April 25, 2017

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

Re: Comment on Advanced Notice of Proposed Rulemaking for Supplemental Capital

Dear Mr. Poliquin:

The National Credit Union Administration (NCUA) Board (the Board) has issued an Advanced Notice of Proposed Rulemaking (ANPR) regarding alternative capital for complex credit unions.

The ANPR addresses numerous 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, and seeks comments on any and all aspects of alternative capital.

<u>Background</u>

The Federal Credit Union Act (FCUA) 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. The FCUA specifically defines the net worth ratio as net worth to total assets; but provides the Board with discretion to design the risk-based net worth requirement.

The FCUA also defines what constitutes net worth and does not give NCUA the authority to change the definition of net worth.

In addition, the FCUA only permits low-income designated credit unions to issue secondary capital, which can count toward their net worth ratios. NCUA further counts secondary capital issued by complex low-income designated credit unions as net worth for the risk-based net worth ratio.

<u>Position</u>

Alternative capital is a complex issue. The Board should be commended for seeking input on this issue.

However, I believe that complex credit unions that are not low-income designated do not have the legal authority under the FCUA to issue alternative or supplemental capital to meet their risk-based net worth requirements.

Can NCUA Legally Authorize Alternative Capital?

The Board is seeking insights on whether complex credit unions that are not low-income designated have the legal authority to issue alternative capital.

The ANPR states that the FCUA "did not define the risk-based net worth requirement, nor how to calculate any corresponding risk-based ratio." The Board concludes that "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."

The ANPR further notes that the FCUA gives federal credit unions broad authority to borrow. According to the ANPR, the only form of borrowing that could count as supplemental capital is subordinated debt. Subordinated debt is the only "instrument that is uninsured and could be structured as loss absorbing capital."

While the Board correctly acknowledges that FCUA gives federal credit unions' authority to borrow and grants the Board discretion to design a risk-based net worth requirement, the Board has overstated its legal authority in allowing complex credit unions that are not low-income designated to issue supplemental or alternative capital. The risk-based net worth requirement specifically contains the language "net worth." The Board is seeking to rewrite the FCUA to expand the numerator of the risk based net worth ratio to include items that are not part of the statutory definition of net worth. If Congress intended to allow complex credit unions to issue supplemental capital, it would have authorized supplemental capital when it enacted Section 1790d(d) of the FCUA in 1998.

Moreover, it is unlikely that any rule that allows complex credit unions to issue alternative capital would withstand a possible legal challenge.

Unfortunately, I believe that the Board is hell-bent on permitting complex credit unions the power to issue alternative capital. The remainder of this comment letter will focus on a myriad of issues identified by the ANPR.

What Impact Will Supplemental Capital Have on Credit Unions' Tax Exempt Status?

The FCUA 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. 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.

The Board recognizes that supplemental capital could have an impact on the credit union tax exemption. The ANPR states "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." If all credit unions, not just low-income designated credit unions, have the ability to access the capital markets to raise capital, it could call into question the credit union tax exemption. If the Board is worried that granting all credit unions access to the capital markets could threaten the credit union tax exemption, then the Board should not move forward with the proposal to allow all credit unions access to capital markets.

In addition, the ANPR notes that for federally insured state chartered credit unions their tax exemption is tied to being without capital stock. However, the problem is there is no definition of capital stock used by the Internal Revenue Services (IRS). The Board writes that in some states it is possible that supplemental capital instruments issued by federally insured state chartered credit unions could have the characteristics of capital stock, which could subject themselves to taxation. The Board is requesting 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 or should it require 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.

It my opinion that the Board should require a federally insured state chartered credit union to provide a formal opinion letter from the IRS that the supplemental capital instrument is not classified as capital stock.

What Will Be the Demand for Alternative Capital?

While it is difficult to predict, the available evidence would suggest that there will not be a large number of complex credit unions issuing supplemental capital.

Currently, most credit unions have enough capital to meet their organic growth and don't need additional capital.

Also, low-income designated credit unions already have the statutory ability to issue secondary capital, which counts towards a credit union's net worth. But only 73 low-income designated credit unions (or 3 percent of low-income designated credit unions) reported holding secondary capital, as of June 30, 2016. Since December 31, 2011, the number of low-income designated credit unions with outstanding secondary capital ranged between 72 and 79.

Furthermore, supplemental capital will not count towards a complex credit union's net worth. According to the ANPR, supplemental capital would only count towards a complex credit union's risk-based capital ratio.

The NCUA Board believes that 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." NCUA estimates that 140 credit unions might issue supplemental capital to boost their risk-based capital ratio.

Moreover, supplemental capital could be very expensive for credit unions, limiting its attractiveness. The ANPR states that the interest rate paid by community banks on subordinated debt was 300 to 400 basis points above the interest rates on ten-year Treasury note. 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.

Therefore, the available evidence indicates that credit unions will not be a strong demand for complex credit unions to issue subordinated debt.

What Will Be the Impact of Supplemental Capital on Mutual Ownership Structure?

The National Credit Union Administration (NCUA) Board is inviting comments on the potential effect supplemental capital may have on the mutual ownership structure and governance of credit unions. Specifically, the Board is exploring whether it should impose restrictions, such as non-voting and limits on covenants, in the investment agreement that may give investors levels of control over the credit union.

The Board believes that federal credit unions can issue supplemental capital only as subordinated debt. Debt holders do not have an ownership interest and cannot vote. It would not endanger the one member one vote structure of credit unions. So, the issuing of supplemental capital will not affect the mutual ownership structure of credit unions.

Should the Use of Covenants in the Investment Agreement Be Limited?

With respect to covenants, NCUA needs to balance the interest of investors with those of regulators. Clearly, covenants in the investment agreement should not impede the authority of NCUA or a State Supervisory Authority to undertake supervisory action. In addition, the covenants should not require credit unions to violate applicable laws or regulations. However, the Board needs to recognize that these covenants protect the interest of the investors in supplemental capital. Therefore, NCUA should not pursue regulations that abridge the rights of investors.

Also, the Board should address what happens to a credit union if it is in violation of its covenants in the investment agreement.

Who Should Be Allowed to Invest in Supplemental Capital Instruments?

The NCUA Board is requesting 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.

The NCUA Board should not allow anyone to purchase secondary or supplemental capital. This product would not be suitable investment for people lacking the appropriate level of financial sophistication.

NCUA could either require credit unions issuing alternative capital to comply with the Security and Exchange Commission's Regulation D or issue regulations comparable to Regulation D.

Under Regulation D, an organization can issue debt or equity through a private offering without officially registering the offering to "go public". This exemption reduces the amount of paperwork required, lessening the time and money it takes to actually raise capital.

However, the Securities and Exchange Commission encourages or requires companies to work with accredited investors when raising capital through a private offering. The rule gives room for 35 non-accredited investors to participate so long as disclosure requirements are met and any non-accredited investor must be a sophisticated investor.

Accredited investor is defined as an individual that has made $200,000 or more on an annual basis for the past two out of three years and is likely to make that same amount this year. If it is a couple qualifying together that amount is raised to $300,000. If they do not meet the income requirements, they can qualify using a net worth of over $1 million excluding their primary residence.

A sophisticated investor is defined as someone that has superior knowledge of business and financial matters.

Another possible option is to limit the purchasers of alternative capital to institutional investors. According to NCUA's Supplemental Capital Working Group, it believed that alternative capital instrument, which is subordinated debt, should be limited to only institutional investors.

What Should NCUA Do to Protect Supplemental Capital Investors?

NCUA needs to incorporate by regulation consumer protection measures to benefit the supplemental capital investor. The regulation should require credit unions issuing supplemental capital have affirmative suitability determination requirements and clear and robust disclosure of the terms and risks of the supplemental capital instrument to ensure that the investor is fully-informed, including periodic reminders that a supplemental capital account is uninsured, will be applied to absorb losses to the extent they exceed retained earnings, and will not be replenished in that event.

As part of the disclosures for investors, credit unions must:

- Provide a prospectus clearly articulating the risks, including providing peer financial performance comparison data and federally insured credit union failure history over the relevant time horizon (20 or more years).
- Provide in advance of issuing the supplemental capital projections 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.
- Receive affirmative written acknowledgment that supplemental capital is uninsured and maintain these signed disclosures for the prescribed retention period. NCUA's Corporate Credit Union Regulation already requires a credit union investing in a corporate credit union to acknowledge in writing that their capital investment is uninsured and is at risk.[1]

[1] 12 CFR Section 704.3(b)(2)

- Provide the investor a copy of the most recent independent certified public accountant (CPA) opinion audit and credit union financial statements.

Other investor safeguards would include:

- Subjecting credit unions and their employees to administrative enforcement sanctions for the failure to carry out the affirmative disclosure and investor suitability obligations.
- Requiring credit unions to be at least adequately capitalized per prompt corrective action standards at the time of issuance. This would ensure a sufficient buffer of retained earnings to protect the investor and to mitigate reputation and financial risks at issuance.
- Requiring credit unions to receive an annual independent CPA opinion audit. This ensures transparency in financial reporting.
- Requiring credit unions to comply with disclosure and transparency standards (e.g., executive compensation) comparable to publicly owned institutions.
- Requiring credit unions to segregate the selling of alternative capital from the place where insured deposits are gathered. This would further ensure that there is no confusion about insured status of alternative capital.
- Requiring credit unions to receive prior approval of the regulator. The regulator must determine for the written record that the credit union is not in danger of failure in the foreseeable future (e.g., 18 months) and the credit union's plans for issuing alternative capital meet all investor disclosure and suitability requirements.

How Should NCUA Adjust for Reciprocal Holdings of Alternative Capital?

The Board is also seeking comment on reciprocal holdings of alternative capital. Reciprocal holdings exist when two or more credit unions hold each other's alternative capital.

However, reciprocal holdings of alternative capital, without some form of adjustment, would artificially inflate the level of capital in the credit union system and could create loss transmission channels between credit unions.

The Board needs to issue regulation that would address this interdependency risk.

For example, the ANPR points out that 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.

Therefore, if a complex federally-insured credit union buys alternative capital issued by another federally-insured credit union, the Board should require the buying credit union to deduct from the numerator of the risk-based capital ratio the amount of the alternative capital purchased.

However, if the purchaser of the capital instrument is a non-complex credit union, NCUA should put in place regulations to limit exposure to a single issuer of supplemental capital, as well as to limit aggregate exposure to supplemental capital. This would limit the cascading of losses through the credit union industry and would protect the NCUSIF.

Other Issues

- *Limiting Supplemental Capital*

The Board is requesting comment on whether to limit the amount of supplemental capital that counts as regulatory capital.

According to the ANPR, the reliance on alternative capital as the primary source of capital is generally unsafe and unsound. Alternative capital lacks permanence and is a lower quality form of capital. Because of its lack of permanence, this could introduce volatility into the risk-based capital ratio as the alternative capital instrument enters its last five years of maturity.

Therefore, NCUA needs to limit the amount of alternative capital. For example, the Community Development Capital Initiative limited unsecured subordinated debt issued by credit unions to no more than 3.5 percent of their assets.[2] Alternatively, the Board could require retained earnings to account for more than 50 percent of the numerator of the risk-based capital ratio.

- *Director and Officer Liability Coverage*

The Board should require that credit unions certify that they have evaluated their policies and have sufficient director or officer liability coverage before beginning to issue secondary or supplemental capital. The ANPR notes that the issuing of securities could impact 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 Start Printed Page 9698ensure these activities are covered under their policy.

- *Prepayment and Call Provisions*

The NCUA will need to issue enabling regulations addressing prepayment and call provisions associated with supplemental capital.

NCUA should require that any redemption of supplemental capital would not cause a credit union to become less than adequately capitalized.

In addition, NCUA should be required to approve any prepayment or call provision before it allows a credit union to issue supplemental capital.

NCUA should also prohibit the exercise of a call option in the first five years following issuance.

---

[2] http://www.gao.gov/assets/690/680814.pdf

- *Sale of Supplemental Capital*

NCUA needs to address via regulation the ability of supplemental capital interest to be transferred. NCUA's Corporate Credit Union Regulation provides guidance regarding the transfer of interest in a nonperpetual capital account.

According to the Corporate Credit Union regulation, "[a]t least 14 days before consummating such a transfer, the member must notify the corporate credit union of the pending transfer. The corporate credit union must, within 10 days of such notice, provide the member and the potential transferee all financial information about the corporate credit union that is available to the public or that the corporate credit union has provided to its members, including any call report data submitted by the corporate credit union to NCUA but not yet posted on NCUA's Web site."[3]

Conclusion

In conclusion, I believe that the complex credit unions that are not low-income designated lack the legal authority to issue supplemental capital. The issuance of supplemental capital may jeopardize the credit union tax exemption. However, if the Board proceeds with issuing a proposed rule, the Board will face a myriad of issues that will need to be addressed.

Sincerely,

Keith Leggett

---

[3] 12 CFR 704.3(b)(6)