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CREDIT UNION LEAGUE

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May 9, 2017

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

Re: ANPR on Supplemental Capital

Dear Mr. Poliquin:

The Carolinas Credit Union League (CCUL), a trade association representing the interests of 140 credit unions in North and South Carolina, appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) Advance Notice of Proposed Rule for Supplemental Capital. Because we understand that credit unions are community institutions built on a philosophy of people helping people, CCUL works to protect and advocate for credit unions that provide financial services to their member-owners.

CCUL supports the development and implementation of a supplemental capital rule for several reasons: (1) credit unions are currently the only financial institutions that do not have the authority to raise supplemental capital and have it count towards the statutory capital requirement;[1] (2) rapidly changing technology; (3) member demands for new products and services; and (4) the current regulatory burden on credit unions. These factors are ample justification for a regulation that will assist credit unions in managing their capital. This letter will discuss these specific issues: public policy, regulatory factors that should be considered when drafting a regulation, mergers, and tax status implications.

<u>Good Public Policy</u>

The ability to build net worth only through retained earnings adds an unnecessary burden on credit unions when there is a viable solution--supplemental capital. The effective date for the risk-based capital regulation is fast approaching and the addition of a supplemental capital rule will help credit unions manage their risk-based net worth. Therefore, supplemental capital is the right thing to do as it will provide a valuable tool for credit unions.

Some credit unions continue to experience high levels of share growth and a reduction of their net worth ratios. Because of this, some well-capitalized credit unions are discouraging member deposits. In this scenario, credit unions are forced to control growth and expansion due to the limitations on raising immediate capital. The result is short-term improvement to the net worth ratio at the expense of the long-term benefit of increased membership participation.

Supplemental capital may shorten recovery of capital from losses caused by uncontrolled external factors such as natural disasters and local market declines. Currently credit union options for recovery from a decline in capital are limited to decreasing assets, reducing share dividend rates, raising loan rates, increasing fees, cutting operating expenses, selling assets, and merging the credit union--all of which have negative member consequences.[2]

[1] NCUA, Supplemental Capital White Paper, (April 12, 2010) p. 4. Available at https://www.ncua.gov/Legal/Documents/SupplementalCapitalWhitePaper.pdf
[2] NCUA, Supplemental Capital White Paper, (April 12, 2010) p. 13. Available at https://www.ncua.gov/Legal/Documents/SupplementalCapitalWhitePaper.pdf

The development of new financial products and services continues to accelerate and credit unions should have the ability to stay competitive. Access to supplemental capital would enable credit unions to implement products and services in a timelier manner.

Regulation

In recent years NCUA has modernized several regulations such as the fixed-asset rule and the field of membership rule. These changes gave credit union leadership more control and flexibility in managing their credit unions. The regulation should establish broad criteria for all forms of supplemental capital rather than listing specific instruments. A flexible regulation allows credit unions to develop supplemental capital instruments that are responsive to market demands.

Supplemental capital should be available to natural persons as well as non-natural person investors. Permitting both types of investors increases the market for secondary and supplemental capital and diversifies the investor pool.

CCUL believes the framework of a supplemental capital regulation should adhere to three principles: (1) preservation of the cooperative mutual credit union model; (2) robust investor safeguards; and (3) prudential safety and soundness requirements.[3]

1) Preservation of the cooperative mutual credit union model

   There are several features that should assist in preserving the cooperative credit union model. They include no voting rights for investors, no put rights on the part of the holder, subordination to the share insurance fund, and redemption at the discretion of the issuer at face value.

2) Robust investor safeguards

   Supplemental capital instruments are uninsured and available to cover losses directly after depleting retained earnings. Therefore any regulation should assure that investors are informed through full and transparent disclosures. When developing the requirements of the disclosures, NCUA should review the secondary capital disclosures applicable to corporate and Low-Income Credit Unions (LICUs), as well as other financial regulators' disclosure requirements for supplemental capital.

3) Prudential safety and soundness requirements

   Credit unions looking to issue a supplemental capital instrument should be required to receive NCUA approval before issuance of any instrument. The credit union should submit a business plan for the issuance, and time limits should be placed on NCUA for efficiency and timeliness. The agency should also consider a streamlined method for a credit union to request approval for a new issuance that is similar to a prior issuance.

   The regulation should also set a standard by which credit unions qualify for supplemental capital. For example, a credit union should be adequately capitalized and the last examination should not contain material requirements.

In the long term, a flexible regulation will facilitate market innovation as credit unions identify different business strategies and develop new capital instruments.

Mergers

NCUA requested comments on how supplemental capital should be treated in the case of voluntary mergers. Current secondary capital rules require LICUs to close and pay out secondary capital accounts to investors before a merger with another credit union. However, the secondary capital regulation for corporate credit unions provides that all capital instruments will be transferred to the continuing credit union, unless otherwise stated in the merger agreement. Credit unions should not be required by regulation to close supplemental capital accounts before a voluntary merger, nor should supplemental

[3] Id p. 15

capital contracts allow investors to call the investment upon a voluntary merger. Mandating the payout of supplemental capital before a merger diminishes one of the growth management benefits of the issuances. With respect to the prohibition on the covenants requiring payout, such covenants complicate the issue of ownership and control. For these reasons, CCUL recommends that NCUA look to the supplemental rules of corporate credit unions for voluntary mergers.

<u>Tax Status</u>

The NCUA Board recognizes that supplemental capital may impact the credit union tax status[4] and requests comments on the possible impact supplemental capital may have on credit unions. As NCUA notes in the Advanced Notice of Proposed Rulemaking (ANPR), the Federal Credit Union Act specifically exempts federally chartered credit unions from income taxation. One reason for this is that Congress recognized that most credit unions could not access capital markets.[5] However, federally insured state-chartered credit unions receive their tax status through the Internal Revenue Code.[6] The code contains a three-pronged test in order to maintain the 501(c) (14) (A) status, and one of the three is that credit unions are barred from issuing “capital stock.”

It is important to note that the IRS has not defined “capital stock” for this purpose. Several court opinions have noted that in order to make an instrument less like capital stock and more like debt, the instrument issuer should avoid (a) voting rights; (b) any holder’s right to put the instrument back to the issuer; and (c) appreciation in the instrument’s value in accordance with the issuer’s profitability.

Further evidence on how the IRS may assess future supplemental capital offerings is detailed in two of its private letter rulings. The first in 1997 to U.S. Central Credit Union states that the credit union’s member paid in capital (PIC) did not constitute capital stock for purposes of its exemption from federal income taxes. The second sent in May 2005 concluded that the Equity Shares issued by State Employees’ Credit Union do not constitute “capital stock” within the meaning of section 501(c)(14)(A) of the Internal Revenue Code. This ruling indicated Equity Shares are merely a means of saving in that they grant neither a participating equity interest in the credit union nor any participation in the management of the credit union. Accordingly, they do not impact the credit union’s tax-exempt status under section 501(c) (14) (A) of the Internal Revenue Code.

CCUL believes a credit union’s tax status will not be impacted as long as any instruments issued neither confer voting rights nor permit management of the credit union, and the credit union maintains the cooperative model.

For the reasons stated above, CCUL supports NCUA development and implementation of a supplemental capital rule. Further, CCUL recommends that the process include forming a working group of all stakeholders and ensuring the rule provides necessary flexibility to allow for new forms of supplemental capital as they evolve.

Sincerely,

Jeanne S. Couchois

Jeanne Couchois, Esq.
VP Compliance and Regulatory Counsel

[4] The ANPR p. 9696

[5] 12 U.S.C. §1768

[6] 26 U.S.C. §501(c)(14)(A)