap into the account to absorb losses after the LICU's own reserves have been depleted, the amount of the secondary capital that is used to absorb losses is gone forever, cannot be replenished. This amount essentially becomes a loss to the investor, since the secondary capital is not insured by NCUA.

- In the event of merger or other voluntary dissolution of the LICU, other than merger into another LICU, the secondary capital accounts will be closed and paid out to the account investor to the extent they are not needed to cover losses at the time of merger or dissolution. They do not automatically carry over when a merger takes place.

- A secondary capital account contract agreement must be executed by an authorized representative of the account investor and the LICU. The agreement must reflect the terms and conditions mandated by Section 701.34(b) and any other terms and conditions consistent with the regulation. In addition, an authorized representative of the LICU and the secondary capital account investor each must execute a ''Disclosure and Acknowledgment'' as set forth in the Appendix of 701.34(b). This document, which must be executed at the time the agreement is signed, contains specific language alerting the investor of the potential prepayment risk and that the LICU cannot use the funds to pay dividends.

- If a LICU is less than adequately capitalized, NCUA may prohibit it from repaying secondary capital funds or the interest on the funds, even if the LICU is eligible to redeem the portion of secondary capital that has been re-categorized as subordinated debt and no longer counts as part of the credit union's net worth.

For questions about secondary capital, contact your examiner or email our Consulting staff at oscuiconsulting@ncua.gov.