



Alternative Sources of Capital for Credit Unions

International Examples

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The global financial meltdown of 2008-2009 has brought the topic of alternative capital sources for credit unions front and center. This subject has been explored for decades, but now a renewed sense of urgency is driving the debate. While retained earnings remain the primary component of credit union capital, this approach carries limitations, such as speed of capital accumulation and difficulty growing in a weak economy. Adding alternative sources of capital can provide avenues to tap new markets and enable more rapid recapitalization of troubled institutions. These sources typically have long maturities and depending on the type may be issued to credit union members or to outside investors. This paper prepared by the World Council of Credit Unions features a variety of solutions credit unions around the world are employing to balance flexibility, cost and speed of access to capital while maintaining their cooperative ownership and governance structures.

The featured case studies include, but are not limited to, Australia, Canada, Dominican Republic, India, Ireland, the Netherlands and Poland. Many examples in this report are from countries where financial cooperatives pay income tax. This paper does not seek to address the political or potential tax dimensions of alternative capital sources but rather to provide clear definitions and examples of how these tools are being utilized outside the U.S. The following table highlights characteristics of seven alternative sources of capital described in this paper:

Type of Capital Instrument	Source of capital	Relative cost of capital	Payout priority in event of liquidation	Regulatory capital treatment	Country Examples
1. Membership Equity Shares	Members	Low	Junior to claims of depositors and all other creditors	Tier 1	Canada, Poland
2. Preferred Shares	Members	High	Senior only to membership equity shares	Tier 1 and Tier 2	Canada, India
3. Trust-Preferred Shares	Non-members	High	Senior to preferred and membership equity shares	Tier 1	Netherlands, Australia
4. Subordinated Debt	Non-members	High	Senior to membership equity shares	Tier 2	Canada
5. Uninsured Long-Term Deposits	Members & non-members	High	Senior to subordinated debt and membership equity shares	Tier 2	Dominican Republic, India
6. Prorated Share of System Capital	Retained earnings	Low	Covers insured losses or stays in System	Tier 2	Canada
7. Minority Stake Listing	Non-members	High	Based on type or class of stock	Tier 1	Ireland



After a short definition of specific capital sources, we provide examples from countries or regions that employ them. We limit our discussion to sources of capital other than retained earnings and do not cover additional ways to increase retained earnings.

COMPONENTS OF THE CAPITAL BASE

Although U.S. credit unions have separate statutory capital requirements per the Federal Credit Union Act, U.S. banks and credit unions in many countries are influenced by the Basel Accord on Capital Adequacy. Therefore, as a starting point we define what is meant by the terms Tier 1 and Tier 2 capital.

From a regulatory perspective, capital is a measure of the relative financial strength and ability to handle unexpected losses by banks, credit unions and other financial institutions. Capital serves as a buffer against such factors as credit, operational and market risks. While regulators define capital requirements and the capital treatment of various financial instruments based upon the laws of their respective countries, international guidelines and recommendations from the Basel Committee on Banking Supervision and Basel Accords I and II have had substantial influence in determining those capital standards. The Basel Accord on Capital Adequacy defines the components of capital into two main categories, or tiers:

Tier 1 or core capital, consists of the types of capital considered the most reliable and permanent, such as equity capital and disclosed reserves. Equity capital includes only permanent shareholders' equity, such as issued and fully-paid ordinary shares/common stock and perpetual non-cumulative preference shares. Disclosed reserves consist of retained earnings or other surplus (e.g. share premiums, retained profit, general reserves and legal reserves.) Basel standards require that at least 50% of a bank's capital base consist of this type of capital.

Tier 2 or supplementary capital, is the second most reliable form. Tier 2 capital is that which does not, under any circumstances during the term of the instrument, require the financial institution to repay, redeem, purchase or otherwise acquire all or any part of the indebtedness until a fixed due date or fixed maturity date. The Basel Accord defines undisclosed reserves, revaluation reserves, general provisions, most hybrid (debt/equity) instruments (such as perpetual cumulative preferred shares) and subordinated debt as belonging to this category of capital. The total of Tier 2 capital elements is limited to a maximum of 100% of the total of Tier 1 elements.

The sum of Tier 1 and Tier 2 elements is eligible for inclusion in the capital base.

EXAMPLES OF ALTERNATIVE CAPITAL SOURCES

1. Membership Equity Shares

Definition: Membership equity shares have the primary role of establishing members' ownership interest and voting rights in the credit union. Mandatory by law and generally uninsured, membership equity shares typically have low or no dividend payments and can usually only be withdrawn upon terminating membership. A credit union may offer an unlimited



number of membership equity shares at a par value as established in its bylaws. A member has one vote, irrespective of how many equity shares he/she owns.

Capital Treatment: Membership equity shares may only be considered to be capital as opposed to liabilities of the credit union if one of the following two conditions is met: a) shares are permanent, having no fixed maturity, and withdrawable under limited circumstances such as membership termination; or b) a level of equity share capital has been fixed under which capital must not fall as a result of redemption of shares. The part of the share capital that is “fixed” qualifies as Tier 1 capital.

Payout Priority in Event of Liquidation: Membership equity shares are at risk in any liquidation of the credit union. The claims of members for their equity shares are subordinate to the claims of depositors and the claims of other creditors.

Example: British Columbia, Canada

Variation A: Membership Equity Shares

All credit union members in British Columbia, Canada are required by law to purchase a minimum amount of membership equity shares. Credit union bylaws can stipulate that the institution can issue additional equity shares. There are also different minimum amounts of equity shares for adult and youth members. Many credit unions have introduced a mandatory purchase of additional equity shares for borrowing members (for example, an additional 100 equity shares must be purchased to get a loan.) The maximum value of equity shares one member can be required to purchase by the rules of the credit union is \$1,000. Membership equity shares are listed as Tier 1 capital.

Membership equity shares may be redeemed only with board approval and in order to qualify as Tier 1 capital, the credit union cannot redeem more than 10% of the shares of any particular class in any one calendar year. Otherwise, the shares are considered Tier 2 capital. This redemption limit applies to credit unions in Peru, Mexico and Bolivia as well.

Example: Poland

In addition to retained earnings, credit unions in Poland build capital by issuing uninsured membership equity shares which are obligatory according to legislation and on which no dividends are paid. In addition, when needed, credit unions can make mandatory assessments for long-term secondary shares. These shares established by credit union bylaws, pay small dividends (0%–1%) and are formed by contributions of \$5–\$20. The amount of secondary shares is determined at the annual general meeting (AGM).

According to the Polish credit union act, both membership and secondary shares can be purchased only by credit union members. A member always has to have a certain amount of membership equity and secondary shares and must supplement them in accordance with decisions made at the AGM.

When a credit union is faced with loan charge-offs or other losses, the AGM passes a resolution regarding the recapitalization and coverage of losses. The AGM may ask members to contribute by calling for additional shares. In the event of liquidation, losses are first



covered by retained earnings and equity shares. If the loss exceeds the amount of these funds, the balance is taken from members' secondary shares. Membership equity and secondary shares can be withdrawn only when membership is terminated and after approval of year-end financial statements by the AGM. By statute, equity shares can be applied to any outstanding loan balances or debt before any payout can occur.

Variation B: Patronage Equity Shares

In the early 1990s some credit unions in British Columbia introduced uninsured patronage equity shares as a way to give back continuing equity to members in the year it was earned. This way members' stake in the credit union's equity grows each year, thus entitling them to a larger portion of the value of the credit union should it one day be demutualized. Patronage shares are allocated on an ongoing basis and are applied proportionately based on each member's use (or patronage) of the credit union. Membership equity allocations may be based on savings interest earned, loan interest paid and/or service charges paid. To meet their Tier 1 capital status, membership and patronage equity shares are only redeemable under limited conditions, such as termination of membership.

2. Preferred (or Preference) Shares

Definition: Preferred shares take many forms across countries but have in common that they are voluntary, uninsured investments made by members in their credit unions. Preferred shares generally require a prospectus approved by the credit union regulator before issuance. They are a relatively high-cost source of capital offering a defined term generally over 5 years or may be perpetual in nature. When preferred share subscriptions exceed credit union needs, the credit union may stop issuing them and has the option to issue a new batch when required.

Preferred shares are called perpetual when they have no fixed maturity date. Preferred shares can be cumulative or non-cumulative. For non-cumulative shares, if dividend payments are not declared in one year, they will not be paid in future years.

Capital Treatment: Preferred shares of a perpetual, non-cumulative nature are categorized as Tier 1 capital. Perpetual cumulative preferred shares and redeemable preferred shares are considered Tier 2 capital. In order to qualify for Tier 1 capital, no more than 10% of preferred shares can be redeemed in any one calendar year. Otherwise, the preferred shares are considered Tier 2 capital.

Payout Priority in Event of Liquidation: In liquidation, preferred shares will be paid out after depositors and all other debt holders but before membership equity shares.

Example: British Columbia, Canada

Variation A: Preferred Equity Shares

In the 1980s, credit unions in British Columbia were stressed by the combination of a weak economy and low earnings, and many credit unions had difficulty earning their way to a strong capital position. In addition, they were required to pay property tax and income tax of 22.5%–45%. For many credit unions the choice was to either merge or ask their members for support.



Credit unions in British Columbia chose to ask members to support them by introducing preferred equity shares. Members proved to be willing to invest in their local credit unions, especially when preferred equity shares pay 0.5%–1% above the highest yielding term deposit rates over a defined term of 5–15 years.

Preferred equity shares require a prospectus approved by the credit union regulator and can only be purchased by credit union members. The minimum for these types of shares is generally \$100 per member, with a typical maximum limit of \$5,000, although some credit unions issue shares for larger amounts in which case regulators require a more detailed prospectus be issued.

Members can redeem their preferred shares only when approved by the credit union board. Preferred equity share redemptions are limited to 10% of the total base of preferred shares in any one year if they are to be included as Tier 1 capital. Preferred equity shares are listed as Tier 2 capital if they fail to meet the redemption test for Tier 1.

This alternative source of capital generally does not allow a credit union to call in the investment early, although preferred share dividends are payable at the board of directors' discretion. The downside of preferred equity shares is their expense. When preferred share subscriptions exceed credit union needs, the credit union may stop issuing them and has the option to issue a new batch when required.

Example: India

In addition to retained earnings, urban cooperative banks (UCBs) in India are permitted to raise capital by issuing the following types of preference shares to members. UCBs, however, are not permitted to issue preference shares to other urban cooperative banks.

Variation B: Perpetual Non-Cumulative Preference Shares (PNCPS)

Variation C: Perpetual Cumulative Preference Shares (PCPS)

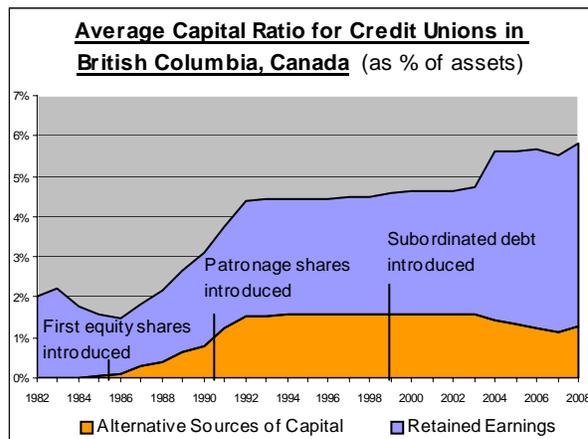
Variation D: Redeemable Non-Cumulative Preference Shares (RNCPS)

Variation E: Redeemable Cumulative Preference Shares (RCPS)

Alternative Capital Sources Timeline British Columbia, Canada

In the mid-1980s the average capital ratio for credit unions in British Columbia, Canada, was below 2% and falling for four straight years. Using new alternative capital sources—a mix of preferred, membership and patronage shares—the movement was able to grow reserves rapidly and improve its overall financial strength.

Ten years after the introduction of preferred and membership shares, the average capital ratio had improved to over 4% and these alternative sources represented more than a third of total capital. Patronage shares were introduced in early 1990s, but as credit unions in British Columbia improved their financial health, the need for alternative sources declined. Over time, retained earnings continued to grow, average capital ratios remained relatively strong and today, over 20 years into the experiment, these alternative sources account for just under one-quarter of total capital.



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Variation D: Redeemable Non-Cumulative Preference Shares (RNCPS)

Variation E: Redeemable Cumulative Preference Shares (RCPS)



The list below highlights features common to all four types of preference shares issued by India's UCBs:

- The preference shares are unsecured and uninsured;
- They carry no voting rights;
- Rates can be fixed or floating where they are tied to a market-determined Rupee benchmark rate index. Dividends will be paid only if the UCBs capital to assets ratio is above minimum regulatory requirement and such payment does not result in the capital ratio falling below the minimum regulatory requirement.
- Preference shares cannot be issued with a *put option*—investors don't have the right to sell back the shares for a fixed price within a specified time; However, UCBs may issue preference shares with a *call option* that can be exercised only after the instrument has run for at least 10 years and subject to regulators' approval. This option provides UCBs with additional flexibility to shorten the maturity by "calling in" the preference shares.
- Claims of the investors holding preference shares are senior to the claims of investors in equity shares but subordinated to the claims of all other creditors and depositors.

The differences among the four types of preference shares issued by India's UCBs are:

Perpetual Non-Cumulative Preference Shares (PNCPS)

- PNCPS are perpetual, having no fixed maturity date;
- Dividends are not cumulative—dividends missed in a year will not be paid in future years;
- Cannot be issued with a *step-up option*—investors don't have right to request a one-time rate increase if market rates increase;
- Treated as Tier 1 capital but cannot exceed 20% of Tier 1 total.

Perpetual Cumulative Preference Shares (PCPS)

- PCPS are perpetual, having no fixed maturity date;
- Dividends are cumulative—dividends missed in a year are treated as liabilities and deferred coupons will be paid in future years when the capital position of the UCB allows;
- May have the *step-up option*—in conjunction with the call option after 10 years from the date of issue investors can request a one-time rate increase of no more than 100 bps;
- Treated as Tier 2 capital, which along with other components of Tier 2 capital cannot exceed 100% of Tier 1.

Redeemable Non-Cumulative Preference Shares (RNCPS)

- RNCPS are issued with a fixed maturity of minimum 15 years;
- Dividends are not cumulative—dividends missed in a year will not be paid in future years;
- May have the step-up option;
- Treated as Tier 2 capital, which along with other components of Tier 2 capital cannot exceed 100% of Tier 1.
- To reflect the diminishing value of these capital instruments for capital adequacy purposes, RNCPS are subject to a progressive discount of 20% per year over their last 5 years to maturity (i.e. at 5 years remaining maturity – 80% of the total RNCPS value will be included as capital; at 4 years remaining maturity – 60% included as capital, etc).



- RNCPS redemption at maturity must be approved by the regulator and made only when the UCB's capital to assets ratio is above the minimum regulatory requirement and the impact of such payment does not cause its capital ratio to fall below the regulatory requirement;

Redeemable Cumulative Preference Shares (RCPS)

- Must be offered with fixed maturity minimum of 15 years;
- Dividends are cumulative—dividends missed in a year are treated as liabilities and deferred coupons will be paid in future years when the capital position of the UCB allows;
- May have the step-up option;
- Treated as Tier 2 capital, which along with other components of Tier 2 capital cannot exceed 100% of Tier 1.
- Subject to a progressive discount of 20% per year over their last 5 years to maturity for inclusion as capital.
- RCPS redemption must be approved by the regulator and made only when the UCB's capital to assets ratio is above the minimum regulatory requirement and the impact of such payment does not cause its capital ratio to fall below the regulatory requirement.

3. Trust-Preferred Shares

Definition: Trust-preferred shares are a hybrid debt-equity instrument. To maintain their cooperative structure, financial cooperatives are not permitted to issue bonds directly in order to gain access to external capital, so a special-purpose entity (trust) must be established. This wholly owned subsidiary issues trust-preferred shares to outside investors and uses the proceeds from the sales to purchase subordinated debt from the financial cooperative. Trust-preferred shares are uninsured, perpetual (no maturity) and non-cumulative (dividends missed in a year will not be paid in future years). These instruments carry no voting rights. A financial cooperative should be fairly large to generate enough scale to establish its own stand-alone trust to issue trust-preferred shares; however, an investment pool approach can also be used for smaller institutions.

Capital Treatment: As a perpetual, non-cumulative capital instrument, trust-preferred shares are treated as Tier 1 capital.

Payout Priority in Event of Liquidation: In liquidation, trust-preferred shares are junior to virtually all other debt, but are senior to membership shares.

Example: The Netherlands

Variation A: Public Offering

In addition to retained earnings, Rabobank, a Dutch cooperative bank, acquires capital through the issuance of ownership share certificates and Class B preferred stock. The stock is issued to Rabobank-created trust companies that then issue trust-preferred securities to outside, non-member investors in exchange for a defined rate of return. Because the preferred stock is actually held by the trust, rights to convert from preferred to normal shares of stock are retained within the trust, which Rabobank controls. Investors in the trust-preferred securities have no defined rights to convert their securities to ownership shares in Rabobank and hold no voting rights. As such, Rabobank has access to capital from both members and



non-members. Rabobank bases the rate of return for trust-preferred securities on prevailing government bond rates.

Example: Australia

Variation B: Pooled Offering

In 2006, as part of an experimental project to gain access to external sources of capital while realizing economies of scale, 21 Australian credit unions created two special purpose entities to serve as conduits for issuing subordinated debt and trust-preferred shares totaling approximately US\$90 million. The project's goal was to raise \$45 million in perpetual, non-cumulative trust-preferred shares in order to qualify as Tier 1 capital, and \$45 million in subordinated debt, qualifying for Tier 2 capital.

This project facilitated by the CUNA Mutual Group has enabled credit unions to pool trust-preferred shares and sell them to institutional investors (i.e., retirement funds) offering returns based upon a spread over BBSW (Australian financial markets reference rate equivalent to LIBOR) equal to the following:

Tier 1: 250 bps inclusive of franking credits (providing tax benefits on dividends)
Tier 2 AAA tranche: 28 bps
Tier 2 BBB tranche: 65 bps
Tier 2 BB tranche: 165 bps

Credit unions provided the special purpose entity with a loan loss reserve equal to 10% of the aggregate face value of the issuance. This reserve provided additional comfort to the market with respect to the securities issued by credit unions, considering their lack of history with such offerings and thus no established track record of payments.

The joint offering enabled small to mid-sized credit unions to collectively reap the benefits of economies of scale by sharing attorneys' fees as well as other design and distribution costs. Credit unions used the funds as seed capital for mergers in which they served as the surviving credit union, and to expand their loan offerings and geographic footprints.

4. Subordinated Debt

Definition: Subordinated debt is a bond issued to outside investors who voluntarily assume the risk of an uninsured, unsecured investment with a defined long-term maturity of 10-20 years. Subordinated debt is subordinate to the interest of the depositors and is capital at risk. Because investors bear more risk, subordinated debt provides higher returns than rates paid on credit union savings. Subordinated debt is non-voting, with a fixed or floating interest rate, usually not including an interest-deferral option. In most cases only large financial cooperatives are able to generate enough scale to issue stand-alone subordinated debt economically; however, an investment pool approach can also be used for smaller institutions.

Capital Treatment: Subordinated debt is treated as Tier 2 capital at a 100% rate until reaching the last 5 years of maturity, where a cumulative discount running at 20% per year is applied. The maximum amount of subordinated debt that qualifies for capital treatment is capped at 50% of Tier 1 capital.



Payout Priority in Event of Liquidation: In liquidation, subordinated debt is junior to all other debt but is senior to membership equity shares.

Subordinated debt is a capital instrument allowed to be used by credit unions in Canada, Australia, the United Kingdom, and Poland.

Example: British Columbia, Canada

Since 1999, credit unions in British Columbia, Canada, have issued subordinated debt. However, it has seldom been used because credit unions can satisfy regulatory capital requirements at lower cost through retained earnings and subscriptions for equity, preferred or patronage shares. It is also relatively expensive to issue subordinated debt because of the increased risk borne by investors and is not feasible for most credit unions other than those looking to raise significant amounts of capital (at least \$50 million). Only one credit union (Coast Capital Savings) used this instrument when it needed to recapitalize itself, after buying back all of its publicly-traded shares after abandoning its attempt to become a “public” credit union. The Central 1 Credit Union (equivalent to an American corporate credit union) has issued subordinated debt as a way to reduce its reliance on credit unions for capital.

Example: Australia

As indicated in the previous section, in addition to raising \$45 million in trust-preferred shares, credit unions in Australia issued \$45 million in subordinated debt. The debt issued by a special purpose entity had a maturity of 10 years and qualified as Tier 2 capital. The subordinated notes were enhanced by way of a loan loss reserve equal to 10% of the aggregate face value. Credit unions obtained a Standard and Poor’s (S&P) rating applied to the subordinated debt offering.

5. Uninsured Long-Term Deposits

Definition: Uninsured long-term deposits are used to raise capital from members or outside investors. Long-term deposits used for capital purposes may pay a fixed or variable rate and sometimes apply a minimum floating rate of inflation to ensure a higher return than that offered by short-term deposits. Their maturity is generally 5-10 years and restrictions are placed on withdrawals in cases in which doing so would cause the credit union’s capital levels to fall below regulatory requirements. Uninsured long-term deposits carry no voting rights (other than a member’s normal voting privileges) and, while similar to subordinated debt, carry senior pay-out priority in the event of liquidation. The downside of this capital source is that selling uninsured instruments to members may lead to confusion about which investments are insured and which ones are not.

Capital Treatment: Long-term uninsured deposits are treated as lower Tier 2 capital operating generally at a 100% rate until reaching the last 5 years of maturity. At that point a cumulative discount or amortization generally running at 20% per year is applied to reflect the diminishing value of the deposit as a continuing source of financial strength. Maximum amounts of long-term uninsured deposits that qualify for Tier 2 capital treatment are often capped at an amount not to exceed 50% of Tier 1 capital.



Payout Priority in Event of Liquidation: In liquidation, long-term deposits are senior to subordinated debt and membership equity shares, but are junior to all other debt.

Example: Dominican Republic

In the Dominican Republic, credit unions require each member to have long-term deposits equal to at least 8% of the member's loan value. The long-term deposits have a minimum withdrawal notification of 10 years and pay a minimum floating rate of inflation plus an additional amount to ensure they pay more than short-term deposits. The long-term deposits count as capital for the first 5 years and then on a discounted basis of 20% per year for the second 5 years.

Example: India

India's urban cooperative banks (UCBs) are permitted to issue uninsured, long-term deposits to members and non-members for a minimum period of 5 years that may carry a fixed or floating rate of interest. UCBs are not permitted to obtain long-term deposits from other UCBs.

Repayment of long-term deposits at maturity shall be made only with the prior approval of the regulator and only when doing so would not cause the credit union's capital level to fall below regulatory requirements.

Uninsured long-term deposits are eligible to be treated as Tier 2 capital. Long-term deposits may be issued to members and non-members. Long-term deposits cannot exceed 50% of total Tier 1 capital and are treated on a discounted basis of 20% per year for each year of the last 5 years of maturity.

6. Prorated Share of System Capital

Definition: In many countries with deposit insurance, credit unions are required to cooperatively pool and replenish a reserve account used for insurance purposes should one or more institutions fail. Some countries allow credit unions to treat a portion of the so-called "common capital" at their deposit insurer and at corporate/central credit unions as individual credit union capital.

Capital treatment: Individual capital treatment is generally limited to 50% of the prorated share of system capital and is classified as Tier 2 capital.

Payout Priority in Event of Liquidation: If a credit union is liquidated, any remaining portion of the credit union's contributions to a corporate/central or deposit insurance corporation is re-allocated among the surviving credit unions. It is not available to the creditors of the liquidating credit union.

Example: British Columbia, Canada

In 1989, during negotiations with the government, the credit union system in British Columbia asserted that, unlike banks, credit unions work together as a cooperative system. As such, credit unions have common capital at provincial centrals and at their deposit insurer. The



credit unions successfully argued that this capital should be included as part of the regulatory capital base.

Today, credit unions include one-half of their prorated retained earnings or deficit in a central credit union and contributions to the deposit insurance corporation as Tier 2 capital. The share of system capital is attributable to the credit union on the basis of its relative share in the total assets of all contributing credit unions.

7. Minority Stake Listing

Definition: Minority stake listings require transferring all assets to an investor-owned firm and selling a minority portion of the stock in the firm on the stock exchange to raise capital directly from outside investors.

Capital Treatment: This approach is much like a bank issuing equity shares and is treated as Tier 1 capital.

Payout Priority in Event of Liquidation: Same-class stock has equal payout priority whether owned by the credit union or external investors.

Example: Ireland

Irish building societies have the option of transferring all assets to a subsidiary, investor-owned firm in exchange for all stock in an investor-owned firm. Then, a minority portion of stock in the investor-owned firm is sold on the Dublin and London stock exchanges to raise external equity capital directly, without making the subsidiary stock investors members of the parent cooperative and without carrying voting rights. This makes the stock tradable on a secondary market, which addresses the horizon and portfolio problems for external investors, providing incentives for external capital to be invested.

Through this model, the cooperative retains control over the assets by holding the majority of stock outstanding, but it can access capital from outside, non-member investors.



CONCLUSION

Limitations to raising capital have traditionally been the Achilles heel of the cooperative model. Many financial cooperative around the world have overcome this weakness by gaining access to additional forms of capital. The experiences in countries outside the U.S. demonstrate that although alternative sources of capital are used less often, having access to them has been critical in persevering through difficult and unforeseen circumstances to emerge stronger and more sustainable financial institutions. The World Council of Credit Unions hopes that this research will provide credit union leaders and policymakers useful examples to inform their decisions.

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