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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: Alternative Capital

Dear Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to provide comment on the National Credit Union Administration (NCUA) advance notice of proposed rulemaking, *Alternative Capital* (ANPR). ICBA shares the view of the federal banking regulators that quality levels of loss-absorbing capital are crucial to ensuring that a community financial institution can thrive in times of severe economic stress. ICBA also agrees that only forms of high quality capital that are subordinate to all other claims against the organization and are not redeemable should be relied upon to provide the loss absorption that could be needed in times of severe or prolonged economic stress. Capital instruments that provide false assurances of capital adequacy put otherwise well-meaning firms at tremendous financial risk when economic conditions are not optimal.

This is precisely why ICBA is calling for NCUA not to proceed with allowing federally insured credit unions to issue supplemental capital to meet the minimum risk-based net worth requirement. Credit unions, most of which lack the sophistication needed to manage complex financial liquidity matrices, should seek to serve account holders of

¹ The Independent Community Bankers of America®, the nation's voice for more than 5,800 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. With 52,000 locations nationwide, community banks employ 760,000 Americans, hold \$4.7 trillion in assets, \$3.7 trillion in deposits, and \$3.2 trillion in loans to consumers, small businesses, and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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limited means with a narrow set of tailored consumer financial products. Without proper controls and limitations, the credit unions themselves, the communities they serve, and taxpayers could be subject to tremendous risk as the insurance currently provided to deposit holders may be in jeopardy.

The Proposed Rulemaking

The NCUA is considering a proposal to allow federally-insured credit unions to issue supplemental capital eligible for inclusion in the risk-based net worth requirement that is required for credit unions identified as complex. NCUA states that supplemental capital should be explored further as a tool for credit unions to use to build capital beyond retained earnings in order to protect the Share Insurance Fund. The proposal would seek to amend the existing alternative capital framework for credit unions from the secondary capital instruments currently issued by low-income designated credit unions by adding the authorization of supplemental capital instruments, which do not currently exist. Supplemental capital would not qualify as eligible capital for a credit union's net worth ratio. However, as discussed below, NCUA sees a path to include supplemental capital in the risk-based net worth requirement for those complex credit unions subject to the risk-based net worth ratios.

The NCUA currently allows low-income designated credit unions to issue secondary capital that qualifies for inclusion in the credit union's net worth ratio and, if applicable, the credit union's risk-based net worth ratio when it is uninsured and subordinate to all other claims of the credit union. Losses on secondary capital must be shared on a pro rata basis and no payment priority is permitted. Secondary capital can only be issued to non-natural persons (generally institutional investors) whether they are members or nonmembers, cannot be insured, and must have a minimum maturity of five years with a haircut applied to inclusion of secondary capital in the net worth ratio of the credit union when the remaining term to maturity is less than five years. Secondary capital instruments can be redeemed early only with NCUA approval.

The NCUA cannot amend the definition of a credit union's current net worth requirement without action by the U.S. Congress. However, NCUA asserts that it has broad powers through the Federal Credit Union Act to amend the risk-based net worth requirement in order to bolster the number and types of capital instruments that would qualify as appropriate regulatory capital for those complex credit unions subject to the risk-based net worth requirement. Similarly, NCUA does not possess the authority to allow credit unions not designated as low income to issue alternative forms of uninsured loss-absorbing capital. However, NCUA believes that the Federal Credit Union Act allows credit unions to borrow from any source based on rules set by the regulator. Thus, NCUA could allow credit unions to structure supplemental capital issuances as subordinated debt.

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Supplemental capital would be designed to be subordinate to the Share Insurance Fund and uninsured shareholders in priority of payment. Because by statute secondary capital must be subordinate to all other claims, supplemental capital would be senior to secondary capital in payment priority for low-income designated credit unions. Payment waterfalls among different tranches of supplemental capital could be established to provide investor yield enhancement. NCUA's current regulations do not address borrowings from non-natural persons so the agency may be required to draft regulations clarifying the ability of a credit union to borrow from a source other than a natural person.

Authority to issue supplemental capital as granted by the NCUA would only apply to federally-chartered credit unions. State chartered credit unions that are federally insured would be allowed to issue supplemental capital only if permitted by state law. Such sanctioned debt instruments would need to be carefully designed to ensure they meet NCUA requirements for supplemental capital in order for them to qualify as regulatory capital for the risk-based net worth requirement. State chartered credit unions that are federally insured have obtained their tax-exempt status through the Internal Revenue Code when they operate for mutual purposes without profit and without capital stock. With no current established definition of capital stock by the Internal Revenue Service (IRS), state chartered credit unions that issue supplemental capital would need to take steps to ensure that such instruments do not meet the IRS threshold for classification as capital stock.

ICBA's Comments

This proposal is another example of NCUA pushing the envelope and acting as a cheerleader for the industry it regulates. The NCUA's proposed rule on alternative capital would undermine credit unions' mutual ownership structure, allow outside investors to leverage the credit union tax subsidy, and fuel runaway growth of an industry that has already expanded beyond its original purpose. The NCUA should focus on the intended mission of credit unions: serving people of modest means through a mutual ownership structure. It is time for Congress to reexamine the tax-exempt status of credit unions.

NCUA Lacks Statutory Authority for the ANPR. While federally-chartered credit unions possess the authority to borrow under the Federal Credit Union Act, they have not been granted the explicit statutory authority to issue debt that acts as risk-based capital and can be used to meet the minimum risk-based net worth requirement. In ICBA's opinion, the NCUA lacks the regulatory authority to allow any except low-income designated credit unions to issue capital in the form of long-term debt and would be in violation of the statute if it were to proceed with the issuance of a formal proposal on the matter. The proposed supplemental capital in its current form would not qualify as tier one capital if

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issued by banks. Therefore, if credit unions were allowed to use the proposed alternative capital instruments to meet the minimum risk-based net worth requirement, they would derive yet another competitive advantage over commercial banks.

Excessive Leverage. ICBA is very disturbed by NCUA actions that seek new exotic forms of regulatory capital for credit unions, which are chartered with the understanding that they do not operate to make a profit and they exist only for the mutual benefit of their members. Once credit unions engage in aggressive borrowing strategies that apply increased leverage to otherwise simple and straightforward balance sheets, disastrous results can occur. Credit unions were never intended to take on the size, complexity, and profitability goals of community banks, and credit unions enjoy very favorable tax exemptions based on the premise that they would not operate in a fashion that puts the taxpayer at risk for massive bailouts. Proceeding down the path of increased borrowings without a solid understanding of how those borrowings can bring a troubled institution to insolvency at a very rapid pace is not healthy for the credit union, its members, alternative capital investors, and the communities that are displaced as a result.

Tax Exemption in Jeopardy. Credit unions today receive an exemption from federal, state, and local taxes except for taxes on real or personal property based on the premise that they would be cooperatives that engaged in very limited deposit taking and lending activities to a narrow membership base. Rather than participate in the commercial lending activities of community banks and other lenders, credit unions were always envisioned as mutual organizations that served a limited number of member depositors and customers. If credit unions are allowed to issue new forms of capital instruments, they will most certainly seek to actively participate in commercial lending activities generally not undertaken by these cooperative organization today. Once their participation is apparent, and some would debate that it has already occurred, credit unions no longer are cooperatives that engage in limited deposit taking and lending activities to mutually benefit a membership base and therefore should naturally lose their tax-exempt status. **At a time when corporate tax relief is at the forefront of the agenda of Congress, requiring credit unions that compete with tax-paying community banks to pay federal income taxes would go a long way in establishing a level playing field with regard to competitive lending and act as a new source of much needed tax revenue for the U.S. Treasury.**

One of the reasons federal credit unions are exempt from taxation is because of their mutual ownership structure and their inability to access the capital markets. This proposal, if implemented, would result in credit unions having an ownership structure similar to most taxpaying banks with a category of investors whose interests are inconsistent with those of its mutual owners. Without a mutual, cooperative form of ownership, there will no longer be any legal or policy justification for credit unions to remain tax exempt.

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It should be noted that the introduction of the ANPR is timed conveniently with the existing drive by a number of large credit unions that are seeking to grow their balance sheets exponentially through the issuance of commercial loans and member business loans, a line of business that is currently restricted by Congress. If the issuance of supplemental capital is permitted to move forward, those large credit unions will be incentivized to become even larger by issuing large amounts of supplemental capital to facilitate the origination of unprecedented levels of commercial and member business loans in defiance of the intent of Congress. As a result, mutual organizations designed to serve a narrow membership focus will become large regional enterprises that circumvent taxation.

Increased Risk to the Taxpayer. NCUA explains that the introduction of supplemental capital could be a risky endeavor for a small number of large credit unions that would hold high concentrations relative to their smaller peers. Supporting this view is NCUA's notation that only about three percent of low-income designated credit unions have secondary capital outstanding. Of the amount outstanding, the majority of existing secondary capital is concentrated in just four low-income designated credit unions. Further noted, the risk profile of low-income designated credit unions increases exponentially when they issue secondary capital. The average annual failure rate of low-income designated credit unions with secondary capital between the years 2000 and 2013 was more than triple the failure rate of low-income designated credit unions without secondary capital. NCUA also notes that in the failures of low-income designated credit unions, failure was correlated to rapid asset growth. **Lack of experience with supplemental capital, coupled with elevated failure rates of low-income designated credit unions that do not rely enough on retained earnings for the absorption of credit losses, is enough evidence to show that the supplemental capital experiment could fail miserably putting taxpayers at great risk.**

Risky Investment. The issuance of supplemental capital to credit unions raises a number of issues with regard to the types of capital that could be made available for investment and who would be eligible to invest in the securities. For example, the issuance of secondary capital by low-income designated credit unions is currently restricted to institutional investors under the assumption that speculative securities should not be issued to consumers who may not have the ability to appreciate the risks present in the underlying investments. Supplemental capital would present the same if not more risks to retail investors, especially if issuers are able to structure the investments. Additionally, low-income designated credit unions market their capital offerings to nonmember entities, which represents outside investment in a limited purpose financial organization established to serve a very specific membership group. If supplemental capital were marketed to and actively acquired by nonmember individuals and entities, the very purpose, goal, and mission of the credit union would be called into question.

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Even more troublesome is the prospect that some credit unions could attempt to market supplemental capital offerings to existing members, who could mistakenly assume that their investments, because they are solicited in a branch or online using the credit union's marketing banner or profile, are guaranteed by the NCUA or some other agency of the United States. When a credit union member must decide between the yield provided by a demand deposit account and an investment in the credit union itself, the member could be steered toward the non-guaranteed investment without fully understanding the potential consequences of an insolvency or closure. Even if the supplemental capital investment is not impaired, its liquidity in the capital markets could be nonexistent, making access to funds impossible or a stressed market sale probable and unexpected for an investor that expects to be made whole. **Therefore, ICBA expects that the NCUA would not permit retail or credit union member investors to submit themselves to credit union supplemental capital exposure without full compliance with all applicable provisions of the Securities Act of 1933 and the Securities Act of 1934.**

Limited Loss Absorption. NCUA notes that issued regulatory capital should be permanent to create stability in the credit union's capital base over a long period of time in order to protect against future losses. These views are shared by both U.S. and international banking regulators and reflects many valuable lessons learned during the financial crisis of 2008-09 about the need to scrutinize the types of capital present on bank balance sheets and the degree to which the capital is able to absorb future unexpected losses. The proposed supplemental capital offering framework could give a false sense of security that the credit union expects the instrument to bring in times of economic strife when the capital is most badly needed. For example, supplemental capital instruments issued by a credit union with a ten-year term would start losing their eligibility for inclusion in regulatory capital in year 6. This potentially could coincide with the advent of an economic or market recession or even a depression event that could last for years. With mounting losses and an erosion of supplemental capital in the risk-based net worth formula, the credit union would be unable to utilize the full loss-absorbing ability of the supplemental capital instrument when it is most needed. Additionally, the credit union would be unable to raise any form of common equity capital and probably would be shut out of the new issue arena of the capital markets for additional supplemental capital. Compound this risk over 100 or more credit unions and the Share Insurance Fund could be depleted at an unprecedented rate.

ICBA agrees with the NCUA that forms of low-quality capital like supplemental capital should not be the primary component of regulatory capital for credit unions. But ICBA does not believe that the annual step reduction in eligibility requirements for risk-based net worth during the last five years of the instrument's life is enough to ensure that the risks introduced through unsafe supplemental capital issuances are mitigated. **Therefore, ICBA believes that the supplemental capital framework proposed by the NCUA**

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does not meet the requirements needed to protect against failure during an economic crisis and should not be pursued.

ICBA appreciates the opportunity to comment on the ANPR. If you have any questions or would like additional information, please do not hesitate to contact James Kendrick at james.kendrick@icba.org.

Sincerely,

/s/

James Kendrick
First Vice President, Accounting and Capital Policy

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