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

May 8, 2017

Dear Mr. Poliquin,

Thank you for the opportunity to provide comments for the proposed rulemaking on alternative capital. Following are our comments:

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?

It is our view that supplemental capital should be included in the numerator for the RBC calculation. From a pragmatic perspective given statutory capital requirements and the way that RBC is calculated very few credit unions would benefit from its inclusion in the current environment. For a credit union to benefit from supplemental capital it would need to have a substantial allocation to assets above the 75% weighting and more likely, a substantial allocation to assets in the 150% weighting categories and above. While many credit unions have some assets in the higher weighting categories, few have enough assets in these categories to cause a shortfall of RBC.

Even though it would benefit few credit unions in the current environment, for reasons discussed in the answers to other question, it should be included, in the numerator of the RBC calculation.

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 GAAP and the Act, and why?

There are a number of specific criteria required in order for supplemental capital to be compliant with GAAP and the Act. Perhaps the most important of these is that the terms of any capital need to be such that the holders would not be able to have control over the credit union given any event including default. Control needs to remain with each credit union's members or in the event of conservatorship, with either the NCUA or state regulator. The Act lays out that the members via their board of directors govern their credit unions except given conservatorship.

There also need to be criteria that ensures that any supplemental capital does not deteriorate the economic value of the credit union to its members, or benefit one group of members over others within the membership. The Act refers to the fiduciary responsibilities of credit union boards, management, employees and certain third party affiliates. In order to meet these obligations supplemental capital must benefit the membership. For example, the rate paid on it must be commensurate with the inherent risks and it cannot be designed in such a way that it performs as an equity instrument. For example, it would not be appropriate for the return to be calculated as a percentage of credit union Net Income or for returns to be generated by drawing down members' equity if there are not sufficient earnings.

If certain forms of certificates of indebtedness were included in the RBC ratio numerator, what specific criteria should such certificates reasonably be consistent with GAAP and the Act, and why?

Since inclusion in a regulatory ratio is not directly part of GAAP, the real concern becomes the Act. Section 1790d contains language that speaks to the cooperative nature of credit unions and that they do not issue capital stock. For this and other reasons, the certificates should not have the ability to be structured such that the owners of the certificates would be viewed as equity owners or so that the terms and conditions of the certificates would potentially give them control of the credit union.

In addition to amending NCUA's RBC regulations, what additional changes to NCUA regulations would be required to count additional supplemental forms of capital in NCUA's RBC ratio numerator?

Changes to Parts 741.4(b), Part 741.9 and Part 745 are discussed later in this document.

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?

We are not aware of state permitted supplemental capital.

What investor suitability, consumer protection, and disclosure requirements should be put in place related to additional forms of supplemental capital?

It is our view that these requirements should be substantially similar to those required of OCC regulated institutions.

Projections on the volume of supplemental capital that credit unions would likely issue:

The volume that credit unions will issue is heavily dependent upon how it is used. There will not likely be substantial volumes issued due to a need to increase RBC, as there are relatively few credit unions with sufficient statutory capital but a need for additional RBC. The more likely uses of supplementary capital will be either to prepare proactively for a change in federal statutes that would allow for supplemental capital or to allow members to obtain supplemental capital to more fully participate financially in their cooperative credit union.

Because credit unions have not had the ability to issue supplemental capital in the past there is not a significant amount of precedent for projecting issuance given enabling regulation.

Structures of supplemental capital instruments, what would be beneficial:

There are a number of structures that would be potentially beneficial. These structures include perpetual, amortizing, callable with extended notice, and due at time of a predefined event.

Perpetual capital offers the credit union a long-term source of capital and funding and it provides the investor with an instrument with limited reinvestment risk.

Amortizing offers the credit union a predictable base of capital and allows the investor access to a predetermined series of cash flows.

Callable with extended notice offers the investor the ability to have their principal returned while the extended call feature would give the credit union time to replace the capital that is set to be paid out. We would recommend a minimum call notice period of five years.

Due at a predetermined event would give the credit union predictability while giving the purchaser some flexibility. For natural person purchasers, predetermined events could include attainment of a particular age, death, or a child reaching a particular age. Such capital would provide the benefit of being able to fund predictable life events.

Why credit unions will issue supplemental capital:

As indicated in the previous answer, the most likely reason is to prepare for a change in federal statutes or to allow members to more deeply participate in their cooperative. It is possible that some credit unions, especially those with significant exposure to significant concentrations in high RBC ratio assets such a MBLs or Home Equity loans, will issue capital to avoid issues with insufficient RBC.

How it fits into the credit unions' business model:

Fit with business model will depend on the credit union. For those with a high exposure to high RBC ratio assets, it will be used to avoid regulatory issues and to provide protection to the insurance fund. For credit unions using it as a tool to provide for deeper member financial participation it could be used as an instrument that allows for the accumulation of patronage dividends that could be paid out at events such as retirement, a child pursuing education, or as a death benefit.

Who will purchase supplemental capital:

This will depend on the business model of the credit union. If it is used as a long-term patronage dividend program, then members. For credit unions with large exposures to MBLs, it could be the businesses that they serve. It could also be institutional investors such as philanthropic foundations, endowment funds, insurance companies, and given the long-term nature, it could include pension plans.

To avoid actual and perceived conflicts of interest we would recommend that insiders such as volunteers and executive level employees not be eligible purchasers.

Regarding issuance costs:

Issuance costs of publicly held securities have been high for a very long time and those costs continue to increase given ever-increasing regulations. As with other business decisions, credit union boards and their management teams are well positioned to weigh the benefits of a decision against the costs. We recommend that the credit unions' boards consider the costs prior to issuance but that it should not be specifically regulated.

If supplemental capital were issued in such a way that it is considered a security the best way to reduce cost would be to allow it to be issued via a private placement.

Should the Board require credit unions issuing alternative capital to register with the NCUA:

This should be a requirement because of the additional regulatory complexity that will evolve from issuance. For example, issuing credit unions may do so to take risks that they otherwise might not consider and they will in all likelihood expose themselves to regulatory oversight from other agencies.

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How could NCUA protect the Share Insurance Fund against potential anti-fraud claims that could impair the alternative capital's ability to cover losses?

There is likely no way to completely avoid this. An investor alleging fraud and ultimately prevailing in that claim would expose the fund to a potential loss. The risk to the fund could be mitigated by having bond coverage commensurate with the size of the outstanding supplemental capital and from a perspective of prudence; volunteers and executives should want such coverage. Other regulations could require issuing credit unions to utilize CPA firms that are subject to oversight by the Public Company Accounting Oversight Board and to have robust and independent internal audit functions. The Board should also consider regulations that require avoidance of certain practices that diminish internal controls and increase exposure to conflicts of interest and fraud such as nepotism at the volunteer, executive and senior levels of issuing credit unions.

Should the Board mandate disclosures all credit unions issuing alternative capital must provide to investors?

We recommend that in general that disclosures be similar to those required by the OCC. There should however be a carve out that allows for low income designated credit unions to issue secondary capital with the same disclosures required under current regulations. Put another way, regulatory requirements for low income designated credit unions should not increase.

The level of disclosure should not vary with the investor type.

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?

Yes. Allowing credit unions to issue alternative capital without these items already in place and functioning would be problematic. For example, a credit union may move forward with alternative capital without being able to ensure that it complies with anti-fraud requirements or even before the cost of such compliance is fully dimensioned by the issuing credit union.

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:

Presumably, the potential liability that would befall the volunteers and executives of a credit union issuing alternative capital should be sufficient motivation for them to ensure that they have sufficient coverage in the event of a bad outcome. For this reason, we do not recommend that it be a regulated requirement.

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:

Again, we do not recommend increasing the existing regulatory burden on low income designated credit unions issuing secondary capital. For credit unions issuing supplemental capital, policies should address communication of non-public information, the requirements of complying with contractual covenants for supplemental capital, and any regulatory requirements whether they relate to NCUA regulations or regulations from another agency with oversite of supplemental capital.

Should the sale of secondary and supplemental capital be limited to only institutional investors, accredited investors or allow anyone to purchase?

This should be left to the discretion of the board of each issuing credit union. Sales to each category have different levels of complexity, regulation and cost as well as differing motivations. For this reason, we recommend that the potential purchasers not be limited.

A credit union wishing to raise supplemental capital at a lower cost may wish to execute a private placement with an institutional investor(s) or accredited investor(s). Alternatively, a credit union wishing to allow for increased economic participation of its membership may wish to allow for sale to members of the credit union or to make a public offering.

There should be a limit to how much supplemental capital can be issued by a credit union in order to retain its cooperative nature. Supplemental capital should not have equity characteristics and it should never be allowed to be greater than a credit union's statutory capital at the time of issuance. Excessive amounts of supplemental capital could lead a board to be motivated by the interests of a group other than its members. Even if a group of members owns all of a credit unions supplemental capital the interests of the overall membership should come first.

State chartered credit unions have their tax exemption tied to Section 501 c (14) of the Internal Revenue Code and that exemption is based on not having capital stock. While federal credit unions have their tax exemption embedded in the Act, the issuance of capital stock with equity like characteristics would become a lightning rod for the repeal of the tax exemption. Loss of tax exemption would do more harm to the industry than supplemental capital would benefit the industry. This is another reason why we recommend against supplemental capital having equity like characteristics.

To protect the rights of members to govern the affairs of their credit union, supplemental capital should not have features or covenants that would allow for the holders of supplemental capital to take over the affairs of the credit union, to fill seats on the board of the credit union or to serve in management roles of the credit union.

Dividend expense as a non-operating expense, cancellation of interest payments on a permanent noncumulative basis and the conflict between the classification of dividend expense for secondary and supplemental capital:

From an economic perspective, dividends paid on shares are analogous to interest paid on deposits. Absent dividends, a credit union will find itself in an immediate liquidity crisis. The clearest solution is that the enabling regulation for supplemental capital needs to define dividends as an operating expense to be paid prior to and with priority over payments on supplemental capital interest while leaving the regulation surrounding interest payments on secondary capital as is.

The enabling regulation will need to define the source of any given interest payment to supplemental capital holders as strictly limited to the current and/or retained earnings of the credit union and to preclude accrual of interest for any payment that would exceed current or retained earnings or that would cause statutory capital to decline below 7.00%.

The exercise of a call option embedded in supplemental capital should be dependent upon regulatory approval. This is especially important given the mutual nature of the share insurance fund that could serve to transfer losses from supplemental capital holders to the members of other credit unions.

Criteria that does not allow a supplemental capital holder to take control of the institution and limits payments in adverse conditions in combination with illiquidity, increases the risk to the investor and thus the cost to the credit union. Without lifting these criteria, which we do not recommend, we have no suggestions for avoiding the cost.

What should be required in an application for authority to issue alternative capital, length of time to issue after approval, and what should be the evaluation criteria to approve or deny alternative capital, including danger of failure:

At a minimum, the application should address the changes to the credit union's business model and strategies that would occur subsequent to issuance. In addition, any expected changes in the overall risk level that the credit union would experience and the change in the risk exposure to the Insurance Fund should be addressed. Even though alternative capital can reduce the risk exposure of the Insurance Fund, additional risks could more than offset the mitigating effects of additional capital.

We recommend a time horizon of five years from approval to issuance. This length of time would allow the credit union to issue capital as its business model changes over time and to adjust to the increased costs of the alternative capital versus the explicit costs of capital from earnings retention. This timeframe would allow for staged issuance and for an effective and efficient implementation of a long-term strategy based on access to alternative capital.

The approval criteria should include the credit union's financial and risk performance over a preceding three-year period as well as pro forma financial projections utilizing alternative capital as well as pro forma projections should the credit union not have access to capital. Part of the process should be to include projections that test the sensitivity of the proposed strategy to a broad range of operating conditions and critical assumptions.

A credit union that is in danger of failure provides an interesting conundrum. On the one hand, new capital could mitigate losses to the fund but it would also run the risk of causing distrust of investor confidence of healthy credit unions that wish to raise alternative capital and also increase the potential for allegations of fraud. It is not recommended that credit unions with a meaningful possibility of failure be allowed to raise alternative capital.

Should regulations allow for different payment priorities:

It would be appropriate to allow for differing priorities. If individual investors are allowed to buy supplemental capital, and as expected no secondary market for that capital develops it would be appropriate to allow a credit union to prioritize payments under certain circumstances. For example, if an investor passes away and the amount of the investor's supplemental capital isn't material to the credit union's overall capital position, payment on death would be appropriate. It would also be appropriate to allow tranching such that different classes would have different payment priorities given adverse events. However, the relative risk levels of the varying tranches and the interaction between tranches should be fully disclosed as part of the offering.

Limits on the amount of supplemental capital included in regulatory capital calculations:

Given that credit unions are subject to a statutory tier 1 capital requirement of 7.00% to avoid PCA, and that supplemental capital isn't considered in the statutes, there is likely limited need to put in place regulatory limits on the amount of supplemental capital that can be used as regulatory capital. While the risk of such an issue between supplemental and statutory capital is remote, a limitation of 7.00% of assets would likely be appropriate because it would limit the amount of high ratio risk based assets that a credit union could have on its balance sheet.

How to reflect the increasingly limited utility as loss absorbing capital for supplemental capital approaching maturity:

The Basel concept of amortizing the amount of supplemental capital that can be included in the risk-based net worth requirement by 20% per year is appropriate. Many financial institution failures occur after large risks are placed on the balance sheet and the institutions' risk measurement practices fail to adequately detect them. While the time between assumption of excessive risks and failure can be long, the time from realization of the magnitude of mismeasured risk and failure tends to be short, typically much less than five years. For this reason, five years is appropriate.

Prepayment and call provisions for alternative capital and how should related requirements be structured:

Our preference would be that a credit union wishing to call or prepay alternative capital should be above both statutory and RBC requirements at the time of the notice of prepayment and/or call and should remain so until the prepayment and/or call is executed. They should also not be trending in a manner that would cause them to violate capital requirements within 24 months of the execution of the prepayment and/or call.

How should reciprocal capital holdings be addressed:

Because the economic nature of the Share Insurance Fund is a mutual form of insurance, any holdings by one credit union of another's alternative capital is reciprocal in nature. For this reason, capital should be reduced by the amount of investment in other credit unions' alternative capital.

Merging credit unions and how alternative capital should be treated post-merger:

Because of the cooperative nature of credit unions, any activity that would give the holder of supplemental capital an owner like role in merger decisions would be inappropriate. On the other hand, it is likely that the purchaser of supplemental capital would have considered many factors when purchasing supplemental capital. These factors include the geographic area served by the credit union, the effects of the credit union on the communities it serves as well as the governance provided by the credit union's board and the management team operating the credit union.

A merger would in many cases have substantial effects on the factors on which a supplemental capital purchaser based their decision. For this reason, and to protect supplemental capital holders in the event of a merger that is not in their best interest, any remaining supplemental capital of the non-surviving credit union should be repaid to investors at the time of merger via a regulatory requirement.

Contractual restrictions for alternative capital instruments:

As stated in other comments, the cooperative nature of credit unions and the need to maintain member control severely limits the covenants that can be placed in the contracts for alternative capital. Simply put, any covenant that would interfere with members' control or the ability of a regulator to step in when necessitated would not be appropriate. Nonetheless, a decision to merge a credit union out of existence should require that alternative capital be paid back or extinguished and this should be required by regulation. Similarly, members of a credit union's board, board committees, and its executives should not have ownership or beneficial ownership of the alternative capital of their credit union as this would in effect allow the holders of alternative capital to have governance and management authority over the credit union. Such a situation would shade alternative capital as an equity instrument.

We recommend that there be a requirement for any issuing credit union to obtain a legal opinion ensuring that the contractual provisions of alternative capital do not allow investors to control a credit union.

Limits placed on alternative capital as it relates to funding:

Because alternative capital is primarily for purposes other than funding, much lower limits are appropriate versus the limits placed on non-member deposits. We recommend that alternative capital be restricted to 10% of member shares at the year-end prior to issuance. This is in line with typical credit union statutory capital levels. This level is intentionally higher than the amount we recommend to be included in the RBC calculation.

Should criteria for obtaining low-income designation and issuing and including secondary capital as regulatory capital be in separate regulations:

For simplicity and clarity, these should be in separate regulations.

Part 741.4(b), Part 741.9, and Part 745.

Part 741.4(b) should be amended such that if a state chartered federally insured credit union could not issue uninsured alternative capital in such a manner that under state law that it would not be considered a share, share draft or share certificate account, that the credit union would not be able to issue alternative capital. As currently worded, this part would potentially insure alternative capital for state chartered federally insured credit unions depending on the structure of state law.

Part 741.9 should be amended to allow for the issuance of alternative capital that is issued to members, but is not considered membership shares and such that it allows for the issuance of uninsured alternative capital not covered by share insurance for reasons other than the exceedance of insurance limits.

Part 745 should be amended such that it clearly defines alternative capital as ineligible for share insurance.

Sincerely,

Brad Miller
SVP/CFO
Kitsap Credit Union