CMS | CU Capital Market Solutions

April 25, 2017

Gerald Poliquin, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA. 22314

Re: CU Capital Markets Solutions (CMS) - Comments on ***"Advance Notice of Proposed Rulemaking for Supplemental Capital"***

Sent by email: regcomments@ncua.gov

Mr. Poliquin,

CU Capital Markets Solutions (CMS) appreciates the opportunity to provide our thoughts regarding your "Advance Notice of Proposed Rulemaking for Supplemental Capital". CMS is a CUSO focused exclusively on the capital market activities of credit unions nationwide. Providing access to secondary capital for our clients is a significant focus of our firm and we strongly support the activities of the NCUA to enhance and expand the availability of "alternative capital" for the credit union industry.

As of 12/31/16, the total assets of all federally insured (NCUA/FDIC) financial institutions in the US were just over $18 trillion. As the table below illustrates, while the number of credit unions represented 50% of all federally insured institutions in the US, they had only 7.2% of the insured assets. Banks less than $10 billion (community banks) comprise 49% of all federally insured institutions and had 16.7% of the insured assets. Banks greater than $10 billion, while representing only 1% of all federally insured institutions, held 76% of the assets.

Federally Insured Financial Institutions (12/31/16):

Charter Type	# Inst.	% Total	Assets	% Total	Avg Inst
Credit Unions	5,909	50%	1,309,136	7%	222
Banks < $10B	5,799	49%	3,027,600	17%	522
Banks > $10B	114	1%	13,752,500	76%	120,636
Total	11,822	100%	18,089,236	100%	

Note: Assets Shown in Millions

The number of credit unions and the number of banks less than $10 billion (community banks) were virtually the same. But the average size of banks less than $10 billion was 235% larger than the average credit union ($522M vs. $222M). This disparity in size is a primary reason we at CMS believe strongly in the ability of LICUs to access secondary capital. While statistics show consumers recognize the benefits of credit unions, to be both relevant and successful in a competitive business like today's financial services market requires asset size. Statistics taken from the 5300 reports at year-end 2016 show that as assets grow the following occurs:

- Membership Grows
- Loan Growth Grows
- Share Growth Grows
- Capital Grows
- Earnings Grow

The safety consumers demand against risks such as cyber-security and the conveniences they demand such as robust online banking (just to name one) requires size to cover the operational costs of providing such services. For credit unions to continue to be relevant and provide a real alternative to individuals seeking financial services, it is the opinion of CMS that credit unions must grow in asset size. At the same time, the pace of growth cannot be limited to just retained earnings for low-income designated credit unions or they or credit unions will fall further behind their competitors and eventually become irrelevant.

CU Metrics (12/31/16):

Metric	**< $10mln**	**$10-$50mln**	**$50-$100mln**	**$100-$500mln**	**> $500mln**
Number of CU's	1,691	1,887	746	1,074	511
Net Worth Ratio	15.16%	12.38%	11.50%	10.93%	10.75%
Capital Growth	0.12%	2.19%	3.30%	4.86%	8.09%
Loan Growth	1.43%	4.06%	6.14%	8.47%	11.89%
Membership Growth	-1.73%	-0.61%	1.14%	2.36%	6.34%
Share Growth	0.62%	3.04%	4.25%	5.70%	9.20%
ROA	0.05%	0.26%	0.38%	0.53%	0.88%
ROE	0.32%	2.12%	3.40%	4.93%	8.41%
Asset Growth	0.55%	2.96%	4.14%	5.71%	8.84%
Income Growth	1.14%	3.17%	4.52%	6.50%	10.50%
Expense Growth	1.74%	3.01%	4.29%	5.96%	8.57%

Secondary Capital Activities to Date:

As pointed out in the ANPR, there are currently 77 LICUs that have $181M in secondary capital on their books. If one excludes the 4 institutions that represent 74% of the outstanding amount ($134M), then you are down to 73 LICUs with $47M in secondary capital, or an average of $665K per LICU. Of those 73 LICUs, 32 LICUs (44%) would have net worth less than 7% if the secondary capital were excluded. A majority of the LICUs are less than $50M in total assets.

As the board noted, low-income designated credit unions that have issued secondary capital have a higher failure rate than other low-income designated credit unions. These failures have resulted in losses to the insurance fund. This result should not be surprising if one evaluates statistics in the industry. As noted in the table above, institutions with assets less than $50M are at a higher risk due to the decline in member growth, loan growth, share growth and earnings growth. This fact is reinforced if one looks at the closure of credit unions since the financial crisis. As the table below illustrates, 83% of all closings from 2009 to the present are applicable to credit unions less than $50M in total assets, and the number of closings has remained reasonably consistent year-by-year. As the assets climb above $50M, the number of closings diminishes rapidly, and those that did close were predominately in the early years of the crisis.

Year	Closings	<50	50-100	100-150	150-250	>250	Total
2009	15	8	3	2	1	1	15
2010	18	13	0	4	1	0	18
2011	18	14	1	1	1	1	18
2012	14	12	0	1	0	1	14
2013	18	18	0	0	0	0	18
2014	10	9	1	0	0	0	10
2015	12	11	0	1	0	0	12
2016	12	12	0	0	0	0	12
2017	1	1	0	0	0	0	1
	118	98	5	9	3	3	118
%		83.1%	4.2%	7.6%	2.5%	2.5%	100.0%

There were five items identified by the NCUA in the ANPR that contributed to LICU failures that took secondary capital. The five items are as follows:

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

While we don’t doubt that the 5 items listed above were contributing factors, we also see from the statistics that LICUs less than $50M in total assets are generally at a disadvantage due simply to market conditions affecting smaller institutions. When one also considers that 44% of the recipients of secondary capital to date would have a net worth ratio less than 7% if the secondary capital were excluded, then it is clear secondary capital to date has been used primarily to supplement existing capital levels and not to expand existing operations.

We don’t believe that the performance results to date regarding secondary capital are representative of how secondary capital could positively impact the industry. The results from smaller LICUs that use secondary capital “shore up” existing capital levels should not be compared to larger, well-capitalized institutions that seek secondary capital to accelerate growth and improve their competitive position. We believe there is a clear distinction between secondary capital activities in LICUs less than $50M and those greater than $50M, and guidelines adopted should be different for each.

This is not to suggest that secondary capital should not be available to all credit unions. However, we do believe there is a distinct difference in the providers of capital to institutions less than $50M in total assets and those greater than $50M in total assets. The work done by the National Federation of Community Development Credit Unions has been significant to address the needs of smaller LICUs, but their activities are totally different than institutional investors that are available to fund larger institutions. Since the business model of CMS is focused primarily on institutions greater than $50M in total assets, our comments to the questions posed below will be with that context in mind.

Further, our comments will primarily address issues surrounding secondary capital as opposed to both secondary capital and supplemental capital. While CMS strongly supports NCUA efforts to expand access to alternative capital in all forms to help “level the playing field” with other insured depositories, based on the information provided in the table on page 18 of the ANPR, CMS does not have enough information available to provide informed comments. In the table on page 18 of the ANPR, the NCUA cited 140 institutions with a net worth ratio greater than 8% and an estimated risk-based capital ratio less than 13.5%. Based on the metrics provided, the average assets of these 140 CUs were just over $800M and the amount of supplemental capital needed by the 140 CUs to achieve a 13.5% risk-based capital ratio was estimated at $1.0B.

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

1. ***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.***

Answer: It is the opinion of CMS that given the “Disclosure and Acknowledgment” provisions incorporated in the Appendix to 12 CFR 701.34 this is an unsuitable instrument for individuals or non-institutional investors. Individual investors should not be expected to fully understand the broad scope of authority the NCUA has in implementing prompt corrective action.

2. ***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.***

Answer: It is the opinion of CMS that added call options embedded in investor loan agreements will come at an additional cost to the LICU and are probably not worth the cost. Secondary capital raised by LICUs is intended to be structured in the form of long-term obligations and initial plans should provide for the utilization of the capital through the period in which it no longer counts as net worth.

3. ***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.***

Answer: CMS is generally of the opinion that the NCUA approval process is necessary to eliminate the 5 items identified above (page 3), which have contributed to previous failures. The one exception that does make sense is for LICUs with prior experience in issuing secondary capital that are at a minimum adequately capitalized.

4. ***Inclusion of more flexibility to fund dividend payments as an operating loss if provided for in the contract.***

Answer: It is our belief that the purpose of secondary capital is intended to support existing capital levels and dividends should be accrued (paid at a later date) but not paid immediately in the event of an operating loss.

5. ***Any other prudential restrictions on secondary capital that should be considered.***

Answer: CMS would recommend that periodically (at least annually) a LICU's actual results should be compared to the original plan submitted to the NCUA for approval and any differences should be addressed.

6. ***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.***

Answer: CMS supports any regulatory actions that improve the clarity of the regulation.

Approval to Issue Alternative Capital and Provide a Notice of Issuance:

7. ***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.***

Answer: The need for the NCUA to eliminate typical loan provisions for lenders to retain flexibility to address problems should they arise will come with a significant cost. Lenders willing to accept the loan provisions required by the NCUA will do so only if they are fairly compensated for the additional risk they assume. Rates referenced in the ANPR of 300-400 bps over 10-year treasuries plus a 1%-3% fee, plus legal and operational costs, are not out of line.

The sub-debt market for community banks is a mature market and there will likely be a "premium" initially attached for LICUs. CMS is constantly looking for ways to reduce the cost of capital and has previously submitted a letter to the NCUA legal department with ideas that could reduce costs for LICU issuers and increase protection for the NCUA share insurance fund.

8. ***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.***

Answer: CMS is generally of the opinion that the NCUA approval process is necessary to eliminate the 5 items identified above (page 3), that have contributed to previous failures. The one exception that does make sense is for LICUs with prior experience in issuing secondary capital and that are well capitalized.

9. ***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.***

Answer: CMS is comfortable with the NCUA's current application requirements for secondary capital. It will take time to complete final lender negotiations and approvals that will be necessary after the NCUA grants approval to raise secondary capital. It would seem that somewhere in the 90- to180-day time frame would not be out of line.

10. ***The Board request comment on the evaluation 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.***

Answer: Since secondary capital issuances are typically 10-year transactions, the NCUA should carefully evaluate applications submitted. CMS believes that the LICU's past performance, current strategic plan and long-term financial plan should be prepared with sufficient details to support the request. In addition, the plan should support the liquidity and earnings necessary to retire the secondary capital raised. Finally, a contingency plan should be put in place that assumes growth projections in the financial plan are not recognized. In no case should credit unions in danger of failing be approved for secondary capital.

11. ***The Board seeks comment on the manner of and what should be included in any post-issuance notice credit unions would file with NCUA.***

Answer: It would seem reasonable that final loan documents should be filed with the NCUA shortly after execution by the parties.

<u>701.32 - Payment on shares by non-members</u>

12. 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.

Answer: As LICUs issue secondary capital to grow their balance sheet and expand member services, member loans and member deposits may not grow at the same pace. If member loans outpace member deposits, the need for non-member funding will arise at least temporarily. As a result, the current 20% non-member deposit limit can restrain the growth of the LICU and in our opinion should be increased to 40%. Since the price difference between non-member deposits and member deposits will encourage LICUs to actively seek member deposits, any growth in non-member deposits will be temporary.

Submitted by: **CU Capital Market Solutions, LLC**
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