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

Re: Alternative Capital - 12 CFR 701-703, 709, 741, and 745 [2017-01713]

5/8/2017

Dear Mr. Poliquin,

The League of Southeastern Credit Unions (League) appreciates the opportunity to comment on the Advanced Notice of Proposed Rulemaking (ANPR) for Alternative Capital. The League believes that credit unions should have access to other forms of capital in addition to retained earnings, which most credit unions are presently limited to. The League supports the creation of a variety of instruments to give credit unions the opportunity to issue alternative capital regardless of a particular credit unions size, location, or membership that will count toward complex credit unions' risk-based net worth ratio (and net worth ratios for low-income credit unions). Specifically, the League believes the industry's priority is to effect legislative changes to the Federal Credit Union Act (FCUA) that will model the Risked Based Capital (RBC) regime to our industry rather than one developed for banks under the Basel

Accords.[1] But for the present rule-making, NCUA should use its full authority under the FCUA to give credit unions the flexibility to issue capital instruments that fit their needs. The League of Southeastern Credit Unions is a trade association that represents 260 credit unions in Florida and Alabama. Our mission is "to create an operating environment that enables credit unions to grow and succeed." The League pursues that mission in its support of the expansion of credit union access to alternative capital.

**Recommendations**

The League recommends the NCUA work with the credit union industry to seek legislative changes to the Federal Credit Union Act to better accommodate the credit union system with the spirit of the Basel Accords. Because the Basel Risked Based Capital regime was not developed to accommodate the credit union model,[2] the credit union system is at an operational disadvantage regarding capital ratios.[3] The FCUA should be amended to allow all credit unions to issue supplemental capital that would count towards both the net worth and the risk-based net worth ratios for Prompt Corrective Action purposes.

In the meantime, the League supports the NCUA promulgating a rule to allow credit unions to offer alternative capital instruments that count towards the risk-based net worth.[4] Specifically, the NCUA should give credit unions the most flexibility under the current law in meeting their needs by allowing instruments to be offered to both members and non-members, including financial institutions.

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[1] A. Michael Andrews, The Filene Research Institute, *Credit Union Capital Adequacy: What's New and What's Next?* 6 (2014).
[2] *Id.* at 30-32.
[3] Robert F. Hoel, The Filene Research Institute, *Alternative Capital for U.S. Credit Unions? A Review and Extension of Evidence Regarding Public Policy Reform* 10-11 (2007).
[4] 82 Fed. Reg. 9691 (Feb 8, 2017).

## The Case for Alternative Capital

*Growth and Competition*

Credit unions should have access to Alternative Capital to confront the challenges in maintaining a healthy portfolio, while promoting growth in membership and assets.[5] With the economic environment continuing to improve,[6] it is important that credit unions have the ability to make new loans without being overly constrained by present PCA rules.[7] Banks have the ability to meet an increase in loan demand by issuing capital in a variety of ways.[8] Credit unions (excepting the low-income credit unions) must rely on retained earnings to build up their capital which is generally a long-term process.[9] The disadvantage in the ability to access capital is magnified by the fact that credit unions are required to hold a higher percentage of capital than banks, even when they operate in a much safer manner.[10] This statement is supported by the fact that the credit union industry fared better through the financial crisis than did banks.[11] Interestingly, the proponents' enigmatic case for higher capital ratios for credit unions is as follows:

1. Credit unions can only use retained earnings to increase net worth.

2. It takes much longer to increase net worth through retained earnings

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[5] Hoel, *supra* at 16.
[6] Paul La Monica, *How the economy is really doing.* CNN Money, May 5, 2017, http://money.cnn.com/2017/05/05/investing/trump-economy-report-card-jobs/
[7] James A. Wilcox, Filene Research Institute, *Subordinated Debt for Credit Unions* 16-17 (2002)
[8] *Id.* at 17.
[9] U.S. Gov't Accountability Office, GAO-04-849, Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital 16 (2004).
[10] Hoel, *supra* at 10.
[11] Peter Hunt, et al., *Raising New Capital in Mutuals: Taking action in the UK* 6 (2013).

3. Therefore, credit unions should have higher net worth requirements.

This is clearly a disadvantage because, in the event that there is a great increase in loan demand, banks are in a better position to grow than credit unions.[12] One could argue that this has always been the case, yet credit unions have fared well.[13] However, there has been sluggish economic growth for nearly a decade,[14] and it is vital that credit unions have similar opportunities to grow as banks do, particularly in light of the trend of credit union closure that has continued for a decade.[15] While this trend may be natural and unavoidable in some ways, when considering economic growth and the inability of some credit unions to adapt to circumstances, such as their sponsor company closing or a decline in the local economy, those credit unions in competitive markets should have all the tools they need to compete with banks. For the largest credit unions it is easy to conceptualize a scenario in which a credit union is actively seeking to gain significant growth in membership but may be forced to restrict offering some products to maintain its well-capitalized rating. Under this possibility, the leadership of a credit union may consider converting to a bank because of the inability to get quick access to capital as a credit union to take advantage of a growth opportunity.[16] Related to this, economic growth may see an increase in deposits which could also cause a credit union to drop below the well capitalized threshold.[17]

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[12] Hoel, *supra* at 10.
[13] GAO, *supra* at 10.
[14] Dennis Lockhart, President & CEO, Fed. Reserve Bank of Atlanta, *Crisis, Recession, and Recovery: 2007-16*, Speech at Rotary Club Atlanta. (2017). https://www.frbatlanta.org/news/speeches/2017/01/09-lockhart-crisis-recession-recovery-2007-2016
[15] Dan Flessner, *Credit unions grow in size and services, shrink in number*, Times Free Press, June 15, 2015, http://www.timesfreepress.com/news/business/aroundregion/story/2015/jun/15/credit-unions-grow-size-and-services-shrink-number/309680/
[16] Hoel, *supra* at 17.
[17] Wilcox, *supra* 17-19.

*2004 GAO Report*

The GAO published a report in 2004 titled, "Available Information Indicates No Compelling Need for Secondary Capital,"[18] may be used by some as a justification for limiting credit union access to alternative capital. They would be wrong for many reasons.

First, because the information is over a decade old, the "available information" is stale. This would be true even without considering the economic changes wrought by the financial crisis and growth of the regulatory state with the passage of the Dodd-Frank Act. The issues the report states the industry is most concerned about: triggering PCA due to conditions beyond credit unions' control, suppressing growth, and artificially high PCA triggers (for credit unions' conservative operations)[19] are still concerns.

Second, the report questions who would buy the instruments. The drafter's concern is that the instruments would be purchased within the industry and therefore would concentrate and spread the risk of unhealthy institutions to healthy ones throughout the whole industry.[20] However, the rule can resolve this issue by having caps for credit union reciprocal (cross) holding capital investment.

Third, the report states that credit union growth has not been impacted by prompt corrective action, however, this issue is complicated by the implementation of the risk-based net worth scheme into the prompt corrective action framework since the report was published. Implementation of risk-based net

[18] GAO, *supra*.
[19] *Id*. at 3.
[20] *Id*.at *18-19*.

worth PCA regime is on New Year's Day 2019[21] and the true test of the impact will come after the implementation.

Finally, the report questions both the form and the lack of consensus within the industry regarding issues relating to the lack of need for access to alternative capital.[22] These concerns are interrelated. The credit union industry is far more diverse than that of banking with institutions being both large and small, filling very unique niches for employees or communities and offering a very wide or very limited range of products. Therefore, the individual needs of an institution will frame the form of the instrument that an institution would need to offer for its particular goals. With that being said the industry has generally agreed on several principles for alternative capital:

1. Preservation of the cooperative ownership model.
2. Consistency with the tax-exempt status of credit unions.
3. Robust investor protection.
4. Equity-like instruments sold only to members.
5. Debt-like instruments may be sold to nonmembers.[23]

***<u>The Legal Framework</u>***

The Federal Credit Union Act allows low-income credit unions to issue secondary capital that is included in their net worth ratio:

[21] 80 Fed. Reg. 66625 (Oct. 29, 2015).
[22] GAO, *supra* at 1.
[23] Andrews, *supra* at 26.

(C) with respect to a low-income credit union, includes secondary capital accounts that are—

(i) uninsured; and

(ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund.[24]

Though alternative capital instruments that can be included in a net worth ratio are limited to low-income credit unions, the Prompt Corrective Action scheme Congress promulgated under the Credit Union Membership Access Act[25] did not similarly limit capital instruments for inclusion in the risk-based net worth for complex credit unions. This statute specifically gives the Board authority to define the requirements based on the assets and liabilities of credit unions,[26] which alternative capital can be included within.

While those instruments mentioned above are likely to be debt instruments, the ability to offer equity instruments (shares) that pay varied dividend rates is provided for under the FCUA:

"(6) to receive from its members, from other credit unions, from an officer, employee, or agent of those nonmember units of Federal, Indian tribal, State, or local governments and political subdivisions thereof enumerated in section 1787 of this title and in the manner so prescribed, from the Central Liquidity Facility, and from nonmembers in the case of credit unions serving

[24] 12 U.S.C. §1790d.(o)(2).
[25] The Credit Union Membership Access Act of 1998, Public Law 105-219, 112 STAT. 913 (1998).
[26] 12 U.S.C. §1790d (d)

predominately low-income members (as defined by the Board) payments, representing equity, on—

> (A) shares which may be issued at varying dividend rates;
>
> (B) share certificates which may be issued at varying dividend rates and maturities; and
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> (C) share draft accounts authorized under section 1785(f) of this title; subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board;"[27]

Under these Code provisions, low-income credit unions can issue equity or debt shares to members or non-members at varying dividend rates. The statutory language clearly gives low-income credit unions the ability to offer a debt or equity (or presumably a hybrid) instrument. Because the section of code references low-income members, it follows that these equity instruments would also count in the net worth ratio, as long as they uninsured and subordinate to other claims, otherwise why would they have the ability to offer an equity instrument. Section C provides that the Board sets limitations on these instruments, so that if there is disagreement about the Board's ability to expand credit union access to alternative capital because of a lack of clarity with the statute, the judiciary should give NCUA deference in its interpretation of these statutes under the Chevron Rule.[28]

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[27] 12 U.S.C. § 1757 (6).

[28] *Chevron U.S.A., Inc v. NRDC*, 467 U.S. 837 (1984) (stating that an agency's interpretation of its authority to create regulations under the statute giving it rulemaking authority is given deference when it is challenged in court unless that interpretation is unreasonable.)

***General Recommendations***

The League has several recommendations for NCUA regarding Alternative Capital. First, NCUA should work with the industry to seek legislative adjustment for the Risk Based Capital regime to better fit with credit union operations. NCUA should support legislation that allows all credit unions, not only low-income credit unions, to offer alternative capital that counts towards the net worth ratio, including FISCUs. Second, and specifically relating to this rule making, NCUA should give credit unions the flexibility to offer different forms of capital instruments including: institutional, voluntary member, mandatory member, and non-member capital. Third, NCUA should study the credit unions and cooperative banks in Europe, Canada, and Australia for potential legislation or regulatory reform that can be adapted and used successfully in the United States.

1. Alternative Capital

The diversity of the credit union industry demands that NCUA create a rule that gives credit unions seeking alternative capital a variety of options to fulfill the requirements of the RBC regime. Of all the forms of alternative capital, offering capital instruments to institutional investors is likely to be the most popular method. This is because a large number of credit unions could get access to capital more quickly compared to the other methods because there is an established industry that provides such funds and because that industry has the resources to purchase large quantities of such instruments. The credit union industry already has an institutional investor in CUNA Mutual Group that has experience in investing in credit unions. However, there is likely to be broad investor interest in credit union capital instruments.[29]

[29] Hoel, *supra* at 48.

The most likely form for these instruments would be subordinated debt,[30] though there appears to be legal authority to offer equity instruments,[31] which would imply the ability to offer hybrid instruments. One particular benefit of use to institutional investors is that they provide a measure of market discipline to the industry in that investors will evaluate at an institution's risk profile before agreeing to purchase alternative capital instruments. Besides institutional investors in the marketplace, employer sponsor groups may also be a good source of capital for some credit union.[32] The League encourages NCUA to allow credit unions to develop the alternative capital instruments which give them the ability to raise the capital in the way that best fits their needs.

Some credit unions may prefer, or be in a better position, to utilize the other primary means of raising capital, from the membership. Raising capital in the method can be done on a voluntary or mandatory basis. Raising voluntary capital can be characterized as similar to a certificate of deposit, while the mandatory capital is similar to the mandatory share that is required for membership in the credit union. What differentiates these products and their progenitors is that the alternative capital products are not insured. Voluntary member capital has the potential benefit of involving less cost to solicit the capital at the detriment of not being able to raise large sums of capital quickly. Mandatory capital contribution has the benefit of being universally required so that a credit union could estimate exactly how much capital they would likely raise. This would be helpful if the needed capital fell within this estimate. However, getting board and membership approval for a sum large enough to make a sizable infusion of capital will be difficult, yet this option should still be available to credit unions. Finally, and perhaps most

[30] *Id.* at 46.
[31] 12 U.S.C. § 1757 (6).
[32] Hoel, *supra* at 37.

interesting, is the non-member share. This type of instrument would be offered to the public at large and not only to the credit union membership. The statute gives authority to offer equity instruments to non-members.[33] Indeed, the model for this instrument can be found in the Netherlands when Rabobank offered non-member shares[34] and is mentioned below.

***International Success with Alternative Capital***

As NCUA proceeds to review changes to the alternative capital market for credit unions, it should thoroughly review the instruments and environment of credit unions and mutual banks in Europe, Canada, and Australia. For instance:

- Rabobank (The Netherlands) - This cooperative bank offers member certificates and several hybrid instruments. Between 2010-2011, it borrowed more than 40 billion Euros annually in various forms.[35]

- The Desjardins Group (Canada) - This credit union association offers qualifying, permanent, surplus, and federation shares. It has approximately 200 billion Canadian dollars in assets and is one of the best capitalized institutions in North America.[36]

- CUNA Mutual (in Australia) - CUNA Mutual worked with the Australian credit union industry to raise 100 million Australian dollars in both Tier 1 and Tier 2 capital in 2006.[37]

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[33] 12 U.S.C. § 1757 (6).
[34] A. Michael Andrews, *Report: Survey of Co-operative Capital*, Filene Research Institute, 33-34.
[35] Hunt, *supra* at 20.
[36] Id. at 21.
[37] Hoel, *supra* at 31.

*2. Other Considerations*

Understandably, regulators are concerned about the risks associated with reciprocal holdings of alternative capital amongst credit unions because of the potential to cause a chain reaction of loss throughout the system. The League would support a cap for credit unions holding other credit unions capital instruments to mitigate the risk of systematic transmission of losses. However, here is a good case to be made for credit unions purchasing capital instruments of other credit unions in a limited manner. For instance, if a large credit union with assets of $5 billion purchased $5 million worth of capital instruments from a small community credit union where the large credit union does not operate it may be uniquely beneficial. The smaller community will have a credit infusion; the small credit union will be able to seek out new loans (especially for small businesses); and the large credit union has its capital operating to generate revenue in a market where it does not operate. Certainly, there should be limits to how much alternative capital a credit union can invest in and how much of it can come from other credit unions, or a particular credit union. While the League does not offer any specific details on appropriate limits, the NCUA is in a better position to make this consideration at present because it does not support an outright prohibition on reciprocal holdings.

Regarding the call options, the credit union should have the option of paying off the capital instrument early if the conditions are right to do so. However, the investing party should be limited to seeking approval from NCUA before any early redemption is possible to ensure that withdrawal of capital will not harm credit union operations or cause degradation in a highly capitalized institution.

The League supports any efforts the NCUA will undertake to reorganize the regulations to include all relevant matters within section 702 (Prompt Corrective Action) that will improve their clarity, functionality, or readability.

3. Promulgating a Comprehensive Borrowing Rule

Considering that NCUA may reorganize the Prompt Corrective Action section of the regulations, the League would support the development of a comprehensive rule. In promulgating such a rule, the NCUA should develop a framework for credit unions to follow when offering capital instruments. However, the framework should be flexible enough to allow credit unions to seek capital in ways that best suits their needs. For instance, NCUA may want to mandate a number of uniform clauses to be included in any investment agreement that stipulates the investors have no ownership interests or voting rights or that dividend payments are up to the discretion of the credit union.

As a rule is developed and an approval process is implemented, NCUA should include a streamlined approval process for those institutions that have experience with supplemental capital, or that meet a number of guidelines that indicate they pose little risk to consumers or to the Share Insurance Fund in their offering.  As part of this process, NCUA should study those credit unions that presently offer alternative capital for best practices and form the basis of a rule on those institutions that are successful in their offerings. It is important that, in developing this rule, NCUA develop a rule that does not favor one size credit union over another (like by conditioning approval for an offering on a lengthy process that smaller credit unions may not have the resources for) but offers the right tools to meet the needs, in this case easy access to additional capital.

4. FISCU Authority to Borrow

Regarding FISCUs, the NCUA should remove the limit placed on their borrowing. FISCUs are already governed by the statutory provisions in their state, and the supervisory efforts of the state regulators are a better means of oversight of FISCU practices than an arbitrary rule. Furthermore, the FISCUs will have to satisfy NCUAs rules to manage their net worth and risk-based net worth ratios under Prompt Correct Action, so there will be no advantage to FISCUs over federal charters regarding PCA.

According to one white paper,[38] the three-prong test for taxation of capital instruments usually does not apply to credit union debt instruments and in at least one case, a federal credit union issued equity shares that the IRS found did not remove the credit unions' tax exemption. This particular case, and others where federal credit unions have offered instruments and maintained their tax exemption, should be models for the rest of the industry in developing their instruments. Also, the NCUA's white paper on Supplemental Capital argued for revision of Section 501(c)(14) of the Internal Revenue Code to exempt state chartered credit unions from taxation when offering capital instruments.[39] The League would support efforts to pursue legislative changes in this manner.

5. Mutual Ownership Structure of Credit Unions:

Any alternative capital offerings must not give an ownership interest or any voting rights to the purchaser of the instrument. While there should be wide freedom of contract between the parties, any language in an investment contract that would give non-member investors any formal influence over credit union operations should be void. Some people are concerned that an investor may still influence

[38] *Id.* Hoel, *supra* at 38-39.
[39] National Credit Union Administraiton, Supplemental Capital White Paper 26 (2010).

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management on credit union operations. While this is a legitimate concern, it is no different from others' efforts to exert influence over credit union practices, including friends, family, lovers, business partners, or politicians. Preventing improper influence over credit union operations by investors will rely on strong, ethical, and persistent leadership by management. Furthermore, it is important than any capital raised through voluntary member shares will get no additional rights so as to maintain the principle of one person, one vote.

6. Securities Law:

Securities law was developed to require investors receive proper information of the risks posed by investment and to prohibit fraud in the sale investments.[40] The credit union industry is known for being consumer friendly and supports the goals of securities laws. The credit union industry should take two different approaches to securities law depending on whether the investor is institutional or a credit union member (consumer). Securities registration requirements can be avoided when raising capital from institutional investors if the credit union follows the guidelines in Rule 506 of Regulation D which, among other things, requires selling to accredited investors and not soliciting investors publicly.[41] While there may be other applications of securities regulation for institutional investments, avoiding the registration requirements will avoid a great deal of regulatory costs in offering these capital instruments.

In the interest of consumer protection, credit unions should develop disclosures for members interested in purchasing alternative capital. The NCUA should develop a common uniform disclosure that credit unions seeking capital from their members can tailor to their specific offering. This development should

[40] The Laws that Govern the Securities Industry, https://www.sec.gov/answers/about-lawsshtml.html (last visited May 8, 2017).

[41] 17 CFR 230.506

be based on the SEC rules and, if feasible, should be done in consultation with SEC. However, if the NCUA determines the SEC would have no jurisdiction over capital raised through voluntary member shares, then the League would not object to disclosures developed by NCUA keeping securities disclosures and consumer protection as the basis for developing these disclosures.

The League supports an NCUA approval process for the offering of capital instruments so that a registration requirement would seem to be redundant and unnecessary. However, requiring credit unions to have policies in place to govern compliance with regulations in offering capital instruments is a reasonable step to ensure compliance and best practices. The League would not recommend required policies for compliance with anti-fraud provisions, investment advisor registration, and state securities law because these areas are very sophisticated areas of the law, and it is unlikely that credit union personnel will have the skills to address them. Therefore, the League would support an element of the approval process to require an opinion letter from an attorney regarding these issues.

***Conclusion***

The League supports reforming of the alternative capital regulations to provide greater flexibility to credit unions in maintaining proper capital adequacy while achieving healthy growth in assets. Flexibility is the key to the alternative capital rule so that it allows all the varied institutions in our diverse industry to obtain capital in a cost-effective manner if it suits the needs of that institution. It is vital to give credit unions the option to raise capital so they can stay competitive with banks as the economy improves. That competition is not only good for the credit union industry, but for American consumers, manifested in lower loan rates and high savings rates and through them it is better for our communities and the American economy.

Sincerely,

Michael Lee
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