BECU.ORG | 800-233-2328

April 27, 2015

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Via email to: regcomments@ncua.gov

RE: Comments on NCUA's Second Proposed Rule on Risk-Based Capital

Dear Mr. Poliquin:

Boeing Employees' Credit Union ("BECU") appreciates the opportunity to comment on NCUA's second proposed rule to implement risk-based capital rules ("Proposed Rule"), published in the Federal Register on January 27, 2015.

These comments: (1) discuss the importance of including a provision for supplemental capital in the risk-based capital numerator in the final rule, (2) address NCUA's legal authority to include supplemental capital in its risk-based capital rules, and (3) respond to the specific questions on supplemental capital that were posed in the preamble of the Proposed Rule.[1]

I. Introduction

BECU commends NCUA for its consideration of the many comments submitted by credit unions and other interested stakeholders on the original proposed rule, published in January 2014. Many of the changes included in the Proposed Rule are responsive to those comments and are improvements. One area where the Proposed Rule continues to fall short, however, is that it fails to include forms of supplemental capital (other than secondary capital) in the risk-based capital numerator for credit unions that are not low-income credit unions ("LICUs").

Two justifications are offered in the Proposed Rule to explain why NCUA chose not to include supplemental capital in the Proposed Rule; neither is persuasive.

The first justification is that NCUA prefers to wait to see what Congress might do to allow supplemental capital to count as a component of net worth as defined in the Federal Credit Union Act ("FCUA") for purposes of the leverage ratio (net worth) requirements. NCUA would then decide "whether and how" to include supplemental capital for purposes of its risk-based capital

[1] BECU is submitting comments on the other aspects of the Proposed Rule under separate cover.

more than just money
BECU
PO Box 97050, Seattle, WA 98124-9750

rules.[2] BECU strongly supports Congressional efforts to provide healthy, well-managed credit unions access to supplemental capital. BECU also appreciates the support of individual NCUA Board members on behalf of those efforts. However, the suggestion that the Board should "await" Congressional action before acting under existing statutory authority cannot be supported. There are several problems with this approach. This position ignores the legal predicate for the Proposed Rule, which we agree with and discuss at length below, that the FCUA requires the NCUA to develop two distinct measures of capital adequacy and, thus, the limitations on including supplemental capital for purposes of the leverage ratio (net worth) requirements are separate from the consideration of whether to include supplemental capital in the risk-based capital rules. It also ignores the statutory requirement that the risk-based capital rules be comparable to those promulgated under the Federal Deposit Insurance Act ("FDI Act").

Moreover, because Congressional action is uncertain, a "wait and see" approach could indefinitely delay the NCUA's consideration of supplemental capital, while at the same time the risk-based capital rules may make it more difficult for many healthy, well-managed credit unions to grow and enhance member services. Again, the two issues are related, but independent. NCUA has the authority to include supplemental capital in its risk-based capital rules regardless of whether Congress acts and doing so will enhance safety and soundness and benefit credit unions and their members.

The second justification for excluding supplemental capital incorrectly assumes that NCUA would need to resolve the "host of other complicated issues" beyond the scope of this rulemaking.[3] The important, but secondary questions regarding prudential limitations, suitability and disclosure issues, and related issues, do not need to be addressed at this stage in order for NCUA to finalize the Proposed Rule. <u>These issues can and should be addressed in a follow-on rulemaking.</u> It would be sufficient, and appropriate, if the final rule implementing risk-based capital standards included a placeholder stating that the NCUA may recognize certain forms of supplemental capital authorized by rule. Including a placeholder in the final rule will avoid the need to reopen the risk-based capital rules in the future and will help spur an expeditious review of the related issues identified above.

There is no reason for further delay. NCUA has the authority to include supplemental capital in its risk-based capital rules and should do so. Including supplemental capital in NCUA's risk-based rules would be consistent with comparable capital rules promulgated by bank regulatory agencies; it would benefit credit unions and their members, and would help protect the NCUSIF from potential losses. NCUA could then proceed in a separate rule-making to set forth the parameters for supplemental capital to be recognized in satisfaction of risk-based capital requirements.

[2] 80 Fed. Reg. 4384 (Jan. 27, 2015).
[3] 80 Fed. Reg. 4384 (Jan. 27, 2015).

II. Discussion

A. NCUA has the Authority to Include Supplemental Capital in its Risk-Based Capital Rules

1. <u>The FCUA Requires NCUA to Develop Two Distinct Measures of Capital Adequacy</u>

Section 216 of the FCUA requires NCUA to promulgate net worth requirements that are comparable to capital requirements promulgated by the bank regulatory agencies[4] under Section 38 of the FDI Act.[5] Such rules must include two distinct measures of capital adequacy: (1) a "net worth ratio" (or leverage ratio) of net worth to total assets[6] and (2) a risk-based net worth requirement for credit unions that are complex.

The FCUA provides specific definitions of the terms "net worth" and "net worth ratio" as follows:

> *"Net worth.—The term "net worth"—*
>
> > *"(A) with respect to any insured credit union, means 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 has combined;*
> >
> > *"(B) with respect to any insured credit union, includes, at the Board's discretion and subject to rules and regulations established by the Board, assistance provided under section 1788 of this title to facilitate a least-cost resolution consistent with the best interests of the credit union system; and*
> >
> > *"(C) with respect to a low-income credit union, includes secondary capital accounts that are—*
> > *(i) uninsured; and*
> > *(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund."*[7]
>
> *"Net worth ratio.—The term "net worth ratio" means, with respect to a credit union, the ratio of the net worth of the credit union to the total assets of the credit union"*[8]

---

[4] The bank regulatory agencies are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.
[5] 12 U.S.C. § 1831o.
[6] 12 U.S.C. §§ 1791d(c), 1791d(o)(3).
[7] 12 U.S.C. § 1790d(o)(2).
[8] 12 U.S.C. § 1790d(o)(3).

The FCUA requires NCUA to develop a "risk-based net worth requirement for complex credit unions" as follows:

> *"Risk-based net worth requirement for complex credit unions.—*
>
> > *"(1) In general.—The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.*
> >
> > *"(2) Standard.—The Board shall design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."*[9]

The explicit definitions of "net worth" and "net worth ratio" apply only to the leverage ratio requirement. Specific definitions for risk-based net worth requirements are not provided in the FCUA. Rather, NCUA is required to develop a "risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection."[10]

As NCUA correctly observes in the preamble of the Proposed Rule, this requirement gives the agency broad discretion to include adjustments — positive and negative — to net worth (*i.e.*, the numerator) of any risk-based net worth ratio requirements.[11]

2. NCUA's Inclusion of Supplemental Capital in Its Risk-Based Capital Framework would be Entitled to Deference Because it is Not Unambiguously Foreclosed by the FCUA

Because the risk-based capital ratio is not limited by the statutory definition of "net worth," there is nothing in the FCUA that precludes an interpretation allowing for adjustments to net worth for risk-based net worth requirements, including adjustments to include supplemental capital components.

NCUA has broad discretion to determine which components may be included or excluded in required calculations of the numerator for its risk-based net worth requirements. Accordingly, NCUA's decision to include supplemental capital in its risk-based capital rules would be entitled to deference under the *Chevron* doctrine of deference.[12]

---

[9] 12 U.S.C. § 1790d(d).
[10] 12 U.S.C. § 1790d(d)(2).
[11] 80 Fed. Reg. 4349 (Jan. 27, 2015).
[12] *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). *See Amerada Hess Pipeline Corp. v. FERC*, 117 F.3d 596, 601 (D.C. Cir. 1997) ("Courts defer to agency interpretations in large part because Congress has chosen to delegate to the agency decision-making in the field."). *See also, Northeast Hosp. Corp. v. Sebelius*, 657 F.3d 1, 4 (D.C. Cir. 2011) (quoting *Nat'l Cable & Telecomm. Ass'n v. FCC*, 567 F.3d 659, 663 (D.C. Cir. 2009) (deferring to agency construction not "unambiguously foreclose[d]" by the statute)). Under *Chevron*'s first step, courts "conduct an 'independent examination' of the statute in question, looking not only 'to the particular statutory

The NCUA has exercised this discretion in the Proposed Rule by requiring adjustments to the numerator in risk-based capital ratios that are different from net worth as defined by the FCUA for the leverage ratio (net worth) requirements (*i.e.*, retained earnings as determined in accordance with generally accepted accounting principles ("GAAP"), and certain other components). For example, NCUA proposes to allow the inclusion of loan loss reserves in the numerator for the risk-based net worth ratio, but would generally require deductions for goodwill, other intangible assets, and the National Credit Union Share Insurance Fund ("NCUSIF") deposit. Therefore, NCUA has already embraced this discretion by including additional components in its risk-based capital numerator. It should use this same authority to include supplemental capital.

The FDI Act requires the bank regulatory agencies to impose (1) a regulatory "leverage limit," which is a "ratio of tangible equity to total assets,"[13] and (2) a "risk-based capital requirement."[14] Like the FCUA, the FDI Act essentially mandates a leverage measure, based upon tangible equity capital, but leaves the bank regulatory agencies discretion to determine the risk-based measure. The bank regulatory agencies have used that authority to include supplemental capital in their risk-based capital rules.

3. <u>Comparable Risk-Based Capital Rules Must Recognize Supplemental Capital</u>

The NCUA is required to develop risk-based net worth requirements that are "comparable" to risk-based capital requirements promulgated by the bank regulatory agencies.[15] Notwithstanding its discretion in developing risk-based net worth rules, NCUA's failure to include any provision for supplemental capital may violate the directive under Section 216 of the FCUA to develop requirements that are comparable to those applicable to banks under Section 38 of the FDI Act.

The preamble of the Proposed Rule states:

> the FCUA gives NCUA broad discretion in designing the risk-based net worth requirement. Thus, this proposal incorporates a broadened definition of capital for purposes of calculating the proposed new risk-based capital ratio . . . The Board proposes to do this to provide for a more comparable measure of capital across all financial institutions and better account for related elements of the

---

language at issue,' but also to 'the language and design of the statute as a whole.'" *Id.* at 8 n.4 (quoting *Martini v. FNMA*, 178 F.3d 1336, 1345-46 (D.C. Cir. 1999) (quoting *N.Y. Shipping Ass'n v. FMC*, 854 F.2d 1338, 1355 (D.C. Cir. 1988))). Under *Chevron*'s second step, courts will defer to the agency's interpretation "so long as it is reasonable." *Northeast Hosp.*, 657 F.3d at 5. To overturn an agency's reasonable interpretation and implementation of a statute, a challenger "must do more than offer a reasonable or, even the best, interpretation." *Vill. of Barrington, Ill. v. STB*, 636 F.3d 650, 661 (D.C. Cir. 2011). Rather, the agency's determination can be overturned only if "the statute *unambiguously* forecloses the [agency's] interpretation." *Id.* (emphasis in original) (citing *Chevron,* 467 U.S. at 843 n. 11) ("The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding."). Establishing unambiguous foreclosure has been recognized as a "heavy burden." *Id.*

[13] 12 U.S.C. §§ 1831o(c)(1)(A)(i), 1831o(c)(3).

[14] 12 U.S.C. § 1831o(c)(1)(A)(ii).

[15] 12 U.S.C. § 1790d(b)(1)(A)

financial statement that are available (or not) to cover losses and protect the NCUSIF.[16]

But the Proposed Rule is not comparable with respect to the inclusion of capital components available to absorb losses in the numerator of the ratio. The Proposed Rule allows negative adjustments, but unlike the regulations promulgated under the FDI Act, it does not allow positive adjustments such as the inclusion of supplemental capital components.

Regulations promulgated under Section 38 of the FDI Act were explicitly designed "to improve the quality and quantity of regulatory capital and build additional capacity into the banking system to absorb losses in times of market and economic stress."[17] For example, the comparable bank regulations permit mutual depository institutions, which do not issue stock, to include instruments that meet specific criteria in common equity tier 1 capital.[18]

NCUA's decision not to include supplemental capital components in its risk-based net worth requirements fails the comparability standard on several levels. First, it is inconsistent with "comparable" regulations promulgated under Section 38 of the FDI Act because it does not account for capital instruments issued by institutions that do not issue stock. Second, and perhaps more importantly, it misses the opportunity to build additional risk absorption capacity into the credit union system to weather losses in times of market and economic stress, thereby missing the opportunity to mitigate "any material risks against which the net worth ratio . . . may not provide adequate protection." In the wake of the most recent financial crisis, credit unions could not fully participate in various initiatives designed to infuse additional dollars into our nation's financial system because there were no rules in place allowing credit unions to accept supplemental capital. Third, unlike banks that can raise other forms of capital like common stock, credit unions (other than LICUs) facing pressure on capital levels have few choices other than increasing fees or making their loan rates less attractive to members or shrinking assets. Therefore, allowing for supplemental capital in the risk-based capital numerator is even more important for credit unions than for banks.

Accordingly, including supplemental capital in NCUA's risk-based capital rules would be a reasonable construction of the FCUA and would be consistent with comparable capital rules promulgated by bank regulatory agencies.

B. The Final Rule Should Include a Provision for Supplemental Capital

There are many complex issues involved in allowing supplemental capital components for risk-based capital, many of which are identified in the preamble of the Proposed Rule. Some of these issues are discussed below. These issues can and should be addressed in a follow-on rulemaking. It would be sufficient, and appropriate, to include a placeholder in the final risk-based capital rule stating that the NCUA may recognize certain forms of supplemental capital.

[16] 80 Fed. Reg. 4381 (Jan. 27, 2015)

[17] 78 Fed. Reg. 62018, 62021 (Oct. 11, 2013).

[18] *See e.g.*, 12 C.F.R. § 324.22(b)(1).

The Proposed Rule could easily be amended to recognize supplemental capital by adding a new subparagraph (ix) to 12 C.F.R. section 702.104(b)(1) of the Proposed Rule to read as follows:

(ix) Supplemental capital elements as authorized by rule of the NCUA;

Using this approach, the reference would serve as a placeholder and preempt the need to open the risk-based capital rule in the future. It is not necessary, at this time, to resolve all of the related questions regarding prudential limitations, suitability and disclosure issues, and related issues. Those issues are beyond the scope of the Proposed Rule and could, and should, be addressed in a follow-on rulemaking.

III. Responses to NCUA's Supplemental Capital Questions

BECU appreciates the attention given to supplemental capital in the preamble of the current Proposed Rule and commends the NCUA for soliciting input on specific questions to help frame the issue. Again, BECU does not believe these issues need to be conclusively addressed for the NCUA to include provision for supplemental capital in the risk-based capital numerator. BECU offers its views on the questions posed in an effort to help further the dialogue on this important issue below.

1. *Should Additional Supplemental Forms of Capital be Included in the Risk-Based Capital Ratio Numerator and How Would Including Such Capital Protect the NCUSIF from Losses?*

Yes. Additional forms of supplemental capital should be included in the risk-based capital numerator. Including supplemental capital in NCUA's risk-based rules would help credit unions and their members, and would help protect the NCUSIF from potential losses.

BECU supports NCUA's efforts to develop an appropriate risk-based capital framework. As a general matter, credit unions holding assets that have historically shown a higher level of risk should be required to hold more capital against those assets. However, NCUA must also recognize that its risk-based capital rules will impose an even greater burden on many credit unions to increase capital and may make it more difficult for many healthy, well-managed credit unions to grow and enhance member services. Allowing non-LICU credit unions to include supplemental capital as part of risk-based capital would help ease the burden of the Proposed Rule on credit unions and their members.

Supplemental capital can serve as a tool for well-managed credit unions to help them meet their members' demand for affordable financial services. Expanded capital authority would allow credit unions to enhance their ability to serve their members (through increased deposit-taking and lending) and improve the efficiency of their operations. Credit union members can benefit from stronger credit unions with more capital. Higher capital levels are not without cost, but that can be managed, among other ways, by limiting access to supplemental capital to support the growth of credit unions that are financially healthy, rather than using it to support financially weak credit unions.

In addition to enhancing the safety and soundness of individual credit unions, allowing supplemental capital would enhance the safety and soundness of the credit union system by protecting the NCUSIF. Supplemental capital cannot function as effectively as retained earnings, but it can help mitigate potential losses. Supplemental capital instruments would rank junior to deposit liabilities and, therefore, would be completely extinguished before any losses to the NCUSIF. A simple example illustrates the point. If a credit union had $100 in share deposits, $10 in retained earnings and $5 in supplemental capital elements, the credit union could absorb losses of $15 before NCUSIF suffers any losses, whereas the same credit union without supplemental capital could only absorb losses of $10. This additional loss absorbing capacity would be a direct benefit to NCUSIF.

Supplemental capital also provides an indirect benefit to NCUSIF because it allows a credit union to grow its assets and thereby spread costs over a larger asset base. If managed properly, the larger asset base (after accounting for the costs of supplemental capital instruments) should provide a credit union with additional earning power, thereby growing retained earnings at a faster pace than would otherwise be possible. The cumulative effect would be enhanced retained earnings over time, providing further capacity to absorb losses.

2. *If Yes, to be Included in the Risk-Based Capital Ratio Numerator, What Specific Criteria Should Such Additional Forms of Capital Reasonably be Required to Meet to be Consistent with GAAP and the FCUA, and Why?*

As an initial matter, it is not clear why supplemental capital in the risk-based capital numerator would need to be treated as equity under GAAP. Section 216 of the FCUA defines "net worth" for leverage ratio requirement purposes in part as "the retained earnings balance of the credit union, as determined under [GAAP]."[19] The definition of "risk-based net worth requirement for complex credit unions" contains no such requirement.[20] Given that the FCUA requires NCUA to develop two distinct measures of capital adequacy, there is no statutory basis for limiting potential forms of supplemental capital for risk-based capital purposes to those that are consistent with GAAP.

In the banking context, various instruments, with varying characteristics, maturities, seniority, and other attributes, may be included in addition to tier 1 capital[21] under comparable bank regulatory risk-based capital rules.[22] Instruments may qualify as tier 2 capital regardless of their treatment under GAAP because they have capacity to absorb losses. Including supplemental capital in the risk-based capital numerator would also have the capacity to absorb losses, irrespective of the supplemental capital's accounting treatment.

More generally, the question correctly focuses on the broad criteria applicable to any form of supplemental capital that may be authorized to be included in the risk-based capital numerator,

[19] 12 U.S.C. § 1790d(o)(2).
[20] 12 U.S.C. § 1790d(d).
[21] The bank regulatory agencies divide capital into different categories (*i.e.*, common equity tier 1 capital, additional tier 1 capital, and tier 2 capital) as a means of taking into consideration the quality of capital and its loss-absorption capacity.
[22] *See e.g.*, 12 C.F.R. §§ 324.22(c), 324.22(d).

rather than seeking to prescribe specific instruments. This is an appropriate analytical framework. NCUA should adopt broad parameters that maximize the flexibility of credit unions to respond to market demand, while simultaneously providing appropriate safeguards and prudential safety and soundness requirements.

Much work has already been done that NCUA can draw from, both in terms of its own experience with LICU secondary capital,[23] its prior work on supplemental capital,[24] Congressional policy direction on supplemental capital,[25] and comparable standards promulgated under the FDI Act for mutual depository institutions.[26]

The criteria must reflect, in part, the unique status of credit unions as not-for-profit financial cooperatives. Accordingly, a bedrock principle for any form of supplemental capital is that it preserves the cooperative, mutual nature of credit unions.[27] In practice, this will mean that no form of supplemental capital will convey voting rights to non-members or alter the one-member, one-vote governance model of credit unions.

Additional criteria for any form of supplemental capital included in the risk-based capital numerator might include the following:

- it is uninsured;
- it is subordinate to all other claims against the credit union;
- it is available to be applied to cover operating losses of the credit union in excess of retained earnings;
- if it has a stated maturity, the initial maturity is at least five years;
- if it has a stated maturity, the risk-based net worth value is discounted (or, alternatively, the interest rate progressively increases) as it approaches maturity;
- it is limited to a certain threshold, ensuring a minimum level of core, non-supplemental capital;
- it is subject to disclosure and consumer protection requirements;
- it is offered by a credit union that is determined by the NCUA to be sufficiently-capitalized and well-managed; and
- it may only be issued pursuant to prior regulatory approval.

Additionally, regulatory limits should be placed on how much capital any single person, group, or entity can hold to prevent excessive concentration. These limits should apply to members and nonmembers of the credit union. The regulations must recognize, for example, that many subordinated debt instruments will contain extensive covenants and conditions that may limit the

[23] Although secondary capital is narrower than the supplemental capital being considered for inclusion in the risk-based capital ratio numerator, these regulations address parallel issues.
[24] *See* NCUA SUPPLEMENTAL CAPITAL WORKING GROUP, SUPPLEMENTAL CAPITAL WHITE PAPER (Apr. 12, 2010).
[25] See *e.g.*, H.R. 989, 114th Cong. (2015).
[26] *See* 12 C.F.R. § 701.34.
[27] Adherence to this principle will also help ensure that access to supplemental capital will not impair the tax status of a state-chartered credit union under section 501(c)(14)(A) of the Internal Revenue Code. *See* NASCUS, ALTERNATIVE CAPITAL FOR CREDIT UNIONS: WHY NOT? (2005) at 3, 5 (citing IRS letter rulings confirming that certain forms of supplemental capital that did not convey voting rights did not constitute "capital stock" within the meaning of section 501(c)(14)(A) and, thus, did not affect the tax status of the credit union making the issuance).

freedom of the credit union's management. This is not necessarily negative. As the GAO noted in its 2007 report, allowing outside investors may bring increased market discipline.[28]

For purposes of comparison, a summary chart showing capital components used in the numerators of the various risk-based capital ratios employed by the bank regulatory agencies is provided as Appendix 1 to this comment letter. Such criteria could be adapted to be both comparable to capital standards adopted under the FDI Act while taking into account the unique, cooperative nature of credit unions.

3. *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 FCUA, and Why?*

Two preliminary comments; first, NCUA should allow other forms of supplemental capital instruments beyond certificates of indebtedness to be included in the risk-based capital ratio numerator to ensure that both NCUA and credit unions have appropriate flexibility to respond to future economic and market conditions. Second, there is no statutory basis for requiring certificates of indebtedness in the context of the risk-based capital rules to be consistent with GAAP.

Although similar criteria should be applied to all instruments, there are some unique considerations for certificates of indebtedness. As discussed in the 2010 NCUA White Paper and the 2005 NASCUS White Paper, these could include: a specified maturity; a rate of return tied to an external benchmark; and subordination to all other claims (including those of other supplemental capital holders).[29]

4. *In Addition to Amending NCUA's Risk-Based Capital Regulations, What Additional Changes to NCUA's Regulations Would be Required to Count Additional Supplemental Forms of Capital in NCUA's Risk-Based Capital Ratio Numerator?*

Additional changes to NCUA's regulations would be required in order to realize the full benefit of supplemental capital. A number of regulations limit the authority of a credit union to engage in various activities based upon the credit union's exposure to the activity in relation to its unimpaired capital and surplus or net worth. In some cases, the limitation is prescribed in statute and cannot be changed by regulation (*e.g.*, member business lending). In many other cases, however, the limitation is imposed by regulation. In those cases, NCUA could exercise its discretion as to whether the limit should be modified. Reference to risk-based capital in these cases would help credit unions realize the full benefit of supplemental capital.

A chart showing a number of these provisions needing change is provided in Appendix 2 of this comment letter.

---

[28] GAO, CREDIT UNIONS: AVAILABLE INFORMATION INDICATES NO COMPELLING NEED FOR SECONDARY CAPITAL at 18 (Aug. 2004).

[29] *See* NCUA SUPPLEMENTAL CAPITAL WORKING GROUP, SUPPLEMENTAL CAPITAL WHITE PAPER (Apr. 12, 2010); NASCUS, ALTERNATIVE CAPITAL FOR CREDIT UNIONS: WHY NOT? (2005).

5. *For State-Chartered Credit Unions, What Specific Examples of Supplemental Capital Currently Allowed under State Law do Commenters Believe Should be Included in the Risk-Based Capital Ratio Numerator, and Why Should They be Included?*

Specific examples are limited because credit unions generally cannot currently count supplemental capital for purposes of regulatory capital. As a consequence, there is no market for these products and, thus, little innovation around new product offerings. Including supplemental capital in the risk-based capital rules will help create a market for new products.

The model instruments identified in the 2010 NCUA White Paper - voluntary patronage capital, mandatory membership capital, and subordinated debt - or those identified in the 2005 NASCUS White Paper — member paid-in capital or non-member paid-in capital — would all work as suitable candidates. These instruments could serve as a starting point, but the rule should not limit supplemental capital instruments only to those types. NCUA should adopt broad parameters that maximize the flexibility of credit unions to respond to market demand, while simultaneously providing appropriate safeguards and prudential safety and soundness requirements.

6. *What Investor Suitability, Consumer Protection, and Disclosure Requirements Should be Put in Place Related to Additional Forms of Supplemental Capital?*

A threshold question is whether NCUA is the appropriate entity to regulate consumer protection and investor eligibility and suitability standards. As noted in the 2010 NCUA White Paper, there is the potential for a conflict of interest in the case of a credit union failure if NCUA is responsible for protecting both the NCUSIF and enforcing investor protection disclosure requirements.[30] Additionally, many of the issues regarding consumer protection and investor eligibility and suitability standards do not have a direct nexus to deposit insurance (safety and soundness), thus, NCUA does not have a legitimate basis to regulate those aspects of a state-chartered credit union's operations.

Setting those issues aside, there are several existing models that could inform investor suitability, consumer protection, and disclosure requirements related to additional forms of supplemental capital. The existing LICU secondary capital regulations are a logical starting point.

Additionally, investor suitability, consumer protection, and disclosure requirements under the Securities Act of 1933, as amended (the "Securities Act") could be referenced, notwithstanding the exemption from the registration requirements of the Securities Act.[31] Many bank regulatory

[30] NCUA Supplemental Capital Working Group, Supplemental Capital White Paper at 17 (Apr. 12, 2010).

[31] Section 3(a)(5) of the Securities Act exempts from the Securities Act;

> Any security issued . . . by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.

In various no-action letters, the Securities and Exchange Commission staff did not recommend enforcement action with respect to securities issued by credit unions in reliance on the exemption in Section 3(a)(5). See, *e.g.*, Idaho Central Credit Union No-action Letter, Fed. Sec. L. Rep. ¶ 81.004 (publicly available Feb. 14, 1977) (CCH), Oregon Telco Credit Union No-action Letter (publicly available April 3, 1978). Reasoning of the SEC staff seemed to focus on the fact that the credit unions involved were subject to regulation and examination by the NCUA and the agencies look to the requirements of the Securities Act and regulations promulgated by the Securities and Exchange Commission ("SEC"). For example, Part 16 of regulations promulgated by the Office of the Comptroller of the Currency generally incorporate by reference SEC regulations, including those governing private placements of securities.[32]

While sales of securities issued by credit unions are exempt from the registration and certain other requirements of the Securities Act, such sales are nevertheless subject to the anti-fraud provisions of that statute. A body of law has developed under the Securities Act and the SEC regulations. By adopting standards that are consistent with SEC regulations, NCUA could provide credit unions with requirements that are no more onerous than what is required under existing law, while at the same time providing investors protections borne out of years of SEC experience. Credit unions would benefit from compliance with long-standing rules that have developed with markets over time. Such requirements would also be consistent with existing practices in the marketplace.

NCUA should ensure that any investor suitability, consumer protection, and disclosure requirements are scalable and effectively targeted to reflect the size and complexity of the credit union and the issuance.

IV. Conclusion

For the reasons discussed above and in its previous comments, BECU respectfully urges the NCUA to include provision for supplemental capital in the risk-based capital numerator when it issues its final rule. NCUA has the authority to include supplemental in its risk-based capital rules and should do so. Including supplemental capital in NCUA's risk-based rules would be consistent with comparable capital rules promulgated by bank regulatory agencies and would help credit unions and their members and would help protect the NCUSIF from potential losses.

BECU looks forward to working with NCUA to develop an appropriate framework for supplemental capital in a follow-on rulemaking.

Thank you for your consideration of these comments.

Sincerely,

Parker Cann
Senior Vice President and General Counsel

---

applicable state regulator.
[32] 12 C.F.R. § 16.1 *et seq.*

APPENDIX 1

COMPARISON OF CHARACTERISTICS OF NON-STOCK CAPITAL COMPONENTS UNDER BANK RISK-BASED CAPITAL RULES

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
Paid-in requirement	The instrument is paid-in, issued directly by the Institution, and represents the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding of the Institution	The instrument is issued and paid-in	The instrument is issued and paid-in
Subordination / priority	The instrument represents the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding of the Institution. The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other common stock instruments before any losses are borne by holders of claims on the Institution with greater priority in a receivership, insolvency, liquidation, or similar proceeding. The holder of the instrument is entitled to a claim on the residual assets of the Institution that is proportional with the holder's share of the	The instrument is subordinated to depositors, general creditors, and subordinated debt holders of the Institution in a receivership, insolvency, liquidation, or similar proceeding	The instrument is subordinated to depositors and general creditors of the Institution

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
	Institution's issued capital after all senior claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding. Dividend payments and any other distributions on the instrument may be paid only after all legal and contractual obligations of the Institution have been satisfied, including payments due on more senior claims.		
Unsecured nature	The instrument is not secured, not covered by a guarantee of the Institution or of an affiliate of the Institution, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument	The instrument is not secured, not covered by a guarantee of the Institution or of an affiliate of the Institution, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument	The instrument is not secured, not covered by a guarantee of the Institution or of an affiliate of the Institution, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument
Maturity	The instrument has no maturity date, can only be redeemed via discretionary repurchases with the prior approval of the applicable regulator, and does not contain any term or feature that creates an incentive to redeem	The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem	The instrument has a minimum original maturity of at least five years. At the beginning of each of the last five years of the life of the instrument, the amount that is eligible to be included in tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
			regulatory capital when the remaining maturity is less than one year. In addition, the instrument must not have any terms or features that require, or create significant incentives for, the Institution to redeem the instrument prior to maturity[33]
Call feature; redemption	The Institution did not create at issuance of the instrument through any action or communication an expectation that it will buy back, cancel, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation	If callable by its terms, the instrument may be called by the Institution only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called earlier than five years upon the occurrence of a regulatory event that precludes the instrument from being included in additional tier 1 capital, a tax event, or if the issuing entity is required to register as an investment company pursuant to the Investment Company Act. In addition: (A) The Institution must receive prior approval from the applicable regulator to exercise a call option on the instrument. (B) The Institution does	The instrument, by its terms, may be called by the Institution only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in tier 2 capital, a tax event, or if the issuing entity is required to register as an investment company pursuant to the Investment Company Act. In addition: (A) The Institution must receive the prior approval of the applicable regulator to exercise a call option on the instrument. (B) The Institution does not create at issuance,

[33] An instrument that by its terms automatically converts into a tier 1 capital instrument prior to five years after issuance complies with the five-year maturity requirement of this criterion.

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
		not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised. (C) Prior to exercising the call option, or immediately thereafter, the Institution must either: Replace the instrument to be called with an equal amount of instruments that meet the criteria for regulatory capital[34] or demonstrate to the satisfaction of the applicable regulator that following redemption, the Institution will continue to hold capital commensurate with its risk.	through action or communication, an expectation the call option will be exercised. (C) Prior to exercising the call option, or immediately thereafter, the Institution must either: Replace any amount called with an equivalent amount of an instrument that meets the criteria for regulatory capital[35] or demonstrate to the satisfaction of the applicable regulator that following redemption, the Institution would continue to hold an amount of capital that is commensurate with its risk.
Regulatory approval of redemption		Redemption or repurchase of the instrument requires prior approval from the applicable regulator.	Redemption of the instrument prior to maturity or repurchase requires the prior approval of the applicable regulator.
Deferral of dividends	The Institution has full discretion at all times to refrain from paying any dividends and making any other distributions on the instrument without triggering an event of default, a requirement to make a	The Institution has full discretion at all times to cancel dividends or other distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other	The holder of the instrument must have no contractual right to accelerate payment of principal or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar

[34] Replacement can be concurrent with redemption of existing additional tier 1 capital instruments.
[35] A FDIC-supervised institution may replace tier 2 capital instruments concurrent with the redemption of existing tier 2 capital instruments.

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
	payment-in-kind, or an imposition of any other restrictions on the Institution.	restrictions on the Institution except in relation to any distributions to holders of common stock or instruments that are *pari passu* with the instrument.	proceeding of the Institution.
Source of dividends	Any cash dividend payments on the instrument are paid out of the Institution's net income and retained earnings and are not subject to a limit imposed by the contractual terms governing the instrument. An Institution must obtain prior Regulatory approval for any dividend payment involving a reduction or retirement of capital.	Any cash dividend payments on the instrument are paid out of the Institution's net income and retained earnings and are not subject to a limit imposed by the contractual terms governing the instrument. An Institution must obtain prior Regulatory approval for any dividend payment involving a reduction or retirement of capital.	
Prohibition on credit-sensitive features		The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or in part on the Institution's credit quality, but may have a dividend rate that is adjusted periodically independent of the Institution's credit quality, in relation to general market interest rates or similar adjustments.	The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the Institution's credit standing, but may have a dividend rate that is adjusted periodically independent of the Institution's credit standing, in relation to general market interest rates or similar adjustments.

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
Equity treatment under GAAP	The paid-in amount is classified as equity under GAAP.	The paid-in amount is classified as equity under GAAP.	
No institution funding	The Institution, or an entity that the Institution controls, did not purchase or directly or indirectly fund the purchase of the instrument.	The Institution, or an entity that the Institution controls, did not purchase or directly or indirectly fund the purchase of the instrument.	The Institution, or an entity that the Institution controls, has not purchased and has not directly or indirectly funded the purchase of the instrument.
No anti-dilution or similar features		The instrument does not have any features that would limit or discourage additional issuance of capital by the Institution, such as provisions that require the Institution to compensate holders of the instrument if a new instrument is issued at a lower price during a specified time frame.	
Special purpose vehicles		If the instrument is not issued directly by the Institution or by a subsidiary of the Institution that is an operating entity, the only asset of the issuing entity is its investment in the capital of the Institution, and proceeds must be immediately available without limitation to the Institution or to the Institution's top-tier holding company in a form which meets or exceeds all of the other criteria for additional	If the instrument is not issued directly by the Institution or by a subsidiary of the Institution that is an operating entity, the only asset of the issuing entity is its investment in the capital of the Institution, and proceeds must be immediately available without limitation to the Institution or the Institution's top-tier holding company in a form that meets or exceeds all the other criteria for tier 2 capital

Characteristic	Common Equity Tier 1	Additional Tier 1	Tier 2
		tier 1 capital instruments.[36]	instruments.[37]
Disclosure requirement for advanced approaches Institutions		For an advanced approaches Institution, the governing agreement, offering circular, or prospectus of an instrument must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the Institution enters into a receivership, insolvency, liquidation, or similar proceeding.	For an advanced approaches Institution, the governing agreement, offering circular, or prospectus of an instrument must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the Institution enters into a receivership, insolvency, liquidation, or similar proceeding.
Other requirements	The instrument (a) has been issued in accordance with applicable laws and regulations; and (b) is reported on the Institution's regulatory financial statements separately from other capital instruments.		

[36] See 77 Fed. Reg. 52856 (August 30, 2012).
[37] A FDIC-supervised institution may disregard de minimis assets related to the operation of the issuing entity for purposes of this criterion.

APPENDIX 2

ADDITIONAL CHANGES NEEDED TO NCUA REGULATIONS

Section	Change Needed
§700.2 Definitions.	"Unimpaired capital and surplus" definition should be revised to include supplemental capital
§701.21 Loans to members and lines of credit to members	(c)(5) reference to "unimpaired capital and surplus" in ten percent limit should include supplemental capital (c)(7)(iii) reference to "net worth" in limitations on payday alternative loans should include supplemental capital (h) references to "net worth" in limitations on third party servicing of indirect automobile loans should include supplemental capital
§701.22 Loan participations	(b)(5) references to "net worth" in limitations on participations in loans should include supplemental capital
§701.23 Purchase, sale, and pledge of eligible obligations	(b)(2) reference to "risk-based net worth (RBNW)" should use terminology consistent with other NCUA regulations (*e.g.*, "risk-based capital") (b)(4) reference to "unimpaired capital and surplus" should include supplemental capital (f) reference to "unimpaired capital and surplus" should include supplemental capital
§701.34 Designation of low income status; Acceptance of secondary capital accounts by low-income designated credit unions	Should be revised to permit all credit unions to accept and redeem secondary capital accounts
§703.5 Discretionary control over investments and investment advisers	(b)(1)(ii) reference to "net worth" in limitation on use of investment advisers should include supplemental capital (b)(2) reference to "net worth" in review of investment advisers should include supplemental capital
§703.12 Monitoring securities	(c)(3) reference to "net worth" should include supplemental capital
§703.13 Permissible investment	(d)(3)(ii) reference to "net worth" in limitation on securities borrowing and repurchase transactions should

Section	Change Needed
activities	include supplemental capital (d)(3)(iii) reference to "net worth" in limitation on securities borrowing and repurchase transactions should include supplemental capital; reference to "risk-based net worth (RBNW)" should use terminology consistent with other NCUA regulations (*e.g.*, "risk-based capital")
§703.14 Permissible investments	(e) reference to "net worth" in limitation on investments in municipal securities should include supplemental capital. (g)(11) reference to "net worth" in limitation on investments in equity-linked member share certificates should include supplemental capital (h)(1) reference to "net worth" in limitation on mortgage loan repurchase transactions should include supplemental capital (i) reference to "risk-based net worth (RBNW)" should use terminology consistent with other NCUA regulations (*e.g.*, "risk-based capital") (j)(4) reference to "net worth" in limitation on investments in commercial mortgage related securities should include supplemental capital; reference to "risk-based net worth (RBNW)" should use terminology consistent with other NCUA regulations (*e.g.*, "risk-based capital")
§703.18 Grandfathered investments	(b) reference to "net worth" should include supplemental capital to coincide with recommended change in §703.14(i)
§703.20 Request for additional authority	(a)(3) reference to "net worth" should include supplemental capital
§703.103 Derivative authority	(a) references to "net worth" should include supplemental capital to coincide with recommended change in §703.14(i)
§709.5 Payout priorities in involuntary liquidation	(b)(8) should be revised to include all supplemental capital, not just secondary capital accounts issued by low income credit unions
§712.2 How much can an FCU invest in or loan to CUSOs, and what parties may participate?	(a) reference to "unimpaired capital and surplus" should include supplemental capital (b) reference to "unimpaired capital and surplus" should

Section	Change Needed
	include supplemental capital (d)(2)(i) reference to "unimpaired capital and surplus" should include supplemental capital
§713.6 What is the permissible deductible?	(c) reference to "risk-based net worth (RBNW)" should use terminology consistent with other NCUA regulations (*e.g.*, "risk-based capital")
§721.3 What categories of activities are preapproved as incidental powers necessary or requisite to carry on a credit union's business?	(i) reference to "net worth" in limitation on investment in charitable donation accounts should include supplemental capital
§741.204 Maximum public unit and nonmember accounts, and low-income designation	(c) Should be revised to permit all credit unions to accept secondary capital accounts (d) Should be revised to permit all credit unions to redeem secondary capital accounts