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May 9, 2017

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

Re: Advance Notice of Proposed Rulemaking for Supplemental Capital

Dear Mr. Poliquin:

On behalf of America's credit unions, I am writing regarding the National Credit Union Administration's (NCUA) Advance Notice of Proposed Rulemaking for Supplemental Capital. The Credit Union National Association (CUNA) represents America's credit unions and their 110 million members.

We appreciate the opportunity to provide input on this important rulemaking for credit unions. We urge the NCUA to allow credit unions to innovate, within appropriate limits in this space, such that they can demonstrate the viability of supplemental capital for risk-based capital purposes. This is appropriate given the recent NCUA Final Rule on Risk-Based Capital (RBC Rule)[1] which might require some credit unions to increase capital beyond the amount necessary under the leverage requirement, which under current rules can only be accomplished through retained earnings. Alternative Capital could provide a viable means of meeting this regulatory requirement while minimizing any risk to the share insurance fund. Further, a financially strong, well-capitalized credit union might in fact be discouraged from growth because of a concern of diluting net worth ratios that may trigger supervisory concerns. To that end, we urge the NCUA to allow credit unions to accept supplemental capital to count towards the risk-based net worth requirement.

In developing this rule, we urge NCUA to create an environment for limited experimentation by credit unions in the creation of supplemental capital instruments, limited in an amount to not expose the share insurance fund to undue risk, but flexible in scope to allow the development of the most appropriate instruments that will be useful and cost effective for credit unions. We recommend that at this stage, the rule not limit permissible supplemental capital instruments to one or two restrictively defined instruments. Rather, the rule should contain several requirements that any capital instrument would have to comply with, without specifying precisely how. Any issuance should be subject to regulatory approval prior to issuance, similar to the initial approach taken by the NCUA with derivatives. After time, the NCUA could revisit the rule to further tailor the parameters based on the collective experience with the offerings during the experimental period, and define more specific instrument characteristics.

Retained Earnings:

In the United States, retained earnings have always been the primary source of credit union capital.[2] The inability to access other forms of capital brings certain structural weaknesses in the regulatory framework that can hinder a credit union's ability to weather a difficult or unforeseen circumstance. A Filene Research

[1] 80 Fed. Reg. 66626 (Oct. 29, 2015).
[2] Only credit unions with a low-income designation can use alternative sources to augment retained earnings.

Institute white paper identified at least six negative consequences of prohibiting the acquisition of alternative capital by U.S. credit unions[3] which included the following:

1. Slower recovery from financial setbacks;
2. Fewer new credit unions;
3. Limitations on growth and the addition of new services;
4. Difficulty in achieving economies of scale;
5. Conversion of credit unions to bank and thrift charters; and
6. Overcapitalization.

As such, CUNA supports NCUA's efforts to explore additional sources of capital that could allow a credit union to tap new markets or enable more rapid recapitalization of a troubled institution. If adopted properly, alternative capital can be a useful tool in providing stronger and more sustainable credit unions. This will allow credit unions to react more quickly during a challenging economic environment and should represent increased comfort to the regulator from a safety and soundness perspective. Further, the ability to accept alternative capital can be obtained without changing or altering the cooperative structure and mutual nature of credit unions.

The NCUA Capital Structure and Authority to Issue a Risk-Based Supplemental Capital Rule:

The Credit Union Membership Access Act of 1998 (CUMAA)[4] provided for a system of prompt corrective action for federally-insured credit unions incorporating capital standards in five categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The capital level is based on a net worth ratio requirement for all credit unions and a risk-based net worth requirement for complex credit unions. The Federal Credit Union Act (FCUA) provides the definition of net worth[5] as follows:

1. The retained earnings balance of the credit union, as determined under Generally Accepted Accounting Principles (GAAP), together with any amounts that were previously retained earnings of any other credit union with which the credit union is combined;
2. Secondary capital of a low-income designated credit union that is uninsured and subordinate to all other claims of the credit union, including the claims of creditors, shareholders, and the Share Insurance Fund; and
3. Certain assistance provided under section 208 of the Act pursuant to NCUA regulations.

Per the FCUA, secondary capital is currently only permissible for low-income designated credit unions and may be counted toward the net worth ratio and for the risk-based net worth ratio; however, the Board has broad discretion to allow credit unions without a low-income designation to issue alternative capital instruments to satisfy the risk-based net worth requirement, but not the net worth requirement. To allow it for the net worth requirement would require a change to the FCUA. The FCUA did not include an express definition of "risk-based net worth" for complex credit unions, thus the NCUA has broad discretion to include alternative capital instruments in the definition. In fact, the NCUA has already done this in the final risk-based capital rule by including Goodwill, the NCUSIF capitalization deposit, and other intangible assets. (*See* 12 C.F.R. 702.104 (b) (not yet effective)). Therefore, the inclusion of alternative capital to satisfy the risk-based net worth requirement falls within the NCUA's authority.

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[3] *See Alternative Capital for U.S. Credit Unions? A Review and Extension of Evidence Regarding Public Policy Reform,* Robert F. Hoel, PHD, *available at* https://filene.org/assets/pdf-reports/145_Hoel_AltCapital.pdf.
[4] HR 1151, Pub. L. 105-219, 112 Stat. 913 (1998).
[5] *See generally,* 12 U.S.C. § 1790d(o)(2).

Global Acceptance of Alternative Capital:

It should be noted that many other credit union systems allow for some form of capital beyond retained earnings, such as some member shares or other instruments. Systems in Latin America, Africa, the Caribbean, Australia, and Canada allow for credit union shares to qualify as regulatory capital to varying degrees. In fact, in the United States the early credit unions in Massachusetts required members to tender a $5 share that initially represented the only form of capital for those credit unions.[6]

Specifically, the Canadian Office of Supervision of Financial Institutions (OSFI) Capital Adequacy Requirements rule, Chapter 2, issued in December 2016, authorizes Canadian federal credit unions to issue Common Equity Tier 1 shares to members and can provide a useful framework for consideration by the NCUA.[7]

CUNA's Guiding Principles on Supplemental Capital (non-low-income designated credit unions):

Under this regulatory framework, CUNA suggests that given the broad discretion available, the NCUA should adopt or allow supplemental capital that can be used for net worth purposes for non-low-income designated credit unions on an experimental basis, with appropriate parameters, that follows the principles listed below. We recommend the rule be written so the NCUA will consider for approval any type of supplemental capital instrument that conforms to these principles:

- Any offering must preserve the cooperative, mutual nature of credit unions and not alter the fundamental structure of the credit union. If supplemental capital is sourced from members in the form of shares, such shares should grant no additional ownership or voting rights. Supplemental capital from non-members should impart no ownership or governance rights. Any agreement or disclosure should be in writing, properly executed, and contain clear language that no ownership interest is created or confers any membership or governance rights over the credit union;
- The specific instrument used - whether an equity instrument, paid-in-capital, or another form of subordinated debt - should be flexible and not prescribed in the rule so a credit union can best take advantage of the market and have the flexibility to structure the offering in a cost-efficient manner.
- The instrument will be uninsured, subordinate to other claims, available to cover operating losses, and only issued pursuant to regulatory approval. A credit union should have an appropriate policy or plan in place prior to obtaining regulatory approval;
- Proper consumer protection, securities/anti-fraud provisions, and disclosure requirements should be provided, with proper suitability standards followed. Circular and disclosure requirements similar to those currently provided by the Low-Income Credit Union Secondary Capital Rule are appropriate, but any securities disclosures should be governed by Securities/Securities Exchange Commission (SEC) rules and regulations and corresponding state blue sky laws based on the particular offering;
- The rule should establish appropriate limits on how much and to whom it can be issued with appropriate suitability standards followed (other than small issuances); and
- We recommend initial volume limits based on a proportion of assets or a proportion of total capital, which standards could be loosened after the industry and the NCUA gain experience in this field. A limit of 25% of retained earnings or 2% of total assets, whichever is greater, would be appropriate.

[6] *See* J. Carroll Moody & Gilbert C. Fite, *The Credit Union Movement: Origins and Development 1850-1980* 5-29 (2d ed. 1984).
[7] http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/car17_index.aspx.

Alternative Approach for Supplemental Capital for Members Only:

Alternative capital could be generated from members only in two ways. First, at its option, a credit union could require each member to purchase a modest amount of uninsured membership shares as a condition of membership. Unlike the debt instruments, these membership shares would be equity rather than debt. As equity, uninsured membership shares would automatically stand ahead of the share insurance fund in the event of the need to absorb losses. This would spread a small amount of risk over all members, and could be used as an educational tool to remind members of the cooperative nature of their credit union.

The total amount of capital that could be generated in this way would be noticeable, but not substantial for most credit unions. On average, $10 per member would generate about 0.08% of assets (8 basis points). Most credit unions currently have a minimum share deposit of $5, $10, or $25 (a few require more), but these are simply part of the member's insured savings account. They are not separate, uninsured accounts. If they were uninsured membership shares, they would on average generate additional capital to assets of about 4 basis points, 8 basis points, or 21 basis points, respectively.

The second way to generate secondary capital from members would be to issue certificates of indebtedness to members that are subordinated to all other claimants of the credit union. This is essentially subordinated debt issued to members. Members could choose whether to purchase such certificates. Members holding these certificates would not be entitled to any special ownership or voting rights beyond those available to all members. Disclosure of the noninsured, at-risk nature of these investments would have to be explicit. Appropriate suitability standards might also apply. With amounts of $500, $1,000, $5,000, $10,000 and perhaps more, significant amounts could be raised.

Proposals for Low-Income Designated Credit Unions (LICUs):

Currently, secondary capital is permissible under the FCUA for low-income designated credit unions to be counted toward both the net worth ratio and the risk-based net worth requirement. We urge the NCUA to continue with this successful rule, however, we recommend that the following items be addressed in any rulemaking:

- The issue of lien order for secondary capital needs to be addressed. This problem will only exist if a credit union has issued both secondary and supplemental capital. For LICUs, only secondary capital counts as net worth versus supplemental which would count only in the Risk-Based Net Worth Ratio numerator. We recommend NCUA address the order of lien priority (§709.5) for those credit unions who have issued both secondary and supplemental capital if both are authorized under the structure of the final rule;

- Partial replenishment of secondary capital, once drawn, has also been an issue for LICUs and should be addressed. If a credit union without any secondary capital has losses, those losses deplete its net worth (retained earnings), but if capital never becomes negative (or low enough for it to be conserved), future income replenishes its net worth once the credit union recovers. For a credit union with secondary capital, retained earnings would be depleted first, then the secondary capital. If the secondary capital is not fully extinguished and the credit union later recovers, under current rules the future earnings are applied to building retained earnings rather than restoring some or all of the depleted secondary capital. While this is not an issue in a liquidation where all capital has been extinguished, in an assisted merger situation the secondary capital investors would be better off if the secondary capital could be partially or fully replenished;

- There are also ambiguities in Purchase & Acquisition resolutions. In general, CUNA recommends that NCUA provide greater clarity as to how and when secondary capital is accessed (i.e., drawn on and written down), and if and how it might later be replenished if results become better than first expected. This is especially important since some losses that require drawing on capital are accounting as opposed to real losses, which are frequently reversed later as more information becomes available. For example, following GAAP, some credit unions overestimated loan losses during the Great Recession. Those loan loss estimates were expensed and taken out of capital. As the economy recovered, they had excess balances in their allowance accounts and that excess was returned to capital, sometimes in the form of negative loan loss expenses. If the expensing of loan loss estimates had been taken out of secondary capital, the negative expense could only go to retained earnings instead of back to secondary capital. There is a need for greater transparency and consistency regarding secondary capital losses; and

- The rule on prepayment plans should be clarified. For example, if a credit union issues subordinated debt with a 10-year initial maturity, after five years the amount that counts as capital is reduced by 20% for each of the next five years, ending at zero. Since the issuing credit union must pay interest on the full amount, it may want to repay the debt before maturity (and perhaps issue a new 10-year debt that counts at 100%). But if issuing credit unions routinely do that, they are merely issuing five-year debt, not 10. This probably requires some restrictions on whether the credit union can repay the debt early depending on its retained earnings. If they are not high enough, the credit union would have to carry the at-risk secondary capital for longer. Even if it did not count as capital, it would still be available to cover losses. As such, standards for approval of prepayment should be clarified and less subjective.

Questions from the ANPR:

The following represent CUNA's responses to the questions posed by the ANPR:

1. 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?

   Response:

   Yes, additional forms of supplemental capital should be included in the RBC numerator. By following our Guiding Principles above, if supplemental capital is allowed it will be uninsured and subordinate to other claims. Thus, the share insurance fund should experience minimal risk by authorizing its use.

2. If yes, 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 Generally Accepted Accounting Practices (GAAP) and the Act, and why?

   Response:

   The General Guidelines above provide a framework that will be compliant with both GAAP and the FCUA.

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 Act, and why?

Response:

The General Guidelines above provide a framework that will be compliant with both GAAP and the Act.

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

   Response:

   The Borrowing Rule in Part 701 will likely need to be changed.

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 RBC ratio numerator, and why should they be included?

   Response:

   Several states have language in their state credit union acts that address alternative sources of capital including California (Cal. Fin. Code § 14400, § 14862), Georgia (GA. Code Ann. § 7-1-652), Indiana (Ind. Code § 28-7-1-19), Michigan (Mich. Comp. Laws § 490.361), and Washington (Wash. Rev. Code § 31.12.005).[8] While the provisions to be included in the RBC ratio numerator are among our recommendations in this letter, we urge the NCUA to work closely with the state regulators, as many of those regulators have significant experience supervising banks with capital instruments, in addition to those with specific authority on supplemental capital for credit unions.

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

   Response:

   As indicated above, disclosure like what is currently provided by the Low-Income Credit Union Secondary Capital Rule are appropriate, but any securities disclosures should be governed by Securities/SEC rules and regulations and corresponding state blue sky laws.

Other Issues Raised in NCUA's ANPR:

Issue: Potential for credit unions' use of supplemental capital

The Board is interested in commenters' thoughts on whether credit unions' - not designated as low-income - use of supplemental capital could affect the availability of secondary capital for low-income designated credit unions. If so, are there measures the Board could take to protect against this?

Response:

CUNA believes that the pools for Low-Income Credit Unions who receive secondary capital are in large part driven by banks seeking Community Reinvestment Act credit. Those likely seeking to

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[8] Per the 2016 NASCUS Profile of State Supervisory Agencies, approximately 1/4th of states permit the issuance of supplemental capital instruments, *available at* www.nascus.org/publications.

obtain supplemental capital that are not designated as low income will likely pull from a different pool of investors. Thus, it is likely one will have little or no effect on the other.

Issue: Authority to issue supplemental capital

The Board invites commenters to identify any other provisions of the Federal Credit Union Act they believe could provide alternative authority for federal credit unions to issue supplemental capital instruments other than as subordinated debt.

Response:

These areas have been identified above, namely the RBC Rule and the Borrowings Rule.

Issue: Need for comprehensive borrowing rule for federal credit unions

The Board invites comments on the need for a comprehensive borrowing rule for federal credit unions and would like to hear from stakeholders on the possible impact a supplemental capital rule may have on the federal credit union tax exemption.

Response:

Congress provided the credit union system with a federal tax-exemption because of the not-for-profit, cooperative structure of credit unions, and the special mission credit unions have to serve consumers. The credit union tax status is based on the credit union corporate structure, not on the products and services it offers. The suggestions contained herein in no way alter the structure of the credit union and in fact, we request disclosures and prohibitions on conferring any governance rights or ability to control the credit union based on an investment in supplemental capital. As such, allowing supplemental capital should not in any way affect the federal tax exemption for credit unions.

Issue: Mutual ownership structure of credit unions

The Board invites comments on how it should structure any potential rule to avoid issues impacting the mutuality of credit unions, and the members' rights to govern the affairs of the institutions.
Specifically, the Board invites comments on restrictions it might impose on characteristics of supplemental capital to avoid these issues such as: non-voting and limits on covenants in the investment agreement that may give investors levels of control over credit union.

Response:

As outlined above, CUNA suggests the rule contain prohibitions that any agreement on supplemental capital should confer no management or corporate governance rights on any investor by virtue of obtaining supplemental capital. As such, the mutual characteristics of the credit union are not altered by the allowance of supplemental capital.

Issue: Designation of low-income status; acceptance of secondary capital accounts by LICUs

NCUA is seeking comment on whether the criteria and process for obtaining the low-income designation, the criteria for issuing secondary capital, and the criteria for including of secondary capital as regulatory capital should be in separate regulations.

Response:

Since the low-income designation confers other rights and privileges (i.e. relief from the Member Business Loan cap, receive deposits from non-members, etc.), it is logical to maintain a separate regulation such that those provisions for LICUs can be readily discerned. Furthermore, the pools of investors from which LICUs versus non-LICUs will likely draw suggests separate rules.

CONCLUSION:

We greatly appreciate the NCUA's willingness to consider allowing credit unions to accept supplemental capital to count towards the risk-based net worth requirement. If structured properly, not only will this enhance the safety and soundness of credit unions, but it can be accomplished without altering the cooperative, mutual structure of credit unions. If you have further questions or would like to discuss this letter in more detail, please feel free to contact me at 202-508-3630.

Sincerely,

Andrew T. Price
Sr. Director of Advocacy & Counsel