

Cooperative Credit Union Association

Delaware • Massachusetts • New Hampshire • Rhode Island

Creating Cooperative Power

May 9, 2017

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

**Cooperative Credit Union Association, Inc. Comments on Advance Notice of Proposed Rulemaking on Alternative Capital
RIN 3133-AE66**

BY EMAIL ONLY

Dear Secretary Poliquin:

On behalf of the member credit unions of the Cooperative Credit Union Association, Inc. (“Association”), please accept this letter relative to the National Credit Union Administration’s (“NCUA”) request for comments on its Advance Notice of Proposed Rulemaking on Alternative Capital (“the ANPR”). The Association is the state trade association representing credit unions located in the states of Delaware, Massachusetts, New Hampshire and Rhode Island, serving approximately 195 credit unions which further serve approximately 3.8 million consumer members.

The Association welcomes this opportunity to provide input on this important issue within the financial services industry. The overwhelming majority of the Association’s members support alternative capital authority for all credit unions. The need for capital modernization continues as credit unions experience the challenges not only of external factors such as economic cycles, but also those such as social media and Bank Transfer Day, with no alternatives for growth opportunities beyond their ability to generate retained earnings. The need for increased earnings through managed risk is stronger than ever and a critical component of capital modernization.

The Association is pleased that the NCUA has issued an ANPR to initiate the process of potentially expanding alternative capital authority. Approaching the process this way, by casting the widest net to receive comments, input, concerns, and suggestions from all stakeholders, is most appropriate for such a weighty issue as alternative capital. Rather than promulgating a rule without input from its regulated industry, only to potentially have to revisit and revise that rule due to post-implementation input, the NCUA is providing stakeholders with two opportunities to comment. The NCUA’s level of engagement within the credit union system and before all stakeholders is not only appropriate given the potential impact of an alternative capital regulation on not only credit unions but the financial services industry overall, including consumers, but also necessary and appreciated.

.....
Cooperative Credit Union Association, Inc.

It is the Association's understanding that the NCUA has issued this ANPR in an attempt to receive more detailed responses and specific suggestions as to how to implement alternative capital, and about the structure, form, regulations and requirements related to it.

In preparation for the development of the present comment letter, to foster a local consensus, and in order to assist in providing thoughtful, detailed comments, the Association conducted a survey of all credit union members in order to assess what the local impact of any expansion to alternative capital authority will be, as well as to elicit a better understanding of how our local credit unions are and will approach this issue. The Association also hosted an industry-wide conference call with one of the NCUA's experts in this arena as well as a growth strategy expert in order to ensure local credit unions understand the possibilities of implications of alternative capital authority.

The Association is pleased that NCUA has acknowledged the need for alternative capital for credit unions before Congress and also in its formation of a working group on the topic for certain credit unions. The Association strongly supported these efforts when undertaken, and has continued to urge the NCUA to extend its work to incorporate alternative capital for all credit unions. Credit unions seek such a tool to increase loan portfolios and other growth opportunities within the not-for-profit cooperative structure.

In summary, the Association strongly feels that having the option to issue and accept alternative capital is vital to safeguarding the future safety and soundness of the credit union system. Unforeseen circumstances that may be beyond a credit union's control could strain its capital position to a point where having the ability to quickly raise supplemental capital would be a valuable option. Often, the only option credit unions currently have to raise capital is by increasing their retained earnings balance, which may not be sufficient in a severely stressed situation. Alternative capital authority would also provide an additional source of protection for the National Credit Union Share Insurance Fund.

I. Background

At present, secondary capital is permissible only for low income designated credit unions ("LICUs"), and can be counted towards both the net worth ratio and the risk-based net worth requirement of NCUA's prompt corrective action ("PCA") standards.¹ Supplemental capital, a distinct authority, is being considered for credit unions more broadly, which would only count towards the risk-based net worth requirement.

A credit union's capital level is defined by its net worth ratio requirement (defined as the credit union's ratio of net worth to total assets), and a risk-based net worth requirement for complex credit unions.² The Association agrees with the NCUA's assessment that it is legally permissible for the NCUA to authorize a credit union that is not low income designated to issue alternative capital instruments that would count towards satisfying the risk-based net worth requirement, but not the net worth ratio.

These comments will primarily focus on this concept of supplemental capital, being any form of capital instruments that credit unions which are not designated as low income might be authorized to issue and

¹ 12 C.F.R. §701.34(b).

² 12 C.F.R. §702.

count only for inclusion in the risk-based net worth requirement. The Association will also briefly comment on secondary capital, and what it believes are the necessary accompanying changes to secondary capital standards as a result of our position on supplemental capital expansion.

II. Alternative Capital Authority Is Necessary Considering Risk-Based Capital Requirements

Alternative capital authority is not only appropriate but necessary given the recent NCUA rule on Risk-Based Capital (“RBC”).³ The new RBC requirements will require some credit unions to increase capital beyond the amount necessary under the leverage requirement, which under current rules, can only be accomplished through retained earnings. Alternative capital provides a workable means of meeting this regulatory requirement while minimizing any risk to the share insurance fund.

Retained earnings have historically been the primary source of credit union capital. The inability to access other forms of capital places restrictions within the regulatory framework that can hinder a credit union’s ability to weather a difficult or unforeseen circumstance.

A major concern of the Association, upon the finalization of the new risk-based capital provisions, was the situation in which a credit union must keep its balance sheet in one hand and its risk-based capital requirement in the other, and be bound strictly by what they can offer to their members with no flexibility to manage the credit union when the financial environment changes. Most credit unions lack access to additional capital outside of retained earnings. All of the Association’s local, non-low income designated credit unions do not have access to supplemental capital in order to meet the additional capital requirements imposed by the new rules. As such, credit unions would have to eliminate or reduce existing products, charge members higher fees, raise loan rates or drop deposit rates, or restructure their balance sheets to sell long-term loans and investments, or deliberately slow or reduce asset growth. None of these choices benefits members or contributes to the long-term sustainability of the credit union charter.

The problem also exists for the majority of low income designated credit unions, as well. Despite the fact that many of our local credit unions have received the low income designation,⁴ the restrictions on secondary capital authority have remained a barrier to those credit unions entering that marketplace.⁵

Allowing for the use of alternative capital more broadly is a necessary step in maintaining a competitive position for credit unions, and ultimately, to maintain the highest level of products and services for credit union members.

As NCUA implements a more complex regulatory capital framework, the agency should also modernize credit union regulatory capital concepts to match. Including supplemental capital in credit union risk-based capital ratio calculations is consistent with the statutory purposes of both state and federal credit unions and is sound public policy.

While supplemental capital cannot be included in net worth for most credit unions without a change in federal law, there is nothing in the FCU Act or GAAP that prevents NCUA from including supplemental

³ 80 Fed. Reg. 66626, October 29, 2015.

⁴ <https://www.ncua.gov/newsroom/Press/NW20121018LICUEncl.pdf>

⁵ See Part III of this letter.

capital in the numerator of the risk-based capital ratio for RBC, which already includes items that are not part of net worth.⁶

The Association supports NCUA's efforts to explore additional sources of capital that could allow an institution to tap new markets or enable more rapid recapitalization of a potentially troubled institution. If adopted properly, alternative capital can provide a useful tool in providing stronger and more sustainable credit unions. This will allow credit unions to react more quickly during a challenging economic environment and should represent increased comfort to the regulator and consumers from a safety and soundness perspective.

The Association also stresses the opportunity for industry collaboration on this issue. All credit unions are subject to RBC requirements. Expanding alternative capital authority more broadly opens a space for innovation. Some credit unions, who are closer to the issue and who already have sound business plans in place to pursue alternative capital more immediately than others, will serve as incubators for rest of the industry, which is an opportunity which should not be overlooked.

III. NCUA Should Consolidate Secondary Capital and Supplemental Capital Concepts

At present, supplemental capital and secondary capital authorities are distinct and separate, and guided by different considerations. The Association suggests combining the concepts however practicable such that all credit unions will be authorized to issue and accept alternative capital to the same extent and degree. Doing so will diminish the potential for confusion among credit unions and the public regarding capital sources beyond retained earnings. In addition, LICUs could benefit from instruments, processes, procedures and disclosures developed by complex credit unions for risk-based supplemental capital.

Secondary capital is designed primarily to boost net worth in a LICU, not generate a return for an investor. Because the supplemental capital market will likely attract investors seeking return, the two markets will remain distinct in certain ways and not threaten LICUs. Of the six low income designated survey respondents, only one indicated that it currently accepts secondary capital. Reasons cited for not partaking in the secondary capital market include:

- Not well-defined;
- Lack of accessibility;
- No easily defined benefit in relation to strategic planning; and
- Insurmountable restrictions.

The one low income designated credit union that has pursued secondary capital has done so on a limited basis, and very much in conjunction with NCUA and only upon the agency's pre-approval.

Combining the authorities will benefit the industry overall, leading to alleviation of the stated LICU concerns over entering the market. Doing so will require the expansion of secondary capital authority for low income designated credit unions. The Association is of the position that it is not practical to have given LICUs secondary capital authority in order to create a more level playing field and allow them an

⁶ 12 U.S.C. §1790d.

opportunity to stay competitive and continue to grow, and subsequently move to give greater authority to the exact credit unions LICUs were trying to catch up to, without simultaneously expanding the LICU authority. LICUs are often more strained than their non-LICU counterparts when it comes to growth, and any options to expand growth opportunities for these credit unions should be extended.

Moreover, all credit unions should have an equal opportunity to engage in a permissible regulated activity when under the same regulating body. Both sophisticated non-LICUs familiar with the supplemental capital domain, as well as current LICUs who do offer secondary capital, will serve as guides for one another under the same regulatory structure.

NCUA has expressed concern that expanding alternative capital authority beyond LICUs will negatively affect LICUs.⁷ The Association does not share that same concern. The low income designated credit unions that are already in the secondary capital marketplace have cornered a specific market that is suitable, cost-effective, and functional for them within the restrictions placed upon them. The alternative capital marketplace is not a small, limited area. Non-LICUs will pursue different investments than their LICU counterparts, as each credit union will have different goals, interests, and growth strategies. It is likely that many of the options that LICUs would be interested in would not work more broadly nor be as economically practical for non-LICUs to entertain, and vice versa.

Non-LICUs will develop their own market and new ideas, which will in turn ultimately benefit LICUs as well. LICUs do not have the resources, market share or scale to put into research to develop more or better instruments and investment opportunities. Therefore, expanding alternative capital authority more broadly will allow for broader experimentation, testing, and will ultimately reveal options that work best in different scenarios and based on different goals, which will benefit LICUs. Expanding alternative capital authority will ultimately create a larger overall market for alternative capital. This market would be more visible and attractive to potential investors, seeing a greater ability to diversify risk, thereby expanding the pot, not limiting it for any participant.

The ANPR explains that secondary capital was initially allowed for low income designated credit unions because the NCUA recognized that it was difficult for low income designated credit unions to accumulate capital only through retained earnings.⁸ The NCUA therefore permitted LICUs to use the borrowing authority in the Act to issue secondary capital accounts. This authority allowed these credit unions to build capital to support greater lending and financial services to their members and their communities, and to absorb losses to protect them from failing.

In this increased regulatory environment in which credit unions have had to dedicate enormous resources to operate in compliance, consistency, ease of use, and clarity are of ultimate value. Separate frameworks for supplemental capital for non-LICU credit unions and secondary capital for LICU credit unions invite confusion and increased costs, and the Association therefore strongly urges the NCUA to consider combining the authorities and pursuing a single rule for general alternative capital authority across credit union charters.

⁷ NCUA Advance Notice of Proposed Rulemaking on Alternative Capital, RIN 3133-AE66, at 9694.

⁸ ANPR at 9692, footnote 6.

IV. Considerations for an Alternative Capital Regulatory Framework

The Association urges NCUA to proscribe a regulation that has flexible parameters which will allow for experimentation by credit unions in the creation of supplemental capital instruments. Flexibility is necessary to allow for the development of the most appropriate instruments that will be useful and cost effective for credit unions. We recommend that at this stage the rule should not limit permissible supplemental capital instruments to one or two restrictively defined instruments. Rather, the rule should contain parameters around capital instruments and investor requirements, without mandating exact specifications at this point.

Local credit unions are focused on providing the best products and services for their members as possible. One constant across every credit union in the country is the need for continued growth. In order to be sustainable and remain the most beneficial option for consumers, credit unions must constantly pursue growth. Alternative capital authority is another tool in the toolbox which will prove useful to support and fund growth opportunities.

The response to the Association's question to local credit unions as to whether they would reconsider participation in the alternative capital market were a new regulation to be promulgated was a unanimous and resounding yes, with proper guidance. These responses underscore a solid understanding of safety and soundness concerns, and of the need to tread lightly in this area by keeping safety and soundness as the key consideration. Such a response should encourage NCUA to move forward with a proposed rule, which will consider credit union input into how and what guidance would be most appropriate.

When surveyed, of primary importance to our local credit unions in the Northeast and Delaware was the cost-effectiveness of a supplemental capital program in any framework. Our local credit unions are more concerned with their ability to actually implement and maintain a supplemental capital program, than with any detailed discussion regarding exactly what instrument will work, specific investor suitability requirements, and other such detailed considerations at this time. Of secondary concern is that any program be flexible and allow for tailoring of instruments to a particular credit union.

NCUA should take a flexible approach to creating the risk-based supplemental capital framework. At a minimum, alternative capital should adhere to the credit union mutual ownership and governance principles, be accompanied by robust investor protections and disclosures, be available to cover losses, and be subject to regulatory approval provisions. Beyond such parameters, the Association recommends that the rule be written so that NCUA would consider for approval any type of supplemental capital instrument that conforms to these principles, and investors and interested parties, and any other additional flexibility.

Any final regulation must provide room for the marketplace to evolve and shape alternative capital in ways that maximize its utility to credit unions as well as its attractiveness to investors by state law or regulation.

Based on feedback from member credit unions, the Association offers the following considerations for any proposed rule on alternative capital.

- Any offering must preserve the cooperative, mutual nature of credit unions, and not alter the fundamental structure of the credit union. If supplemental capital is sourced from members in the form of shares, such shares should grant no additional ownership or voting rights. Supplemental

capital from non-members should impart no ownership or governance rights. A prohibition that any agreement on supplemental capital should confer no management or corporate governance rights on any investor by virtue of obtaining supplemental capital may be appropriate. As such the mutual characteristics of the credit union are not altered by the allowance of supplemental capital.

- Additional prudential considerations include the following criteria for alternative capital: uninsured and subordinate to other claims against the credit union; available to cover operating losses of the credit union in excess of retained earnings; subject to concentration and aggregate limits; and reciprocal holdings should be limited.
- Credit unions vary, fields of membership vary, and the market varies. By and large, this will be a new authority for the majority of credit unions. It is therefore imperative that any structure allow for flexibility. Member credit unions were surveyed as to the types of instruments their credit union would offer. While most agreed that it would be some form of subordinated debt,⁹ specific responses varied when probed further. Options ranged from paid-in capital, preferred stock, long-term share instrument, member capital CD, and interest bearing shares, among others.¹⁰ The Association offers that given such a varied response from what represents a very small percentage of the industry, credit unions have their own ideas as to what will work. And any rule must provide flexibility to allow for all such ideas.
- The decision to engage in the alternative capital space is a balancing test requiring a cost/benefit analysis. The overwhelming advantage and benefit will be the support of organic growth and market expansion and the ability to grow the credit union rapidly. The most significant advantage is potential to leverage existing capital to an even greater penetration of core markets, resulting in greater market share and greater benefits to members and the public in general. On the other side of the scale is the current cost prohibitiveness of the market. Alternative capital allows for profitable growth. Expanding the authority will ultimately alleviate cost, thereby broadening options for credit unions.
- Many credit unions will likely only engage in the alternative capital marketplace if there is regulatory space for a third-party aggregator concept. 77% of member credit unions responding to the Association's survey question as to whether they will participate in alternative capital responded that they will only participate through such a third-party aggregator, due to cost effectiveness, the education that would be provided on method and timing of access, the need for diversification of investor risk, and the better method efficiencies to raise capital an aggregator can provide. The Association notes that in 2006, as part of an experimental project to gain access to external sources of capital while realizing economies of scale, Australian credit unions created entities to serve as conduits for issuing subordinated debt and trust-preferred shares. This project was facilitated by CUNA Mutual Group, and enabled credit unions to pool the shares and sell them to institutional

⁹ 12 U.S.C. §107(9).

¹⁰ The Association believes that the authority to issue perpetual capital shares is clear under Section 107(6) of the Federal Credit Union Act.

investors offering strong returns.¹¹ This existing market provider, that is already a part of the US credit union system, has familiarity with the aggregator concept and could serve as a resource.

- Any framework should require credit unions to have an appropriate policy or plan in place prior to obtaining regulatory approval, and the credit union must obtain approval from the NCUA prior to engaging in a new activity within the alternative capital arena.
- Member credit unions were asked what changes would need to be made to business plans should alternative capital authority be expanded. The varied responses provided should encourage NCUA. One local credit union suggested that ratios would be elevated, thereby increasing the ability to meet members' needs in the area of lending which the credit union would respond to. Another credit union discussed the idea of better capital planning, and interface with new potential stakeholders. Another mentioned that it would expand its branch network. Yet another cited stronger growth in deposits and commercial loans, and additional growth in services. Knowing that local credit unions are engaged and have already assessed what changes to business plans would need to be made in order to maintain safety and soundness within the industry is yet another reason for expanding alternative capital authority.
- Any alternative capital rule must legally and definitively stipulate that the investors have no authority to gain control of entity. All investor positions must be subordinate to members, non-members and vendors, and must confer no voting rights.
- Local credit unions are mindful of mergers and the implications of alternative capital on a credit union merger. In order to avoid a situation in which the surviving entity unwilling must accept alternative capital investments, the Association suggests the inclusion of a buy-back option, with NCUA approval.

V. NCUA Should Use the Resources and Models Currently Available

While alternative capital authority may be new for non-LICU credit unions, it is not a new concept for other US financial institutions nor to credit unions globally. Canada and Australia have systems that allow for capital beyond retained earnings, as do other credit union systems in Latin America, Africa, and the Caribbean.

More specifically, Canada's Office of the Superintendent of Financial Institutions has authorized perpetual capital shares similar to the ones currently authorized for corporate credit unions. Such capital shares issued could be invested in by the credit union's members. As our member marketplace has a significant concentration of higher education facilities, many employer-based credit unions serve colleges and universities that would assist in helping the credit union accumulate capital for growth, as well as provide significant safety and soundness benefits.

¹¹ World Council of Credit Unions, Inc., *Alternative Sources of Capital for Credit Unions: International Examples*, March 2009, at page 8.

For purposes of developing an alternative capital rule, the NCUA should focus on general attributes of potential alternative capital offerings. In contrast, a rule that prescribes specific instruments and restrictions would quickly prove limiting and inflexible. Broad parameters should be adopted that maximize flexibility for credit unions, while simultaneously providing appropriate safeguards and prudential standards.

The NCUA should draw on its own experiences with and its existing rules on LICU secondary capital. NCUA's own *Supplemental Capital White Paper*, which describes the process undertaken by the Working Group of dialogue with regulators from Canada and Australia, and review of research papers and reports. Other sources include the standards for bank supplemental capital as promulgated by the Comptroller of the currency and the Federal Deposit Insurance Corporation.¹²

It is the position of the Association that the NCUA already had a solid basis on which to move forward to implementation of an alternative capital rule, and therefore it is strongly urged that NCUA should adopt provisions from existing state, federal and international regulatory regimes and tailor those to safeguard investors, members, and the National Credit Union Share Insurance Fund.

VI. Relationship to State Law and FISCUs

The authority for federally insured state chartered credit unions ("FISCUs") to raise supplemental capital is a matter of state law. Currently, more than a quarter of states that charter credit unions permit the issuance of supplemental capital instruments.

The NCUA should closely work with state regulators in the drafting and ultimate implementation of a final alternative capital rule. Consulting and cooperating with state regulators will be invaluable given the experiences that many states have in this arena. The Association suggests that a formal working group with state regulators would be a useful undertaking, and offers its assistance in the formation of such a working group in any way possible.

VII. Credit Union Tax Exempt Status

The Association notes NCUA's raising of the consideration of the credit union tax exemption in the ANPR. Member credit unions continue to express that the tax-exempt status is their ultimate priority. However, we are of the position that expanding credit union access to supplemental capital will not impair credit union mutual ownership and governance, and therefore should not impact the credit union tax exemption, so long as the rule is written within the parameters described throughout this comment letter.

Congress provided the credit union system with a federal tax exemption because of the not-for-profit, cooperative structure of credit unions. The credit union tax status is based on the credit union corporate structure and is not based on the products and services it offers. Alternative capital, if approached thoughtfully and deliberately and if allowed time to develop, will be just another tool for credit unions to use which does not necessarily implicate or affect the philosophy of the credit union system. Alternative capital authority will not alter the structure of a credit union, and in fact any rule should affirmatively state

¹² National Credit Union Administration, *Supplemental Capital White Paper* prepared by the Supplemental Capital Working Group, April 12, 2010, at page 1. Available at <https://www.ncua.gov/Legal/Documents/SupplementalCapitalWhitePaper.pdf>.

that such authority will not confer any governance rights or ability to control the credit union based on an investment in supplemental capital. As such, allowing supplemental capital should not in any way affect the federal tax exemption for credit unions.

In addition, the ANPR notes that the federal credit union tax exempt status is derived in part because federal credit unions cannot access capital markets to raise capital, and FISCUs lack capital stock. In response to the question in the ANPR of whether a FISCU should be required to provide a formal opinion from the IRS that the supplemental capital instrument it wishes to issue will not be classified as capital stock, or whether to require a FISCU to provide projections in advance showing that it can afford to be taxed, the Association does not think such an approach is appropriate or necessary. Furthermore, the Association is aware of at least two existing opinions from the Internal Revenue Service on supplemental capital instruments issued by credit unions stating that the instruments did not constitute capital stock as that term is used within the Internal Revenue Code.¹³

VIII. Timeliness and Guidance

If, upon conclusion of this public comment period and review of stakeholder comments, the NCUA decides to move forward in proposing a rule on expanding alternative capital authority, the Association suggests that the process as closely follow the parameters and timing of the risk-based capital rule in order to make the transition as smooth as possible.

Another important consideration in terms of the timing of a rule on alternative capital is the implementation of the Financial Accounting Standards Board's new current expected credit loss ("CECL") model. The CECL model, which some credit unions are already in the process of implementing and which all credit unions will have to comply over the next few years, will likely increase an institution's allowance reserve, requiring a one-time adjustment to capital. NCUA should consider the current restrictions on raising capital faced by credit unions, and keep the effects the CECL rule will have on raising capital in mind when promulgating any regulation on alternative capital. Furthermore, the new loan loss reserves required by CECL should be included as a form of supplemental capital in the numerator of the risk-based capital ratio as consistent with the Basel Committee on Banking Supervisions.

In addition, the Association offers local credit union input that a pilot program would be an acceptable way to initiate a broader authority for alternative capital.

The Association also suggests that guidelines will mitigate any unintended consequences such a far-reaching rule could have, and are necessary early in the process, and should be updated regularly based on market feedback.

Lastly, the Association strongly urges the NCUA to implement its alternative capital rule now, and address changes to non-priority related rules, to include the borrowing rule, in parallel and follow-on rulemakings.

IX. Conclusion

¹³ See National Association of State Credit Union Supervisors, *Alternative Capital for Credit Unions... Why Not?*, 2005, at page 7, available at <http://www.nascus.org/publications/alternativecapitalforcreditunionswhynot.pdf>.

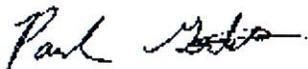
May 9, 2017

Page 11

The Association expresses its appreciation to the NCUA for seeking stakeholder input into this subject, and requests that the NCUA move forward with a proposed rule on alternative capital.

Thank you for your consideration of these views. The Association appreciates the opportunity to provide input and I remain available to address any questions or concerns at pgentile@ccua.org that you or your staff may have at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Paul C. Gentile". The signature is fluid and cursive, with a horizontal line extending to the right.

Paul C. Gentile
President/CEO

PCG/mabc/kb