Corning Credit Union

Gary A. Grinnell, President and Chief Executive Officer

May 8, 2017

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

RE: Advance Notice of Proposed Rulemaking for Alternative Capital

Dear Mr. Poliquin:

On behalf of the Board and Management of Corning Federal Credit Union (CCU), I would like to take this opportunity to comment on the National Credit Union Administration's recent Advance Notice of Proposed Rulemaking for Alternative Capital.

By way of background, CCU is a $1.3 billion asset institution, serving more than 102,000 members. Our charter is multiple common bond, and we serve several underserved areas in our geographic markets in New York, North Carolina, and Pennsylvania.

We commend NCUA for initiating this rulemaking and exploring relief options for credit unions that must meet regulatory capital requirements. With respect to secondary capital, we welcome the opportunity to suggest modest improvements, such as additional flexibility during the preapproval stage for issuing credit unions and broader call options to encourage investor interest.

For a hundred years, and particularly over the past decade, credit unions have served as a vital source of capital and market liquidity in local communities. Credit unions have never engaged in the types of risky lending practices that led to the recent financial crisis, and unlike banks have not resorted to Federal government bailouts or cost taxpayers a dime. Banks scaled back their lending to small businesses and homebuyers during the recession, causing a liquidity crisis among middle-class borrowers. In many parts of the country, credit unions were the only lenders available to fill that gap. Were NCUA to offer a prudent regulatory framework for supplemental capital, it would grant credit unions an additional option to achieve long-term, stable growth and ensure the safety and soundness of the industry for the country's 110 million credit union members.

In response to critics who may believe any expansion of credit unions' ability to access capital markets threatens the viability of the credit union tax exemption, we offer the following arguments:

1. Low-income credit unions (LICUs) are already authorized to offer supplemental (secondary) capital by Congressional statute, originally enacted over four decades ago. With nearly half of credit unions designated as low-income today, the credit union movement has already shown that supplemental capital has no justifiable impact on the status of the credit union tax exemption. What is needed now from NCUA is practical, common-sense regulation to help LICUs establish cohesive, safe secondary capital programs.

2. Supplemental capital in the banking industry is structured as subordinated debt. In the event of insolvency, subordinated debt is tiered below every other liability in order of payment. The bank's stockholders ultimately own the debt to cover potential losses.

   For credit unions, supplemental capital would most likely also be structured as subordinated debt, a structure that would allow a credit union's owners to be protected in the case of potential losses. However, due to the unique non-for-profit cooperative structure of credit unions, the ultimate owners are the credit union's members, not stockholders. Therefore, because supplemental capital (like all credit union capital), is owned by the cooperative's member-owners, the expansion of supplemental capital options for credit unions would have no impact on the structural justification for the credit union tax exemption.

3. Ultimately, supplemental capital is a safety and soundness issue designed to help protect the share insurance fund from potential credit union losses. The full faith and credit of the U.S. government backs the National Credit Union Share Insurance Fund (NCUSIF). Anything that reduces the probability of any losses to that fund decreases the potential likelihood of future taxpayer bailouts, such as those that rocked the banking industry just a few years ago.

In CCU's opinion, any prudent framework for alternative capital should meet the following criteria:

1. Preserve the not-for-profit, mutual, member-owned, and cooperative structure of credit unions.
2. Ensure that the capital structure of credit unions is not fundamentally changed and that the safety and soundness of the credit union industry is preserved.
3. Provide a degree of permanence such that a sudden outflow of capital will not occur.
4. Ensure that any solution has a ready and available market.

CCU recommends creating a pilot program for alternative capital, similar to what the NCUA Board implemented for the derivatives rule.[1] By piloting supplemental capital with a select group of well-capitalized, well-managed credit unions, NCUA would be able to effectively monitor the effectiveness of the program and glean best practices that could benefit the entire industry.

[1] *See* 12 CFR 703.113.

It may be necessary to enact statutory amendments to provide meaningful alternative capital options for all credit unions; however, a regulatory capital framework would still offer increased flexibility to credit unions that must meet NCUA's risk-based net worth requirement.

We recommend the following approach for structuring and developing a prudent supplemental capital program for well-capitalized credit unions:

Supplemental Capital

CCU supports supplemental capital as an option for improving capital buffers, encouraging growth, and meeting regulatory capital requirements—so long as it is compatible with the not-for-profit, mutual, and cooperative structure of credit unions. Subordinated debt is one option that ensures such compatibility. We also expect appropriately structured supplemental capital to complement the mission and purpose of credit unions in a way that raises no question about the tax-exempt status of credit unions.

Of the three capital instruments identified in NCUA's April 2010 "Supplemental Capital White Paper," CCU believes that subordinated debt possesses characteristics that guarantee the greatest amount of compatibility with the Federal Credit Union Act and will also yield sufficient investor interest to develop a healthy supplemental capital market. CCU believes that subordinated debt should be the focus of NCUA's preliminary efforts.

We also feel that NCUA possesses the legal authority to allow federally-chartered credit unions to issue subordinated debt and count it toward risk-based net worth calculations. As the ANPR acknowledges, Congress has not defined risk-based net worth, which 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."[2] Because all forms of supplemental capital would be subordinate to the Share Insurance Fund (SIF) and only count toward satisfying credit unions' risk-based net worth ratio, NCUA may permit these types of capital instruments consistent with credit unions' borrowing authority.

If NCUA decides to allow natural person investors to purchase forms of supplemental capital, we recommend the creation of rules to clarify credit unions' borrowing authority. CCU also recommends NCUA design these rules to specify what types of supplemental capital instruments may be sold to natural person investors, if any, and in what amount.

1. *Prudential Safety and Soundness*

In general, the ability to issue supplemental capital would help credit unions adjust to changing economic conditions more effectively. When a credit union faces fluctuations in its financial outlook, it must rely on retained earnings to satisfy regulatory capital requirements. Because retained earnings accumulate slowly, the present cost of ensuring future financial stability is much higher for credit unions than banks, and the burden ultimately falls upon the member-owners, through the issuance of less attractive rates or a reduction in services. Supplemental

[2] *See* Advanced Notice of Proposed Rulemaking, Alternative Capital, 82 Fed. Reg. 9691, 9695 (Jan. 2017).

capital would introduce greater predictability and flexibility to the process of capital planning, ultimately saving money for members.

The Risk-Based Capital Rule will go into effect January 1, 2019, establishing a risk-based capital ratio of 10 percent for complex credit unions to qualify as "well-capitalized." Many credit unions may struggle to achieve their desired capitalization level because they lack access to capital in the financial markets. Although CCU does not presently fall within this category, we sympathize with credit unions facing this dilemma. Alternative capital frameworks can offer an additional option for credit unions to raise capital outside of retained earnings, quickly and efficiently.

Requiring credit unions to build capital exclusively through retained earnings impairs their adaptability and increases opportunity costs within every economic cycle, putting them at a significant competitive disadvantage relative to banks. A healthy, growing credit union operating in a favorable economic climate may have to forgo attractive opportunities to expand its market share and serve its members to maintain its required risk-based net worth ratio. Similarly, during an economic downturn, that same credit union may be forced to rebuild capital quickly by reducing share rates, raising loan rates, closing branches, or eliminating popular member services. Access to supplemental capital would allow credit unions to respond more effectively to opportunities and shocks and avoid unnecessary tradeoffs. In addition, allowing outside investors to purchase supplemental capital would help shift risk outside of the credit union industry and improve resiliency during economic downturns.

Supplemental capital structured as subordinated debt would offer credit unions the necessary leverage to meet their risk-based capital requirements while maintaining strong growth. CCU agrees that subordinated debt is analogous to Tier 2 capital, and as such, may need to meet additional risk-based requirements. In addition, supplemental capital could not exceed 50 percent of a credit union's paid-in and unimpaired capital pursuant to Section 107(9) of the FCU Act.

It may be prudent to model supplemental capital on certain features of NCUA's secondary capital framework to ensure that credit unions are adequately prepared to issue subordinated debt. For example, the requirement to seek prior approval from NCUA would be an essential prudential safeguard in a supplemental capital framework. As with secondary capital, NCUA would review a credit union's plans for issuing subordinated debt (or other forms of regulatory capital) and ensure that it does not involve an unsafe or unsound business strategy. The conditions outlined in 12 CFR 701.34(b) could serve as a starting point for such regulatory approval. At a minimum, credit unions should be adequately or well capitalized under Prompt Corrective Action (PCA) standards before receiving authorization to issue supplemental capital.

2. Preservation of Mutuality and Cooperative Structure of Credit Unions

Supplemental capital structured as subordinated debt is compatible with the mutual and cooperative structure of credit unions. Subordinated debt confers no voting rights, carries a fixed or floating interest rate, and would be subordinate to all other claims of the credit union (excepting secondary capital), including the claims of creditors and shareholders. As a result, investors would not be able to interfere with member control of credit unions.

In addition, subordinated debt is capable of satisfying all of the key requirements that NCUA has identified in the ANPR; namely, that supplemental capital must be uninsured, subordinate to all other claims against the credit union—including the claims of creditors, shareholders, and the

NCUSIF—available to cover operating losses in excess of the credit union's retained earnings, adhere to maturity limits as determined by the NCUA Board, and remain limited to those credit unions designated as sufficiently capitalized. These requirements are the same as those that apply to secondary capital, and as such, should raise no material concern about the cooperative status of credit unions.

As a matter of comparison, low-income designated credit unions have been able to count secondary capital toward net worth calculations since the passage of *Credit Union Membership Access Act of 1998* (CUMAA). Secondary capital resembles subordinated debt in all functional aspects and preserves the mutual and cooperative structure of credit unions. Accordingly, supplemental capital structured as subordinated debt should be viewed as equally accommodating so long as it avoids conflict with the FCU Act (i.e., only satisfies risk-based net worth requirements).

Supplemental capital will have no effect on credit unions' tax exempt status.

As mentioned earlier in this letter, CCU believes that supplemental capital structured as a form of regulatory capital does not raise any question regarding the tax-exempt status of credit unions. Subordinated debt would not offer voting rights, and restrictions on prescriptive covenants (like what exists for secondary capital) would easily limit interference with a credit union's governance and business planning.

Section 122 of the FCU Act (12 U.S.C. 1768) confers tax exempt status to FCUs, and does not reference capital structure. In addition, Congress' findings in CUMAA have since clarified that credit unions receive a tax exemption because they are "member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means."[3] Because subordinated debt does not alter these essential features, it should be viewed as wholly compatible with the legislative rationale for the credit union tax exemption.

3. Investor Safeguards

We believe it would be appropriate for NCUA to seek investor safeguards in proportion to investor sophistication. CCU agrees with the sentiments expressed in the ANPR that a lack of disclosure in specific cases could produce litigation risk for credit unions that may not only harm the individual credit union, but might also pose significant harm to the SIF. To guard against these possible risks while simultaneously providing a straightforward and accessible approval process for issuers of supplemental capital, NCUA should offer credit unions the greatest flexibility possible in pursuing investors. Below, we discuss considerations related to the potential types of investors mentioned in the ANPR.

Non-Natural Person Investors

CCU believes that allowing non-natural persons (institutional investors) to purchase alternative capital is non-controversial. Institutional investors are not sensitive to the same risks as natural person investors and possess the experience and expertise necessary to evaluate a credit union's

[3] Pub. L. 105–219, § 2, Aug. 7, 1998, 112 Stat. 913.

capital plan (as part of the preapproval process) and determine the risks associated with holding subordinated debt. To this end, we feel institutional investors would be adequately protected if NCUA required credit unions to provide the same "Disclosure and Acknowledgment" form that is used for offerings of secondary capital.

In addition, credit unions should be allowed to seek alternative capital from institutional investors outside of their membership. In terms of relative knowledge of investment risks, non-members are not any less sophisticated than members. In fact, it is probable that the initial market for subordinated debt among institutional non-member investors would be comprised of entities experienced in purchasing debt from other financial institutions, such as banks. We do not believe the differences between bank and credit union supplemental capital warrant a prohibition on non-member purchases.

Natural Person Investors

As NCUA noted in the ANPR, the relative level of financial sophistication of natural person investors varies greatly. While some individual investors, such as those who satisfy the definition of "accredited investor" under Regulation D, are quite sophisticated, other individuals who lack such a designation may carry more risk. Again, CCU does not see a need to prohibit the sale of supplemental capital to non-members, so long as investors are educated on the risks of the instrument. The level of necessary disclosure to achieve this purpose should align with an investor's sophistication.

Natural person investors who satisfy the definition of an "accredited investor" are likely capable of evaluating the risks of supplemental capital investments based on a credit union's business plan for issuing subordinated debt. Like institutional investors, they are presumed to have experience and expertise gleaned from prior purchases of securities. For example, private placements to qualifying investors could benefit from certain exemptions provided in Sections 505 and 506 of Regulation D. We believe these exemptions could serve as an appropriate benchmark for investor sophistication and would support exemptions from disclosure requirements if offerings were made to this class of investors.

NCUA's ANPR also considered the possibility of allowing non-accredited natural person investors to purchase alternative capital from credit unions. In this case, it may be appropriate for NCUA to require credit unions to provide disclosures to investors and register the offering with the agency. Initial and ongoing costs of educating these types of investors would likely cause the cost of issuing the instrument to rise.

The ANPR noted that the sale of secondary capital was not originally permitted to natural persons, accredited or not, because those consumers may be confused "given that the low-income designated credit union is federally insured."[4] A simple disclosure specifying that purchases of supplemental capital are not insured would address this confusion adequately.

Amount of Disclosure Necessary to Achieve Anti-Fraud Purpose

CCU understands that investors in supplemental capital must receive certain minimum protections embodied in Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act);

[4] *See* ANPR, Alternative Capital, 82 Fed. Reg 9698.

however, we do not think that supplemental capital—and particularly subordinated debt—must necessarily conform to Securities Exchange Commission (SEC) regulations. We believe the timing, content, and frequency of investor disclosures should depend upon the nature of the investor.

We agree with the findings of the Supplemental Capital Working Group that there are benefits to limiting subordinated debt offerings to institutional investors, "regardless of whether such investors are members of the credit union or external."[5] Such a limitation would have two main advantages: a sophisticated investor class reduces the need for NCUA to mandate additional disclosures, and institutional investors are more likely to exert both direct and indirect market discipline on credit unions.

With respect to consumer disclosures, any plan to allow non-institutional investors to purchase supplemental capital should require a greater degree of investor protection. If natural person investors can purchase alternative capital instruments, then NCUA should adopt the same disclosures used by the OCC for subordinated debt offerings. These disclosures are flexible as far as they cross-reference the SEC's own safe-harbor language for accredited investors. CCU believes that NCUA could use these disclosures as-is, reducing the need to develop new forms or rely on novel standards for meeting the investor safeguards and anti-fraud provisions described in §10(b) of the Exchange Act.

Treatment of Supplemental Capital as Registered Security

We feel that Section 3(a)(5) of the Securities Act would exempt credit unions from the SEC's registration and disclosure requirements when issuing supplemental capital. In addition, Rule 506 of Regulation D would also provide an independent exemption for accredited investors. Although the ANPR mentions the possibility of registering supplemental capital offerings with NCUA, this requirement would not materially enhance investor protection. While the OCC requires national banks to register subordinated debt, the FDIC imposes no such requirement. We believe credit unions should not be subject to registration requirements that community banks would not face when offering subordinated debt. Furthermore, NCUA has never imposed a registration requirement for secondary capital; there is no prospectus requirement and the only disclosure a LICU must provide is the Disclosure and Acknowledgment form.

We urge NCUA to develop a regulatory capital framework that does not impose burdensome registration requirements on credit unions that are disproportionate to the complexity and risk of supplemental capital offerings. NCUA should avoid any proposal requiring credit unions to register a prospectus with either the SEC or NCUA, and instead model the framework on the current model LICUs use when issuing secondary capital. CCU believes that streamlining investor disclosures as much as possible is essential to reducing the cost of issuing alternative capital.

CCU also does not see why the ANPR raises the issue of broker-dealer registration when credit unions cannot register as broker-dealers and have traditionally received an exemption from the SEC's registration requirements when selling non-deposit investments to members.[6] The SEC

[5] *See* Supplemental Capital White Paper, 23.
[6] *See* NCUA Letter to FCUs 10-FCU-03, Sale of Nondeposit Investments, December 2010.

permits this activity through "networking" arrangements, where an affiliated or third-party broker-dealer provides brokerage services for the financial institution's customers, according to conditions stated in no-action letters.[7] The ANPR recognizes that credit unions would still need to meet a due diligence requirement when selecting a broker-dealer, but these requirements could be completely avoided if credit unions were limited to raising supplemental capital through non-member investors. CCU encourages NCUA to explore regulatory options that could reasonably permit member investments, and in doing so, clarify its position on broker-dealer registration by explaining how its previous guidance must be reconsidered.

In general, our preference is for NCUA to identify a regulatory capital framework that does not force credit unions into a position where they must perform costly due diligence to take advantage of the broker-dealer exemption. CCU believes that avoiding broker-dealer registration is essential to reducing the cost of issuing supplemental capital.

Secondary Capital

Although CCU is not currently approved as a low-income credit union (LICU), we support such credit unions' longstanding ability to offer secondary capital. We suggest some modest changes to the approval and review of secondary capital issuers and recommend NCUA offer LICUs broader call options to relieve certain market inefficiencies. To the extent that the ANPR raises questions about the application of securities law to secondary capital and whether additional investor protections are required, we support the current framework for secondary capital and feel it adequately addresses those concerns. We do not think that additional prudential restrictions on secondary capital are warranted.

1. *Impact of supplemental capital on market for secondary capital; suitability for natural person investors*

CCU is aware that secondary capital investors are sensitive to regulatory changes that would make secondary capital subordinate to supplemental capital. Because the FCU Act requires that secondary capital must remain the most subordinate form of debt on a credit union's balance sheet, NCUA should consider whether it would be advantageous to credit unions (for the purposes of preserving investor confidence) to segregate supplemental and secondary capital markets.

CCU does not see a significant benefit in allowing natural person investors to purchase secondary capital. The ANPR notes that when the secondary capital regulations were initially written, "the purchasers were presumed to be foundations and other philanthropic-minded institutional investors." Our understanding is that institutional investors will continue to represent the primary market for secondary capital purchases.

2. *Relaxed pre-approval standards for issuing secondary capital*

The current preapproval process for obtaining authorization to issue secondary capital could benefit from additional streamlining to reduce the cost of funds. Our suggestion is for NCUA to consider a preapproval process whereby a credit union submits a capital plan that can be reused

[7] See SEC "Guide to Broker - Dealer Registration" *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm).

in subsequent offerings, provided that future offerings conform to the original plan in general size and scope. If the capital plan were to change materially, a credit union could amend its original capital plan and receive approval on an expedited basis, without having to submit a new plan for each new offering.

3. <u>Need for broader call options</u>

There is an appetite among large national banks to purchase secondary capital from credit unions for *Community Reinvestment Act* credit. However, the rate at which capital moves in and out of secondary capital accounts limits the amount of investment these institutions can make. NCUA could ease this bottleneck by granting credit unions more flexible early redemption options and relaxing the preapproval process based on the remaining maturity of the capital account.

For example, a credit union that has previously issued secondary capital, is well capitalized, and successfully obtained streamlined approval to redeem secondary capital early should not need to seek NCUA approval for redemption in the future. Additionally, NCUA should consider allowing credit unions to redeem secondary capital that has been on deposit for less than two years depending on the term to maturity and whether the credit union satisfies all other components of § 701.34(d)(1). We believe that granting LICUs flexibility when redeeming discounted secondary capital could yield additional market efficiency.

<u>Conclusion</u>

Thank you again for your consideration of our comments and those of others in the credit union industry as you seek to develop new guidelines for the issuance of alternative capital. We are encouraged by NCUA's willingness to approach the issue in a thoughtful and comprehensive way. We hope this is a positive indicator of a willingness to modernize in other areas as NCUA continues to focus on regulatory relief.

Should you have any questions or require additional information in support of the recommendations made herein, please feel free to contact me at 607-962-3144, ext. 5292.

Sincerely,

Gary Grinnell
President and Chief Executive Officer

cc: The Honorable J. Mark McWatters, Acting Chairman
The Honorable Richard Metsger, Board Member