



May 9, 2017

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

Re: National Federation of Community Development Credit Unions (the "Federation") Comments on "Advance Notice of Proposed Rulemaking for Alternative Capital"

VIA EMAIL

Dear Mr. Poliquin:

The National Federation of Community Development Credit Unions (the "Federation") appreciates the opportunity to provide comments on NCUA's Advance Notice of Proposed Rulemaking for Alternative Capital. The Federation is a dynamic, growth-oriented association of credit unions that provide safe and responsible financial services to underserved communities. Since 1974, the Federation has been promoting financial inclusion by organizing, supporting, and investing in community development credit unions (CDCUs), which specialize in serving populations with limited access to affordable financial services, including low-income wage earners, families, new immigrants, young people and the growing number of Americans seeking financial independence through credit unions. Our network represents over 200 diverse CDCUs with over \$60 billion in community controlled assets. They provide financial and development services to 6 million people of modest means.

We are pleased to see that the NCUA is seeking comments on alternative capital frameworks, including how to improve current practices regarding secondary capital. As a CDFI intermediary and impact investor, the Federation is one of the first and only national lenders of secondary capital to credit unions. The Federation's Community Development Investment Program invests in CDCUs to strengthen their financial position and expand their impact on the low-income communities they serve. Our investments are designed to help CDCUs to grow, offer innovative and responsible loan products and help consumers to protect and build assets. With 20 years of experience as a secondary capital lender, our research and experience strongly demonstrates the positive impact of secondary capital on the credit union industry and its potential to strengthen the financial performance and community impact of credit unions on underserved communities.

1. The Significance of Secondary Capital, Financial Performance and Community Impact of Low-Income Designated Credit Union Borrowers

Addressing Financial Service and Market Needs for Low- and Moderate-Income Households

According to the *2015 FDIC National Survey of Unbanked and Underbanked Households*, more than 33.5 million American households (26.9%) are either unbanked or underbanked. These households are disproportionately comprised of people of modest who pay billions of dollars in fees for high-cost alternative financial products. As of December 31, 2016, more than 40% of the country's 5,909 credit unions were low-income designated (LID). The significant market share of LIDs provides tremendous



opportunities for credit unions to be a cogent force in bridging this gap between low-income households and their financial service needs.

Based on our analysis of secondary capital borrowers, the Federation has found that secondary capital can be an effective resource to strengthen both the financial and social impact of credit unions in providing safe, sustainable and fair financial services to low- and moderate-income (LMI) communities.

Secondary Capital Borrowers Demonstrate Strong Financial Results and Community Impact

The Federation’s Community Development Investment Program is one of the first and only private lenders of secondary capital. Since inception, we have made secondary capital loans to more than 70 credit unions. These credit unions have ranged in size from \$1 million to more than \$7 billion in assets. Our current portfolio is comprised of \$10 million in community development credit unions that provide financial and development services to more than 1.1 million members of modest means across the country. While their profiles vary, they all share business models that are centered on the mission of “helping low- and moderate-income communities achieve financial independence,” and demonstrate their ability to meet a double bottom line of social and financial returns. According to 2016 NCUA Call Report data, the median ROA for the Federation’s secondary capital borrowers was 0.60%, higher than other peer groups. Similar performance was also reported for all low-income designated credit unions with secondary capital (these credit unions also reported higher earnings than non-low-income designation credit unions and LIDs without secondary capital).

Table 1. Return on Average Assets, As of December 31, 2016

ROA	Average	Median
Non-LID CU	0.39%	0.22%
LID CU	0.39%	0.22%
Federation Secondary Capital Investees	0.74%	0.60%
All Credit Unions with Secondary Capital	0.83%	0.50%

While our current portfolio is comprised of strong partners and borrowers, secondary capital in and of itself is not a silver bullet for challenges credit unions may encounter. The Federation’s own experience is in line with the Board’s general finding of historical losses associated with credit unions with secondary capital loans¹. However, it is important to disaggregate the loss ratio. There are bifurcated and decreasing trends in terms of secondary capital losses. From the Federation’s own lending experience, loss ratios significantly decreased since 2010 (annual loss rates decreased from 1.31% to 0.02%). Successful partnerships and improvements in portfolio performance can be attributed to several factors, including:

¹ “The Board notes that low-income designated credit unions that have issued secondary capital have a higher failure rate than other low-income designated credit unions. The average annual failure rate for low-income designated credit unions with secondary capital was 2.9 percent from 2000-2013, compared to 0.8 percent for low-income designated credit unions without secondary capital during the same period.” See *NCUA Advanced Notice of Proposed Rulemaking for Alternative Capital*.

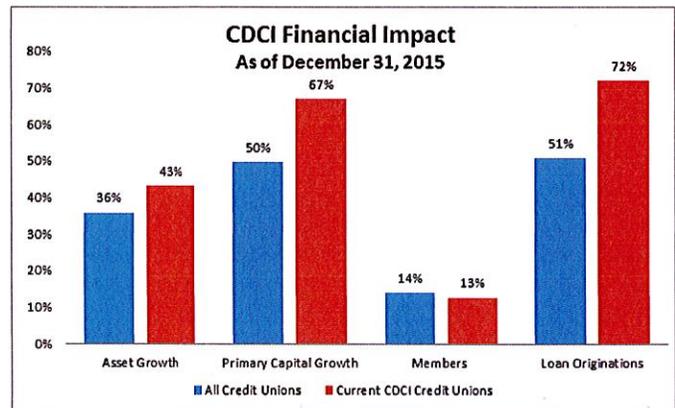


- Increased understanding of secondary capital (a capital resource for promoting growth versus use of secondary capital solely to delay prompt corrective action)
- Improved underwriting parameters and program guidelines. All borrowers are required to submit a business and community impact plan, which is evaluated as part of our due diligence process
- Improved understanding and modeling in accounting for cost/ benefit analysis of secondary capital borrowings

The collective impact and ability of secondary capital borrowers to be effective social enterprises is also demonstrated by the credit unions who participated in the US Department of Treasury's Community Development Capital Initiative (CDCI). In 2010, Treasury invested \$69.9 million in secondary capital loans to qualified CDFI certified credit unions. The Federation analyzed the financial performance and community impact of the 31 credit unions that had CDCI secondary capital outstanding between 2010 and 2015. Based on our analysis, CDCI credit unions represented \$1.8 billion in community assets and serve nearly 220,000 members of underserved and under-resourced communities. These credit unions leveraged CDCI secondary capital more than 60 times in LMI communities.

CDCI credit unions reported tremendous growth since receiving Treasury's investment:

- **Net Asset Growth in Low-Income, CDCI Credit Unions:** \$577.5 million (43%)
- **Primary Capital Growth:** \$63.8 million (67%)
- **Member Growth:** 28,002 (13%) additional LMI consumers received financial services from CDCI credit unions.
- **Total Loan Originations since CDCI:** \$2.6 billion
- **Total Mortgages:** \$803.7 million
- **Total 1st Mortgages Financed:** 5,666



CDCI credit unions offer affordable financial services and access to more than 200,000 low- and moderate-income consumers. Their capacity to do so also increased after receiving secondary capital from Treasury. As of December 31, 2015, CDCI credit unions provided:

- Financial Access to more than 246,000 LMI consumers (increase of 86%)
- Debt/ Money Management services such as financial education to 234,000 LMI consumers (increase of 14%)
- Credit Building and Development Services to 223,000 members (increase of 42%)
- Preserve Assets by Providing Alternative to Predatory Loans to more than 102,000 members

2. Need for Continued Improvements In Consistency and Transparency of Regulatory Review and Approval of Secondary Capital Related Requests



Secondary capital requires regulatory approval before borrowing as well as early redemption of amortized portions of the loan. As a CDFI intermediary that partners with both investors and borrowers, we found that consistency and transparency by regulators can greatly impact market expectations from both the demand and supply sides.

We interviewed both investors and CDCU borrowers on their needs and what would be necessary in meeting both the financial and social impact expectations. Based on our due diligence with current and potential investors, the flow of capital and repayments are critical to investment decisions. For credit unions, while awareness of secondary capital increased, questions concerning the amortization structure remain. Increased market understanding of secondary capital as a resource for growth versus part of a response to prompt corrective action, and strengthened industry understanding of the market opportunities and effective ways to serve LMI communities have resulted in increased credit union interest and decreased losses.

The updates to NCUA's Supervisory Policy Manual regarding secondary capital, streamlined processes and clarification on review of secondary capital requests have been instrumental in our ability to raise additional capital. As a result of minor adjustments that provided greater clarity and consistency, the Federation was able to raise an additional \$15 million for secondary capital loans from external investors. While the Federation applauds the NCUA for these positive updates, there remains a need for additional improvements in transparency and consistency across regions for secondary capital related requests, specifically:

- Reviews of secondary capital plans must be standardized across all region and regular and consistent training of examiners and supervisory examiners is critical to streamline review and approval processes.
- With regards to the Board's questions concerning secondary capital, the Federation supports the allowance of broader call options for low-income designated credit unions other than just the portion no longer counting as net worth and subject to NCUA approval. The standards for prepayment should be clarified and based on objective standards.
- NCUA's guidelines and standards regarding the approval process for such requests should be clear and consistent across regions. The Federation also supports the consideration to relax pre-approval of issuing secondary capital if a low-income designated credit union meets certain conditions, inter alia, being adequately capitalized. However the Federation strongly recommends that any such standards be objective and clear.
- There is a need for greater transparency and consistency from NCUA and the Asset Recovery Office with regards to the treatment of secondary capital losses. According to current regulations "...in the event of merger of a low-income designated credit union (other than merger into another low-income designated credit union) the secondary capital accounts will be closed and paid out to the investor to the extent they are not needed to cover losses at the time of merger or dissolution." However, lenders are not provided with financial information regarding the status of the secondary capital or credit union at merger or liquidation. As a lender, and per our engagement with others, the assurance of access to this information would greatly increase available capital.



In order for any market to succeed, there must be transparency and consistency.

3. Supplemental Capital and Subordination

Lastly, the Board requested comments on whether authorizing supplemental capital regulations should contain any restrictions on payment priority option. The Federation submits that any considerations regarding supplemental capital and payment priority must take into consideration the provisions regarding secondary capital.

As the Board noted in the ANPR:

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... This means that any secondary capital issued by a low-income designated credit union must be the most subordinated item on the balance sheet (first loss position after retained earnings) and any losses to secondary capital must be pro-rated equally – that is without preference or priority...

In the section regarding supplemental capital, the Board also submitted:

Supplemental capital would have to be subordinate to the Share Insurance Fund and uninsured shareholders in the payout priorities. However, since secondary capital, per the Act, must be subordinate to all other claims, supplemental capital would be senior to secondary capital in the payout priorities. Credit unions issuing supplemental capital could be provided flexibility to include payment priority structures within or between supplemental capital instruments to enhance investors' interests.

As secondary capital is already the most subordinated debt, placing secondary capital investors further behind in lien position will result decreased investor interest and diminish opportunities for low-income designated credit unions to scale their impact. One way to avoid this conflict would be for the Board to add the requirement that any credit union cannot hold both secondary capital and supplemental capital. This addition would allow for a vibrant market for both secondary and supplemental capital.

We appreciate your review of this letter and welcome the opportunity to further discuss this matter.

Respectfully submitted,

Cathleen Mahon
President/ CEO
National Federation of Community Development Credit Unions