

May 09, 2017

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

RE: Comments on Alternative Capital

Dear Mr. Gerald Poliquin,

I am writing on behalf of the California and Nevada Credit Union Leagues (Leagues), one of the largest state trade associations for credit unions in the United States, representing the interests of more than 250 credit unions and their approximately 10 million members/consumers.

The Leagues welcome the opportunity to provide comments to the National Credit Union Administration (NCUA) on their Advanced Notice of Proposed Rulemaking (ANPR) for Alternative Capital. The Leagues believe that supplemental capital, if administered properly, should be permissible for all federally insured credit unions (FICUs) and should count towards both the net worth requirement and the risk-based net worth requirement. However, we recognize the Federal Credit Union Act (FCU Act), does not permit supplemental capital to count towards net worth requirements for non-low income credit unions (non-LICUs)[\[1\]](#) and a statutory modernization of credit union capital definitions is needed for this to happen. Therefore, our comments contained herein are limited to the scope of this ANPR.

We support permitting all FICUs to issue supplemental capital that would count towards the risk-based net worth requirement. We believe this important tool should be available to all FICUs as we approach the January 1, 2019 effective date of NCUA's Final Rule on Risk-Based Capital [\[2\]](#) (RBC Rule). In addition, it is a good first step in a measured approach to obtaining real capital reform for FICUs.

While we support the permissibility of supplemental capital for RBC purposes, the Leagues strongly recommend the NCUA take a measured approach with implementation and adhere to the three key public policy principles identified by NCUA's Supplemental Capital Working Group in 2010 [\[3\]](#), which are: (1) preserve the cooperative mutual credit union model; (2) include robust investor safeguards; and (3) provide prudential safety and soundness requirements.

Use of Supplemental Capital

The ability for FICUs to raise supplemental capital for risk-based net worth requirements will benefit FICUs and their members in several ways. First, it is important this tool to be available to assist the few credit unions who may need it to meet the 10 percent well-capitalized risk-based capital ratio requirement effective January 1, 2019 [\[4\]](#). Having this tool will allow these credit unions to continue their proven business models. Second, we believe supplemental capital will allow FICUs to better proactively manage the impact of growth and meet their members' financial needs.

Third, while few credit unions may be looking for supplemental capital today, having the ability

to raise capital beyond retained earnings will increase the ability of credit unions to react and recover from economic downturns or challenges more quickly in the future, thus protecting their members' funds and the National Credit Union Share Insurance Fund (NCUSIF). Having supplemental capital in addition to retained earnings better safeguards credit unions and the system from losses. We believe it is prudent for the NCUA to build the authority today so it is there when the industry needs it in the future.

Member Focused

In taking a measured approach we recommend the NCUA first focus on member equity deposits and permit all FICUs to issue supplemental capital to members.

Voluntary Member Deposits

The Leagues recommend allowing all FICUs to accept supplemental capital in the form of natural person member deposits. We believe there is a market for voluntary patronage capital. Many members currently have uninsured shares due to their deposit account structures and balances. The risk to these individuals would not increase should they instead choose to support their credit union by contributing capital. This type of capital would function as equity, would be subordinate to the NCUSIF, and would not affect a member's ownership or voting rights.

Mandatory Membership Capital

The Leagues also recommend permitting FICUs who choose to do so to require natural person and entity members to purchase supplemental capital as a condition of membership. Rather than purchasing a par value share that is held as an insured savings deposit, the purchase of a par value share would be uninsured, subordinated to the NCUSIF, and function as equity.

Mandatory capital would require a bylaw amendment approved by a credit union's board of directors. Mandatory membership capital could increase membership awareness of the member-owner structure and increase the perceived value of membership. This type of capital would not affect a member's ownership or voting rights.

Other Forms of Supplemental Capital

Under the borrowing authority, the NCUA Board believes FCUs could issue supplemental capital as subordinated debt. Subordinated debt would typically be issued to institutional or accredited investors, regardless of whether the investors are members of the credit union.

While subordinated debt is one form of supplemental capital, the Leagues encourage the NCUA to not define or restrict investment types, but rather allow for flexibility and innovation in the market.

Pilot Program

The Leagues strongly urge the NCUA carefully consider whether permitting FICUs to issue subordinated debt or other non-member forms of supplemental capital adheres to the three key public policy principles identified above.

We recommend the NCUA proceed with limited experimentation and allow a small group of

complex FICUs, who demonstrate the desire and the expertise to do so, to pilot a supplemental capital program.

The pilot program should provide enough flexibility to allow participating credit unions to utilize the best tools for their business needs while maintaining sound prudential standards.

Limits

The Leagues recommend there be some limit on how much supplemental capital will count for risk-based capital requirements to ensure it remains supplemental and not the primary source of capital. We support a limit of 50 percent.

Disclosures

The Leagues support the provision of clear, transparent, and robust investor disclosures. The Leagues strongly recommend the NCUA not recreate the wheel. Instead, the agency should look to existing regulatory frameworks and disclosure requirements and vary those only as needed to incorporate the credit union difference (e.g., no voting or ownership rights).

Reciprocal Holdings

Regulations for alternative capital should address reciprocal holdings that exist when two or more credit unions hold each other's alternative capital. The NCUA notes that reciprocal holdings of alternative capital would artificially inflate the level of capital in the credit union system, create loss transmission channels between credit unions, and could be subject to abuse. The Leagues agree an accounting adjustment should be required if the NCUA permits reciprocal holdings.

Low-Income Designated Credit Unions

The ANPR questions whether the use of supplemental capital by non-LICUs will negatively impact LICUs. The Leagues do not think it would. In California and Nevada, six of the 81 LICUs have accepted secondary capital. Some of these investments have been philanthropic and some from government programs, such as the U.S. Treasury Department's Community Development Capital Initiative (CDCI)[\[5\]](#), designed to help viable certified Community Development Financial Institutions (CDFIs) and their communities cope with the effects of the financial crisis. Rather than diluting or negatively impacting the opportunities for LICUs, the Leagues believe permitting supplemental capital for all FICUs will expand the market for LICU capital instruments.

NCUA's Rules and Regulations, Part 701.34, sets out the requirements and process for a credit union to receive a low-income designation, the criteria for accepting secondary capital, and the inclusion of secondary capital as regulatory capital. The Leagues support revising Part 701.34 to be solely focused on the process to receive a low-income designation. All requirements for alternative capital, for both LICUs and non-LICUs, should be moved to one section.

Dividends

The existing regulatory language regarding secondary capital for LICUs requires that it is available to "cover operating losses." The term "operating losses" has been interpreted to not include the payment of dividends on shares. The Leagues agree this could create liquidity and

reputation risk.

Currently, credit unions have the ability to pay dividends on shares from capital. This should also be a permitted use of alternative capital. Alternative capital should be available to absorb all losses in excess of retained earnings, including the payment of dividends on shares.

Federally Insured State Chartered Credit Unions

Supplemental Capital Limits

The Leagues strongly support the dual chartering system, and we recommend the NCUA allow federally insured state chartered credit unions (FISCUs) to raise supplemental capital as permitted by applicable state law. We strongly encourage the agency to work with state regulators when drafting a future alternative capital rule.

Borrowing Limits

The FCU Act limits the aggregate amount of borrowed funds for FCUs to 50 percent of paid-in and unimpaired capital and surplus. NCUA's regulations, Part 741.2, prescribes the same borrowing limits for all FICUs, but provides the ability for FISCUs to obtain a waiver up to the amount of borrowing allowed under state law. As the Leagues believe FISCUs should be able to follow state law without additional constraints by the NCUA, we support retaining this borrowing limit waiver.

Capital Stock

The Internal Revenue states that to qualify as a credit union exempt from federal income tax under section 501(c)(14)(A) of the Internal Revenue Code (IRC), a credit union must be formed and operated under a state credit union law, without capital stock and, thus, have state defined characteristics, operate without profit and for the mutual benefit of its members.

As NCUA notes in the ANPR, the Internal Revenue Service (IRS) has not established a definition of "capital stock." Absent a definition from the IRS or under the IRC, a few courts have opined that a lack of certain features tends to make an instrument less like common stock or capital stock and more like debt. One of those features is the lack of voting rights [\[6\]](#). It is imperative that any future NCUA regulations stipulate that supplemental capital instruments do not confer voting rights.

NCUA Approval

The Leagues recommend any future regulation require that credit unions obtain NCUA and state supervisory approval (as applicable) prior to issuing supplemental capital. To ensure a timely process, the Leagues also recommend the regulation provide that a credit union may deem its plan approved 90 days after its plan is submitted to regulators, unless informed otherwise in writing. Once approved, or the 90-day period has run, the rule should give a set time frame within which to issue the supplemental capital. These timeframes provide structure and a degree of certainty for the credit union, the NCUA, and state regulators (as applicable).

NCUA's regulation should establish the criteria for FICU's supplemental capital plans that include, among other things, the credit union's sound business use of the proceeds, the amount of supplemental capital to be offered, the rates and maturities and, as discussed above, a legal opinion that the supplemental capital offering does not convey voting rights.

Tax Exemption

The NCUA has expressed concern that part of the basis for the credit union tax exemption was that Congress recognized most credit unions could not access the capital markets to raise capital. The Leagues, on the other hand, believe that the reason credit unions are tax exempt is because they are not-for-profit. Issuing supplemental capital does not alter credit union mutual ownership and governance or the not-for-profit structure. While there is concern about the tax exemption status, we cannot and should not allow others to define what constitutes tax exemption.

Conclusion

The Leagues commend the NCUA Board for its efforts in exploring alternative capital for all credit unions. Issuing this ANPR in order to receive comments and recommendations from the industry in advance of any proposed rule is both appropriate and appreciated.

In conclusion, the Leagues highly recommend the NCUA take a reasoned and measured approach to implementing any supplemental capital regulations. Supplemental capital issued to members as equity capital or raised through a mandatory membership share purchase should be permitted for all FICUs. However, we recommend the use of subordinated debt or other forms of supplemental capital be first tested in a limited scope with credit unions who have the desire and expertise to do so. In addition, the NCUA should not put in place any requirements that constrain FISCUs from following their applicable state law.

We believe the agency can and should permit the use of supplemental capital in a measured approach that will adhere to the three public policy principles discussed above. We thank you for the opportunity to comment on the proposal and for considering our views.

[1] FCU Act 1790d(o)(2)

[2] 80 FR 6626 (Oct. 29, 2015)

[3] NCUA Supplemental Capital White Paper 2010

[4] NCUA Report to the House Financial Services Committee on the Final Risk-Based Capital Rule, November 2015. Sixteen complex credit unions would be subject to a decrease in their prompt corrective action classification based on December 31, 2014 Call Report data. Thus, approximately 98.5 percent of all complex credit unions will remain well capitalized.

[5] <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cdci/Pages/Overview.aspx>

There are currently 59 financial institutions remaining in the CDCI program.

[6] NASCUS Report: Alternative Capital for Credit Unions...Why Not?; p. 4; dated Summer 2005.

<http://www.nascus.org/publications/alternativecapitalforcreditunionswhynot.pdf>

Sincerely,

Diana Dykstra
President and CEO
California and Nevada Credit Union Leagues

cc: CUNA, CCUL