3133-AE66

NATIONAL CREDIT UNION ADMINISTRATION

12 C.F.R. Parts 701, 702, 703, 709, 741, and 745

Alternative Capital

AGENCY: National Credit Union Administration

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: The NCUA Board (Board) is issuing this advanced notice of proposed rulemaking (ANPR) to solicit comments on alternative forms of capital federally insured credit unions could use in meeting capital standards required by statute and regulation.[1] For purposes of this ANPR, alternative capital includes two different categories: secondary capital and supplemental capital. Secondary capital is currently permissible under the Federal Credit Union Act (Act) only for low-income designated credit unions to issue and to be counted toward both the net worth ratio and the risk-based net worth requirement of NCUA's prompt corrective action standards. The Board is considering changes to the secondary capital regulation for low-income

[1] At its October 2016 meeting, the Board held a public briefing on the topic of alternative capital for credit unions. That briefing identified the complex nature of alternative capital for credit unions. Among the points discussed were: the implications of securities laws; the tax exemptions for federal and state chartered credit unions; the utility of supplemental capital; and regulations that would need to be amended or added to allow for supplemental capital. At the conclusion of the briefing, the Board stated that it would issue an ANPR to obtain stakeholder input on the myriad of complex matters involving alternative capital for credit unions.

designated credit unions. There are no other forms of alternative capital currently authorized. However, the Board is also considering whether or not to authorize credit unions to issue supplemental capital instruments that would only count towards the risk-based net worth requirement.

This ANPR provides relevant background information and seeks comment on a broad range of considerations with respect to alternative capital for federally insured credit unions. This ANPR addresses topics including: (1) NCUA's authority to include alternative capital for prompt corrective action purposes; (2) credit unions' authority to issue alternative forms of capital; (3) prudential standards regarding the extent to which various forms of instruments would qualify as capital for prompt corrective action purposes and credit union eligibility for the sale of alternative capital; (4) the utility and suitability of supplemental capital for credit unions; (5) standards for investor protection, including disclosure requirements and investor eligibility criteria for the purchase of alternative capital; (6) implications of securities law for supplemental and secondary capital; (7) potential implications for credit unions, including the credit union tax exemption; and (8) overall regulatory changes the Board would need to make to permit supplemental capital, improve secondary capital standards, and provide or modify related supporting authorities. The Board has posed a number of specific questions on these and other topics, but invites comments on any and all aspects of alternative capital.

DATES: Comments must be received on or before [90 days after publication in the FEDERAL REGISTER].

ADDRESSES: You may submit comments by any one of the following methods **(Please send comments by one method only)**:

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: Address to regcomments@ncua.gov. Include "[Your name]—Comments on Advance Notice of Proposed Rulemaking for Supplemental Capital" in the e-mail subject line.
- Fax: (703) 518-6319. Use the subject line described above for e-mail.
- Mail: Address to Gerald Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

PUBLIC INSPECTION: You can view all public comments on NCUA's website at http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx as submitted, except for those we cannot post for technical reasons. NCUA will not edit or remove any identifying or contact information from the public comments submitted. You may inspect paper copies of comments in NCUA's law library at 1775 Duke Street, Alexandria, Virginia 22314, by appointment weekdays between 9 a.m. and 3 p.m. To make an appointment, call (703) 518-6546 or send an e-mail to OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT: Steve Farrar, Supervisory Financial Analyst, at (703) 518-6360; or Justin Anderson, Senior Staff Attorney, Office of General Counsel, at

(703) 518-6540. You may also contact them at the National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314.

SUPPLEMENTARY INFORMATION:

I. Background

In 1998, Congress passed the Credit Union Membership Access Act (CUMAA) which amended the Act to mandate a system of prompt corrective action for federally insured natural person credit unions (credit unions).[2] The prompt corrective action system incorporates capital standards for credit unions. The Act indexes a credit union's prompt corrective action status to five categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.[3] As a credit union's capital level falls, its classification among the prompt corrective action categories can decline below well capitalized, thus exposing it to an expanding range of mandatory and discretionary supervisory actions designed to remedy the problem and minimize any loss to the National Credit Union Share Insurance Fund (Share Insurance Fund).[4]

The Act defines a credit union's capital level based on a net worth ratio requirement for all credit unions and a risk-based net worth requirement for credit unions the Board defines as complex.[5] The Act also provides the NCUA Board with broad discretion to design the risk-based net worth requirement. However, the net worth ratio is defined in the Act as a credit union's ratio of net worth to total assets. The Act defines net worth as:[6]

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[2] The Credit Union Membership Access Act of 1998, HR 1151, Pub. L. 105-219, 112 Stat. 913 (1998).
[3] 12 U.S.C. §1790d(c); 12 CFR part 702; 65 FR 8560 (Feb. 18, 2000); see 702 Subpart C for categories for "new" credit unions.
[4] Id. at §1790d(e), (f) and (g); 12 CFR 702 Subpart B.
[5] In 2000, NCUA adopted Part 702 of NCUA Rules and Regulations to implement the Act's system of prompt corrective action.
[6] Id. at §1790d(o)(3); 12 CFR §702.2(g) and (k).

- The retained earnings balance of the credit union, as determined under generally accepted accounting principles, together with any amounts that were previously retained earnings of any other credit union with which the credit union is combined;
- Secondary capital of a low-income designated credit union that is uninsured and subordinate to all other claims of the credit union, including the claims of creditors, shareholders, and the Share Insurance Fund; and[7]
- Certain assistance provided under section 208 of the Act pursuant to NCUA regulations.[8]

As noted above, per the Act, secondary capital is currently only permissible for low-income designated credit unions to issue and to be counted toward the net worth ratio. NCUA also counts secondary capital issued by low-income designated credit unions as net worth for the risk-based net worth ratio.

The Board notes that, NCUA cannot change the Act's definition of net worth – only Congress can. However, the Board has broad discretion in designing the risk-based net worth requirement. Thus, it is possible for the Board to authorize a credit union that is not low-income designated to issue alternative capital instruments that would count towards satisfying the risk-based net worth requirement – but not the net worth ratio. (See the discussion of legal authority in Section IV).

[7] In 1996, the NCUA Board authorized low-income designated credit unions, including state chartered credit unions to the extent permitted by state law, to count as capital uninsured secondary capital. At the time, the Board recognized that it was difficult for low-income designated credit unions to accumulate capital only through retained earnings. The Board, therefore, permitted low-income designated credit unions to use the borrowing authority in the Act to issue secondary capital accounts. This authority would allow these credit unions to build capital to support greater lending and financial services to their members and their communities, and to absorb losses to protect them from failing. To ensure the safety and soundness of secondary capital activity, the 1996 rule imposed various restrictions on its use and structure. At this time, prompt corrective action and the associated definition of net worth was not yet part of the Act. 61 FR 50696 (Sept. 27, 1996).

[8] 12 U.S.C. §1790d(o)(2).

For purposes of this ANPR, the term supplemental capital includes any form of capital instruments credit unions that are not designated as low-income might be authorized to issue and count only for inclusion in the risk-based net worth requirement.

The risk-based net worth requirement for federally insured credit unions is based on a risk-based net worth ratio calculation in Part 702 of NCUA's Rules and Regulations.[9] Per the Board's October 2015 final rule, on January 1, 2019, the risk-based net worth requirement will be updated to replace the risk-based net worth ratio with a new risk-based capital ratio.[10]

During the risk-based capital rulemaking process, the Board asked for stakeholder input on supplemental capital. Specifically, in the January 2015 risk-based capital (RBC) proposal the NCUA Board posed the following six questions:[11]

1. *Should additional supplemental forms of capital be included in the RBC numerator and how would including such capital protect the Share Insurance Fund from losses?*

2. *If yes, to be included in the RBC numerator, what specific criteria should such additional forms of capital reasonably be required to meet to be consistent with Generally Accepted Accounting Practices (GAAP) and the Act, and why?*

[9] Unless otherwise noted, throughout this ANPR references to prompt corrective action, risk-based capital, and citations to Part 702 refer to Part 702 as revised by the Board at its October 2015 meeting.
[10] 80 FR 66626 (Oct. 29, 2015).
[11] 80 FR 4340, 4384 (Jan. 27, 2015).

3. *<u>If certain forms of certificates of indebtedness were included in the risk based capital ratio numerator, what specific criteria should such certificates reasonably be required to meet to be consistent with GAAP and the Act, and why?</u>*

4. *<u>In addition to amending NCUA's RBC regulations, what additional changes to NCUA's regulations would be required to count additional supplemental forms of capital in NCUA's RBC ratio numerator?</u>*

5. *<u>For state-chartered credit unions, what specific examples of supplemental capital currently allowed under state law do commenters believe should be included in the RBC ratio numerator, and why should they be included?</u>*

6. *<u>What investor suitability, consumer protection, and disclosure requirements should be put in place related to additional forms of supplemental capital?</u>*

In response to these questions, a majority of the commenters who addressed supplemental capital stated that it was imperative that the Board consider allowing credit unions access to additional forms of capital. The commenters suggested credit union authority to issue supplemental capital was particularly important as credit unions are at a disadvantage in the financial market because most lack access to additional capital outside of retained earnings. While none of the commenters offered specific suggestions on how to implement supplemental capital, a few did suggest that the Board should promulgate broad, non-prescriptive rules to allow credit unions maximum flexibility in issuing supplemental capital.

As the Board did not receive comments with sufficient detail in response to the RBC proposal, the Board is again posing the six questions listed above for commenters to consider and address. Throughout this ANPR, the Board will expand on these six questions and ask more specific questions about the structure, form, regulations, and requirements related to supplemental capital, as well as relevant changes and improvements to secondary capital. The Board encourages all stakeholders to address in detail as many of these questions as possible and provide the Board with specific comments and responses. The Board intends these questions to be a starting point for commenters to present their thoughts, but invites comments on all aspects of alternative capital

Throughout this ANPR the Board discusses several complex topics and uses terms to refer to specific forms of capital. In addition to supplemental, secondary, and alternative capital, the Board will use the term "regulatory capital" when referring to financial instruments issued by credit unions or banks, that include both equity and debt, and other financial statement account which meet the criteria contained in regulations for inclusion in the calculation of capital adequacy measures.

II. Current Secondary Capital Standards

The Act's definition of net worth states that secondary capital must be "uninsured and subordinate to all other claims of the credit union, including the claims of creditors, shareholders, and the Share Insurance Fund."[12] This means that any secondary capital issued by a low-income

[12] 12 U.S.C. §1790d(o)(C)(ii).

designated credit union must be the most subordinated item on the balance sheet (first loss position after retained earnings) and any losses to secondary capital must be pro-rated equally – that is without preference or priority. The practical effect is that low-income designated credit unions cannot include payment priority structures within or between secondary capital instruments to enhance investors' interests.

NCUA's rules and regulations also contain various provisions addressing the prudent and appropriate issuance and use of secondary capital by low-income designated credit unions. These provisions are as follows:

- Low-income designed credit unions:
  - May only accept secondary capital accounts from non-natural person members and non-natural person nonmembers.
  - Must submit and receive approval by NCUA of a Secondary Capital Plan.
  - Must execute a Disclosure and Acknowledgement statement.

- A secondary capital account:
  - Must be uninsured;
  - Have a minimum maturity of five years with a reduction in the recognition of the net worth value of accounts with less than five years of remaining maturity;
  - Must be subordinate to all other claims, including those of shareholders, creditors and the Share Insurance Fund;
  - Must be available to cover operating losses that exceed net available reserves and to extent losses are applied the accounts must not be restored;

- Cannot be pledged by investors as security on a loan;
- Are subject to restrictions of dividends as provided in prompt corrective action; and
- May only in certain circumstances be redeemed early and only with prior NCUA approval;[13]

The regulations allow NCUA to prohibit a low-income designated credit union classified as critically undercapitalized from paying principal, dividends, or interest on secondary capital. This provision is to ensure secondary capital is available to cover losses while the low-income designated credit union is operating as a going concern. These payment restrictions are consistent with limitations on principal and interest payments imposed by the federal banking regulators for subordinated debt issued by banks.[14]

Further, due to the fact that secondary capital is not a permanent form of capital, NCUA's regulations reduce the portion of secondary capital that is included in the net worth ratio as it approaches maturity. Once the remaining maturity is less than five years, the regulations require low-income designated credit unions to discount how much a secondary capital account contributes to the credit union's net worth value based on the following schedule:[15]

Remaining maturity	**Net worth value of original balance (percent)**

[13] 12 CFR §701.34.
[14] 12 CFR §5.47(d)(3)(ii)(B)(3).
[15] Id. at §701.34(c).

Four to less than five years	80
Three to less than four years	60
Two to less than three years	40
One to less than two years	20
Less than one year	0

Since 2006, low-income credit unions may request NCUA approval to redeem the portion of secondary capital no longer included in net worth if:

- The credit union will have a post-redemption net worth classification of at least adequately capitalized;
- The discounted secondary capital has been on deposit at least two years; and
- The discounted secondary capital will not be needed to cover losses prior to the final maturity date.[16]

With respect to secondary capital, the Board specifically seeks comments on the following:

- Whether or not to permit a low-income designated credit union to sell secondary capital to non-institutional investors (*see* Sections V and VI for more discussion on investor protection and suitability issues), and whether this would be for members only or any party.

[16] Id. at §701.34(d).

- Allowing for broader call options for the low-income designated credit union, other than just the portion no longer counting as net worth and subject to NCUA approval, if provided for in the secondary capital contract.
- Relaxation of pre-approval of issuing secondary capital if a low-income designated credit union meets certain conditions such as being at least adequately capitalized and having prior experience issuing secondary capital.
- Inclusion of more flexibility to fund dividend payments as an operating loss if provided for in the contract.
- Any other prudential restrictions on secondary capital that should be considered.
- Reorganization of the regulation to improve clarity by moving to Part 702 (Prompt Corrective Action) all matters related to how the instrument must be structured to qualify for capital treatment. This would move these conditions to the section of NCUA rules and regulations applicable to all insured natural person credit unions, and leave the provisions specific to federal credit union issuance authority in Part 701.

III. Current and Prospective Use of Alternative Capital

This section provides information on community bank use of subordinated debt and low-income designated credit unions' use of secondary capital. This section also provides information on the projected impact of risk-based capital standards on complex credit unions to estimate the potential need for supplemental capital for risk-based net worth requirement purposes. This information provides a basis for estimating the potential for use of supplemental capital, the purpose of its use, the potential purchasers, and the related costs. The Board is interested in receiving comments concerning projections on the volume of supplemental capital that credit unions would be likely to issue. The Board also seeks specific comments on the structures of supplemental capital instruments that would be beneficial, why credit unions will issue supplemental capital, and how it fits into the credit union's business model. The Board is also interested in any comments about who will purchase supplemental capital. Since the costs associated with supplemental capital are significant to the issuing credit union, the Board seeks comments on how any regulations should address the issue of the cost of the instrument and any items that may be helpful in reducing the cost while maintaining adequate protection for investors and the Share Insurance Fund.

A. Community bank use of subordinated debt

Community bank use of subordinated debt increased in 2016. As of June, 30, 2016, the amount outstanding was $831 million compared to $479 million as of December 31, 2016.[17] Despite the increase, subordinated debt is only 0.34 percent of total community bank capital. The stated purpose of recent issuances of subordinated debt by community banks generally fall into three categories:

- Facilitate mergers and acquisitions;
- Redemption of preferred stock held by the U.S. Treasury Department due to increasing costs; and
- Fund organic growth.[18]

[17] FDIC Quarterly, Volume 10, Number 2, page 18.
[18] Based on review of a sample of SEC Form D filed by issuers.

While the interest rate paid on community bank subordinated debt can vary significantly, generally the interest rate is from 300 to 400 basis points over ten year treasury note rates.[19] Additionally community banks report expenses associated with sales commissions, ranging from 1.25 percent to 3 percent, and fees along with legal and operational costs.[20] Most buyers of bank subordinated debt are reported to be pension funds, mutual funds, other banks, and high net worth investors.[21]

B. Low-income designated credit union use of secondary capital

As of June 30, 2016, there were 2,426 low-income designated credit unions. Only 73 low-income designated credit unions (about 3 percent) report total outstanding secondary capital of $181 million.[22] Since December 31, 2011, the number of low-income designated credit unions has increased by 117 percent, from 1,119 to 2,426. However, the number of low-income designated credit unions with outstanding secondary capital has ranged from 72 to 79 during this period.

The $181 million in outstanding secondary capital equates to 13 percent of the total net worth of the low-income designated credit unions that issued it – with an average balance of about $2.5 million. However, outstanding secondary capital is concentrated in four low-income designated credit unions, which hold 74 percent of the total secondary capital outstanding. When excluding these four low-income designated credit unions, the average amount of secondary capital is

[19] Based on review of a sample of capital market announcements and publications of completed offerings.
[20] Based on review of a sample of SEC Form D filed by issuers.
[21] Based on review of a sample of capital market announcements, publication of completed offerings, and SEC Form D.
[22] NCUA Call Report data.

under $700,000 per low-income designated credit union. The interest rate paid by the four largest holders of the outstanding secondary capital ranges from 0.14 percent to 3.5 percent.

Secondary capital does, however, significantly benefit a low-income designated credit union's net worth ratio. The secondary capital adds an average of nearly 300 basis points to the net worth ratio, which brings the average from just below 7 percent to near 10 percent. Out of the 73 low-income designated credit unions with secondary capital, 66 have a net worth ratio greater than the well capitalized 7 percent level. Without the secondary capital, 25 of the 66 would have a net worth ratio less than 7 percent.[23]

The Board notes that low-income designated credit unions that have issued secondary capital have a higher failure rate than other low-income designated credit unions. The average annual failure rate for low-income designated credit unions with secondary capital was 2.9 percent from 2000-2013, compared to 0.8 percent for low-income designated credit unions without secondary capital during the same period.[24] In a few failures of low-income designated credit unions, the assets in the credit union grew rapidly around the time the secondary capital was issued, which in turn led to higher losses to the Share Insurance Fund. NCUA has noted a pattern of poor practices in some low-income designated credit unions with secondary capital that could account for the higher failure rate, including:[25]

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[23] Secondary capital is estimated to add an average of 414 basis points to the risk-based capital ratio that will go into effect on January 1, 2019.

[24] See. Secondary Capital Best Practices Guide available at https://www.ncua.gov/services/Pages/small-credit-union-learning-center/Documents/secondary-capital-guide.pdf.

[25] Id.

- Poor due diligence, inaccurate cost benefit analysis and weak strategic planning in connection with establishing and expanding member service programs funded by secondary capital.
- Concentrations of secondary capital to support unproven or poorly performing programs.
- Failure to realistically assess and timely curtail programs not meeting expectations.
- Use of secondary capital solely to delay prompt corrective action.
- Insufficient liquidity to repay secondary capital at maturity.

C. Potential for credit unions' use of supplemental capital

The potential use of supplemental capital is difficult to predict due to the probable changes in market factors such as interest rates, demographics, and competition. Since supplemental capital would only increase a credit union's risk-based capital ratio, the most likely users would be those credit unions with net worth ratios above the well capitalized level but with a risk-based capital below or near the minimum needed to be well capitalized.

The following table contains an estimate of the number of credit unions likely to issue supplemental capital and the potential amount of supplemental capital that might be issued. Using Call Report data as of December 31, 2015, applied to FICUs with more than $100 million in assets[26], results in the following:

[26] The new risk-based net worth requirements will only apply to credit unions with assets of $100 million or more.

Number of credit unions that do not have a low-income designation with a net worth ratio greater than 8% and an estimated risk-based capital ratio less than 13.5%	140
Net worth of the 140 credit unions that do not have a low-income designation with a net worth ratio greater than 8% and an estimated risk-based capital ratio less than 13.5%	$9.2 billion
Maximum amount of subordinated debt that could be issued with a limit set at 50% of net worth[27]	$4.5 billion
Amount of supplemental capital needed by the 140 to achieve a 13.5% risk-based capital ratio	$1.0 billion

The Board is interested in commenter's thoughts on whether credit unions that are not designated as low-income use of supplemental capital could affect the availability of secondary capital for low-income designated credit unions. If so, are there any measures the Board could take to protect against this?

IV. Supplemental Capital Legal Authority and Potential Taxation Implications

A. Risk-based net worth requirement

In addition to the Act's requirements related to the net worth ratio, the Act requires the Board to design "a risk-based net worth requirement for credit unions defined as complex."[28] The risk-based net worth requirement for credit unions meeting the definition of "complex" was first

[27] The Board would contemplate some limit on how much supplemental capital will count for risk-based capital requirements to ensure it remains a supplemental but not the primary source of capital. For illustration purposes the estimate uses a 50% limit so that it would not become the primary form of capital held by these credit unions.
[28] 12 U.S.C. §1790d(d)(1).

applied on the basis of data in the Call Report as of March 31, 2001.[29] Since its inception, the risk-based net worth requirement has included secondary capital issued by low-income designated credit unions.

While the Act defined the term "net worth," it did not define the risk-based net worth requirement, nor how to calculate any corresponding risk-based ratio. In contrast to the narrow definition of net worth, the lack of a statutory prescription for the risk-based net worth requirement gives the Board the latitude to include within that requirement items that would not meet the statutory definition of "net worth" but otherwise serve as capital in protecting the Share Insurance Fund from losses when a credit union fails. Given the statutory objective of prompt corrective action "to resolve the problems of insured credit unions at the least possible long-term loss" to the Share Insurance Fund, the Board believes it should explore expanded options for credit unions to build capital beyond retained earnings.

For a credit union defined as complex to be classified well capitalized, the Act requires the credit union to have a net worth ratio of 7 percent or greater (6 percent for adequately capitalized) and to meet the applicable risk-based net worth requirement. Starting in January 2019, the risk-based net worth requirement will require the risk-based capital ratio to be 10 percent or greater to be well capitalized (8 percent for adequately capitalized). The Act classifies a credit union as undercapitalized if it is unable to achieve the applicable risk-based net worth requirement, even if it has a high net worth ratio, thus subjecting the credit union to the corresponding prompt corrective action supervisory consequences.[30]

[29] 65 FR 44950 (July 20, 2000).
[30] 12 USC §1790d(c)(1)(C)(ii).

B. Authority to issue supplemental capital

The authority for low-income designated credit unions to issue secondary capital is established in the Act. Conversely, there is no express authority for credit unions not designated as low-income to issue alternative forms of capital. However, the Act does provide federal credit unions with relatively broad authority to borrow from any source in accordance with such rules and regulations as may be prescribed by the Board.[31] The Board has reviewed all applicable sections of the Act to determine the ability of federal credit unions to issue various types of financial instruments that could serve as alternative capital.[32] Other than as a form of debt, there is no other explicit authority in the Act for federal credit unions to issue an instrument that is uninsured and could be structured as loss absorbing capital. As a result, the Board believes only the borrowing authority is available for federal credit unions to issue supplemental capital.[33] This means that federal credit unions could only issue supplemental capital as subordinated debt. However, the Board invites commenters to identify any other provisions of the Act they believe could provide alternative authority for federal credit unions to issue supplemental capital instruments other than as subordinated debt.

[31] 12 U.S.C. §1757(9).

[32] Authority to issue capital instruments for FISCUs is determined under applicable state law.

[33] In December 2010, the Board issued Letter to Federal Credit Unions 10-FCU-03: Sales of Nondeposit Investments, which stated that federal credit unions are not authorized under the Act to sell nondeposit investments directly to their members. After further consideration, the Board believes federal credit unions have the authority to issue supplemental capital instruments under the borrowing authority in the Act, even though these instruments may be considered securities for purposes of state and federal securities laws.

C. Supplemental capital relationship to secondary capital

Supplemental capital and secondary capital are similar in that, for federal credit unions, both are uninsured accounts issued as borrowings and subject to applicable statutory borrowing limits. Secondary capital, however, is included in the statutory definition of net worth and counts towards both the net worth ratio and the risk-based net worth requirement. Supplemental capital is not included the statutory definition of net worth and can only be considered for inclusion in the computation of the risk-based net worth requirement.

Supplemental capital would have to be subordinate to the Share Insurance Fund and uninsured shareholders in the payout priorities. However, since secondary capital, per the Act, must be subordinate to all other claims, supplemental capital would be senior to secondary capital in the payout priorities. Credit unions issuing supplemental capital could be provided flexibility to include payment priority structures within or between supplemental capital instruments to enhance investors' interests.

D. Need for comprehensive borrowing rule for federal credit unions

The Board is considering expanding the borrowing rule to clarify this authority for federal credit unions. As noted above, the Act states that federal credit unions may "borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source." Currently, NCUA's regulations only contain a rule addressing when federal credit unions borrow from natural persons. Given that the wording of the Act could suggest a federal credit union's borrowing authority is contingent on rules and regulations prescribed by the Board, it may appear to investors that federal credit unions are restricted to only borrowing from natural persons. While the Board disagrees with this reading of the Act, the Board is concerned that some supplemental capital investors may question a federal credit union's authority to issue supplemental capital instruments to anyone other than natural persons. Clarity and certainty about a federal credit union's borrowing authority may be important to the sale of supplemental capital – by expanding the potential investor base and reducing unnecessary transaction complications. With respect to this topic, the Board is interested in commenter's views on whether the Board should promulgate a more comprehensive borrowing rule as part of any authorization of supplemental capital, and what the rule should address.

E. Authority for federally insured state chartered credit unions to issue supplemental capital

The authority under which a federally insured state chartered credit union could issue alternative capital instruments is distinct from whether and to what extent NCUA, as insurer, would recognize it as regulatory capital for prompt corrective action purposes. A federally insured state chartered credit union's authority to issue supplemental capital would be derived from applicable state law and regulation regarding its ability to issue liability and equity instruments. Such state laws may be narrower or broader than those for federal credit unions. Recognition as regulatory capital will depend on the characteristics of the instrument and its availability to protect the Share Insurance Fund – which would be based on uniform criteria that apply to all federally insured credit unions. (*see* section VI for more discussion)

For federal credit unions, the Act limits the aggregate amount of borrowed funds to 50 percent of paid-in and unimpaired capital and surplus.[34] Per §741.2, NCUA's rules and regulations limit borrowing by federally insured state chartered credit unions to 50 percent of paid-in and unimpaired capital and surplus. The regulation does provide the ability for state credit unions to obtain a waiver up to the amount of borrowing allowed under state law.[35] The Board is not aware of any federally insured state chartered credit unions that have requested a waiver to the borrowing limit in the past decade. While authority to issue alternative capital instruments for federally insured state chartered credit union is determined under state law, it is possible that some states will only allow their credit unions to issue alternative capital instruments under applicable borrowing authority. As NCUA's borrowing limit for federally insured state chartered credit union is not statutory, the Board can entertain removing this limit and requests comment on this option.

F. Potential taxation implications

The Board recognizes that supplemental capital could have an impact on the credit union tax exemption. The Act specifically exempts federal credit unions from taxation by the United States or by any State or local taxing authority, except real and personal property taxes.[36] With respect to federal credit unions, the Board is aware that part of the basis for the credit union tax exemption was that Congress recognized most credit unions could not access the capital markets to raise capital.[37] If all credit unions, not just low-income designated credit unions, have the

[34] Section 700.2 of NCUA Rules and Regulations defines *Paid-in and unimpaired capital and surplus* as shares plus post-closing, undivided earnings. This does not include regular reserves or special reserves required by law, regulation or special agreement between the credit union and its regulator or share insurer. 12 CFR §700.2.
[35] 12 CFR §741.2.
[36] 12 U.S.C. 1768.
[37] It is noteworthy that, in 1951, thrift institutions lost their tax exemption. The Senate report to the Revenue Act of 1951 stated that mutual savings banks and savings and loan associations were losing their tax exemption because

ability to access the capital markets to meet capital standards, it could call into question one of the bases for the credit union tax exemption. The Board invites comments on this topic and would like to hear from stakeholders on the possible impact a supplemental capital rule may have on the federal credit union tax exemption.

Unlike federal credit unions, the Act does not exempt federally insured state chartered credit unions from taxation. Federally insured state chartered credit unions are exempt from federal income tax under §501(c)(14)(A) of the Internal Revenue Code. Section 501(c)(14)(A) of the Internal Revenue Code provides for exemption from federal income taxes for state credit unions without capital stock organized and operated for mutual purposes without profit. At this time, there does not appear to be an established definition of "capital stock" used by the IRS. It is possible federally insured state chartered credit unions in some states will have broad authority to issue supplemental capital instruments that have the characteristics of capital stock, and by doing so could subject themselves to taxation. The Board therefore requests comment on whether NCUA should limit the types of instruments issued by federally insured state chartered credit unions to those that would clearly not meet the definition of capital stock. Other options the Board could consider, include requiring a federally insured state chartered credit unions to provide a formal opinion from the IRS that the supplemental capital instrument it is issuing will not be classified as capital stock or requiring the credit union to provide projections in advance of issuing the supplemental capital demonstrating that it can afford to be taxed and the benefits of the supplemental capital outweigh the cost of any taxes it might become subject to.

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they had evolved into commercial bank competitors. In addition, thrifts had evolved from mutual organizations to ones that operated in a similar manner to banks. Finally, the exemption had given thrifts a competitive advantage over taxable commercial banks and life insurance companies.

G. Mutual ownership structure of credit unions

The Board also invites comments on the potential effect supplemental capital may have on the mutual ownership structure and governance of credit unions. The Board invites comments on how it should structure any potential rule to avoid issues impacting the mutuality of credit unions, and the members' rights to govern the affairs of the institution. Specifically, the Board invites comments on restrictions it might impose on characteristics of supplemental capital to avoid these issues, such as: non-voting and limits on covenants in the investment agreement that may give investors levels of control over the credit union.

V. Securities Law Applicability

The Board believes that both secondary and supplemental capital would be considered securities for purposes of state and federal securities laws. The Board invites comment on this topic and its relationship to credit unions issuing securities as supplemental capital.

Being subject to securities laws can impose requirements on the issuer to register with the Securities Exchange Commission (SEC), issue SEC mandated disclosures, and comply with the SEC's broad anti-fraud rules. The Board, however, is aware that there are two exemptions that would likely be available to credit unions:

- Section 3(a)(5) of the Securities Act, which is available to certain types of financial institutions, including credit unions, for the issuance of any type of security to any type of investor;[38] and
- Rule 506 under Regulation D under the Securities Act, which is available to any entity offering any type of security, provided that purchasers of the securities are "accredited investors" (although sales to a limited number of investors who are not accredited are also possible under certain circumstances).[39]

While these exemptions are likely to relieve credit unions of the requirements to register with the SEC and issue SEC mandated disclosures, there are a number of other issues that credit unions must consider and comply with before issuing any instrument that would be considered a security. The Board briefly addresses each of these issues below.

A. Federal securities requirements

Regardless of any exemption from registration and disclosure, credit unions issuing alternative capital must still comply with the SEC's broad anti-fraud regulations.[40] The Securities Exchange Act of 1934's (Exchange Act) general anti-fraud prohibitions are embodied in §10(b), which generally prohibits the use of manipulative or deceptive devices or contrivances that violate SEC rules in connection with the purchase or sale of securities. Most of the litigation brought with

[38] 17 CFR §240.3a5.
[39] Id. at §230.506.
[40] *See*, e.g., Regulation D, Rule 501(a): "Users of Regulation D (§§230.500 et seq.) should note the following:

(a) Regulation D relates to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the Act) (15 U.S.C.77a et seq., as amended). Such transactions are not exempt from the anti-fraud, civil liability, or other provisions of the federal securities laws."

respect to the rules promulgated under §10(b) has been brought under the general anti-fraud provision, Rule 10b-5, which provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[41]

The primary intent of Rule 10b-5 and, more broadly, the anti-fraud provisions of the Securities Act of 1933 (Securities Act) and Exchange Act, is to prevent fraud, deceit, and incorrect or misleading statements or omissions in the offering, purchase and sale of securities. Given that intent, clear and complete disclosure is the critical factor in ensuring the anti-fraud provisions of the Securities Act and Exchange Act are not breached in any offering by credit unions, regardless

[41] 17 CFR §240.10b-5.

of whether the offering is registered with the SEC under the Securities Act or exempt from registration.

In the absence of SEC-mandated disclosure delivery requirements, the practical concern for credit unions relying on either the Section 3(a)(5) or Regulation D, Rule 506 exemption is determining what type and amount of disclosure is appropriate to meet the anti-fraud standards. The Board is aware that the amount of disclosure varies depending on multiple factors, including:

- The nature of the potential investors (focusing on their level of sophistication);
- The nature of the security being offered (focusing on the complexity of the instrument);
- The nature of the business of the issuer and the industry in which the issuer operates (focusing on the complexity of the business or industry); and
- Market practices (focusing on the types of disclosure commonly provided by peer companies).

In addition, the Board is aware that for any disclosure to meet the standards of Rule 10b-5, the disclosure must not contain any untrue statement of a material fact and must not omit to state a material fact, the absence of which renders any disclosure being made misleading. Further, the disclosure must be clear, accurate and verifiable, and should cover topics that are typically important to investors in making an investment decision, including:

- Material risks relating to the issuer and the industry in which the issuer operates;

- Material risks relating to the security being offered;
- The issuer's planned uses for the proceeds of the offering;
- Regulatory matters impacting the issuer and its operations;
- Tax issues associated with the security being offered; and
- How the securities are being offered and sold, including any conditions to be met in order to complete the offering.

The Board is also aware that the Office of Comptroller of the Currency (OCC) promulgated regulations that require supervised banks issuing securities to register directly with the OCC and issue OCC mandated disclosures. The OCC mandated disclosures are very similar to those required by the SEC.[42] The Board is considering requiring similar registration and disclosures for credit unions issuing alternative capital. The Board is concerned that without mandated disclosures, credit unions may be at greater risk for anti-fraud suits, which, if successful, would impair not only the credit union but also the Share Insurance Fund's ability to use secondary or supplemental capital to cover losses. Further, the Board also believes it is important that investors in credit union alternative capital instruments have similar protections to those provided investors in SEC and OCC covered entities. The Board is interested in comments on the following questions in particular:

- Should the Board require credit unions issuing alternative capital to register with NCUA?
- How could NCUA protect the Share Insurance Fund against potential anti-fraud claims that could impair the alternative capital's ability to cover losses?

[42] 12 CFR 16.

- Should the Board mandate disclosures all credit unions issuing alternative capital must provide to investors? If the Board should mandate disclosures, should it base them on the SEC's, the OCC's, or create a unique set of disclosures for credit unions? If the Board creates a unique set of disclosures, what should it include in those disclosures? Should the level of disclosures vary based on the level of the investor (institutional, accredited, natural person)?
- Should the Board require credit unions to develop policies and procedures to ensure ongoing compliance with anti-fraud requirements before it begins issuing alternative capital?

The Board is also aware that there may be potential broker-dealer registration issues related to secondary and supplemental capital. Specifically, marketing activities by a credit union and its employees could require the credit union to register as a broker-dealer. While there are exemptions available to credit unions and their employees, the Board notes that these exemptions are complex and require a thorough evaluation of a credit union's practices and the activities of its employees. If a credit union or its employees fail to qualify for an exemption, the credit union or employee could be required to register as a broker-dealer or face penalties for failure to comply with applicable rules. The Board has previously stated that federal credit unions are not permitted to register as broker-dealers.[43] The Board invites comments on how it should ensure a credit union has determined if it or its employees are required to register.

[43] NCUA Letter to FCUs 10-FCU-03, Sale of Nondeposit Investments, December 2010.

In addition, it is unlikely that credit unions and their employees would be subject to investment adviser registration requirements. The Board notes that certain marketing activities and relationships with other credit unions could raise investment adviser requirements. The Board, therefore, invites comments on this issue and if NCUA should require credit unions to have policies and procedures to ensure their activities do not trigger investment adviser registration requirements.

B. State securities requirements

First, certain provisions of the Securities Act and SEC rules have preempted state securities laws with respect to most covered securities. However, states may require issuers to register with the state and/or pay state registration fees. Further, states may also pursue fraud-based claims. The Board invites comment on how it should ensure that any credit union issuing alternative capital has considered and complied with all applicable state laws.

C. Director and officer liability coverage

The Board also notes that issuing securities can affect a credit union's director and officer liability coverage. A lack of coverage could not only impair the credit union, but also threaten the Share Insurance Fund in the event there are losses that the credit union is ultimately responsible for. Before engaging in supplemental or secondary capital activities, therefore, credit unions will need to evaluate coverage to ensure these activities are covered under their policy. The Board requests comments on if it should mandate that credit unions certify that they have evaluated their policies and have sufficient coverage before beginning secondary or supplemental capital activities.

D. Contractual matters and communications

A credit union will need to address contractual provisions between the credit union and its investors. Often these provisions will include requiring ongoing communications with investors, reporting of compliance with the contractual covenants, and sharing of information with current and prospective investors. Credit unions will have to develop policies and procedures to comply with these covenants and provisions and ensure that they are not providing non-public information to investors that is not generally available to all investors. Failure to comply with the investment contracts or to properly monitor communications and sharing of information could subject the credit union to liability, which could negatively impact the Share Insurance Fund. As such, the Board requests comment on if it should mandate comprehensive policies addressing compliance with investment contracts, communications, and information sharing. The Board invites commenters to provide suggestions on the specific details that should be in the policy and if sufficient policies should be a prerequisite to engaging in supplemental or secondary capital activities.

VI. Other Investor Considerations

Section 701.34(b) of NCUA's regulations limits eligible investors in secondary capital to institutional investors, referenced as non-natural persons.[44] This limitation is not required by the Act. This limitation prevents the sale of secondary capital to consumers who could lack the ability to understand the risks associated with secondary capital, especially when there is opportunity for confusion given that the low-income designated credit union is federally insured.

[44] 12 CFR §701.34(b).

Also, low-income designated credit unions can sell secondary capital to nonmembers. When the secondary capital regulations were written in 1996 the purchasers of secondary capital were presumed to be foundations and other philanthropic-minded institutional investors.[45]

From an investor protection standpoint, the issue of limiting the sale of secondary capital and supplemental capital largely focuses on providing adequate protections to the purchasers through the issuance of initial disclosures, transparency standards with respect to reporting of information about the operations and performance of the credit union, and whether the purchaser has the necessary sophistication relative to the complexity and risk of the instrument. As discussed in more detail in the Section V, Securities Law Applicability, of this ANPR, the OCC requires banks issuing subordinated debt to comply with the securities offering disclosure rules in its regulations.[46] The OCC's regulations establish registration statement and prospectus requirements for the offer and sale of securities issued, subject to exemptions and disclosure requirements based on the sophistication of the investor. As banks are not restricted in who they can sell securities to, these rules, in part, help provide a level of investor protection, particularly for less sophisticated, non-institutional investors.

The issue of permissible investors is also related to anti-fraud considerations. As noted above, the level of disclosures necessary to comply with anti-fraud rules varies, in part, on the level of sophistication of the investors. In practice, selling to non-sophisticated investors would likely involve a much higher initial and ongoing disclosure and communications burden for credit unions.

[45] 61 FR 378 (Feb. 2, 1996).
[46] 12 CFR §5.47(d)(3)(iii).

Thus, the Board requests comment on whether the sale of secondary and supplemental capital should be limited to only institutional investors, include accredited investor, or allow for anyone to purchase. If the Board were to allow credit unions to sell alternative capital to non-accredited investors, should there be limits on the amount individual investors can purchase? Also, should there be conditions on how the sale to non-accredited investors must be handled to minimize potential confusion about its lack of federal insurance?

Whether credit unions that are not low-income designated should be able sell supplemental capital instruments to nonmembers with equity like characteristics is a matter relevant to considerations about the mutual model of credit unions. The Board requests comments on the extent to which credit unions should be allowed to sell alternative capital with equity like characteristics to nonmembers, and if so, what controls are necessary to preserve the mutual ownership structure and democratic governance of credit unions. The Board invites comments on how it should structure any potential rule to avoid issues impacting the mutuality of credit unions, and the members' rights to govern the affairs of the institution.

VII. Prudential Standards for Issuing and Counting Alternative Capital for Prompt Corrective Action

For a financial instrument to be considered regulatory capital for prompt corrective action purposes, NCUA must consider the instrument's degree of permanence, capacity to absorb losses as a going concern, the flexibility of principal and interest payments, and intended use of the proceeds. These characteristics are consistent with the Basel Tier 2 capital criteria.[47] These same criteria are also contained in the regulatory capital quality distinctions for the U.S. banking system.[48] Provisions related to these characteristics are intended to ensure the funds will be available to protect the Share Insurance Fund and do not create incentives for credit unions to engage in unsafe or unsound practices.

The function of supplemental capital is to protect the credit union and the Share Insurance Fund in the event of loss. Supplemental capital, therefore, must be able to absorb losses ahead of the Share Insurance Fund while not conferring control of the credit union to the investor. The instruments must be uninsured and cannot be guaranteed or secured by the credit union or its assets. These features ensure supplemental capital fulfils its ultimate purpose and does not result in unintended encumbrances to the credit union or the Share Insurance Fund.

The degree of permanence is important because the instrument must create sufficient stability in the credit union's capital base to be available to cover losses over a long time period. This is the reason for the minimum five year maturity contained in the Basel accords, the U.S. banking capital regulations, and for secondary capital for low-income designated credit unions. With respect to secondary capital, a low-income designated credit unions is allowed to have a call option for the portion no longer qualifying as net worth so that they may retire the instrument if it is no longer needed or market conditions allow them to reprice the capital at a lower rate.

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[47] Basel III was published in December 2010 and revised in June 2011. The text is available at *http://www.bis.org/publ/bcbs189.htm*. The BCBS is a committee of banking supervisory authorities, which was established by the central bank governors of the G–10 countries in 1975. More information regarding the BCBS and its membership is available at *http://www.bis.org/bcbs/about.htm*. Documents issued by the BCBS are available through the Bank for International Settlements web site at *http://www.bis.org*. See paragraph number 58 for criteria for inclusion in Tier 2 Capital.

[48] 12 U.S.C. §324.20.

However, supervisory approval is needed before any call is exercised because it represents a potentially material change to the risk to the Share Insurance Fund.

The alternative capital must be able to absorb losses while the institution is still a going concern, and not just in the case of liquidation. The existing regulatory language regarding secondary capital requires that it is available to "cover operating losses."[49] The term "operating losses" has been interpreted to not include the payment of dividends on shares.[50] However, a credit union's inability to fund a dividend rate that is consistent with prevailing rates can create liquidity and reputation risk. Therefore, credit unions may need the flexibility to issue alternative capital instruments that are available to absorb all losses in excess of retained earnings, *including* the payment of dividends on shares.[51] The Board is seeking comment on the exclusion of dividend expenses as an operating expense and seeks comment on how to resolve the complexity that can result from excluding dividend expense from losses applied to secondary capital but not from losses applied to supplemental capital.

Further, the payment of interest on the instruments must be capable of being cancelled on a permanent, noncumulative basis without constituting a default. The interest provisions must also not contain any feature which would provide incentive for the credit union to exercise a call option, such as a large increase in the interest rate. The flexibility of payments ensures investors cannot obviate any risk exposure to their principal through problematic dividend and interest

[49] 12 CFR §701.34(b)(7).
[50] 12 CFR §701.34.
[51] If the Board authorizes supplemental capital, it could be possible for low income designated credit unions to concurrently offer both supplemental and secondary capital instruments. The differing treatment of payments on dividends could make the administration of losses applied to alternative capital complex and potentially confusing.

provisions. These criteria are consistent with the criteria for inclusion in Tier 2 capital used by the other banking regulators[52] and are contained in Basel III.[53]

Because of these characteristics, most alternative capital instruments can have relatively low liquidity for the purchaser and there is no guarantee of a secondary market. These characteristics also impact the interest rate the credit union must pay for alternative capital. The Board seeks comment on how to maintain protection of the Share Insurance Fund while minimizing the impact the criteria would have on the cost and marketability of the alternative capital instruments.

A. Approval to issue and notice

The Board is considering including an application and notice requirement in any supplemental capital regulations it may issue.[54] The Board notes that requiring a credit union to obtain approval to issue alternative capital and provide a notice of issuance can contribute to ensuring alternative capital instruments are issued in accordance with applicable regulations, part of a sound management plan, and are structured to properly protect the Share Insurance Fund.[55]

The Board notes that currently NCUA requires a low-income designated credit union to submit a "Secondary Capital Plan" prior to the acceptance of secondary capital that includes:[56]

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[52] 12 CFR §5.47.
[53] Basel III was published in December 2010 and revised in June 2011. The text is available at http://www.bis.org/publ/bcbs189.htm.. *See.* paragraph 58 for criteria for inclusion in Tier 2 Capital.
[54] Secondary capital provisions already require low income designated credit unions to obtain prior NCUA approval.
[55] *See*. 12 CFR §§ 5.47(f) and (h) for the OCC's requirements for prior approval for issuance of subordinated debt and for the notice procedure for inclusion as tier 2 capital.
[56] 12 CFR §701.34(b)(1).

- The maximum aggregate amount of secondary capital the low-income designated credit union plans to accept;
- The purpose for which the secondary capital will be used and how it will be repaid;
- Demonstration that the uses of the secondary capital conform to the low-income designated credit union's strategic plan, business plan, and budget; and
- Supporting pro forma financial statements covering a minimum of two years.

The account agreement associated with any alternative capital needs to conform to the standards that ensure it protects the Share Insurance Fund and provide the credit union with flexibility in conducting its daily affairs. The secondary capital regulation currently requires that the low-income designated credit union retain the original account agreement and the "Disclosure and Acknowledgment" for the term of the agreement.[57] The regulation does not specifically require a low-income designated credit union to submit to NCUA either a draft account agreement with the application or the executed agreement.

For all forms of alternative capital, the Board seeks comments on the utility of a prior approval process and a post-issuance notification process. The Board can also consider under what conditions prior approval would not be necessary, such as credit unions that are well capitalized with a successful history of issuing alternative capital. When prior approval would be necessary, however, the Board requests comments on what should be required in an application for authority to issue alternative capital, and how long the credit union would have to issue the alternative capital after approval. In addition, the Board request comment on the evaluation

[57] Id. at §701.34(b)(11).

criteria NCUA should use to approve or deny the application, including whether or not certain credit unions that are already in danger of failing should be precluded from issuing alternative capital as a form of investor protection. Also, the Board seeks comment on the manner of and what should be included in any post-issuance notice credit unions would file with NCUA.

B. Subordination

Secondary capital must be subordinate to all other claims per the Act.[58] Thus, supplemental capital must have a payout priority senior to secondary capital but still subordinate to the Share Insurance Fund. The requirement that alternative capital instruments are subordinate to the Share Insurance Fund, uninsured shareholders, and general creditors is consistent with the Basel criteria for Tier 2 capital.[59]

Unlike secondary capital, supplemental capital is not subject to provisions in the Act that limit flexibility in structuring payment priorities within and between supplemental capital instruments. For example, a credit union could issue a supplemental capital instrument with two tranches, a high-yield-high-risk supporting tranche and a lower-yielding-lower risk tranche. Credit unions could also issue supplemental capital instruments that have first in-first out, or last in-first out contractual payment priorities. This flexibility could help credit unions attract investors of different risk tolerances and profiles. The Board seeks comment on whether authorizing

[58] 12 U.S.C. §1790d(o)(2)(C)(ii).

[59] Basel III was published in December 2010 and revised in June 2011. The text is available at *http://www.bis.org/publ/bcbs189.htm*. The BCBS is a committee of banking supervisory authorities, which was established by the central bank governors of the G–10 countries in 1975. More information regarding the BCBS and its membership is available at *http://www.bis.org/bcbs/about.htm*. Documents issued by the BCBS are available through the Bank for International Settlements Web site at *http://www.bis.org*. See paragraph number 58 for criteria for inclusion in Tier 2 Capital.

supplemental capital regulations should contain any restrictions on payment priority options, and if so, what should they be.

C. Limit on amount of supplemental capital that counts as regulatory capital

While supplemental capital can protect the Share Insurance Fund and uninsured shares from losses, reliance on alternative capital as the primary source of capital is generally unsafe and unsound. Even with a high level of permanent capital, such as retained earnings and common stock, heavy reliance on alternative capital can result in wide fluctuations in capital measures due to the timing of its maturity and negative impact on earnings due to the associated costs.

U.S. bank capital regulations require banks to hold minimum levels of common equity tier 1 capital, total tier 1 capital, and total tier 1 and tier 2 capital to total risk assets that ensures that permanent capital is generally the primary source of regulatory capital.[60] An FDIC-supervised institution must maintain the following minimum capital ratios:[61]

- A common equity tier 1 capital ratio of 4.5 percent;
- A tier 1 capital ratio of 6 percent;
- A total capital ratio of 8 percent; and
- A leverage ratio of 4 percent.[62]

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[60] 12 CFR §324.10(a).

[61] The standardized capital ratio calculations are defined in 12 CFR §3.10(b). The Common Equity Tier 1 Capital Ratio is the ratio of Common Equity Tier 1 Capital to standardized total risk-weighted assets. The Tier 1 Capital Ratio is the ratio of Tier 1 Capital to standardized total risk-weighted assets. The Total Capital Ratio is the ratio of total capital (Tier 1 Capital plus Tier 2 Capital) to standardized total risk-weighted assets. The Leverage Ratio is generally Tier 1 Capital to total consolidated assets. The components of regulatory capital are defined in 12 CFR §3.20. Common Equity Tier 1 Capital is generally common stock, retained earnings, and accumulated other comprehensive income. Additional Tier 1 Capital primarily includes noncumulative perpetual preferred stock. Tier 2 Capital generally includes limited allowance for loan and lease losses, certain subordinated debt and preferred stock, and qualifying capital minority interests.

[62] Id. at §324.10(a).

Additionally to be classified as well capitalized a bank must have:

- A total risk-based capital ratio of 10.0 percent or greater;
- A Tier 1 risk-based capital ratio of 8.0 percent or greater;
- A common equity tier 1 capital ratio of 6.5 percent or greater; and
- A leverage ratio of 5.0 percent or greater.[63]

As a result, banks are inherently limited in how much Tier 2 forms of capital will be included in meeting their regulatory capital standards. Most forms of alternative capital likely available to credit unions will be in the form of subordinated debt – which does not meet the standards to qualify as Tier 1 capital.

Neither the Act nor NCUA regulations limit the amount of secondary capital that can make up a low income designated credit union's net worth. Given their unique needs and mission, low-income designated credit unions can primarily rely on secondary capital to meet prompt corrective action requirements, provided their use of the proceeds and overall ongoing management of their secondary capital is otherwise safe and sound. However, the Board believes any regulation for supplemental capital needs to contain some method of preventing supplemental capital, a lower quality of capital, from becoming the primary component of regulatory capital for credit unions. The Board seeks comments on how capital regulations could

[63] Id. at §324.403(b)(1).

be designed to limit the amount of supplemental capital included in regulatory capital calculations.

Consistent with Basel, U.S. bank capital standards,[64] and secondary capital regulations, the portion of supplemental capital that would be considered as regulatory capital and included in the calculation of the risk-based net worth requirement would be subject to reductions during the last five years of the life of the instrument. Consistent with secondary capital, at the beginning of the each of last five years of the life of the supplemental capital, the amount that is eligible to be included in the risk-based net worth requirement would be reduced by 20 percent of the original amount of the instrument (less any redemptions that may have occurred). The Board seeks comments on this concept and how to reflect the increasingly limited utility as loss absorbing capital for supplemental capital approaching maturity.

The Board also notes that changing conditions and circumstances may warrant early repayment of alternative capital, in part or in whole. The decision on early repayment must reside with the issuing credit union and not the holder of the instrument, to ensure the permanence of the instrument and prevent undue influence by investors. Currently the secondary capital regulations only allow for early redemption of the amount of secondary capital that is not recognized as net worth, with approval by NCUA.[65]

Regulatory controls over early repayment are necessary to protect the Share Insurance Fund and uninsured shares. Regulatory controls over early repayment are also consistent with the Basel

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[64] 12 CFR §324.20(d)(iv).
[65] 12 CFR §701.34(d).

framework for subordinated debt and the other banking agencies' regulations, which provide control over the early repayment of subordinated debt by:

- Requiring all banks to obtain prior approval to prepay or call subordinated debt included in tier 2 capital.[66]
- Prohibiting the holder of subordinated debt from having a contractual right to accelerate principal or interest payments in the instrument, except in the event of a receivership, insolvency, liquidation, or other similar proceeding.[67]
- Prohibiting the exercise of a call option in the first five years following issuance, except in certain very limited circumstances.

Enabling regulations for supplemental capital will need to address the issue of prepayment and call provisions for supplemental capital. The options regarding the abilities of a credit union to prepay supplemental capital could include minimum capital measures after repayment, current and expected future performance measures and notice criteria of varying degrees. The Board invites comments on the topic of prepayment and call provisions for alternative capital and how it should structure any related requirements. Allowing credit unions greater flexibility to eliminate the cost of alternative capital or reprice the instrument under better terms could provide benefits to the credit union. Any alternative to the redemption process would be contingent on the credit union no longer relying on the alternative capital to achieve an appropriate level of capital.

[66] Id. at §5.47(d)(1)(vii).
[67] Id. at §5.47(d)(2).

D. Reciprocal holdings

Regulations for alternative capital need to address reciprocal holdings. Reciprocal holdings exist when two or more credit unions hold each other's alternative capital. Reciprocal holdings of alternative capital, without some form of adjustment, would artificially inflate the level of capital in the credit union system, create loss transmission channels between credit unions, and could be subject to abuse.

The Board notes a national bank or federal savings association must deduct investments in the capital of other financial institutions it holds reciprocally, where such reciprocal cross holdings result from a formal or informal arrangement to swap, exchange, or otherwise intent to hold each other's capital instruments, by applying the corresponding deduction approach.[68] The Board requests comment on how NCUA should address this concern.

E. Merger

Per the current regulation, in the event of merger of a low-income designated credit union (other than merger into another low-income designated credit union) the secondary capital accounts will be closed and paid out to the investor to the extent they are not needed to cover losses at the time of merger or dissolution. The OCC prohibits a covenant or provision in subordinated debt instruments that requires the prior approval of a purchaser or holder of the subordinated debt note in the case of a voluntary merger where the resulting institution assumes the due and punctual performance of all conditions of the subordinated debt note and where the agreement is not in default of the various other covenants.[69]

[68] 12 CFR §3.22(c)(3).
[69] 12 CFR §5.47(d)(2)(iv).

In order to avoid any perceptions of an alternative capital holder having ownership rights, any restrictions on merger or other change of control must not interfere with the credit union's ability to exercise its business judgement and management of the credit union in a manner that avoids unsafe and unsound practices. The Board seeks comment on the issue of merging credit unions and how alternative capital should be treated post-merger.

F. Other restrictions

Supplemental capital must not contain contractual terms that would limit or impede the authority of NCUA or a State Supervisory Authority to undertake supervisory action, as necessary, to protect the issuing credit union's members or the Share Insurance Fund. Any such contractual terms would impose unsafe and unsound limits on the credit union's and regulators' ability to manage the institution and address problems. Affirmative covenants within the supplemental capital note or agreement must not restrict operations or potentially require a credit union to violate a law or regulation. Negative covenants should not unreasonably impair the credit union's flexibility in conducting its operations or interfere with management. Without these restrictions, contractual terms could undermine the purpose of supplemental capital and provide holders of these obligations with unintended rights and control over the credit union's operations. Any representation or warranties contained in the agreements that would require acceleration and repayment of the subordinated debt note because of a technical violation that does not reflect underlying credit issues could be contrary to safety and soundness. The Board seeks comments on the issue of contractual restrictions for alternative capital instruments.

VIII. Supporting Regulatory Changes

A. 701.32 - Payment on shares by public unit nonmembers

Due to the potential use of alternative capital as a funding source similar to public units and nonmembers, the NCUA Board is seeking comment on §701.32 of NCUA's regulations as it prescribes limits placed on these accounts.

Section 1757(6) of the FCU Act grants federal credit unions the power "to receive from its members, from other credit unions, from an officer, employee, or agent of those nonmember units of Federal, Indian tribal, State, or local governments and political subdivisions thereof enumerated in section 1787 of this title and in the manner so prescribed, from the Central Liquidity Facility, and from nonmembers in the case of credit unions serving predominately low-income members (as defined by the Board) payments, representing equity, on— (A) shares which may be issued at varying dividend rates; (B) share certificates which may be issued at varying dividend rates and maturities; and (C) share draft accounts authorized under section 1785(f) of this title; subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board."[70]

Currently the regulation limits total public unit and nonmember shares to 20 percent of the total shares of the federal credit union or $3 million, whichever is greater.[71] Federal credit unions seeking to exceed the limit must:

[70] 12 U.S.C. §1785(f).
[71] 12 CFR §701.32(b)(1).

- Adopt a specific written plan concerning the intended use of these shares and provide it to the Regional Director before accepting the funds; and
- Submit a written request to the Regional Director for a new maximum level of pubic unit and nonmember shares.[72]

Under §741.204, federally insured state chartered credit unions must adhere to the requirements of §701.32 regarding public unit and nonmember accounts.[73] This regulation also addresses a federally insured state chartered credit union obtaining a low-income designation, as provided under state law, in order to accept nonmember accounts other than from public units or other credit unions.[74] Additionally this section addressed the ability of a federally insured state chartered credit union to receive and redeem secondary capital consistent with §701.34 and consistent with applicable state law and regulation.[75]

Because the limitations the NCUA board may prescribe to these accounts is not statutory, the NCUA Board is interested in comments on revisions to this regulation which would reduce the regulatory burden of the waiver process but still provide for adequate protection of the Share Insurance Fund.

[72] Id. at §701.32(b)(2).
[73] Id. at §741.204(a).
[74] Id. at §741.204(b).
[75] Id. at §741.204(c) and (d).

B. 701.34 - Designation of low-income status; acceptance of secondary capital accounts by LICUs

Section 701.34 of NCUA's Rules and Regulations sets out the requirements and process for a credit union to receive a low-income designation, the criteria for accepting secondary capital and the inclusion of secondary capital as regulatory capital. NCUA is seeking comment on whether the criteria and process for obtaining the low income designation, the criteria for issuing secondary capital, and the criteria for inclusion of secondary capital as regulatory capital should be in separate regulations.

Section 701.34 could be solely focused on the process to receive a low-income designation. A new section of 701 could be used to address:

- The authority and requirements of secondary capital;
- Grandfathering treatment of existing secondary capital in the event of regulatory changes;
- Requirement to comply with all applicable federal and state laws in the issuance of secondary capital;
- Requirements for written contract agreements covering the terms and conditions of the secondary capital;
- Requirements for disclosures and acknowledgement;
- Investor suitability; and
- Prohibitions.

The items specific to secondary capital's and supplemental capital's inclusion in regulatory capital and related capital adequacy issues could be consolidated into Section 702 – Capital Adequacy, including:

- Standards for alternative capital instruments to be counted as regulatory capital;
- Any limits on the amount of alternative capital counted as regulatory capital;
- The role of supplemental capital in approval of a net worth restoration plan;
- Provisions for discounting regulatory capital treatments such as violations of applicable laws or regulation, including any deficiency cure alternatives; and
- Risk weight for an investment in supplemental capital.

C. Payout priorities

To conform the regulatory payout priorities for supplemental capital, the payout priorities for an involuntary liquidation will need to be revised.[76] Supplemental capital would be listed in the payout priority after uninsured shareholders and the Share Insurance Fund.

D. Other regulations

The Board seeks comments on any other related changes to existing regulations, such as:

- Modifying the definition of insured shares in 741.4(b) to exclude any equity shares allowed under state law, if they are in fact uninsured;

[76] 12 CFR §709.5.

- Modifying 741.9 to provide for the existence of uninsured accounts issued under state law by FISCUs; and
- Any cohering changes to Part 745 as necessary.

By the National Credit Union Administration Board on January 19, 2017.

Gerald Poliquin

Secretary of the Board