

8 May 2017

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

**Re: Advanced Notice of Proposed
Rulemaking – Alternative Capital**

Dear Mr. Poliquin,

Navy Federal Credit Union (“Navy Federal”) is providing comments on the National Credit Union Administration's Advanced Notice of Proposed Rulemaking governing Alternative Capital as published in the Federal Register on February 8th, 2017.

Navy Federal supports granting federally insured credit unions the authority to issue alternative capital. Granting credit unions the ability to raise alternative capital not only reduces risk to NCUSIF, it also enables credit unions to better serve their members while enhancing safety and soundness. To be truly effective, NCUA’s alternative capital authority should adhere to these principles:

1. Transfer risk outside the credit union system,
2. Ensure parity with banks so as not to disadvantage credit unions, and,
3. Provide sufficient scale to meet the needs of all credit unions.

In many ways, our thoughts align with those put forth by NCUA in its 2010 Supplemental Capital White Paper. In particular, we support the ability to access the capital markets by issuing subordinate debt. Subordinated debt reduces risk to NCUSIF, is scalable, and can be structured to achieve parity with the banking industry. More specifically, we support both public and private issuance of subordinated debt but we do not believe credit unions should market or sell these securities directly to their members. Direct sales to members have the potential to cause confusion regarding share insurance coverage, and, they fail the principle of transferring risk outside of the credit union system.

As part of the implementation of alternative capital, NCUA should also amend its Risk Based Capital rule to allow subordinated debt to meet Total Risk Based Capital requirements. Specifically, we recommend adopting the Tier 1 and Total RBC capital requirements used in the banking industry.

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Lastly, we recommend NCUA clarify the scope of the credit union's authority to specifically include unsecured debt and securitization. Including these authorities will enhance a credit union's ability to access the capital markets for funding while transferring additional risk outside the credit union system.

In summary, Navy Federal supports granting qualified credit unions the ability to issue subordinated debt to meet their Risk Based Capital requirements. Structured properly, these instruments will transfer risk outside the credit union system thereby providing NCUSIF with an additional layer of protection while, at the same time, enabling credit unions to better serve their members in a safe and sound manner. We have provided additional commentary in Attachment 1.

If you have any questions, please feel free to contact Vince Pennisi, Chief Financial Officer at (703) 255-8740.

Sincerely,

A handwritten signature in black ink that reads "Cutler Dawson". The signature is written in a cursive style with a large initial "C" and a long, sweeping tail.

Cutler Dawson
President/CEO

Attachment 1

This attachment supplements Navy Federal's response regarding NCUA's Advanced Notice of Proposed Rulemaking for Alternative Capital. It is organized in four sections: first, we provide our comments on the types of alternative capital instruments we believe are appropriate for credit unions; second, we provide comments on restrictions and protocols surrounding the issuance of alternative capital to investors; third, we provide comments on how alternative capital authority should be incorporated into the upcoming Risk Based Capital Framework, and; fourth, we provide comments addressing other questions and considerations raised by NCUA in the Advanced Notice of Proposed Rulemaking.

Types of Alternative Capital Instruments

In the 2010 Supplemental Capital White Paper, and the 2017 Advanced Notice of Proposed Rulemaking, NCUA identifies three types of alternative capital instruments: Voluntary Patronage Capital (VPC), Mandatory Membership Capital (MMC), and subordinated debt.

In evaluating which types of capital instruments best serve the needs of the credit union industry, we believe three guiding principles should be paramount; specifically, alternative capital instruments should:

1. Transfer risk outside the credit union system,
2. Ensure parity with banks so as not to disadvantage credit unions, and,
3. Provide sufficient scale to meet the needs of all credit unions.

We strongly believe subordinated debt is the only form of alternative capital that meets all three of these fundamental principles. It is the most effective form of alternative capital and it can materially enhance the capital reserves on credit union balance sheets.

Fundamentally, subordinated debt transfers risk from the credit union system to third party investors. This provides an important layer of protection for NCUSIF as qualified third party investors will stand before NCUSIF in a failed credit union's bankruptcy waterfall. Subordinated debt investors are already familiar with the structure and nature of this risk and have demonstrated an appetite for this type of investment. Investor familiarity will enable credit unions to access this debt market without negative consequences arising from unfamiliar structures or covenants. Lastly, the subordinated debt market is deep enough to absorb the alternative capital needs of the credit union industry. As such, credit unions will be able to establish a presence and engage in programmatic issuance which is critical to maintaining capital levels as these instruments age over time. In short, subordinated debt reduces risk to NCUSIF, is saleable to a wide range of qualified investors, and, is scalable to meet the industry's needs. The other types of alternative capital NCUA has identified do not provide the same degree of flexibility and utility.

A concern with both VPC and MMC is the potential for investor confusion as to whether the investment qualifies for share insurance coverage. This concern is magnified if these instruments are marketed

directly to the retail membership. In its 2010 Supplemental Capital White Paper, NCUA highlighted the likely buyers of the different types of capital instruments, see Table 1 below.¹

Source	Instrument Characteristics	
	Debt	Equity
Member / Owner	Membership Capital Voluntary Patronage Capital	
External Investor	Subordinated Debt	

Table 1

By their design, VPC and MMC are targeted towards the credit union member. There is a high likelihood the average member is not fully qualified to evaluate the risk/return trade-offs of an equity-like investment in a non-publicly traded institution that is not easily redeemable, cannot be readily withdrawn, has limited liquidity, and, may suffer a loss in value. There is also a risk members may believe alternative capital investments are akin to other investments offered by their credit union that carry share insurance coverage (i.e., share certificates). As a result, there could be significant reputation risk for credit unions raising VPC and MMC directly from their members.

Additionally, the structure of VPC and MMC limits a member's ability to redeem or withdraw their funds. If the financial stability of a credit union that issued VPC or MMC were to erode, members with these types of capital investments would therefore be more inclined to withdraw any deposits they have with the credit union in order to limit their total exposure. If this were to occur, the credit union could face liquidity issues that would compound the capital issues they already face. Since members deposits are an integral part of the credit union system's stability, VPC and MMC do not meet the objective of transferring risk outside the system.

NCUA should focus its rulemaking efforts on subordinated debt. Subordinated debt transfers risk outside the credit union system, ensures parity with the banking industry, and is scalable to support the needs of the credit union system.

Issuance Considerations

As noted above, Navy Federal believes subordinated debt is the best form of alternative capital for complex credit unions. In this section, we provide our thoughts on issuance requirements and protocols that will ensure credit unions access the capital markets in a safe, sound, and efficient manner.

The issuance of subordinated debt to third party investors typically occurs in two ways, either as a Rule 144(a)² (e.g., private placement) offering to a Qualified Institutional Buyer (QIB), or, as a public security

¹ 2010 Supplemental Capital White Paper, Page 19

² 17 C.F.R. §230.144A

that is subject to SEC requirements. To ensure unfettered access to the subordinated debt market, NCUA should not limit the means by which qualified credit unions issue subordinated debt.

For Rule 144(a) issuances, terms and conditions are negotiated directly between the issuer and investor. NCUA's rulemaking should support the ability for qualified credit unions to issue subordinated debt under this structure. We strongly encourage NCUA to adopt the same principles, rules and guidelines implemented by the OCC and the FDIC. For example, in addition to establishing the regulatory authority to issue subordinated debt, we encourage NCUA to provide credit unions Guidelines and Sample Notes similar to those issued by the OCC.³

It is vital credit unions have the ability to structure subordinated debt instruments to mirror those issued by banks. NCUA imposed restrictions, or structural differences, can put credit unions at a disadvantage with investors. These disadvantages would limit the pool of available investors and/or increase the cost of issuance. Simply put, in order for credit unions to be successful, they need the ability to structure their subordinated debt as closely as possible to the instruments already available to investors.

NCUA must also establish rules and guidelines that support public issuance of subordinated debt. To ensure credit unions are not placed at a disadvantage, NCUA's rules, regulations and requirements must mirror, both in form and substance, OCC and SEC requirements.⁴ Maintaining parity with the banks will; (1) minimize investor uncertainty, (2) establish comparable levels of investor protection, and (3) provide equivalent transparency to investors. In particular, NCUA's required disclosures must mirror those of the OCC to eliminate a potential source of investor uncertainty that may adversely affect the market for credit union securities.

Lastly, the issuance of public subordinated debt creates the possibility of retail ownership of these securities. As noted above, retail ownership of subordinated debt may not be appropriate for members as it could create confusion regarding share insurance protection and increase liquidity risk for the issuing institution. However, given the typical investor pool, issuance size, and, minimum security size, we believe it is unlikely credit union subordinated securities will have substantial retail ownership; more likely, these securities will be owned by institutional investors. Accordingly, NCUA should prohibit credit unions from engaging in direct sales or marketing to its members. This also eliminates the need for the registration and disclosure requirements associated with being a broker-dealer.

Regulatory Capital Treatment

Subordinated debt's primary purpose would be to satisfy a credit union's Risk Based Capital requirements. To achieve this goal we recommend NCUA; (1) allow complex credit unions to use alternative capital to meet their requirements under the current Risk Based Net Worth requirement, and, (2) amend the Risk Based Capital rule to enable credit unions to use alternative capital instruments to satisfy their Total Risk Based Capital requirements.

³ See OCC Bulletin 2015-11 and OCC Bulletin 2015-22

⁴ See e.g., 12 C.F.R. §5.47; 12 C.F.R. Part 16

First, under the current Risk Based Net Worth (RBNW) framework, complex credit unions must maintain net worth above their risk-adjusted capital requirement.⁵ We recommend NCUA permit credit unions to count subordinated debt towards meeting RBNW requirements until such time the Risk Based Capital Requirements are fully implemented.⁶

Second, coincident with the ability to raise alternative capital, NCUA should amend its Risk Based Capital rule to mirror the capital requirements applicable to the banking industry. During the notice and comment period for the Risk Based Capital rule, Navy Federal highlighted the Total Risk Based Capital requirement of 10% was more onerous than the requirements applied to the banking industry because banks could use alternative capital (e.g., Tier 2) to meet their Total RBC requirement. We strongly urged NCUA to enable credit unions to use Tier 2 capital, such as subordinated debt, to satisfy its Risk Based Capital requirements. Specifically, NCUA should establish Tier 1 and Total RBC requirements that are consistent, in both form and substance, with those established for banks (see Table 2 below).

PCA Category	Total RBC Ratio	Tier 1 RBC Ratio
Well Capitalized	10%	8%
Adequately Capitalized	8%	6%
Undercapitalized	< 8%	< 6%
Significantly Undercapitalized	< 6%	< 4%
Critically Undercapitalized	N/A	N/A

Table 2

This capital structure ensures (1) parity with the risk based capital requirements for banks, (2) the relative attractiveness of credit union subordinated debt versus that of banks from an investor perspective, and, (3) that credit unions issuing subordinated debt do not “over pay” investors for capital that does not provide the same amount of regulatory capital benefit. Lastly, this structure prevents a credit union from relying too heavily on subordinated debt as a means of satisfying its Risk Based Capital requirements.

Other Considerations

In this section we address several additional items raised by NCUA.

- **Need for Comprehensive Borrowing Rule and Securitization Rule:** In addition to clarifying the authority for Federal credit unions to raise supplemental capital, NCUA should expand the borrowing rule to include unsecured debt and securitization. We recommend NCUA explicitly grant credit unions the authority to access the capital markets for unsecured debt. Credit unions

⁵ See 12 CFR §702.106

⁶ Assuming credit unions issue subordinated debt prior to the full adoption of the Risk Based Capital rule in 2019.

are currently able to borrow from numerous sources including the Federal Home Loan Banks and the repo markets. Explicitly granting credit unions the authority to issue unsecured debt is a natural extension of existing practices and would only serve to enhance a credit union's ability to manage its risk and liquidity needs in the most cost effective manner. Additionally, NCUA is currently considering a rule granting credit unions the authority to raise funding through securitization. We recommend NCUA approve this rule. The ability to issue unsecured debt and raise funds through securitization provides greater protection to NCUSIF by enabling credit unions to access additional sources of liquidity while also providing an additional means of transferring risk to investors outside the credit union system.

- **Subordinated Debt Authority and Registration:** Debt issuance, whether public or private, requires certain expertise. Due to the complexities and risks associated with issuing subordinated debt, NCUA should institute an application and review process similar to what was established for derivatives authority. In other words, credit unions should apply for authority to issue subordinated debt. As part of this process, NCUA should establish a clear list of requirements for receiving this authority. These requirements should be specific to the type of issuance (i.e., public versus private). Once a credit union has been granted authority, further approvals should not be required. Similar to the derivatives program, ongoing monitoring of the subordinated debt program should be handled by the routine examination process.
- **Eligible Investments:** In addition to amending its rules to enable credit union alternative capital, NCUA should amend its rule covering investment and deposit activities⁷ to include credit union issued subordinated debt as a permissible investment unless the investment would result in a reciprocal holding. Such investments would be consistent with the cooperative nature of the credit union system because they would enable well capitalized credit unions to supplement the capital of other credit unions while also keeping the returns for doing so within the credit union system.

⁷ 12 CFR §703.14