One League, One Focus - Your Success!

Submitted via email: regcomments@ncua.gov

May 9, 2017

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

Re: Advanced Notice of Proposed Rulemaking for Alternative Capital

Dear Mr. Poliquin:

On behalf of Wisconsin's credit unions® and their nearly 3 million members, The Wisconsin Credit Union League welcomes the opportunity to comment on the National Credit Union Administration's (NCUA's) Advanced Notice of Proposed Rulemaking (ANPR) for Alternative Capital.

We applaud the NCUA for taking this step and urge it to proceed with rulemaking on this important issue. Allowing non-low-income credit unions to use supplemental capital would benefit credit unions, their members and the National Credit Union Share Insurance Fund (NCUSIF). However, any such rule must be drafted carefully. In particular, it must not, in any way, jeopardize credit unions' tax exemption. The rule should be flexible, giving credit unions the freedom to explore alternative capital approaches within a basic framework of substantive requirements. Appropriate disclosure rules can help protect credit unions and investors (whether they are institutional, accredited, or individual members or non-members), while recognizing the unique nature of credit unions as member-owned financial cooperatives.

Benefits & risks

Allowing access to alternative capital clearly would benefit credit unions, their members, and the NCUSIF:

- Expanding credit unions' access to supplemental capital is a necessary corollary to the recent Risk-Based Capital (RBC) rule, which will require some credit unions to increase capital in order to meet regulatory risk-based net worth requirements. Currently, nearly all credit unions must rely on retained earnings to build capital.[1] (Only designated low-income credit unions (LICUs) can use alternative sources to augment retained earnings.)
    - To answer a question posed in the ANPR: We do not believe that the use of supplemental capital by non-LICUs will adversely affect the availability of secondary capital for LICUs. If anything, the development of a supplemental capital market will increase awareness of secondary capital and help to attract potential investors for LICUs.

[1] *See* "Supplemental Capital White Paper," NCUA Supplemental Capital Working Group (April 12, 2010), at p. 4 (hereafter "NCUA White Paper").

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- Without the freedom to issue supplemental capital, credit unions will continue to be forced to control growth and expansion due to the limits on raising immediate capital.[2] However, with the freedom to issue supplemental capital, they will be better able to satisfy regulatory risk-based net worth requirements and thus more easily meet their members' needs, grow their fields of membership, and offer greater options to consumers for affordable services.[3] (We hope that positive experiences with supplemental capital eventually will help credit unions persuade Congress to amend the Federal Credit Union Act (FCUA) and allow healthy and well-managed credit unions to issue supplemental capital that will count as statutory net worth, as well.[4])

- Supplemental capital can also be a valuable tool to help credit unions meet future economic downturns without curtailing member services, while at the same time minimizing risks for the NCUSIF. As the NCUA has said:

  > Supplemental capital can mitigate insurance fund losses upon failure. It may shorten recovery from losses caused by uncontrolled external factors (i.e., flights to safety, natural disasters, and local market declines). Currently, credit union strategies for recovery are limited to shrinking assets to achieve improved net worth ratios, reductions of share dividend rates, raising loan rates, increasing fees, cutting operating expenses, selling assets, and merging the credit union – all of which have a negative member and community consequence.[5]

These benefits come with risks, however. We believe that the NCUA should take a measured approach to expanding credit unions' access to supplemental capital. Of particular importance, an alternative capital rule must not, in any way, jeopardize the tax-exempt status of either federal credit unions (FCUs) or federally insured state-chartered credit unions (FISCUs). For that reason, we support the "guiding principles" CUNA outlined in its comments for non-LICU supplemental capital:

- Any offering must preserve the cooperative, mutual nature of credit unions, and not alter the fundamental structure of the credit union.

- The specific instrument used, whether an equity instrument, paid-in capital or another form of subordinated debt, should be flexible and not prescribed in the rules such that a credit union can best take advantage of the market and have the flexibility to structure the offering in a cost-efficient manner.

- The instrument will be uninsured and subordinate to other claims and available to cover operating losses and only issued pursuant to regulatory approval; a credit union should have an appropriate policy or plan in place prior to obtaining regulatory approval.

- Proper consumer protection, securities/anti-fraud provisions, and disclosure requirements should be provided, with proper suitability standards followed.

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[2] *Id.* at p. 7.

[3] *See* "Report to the House Financial Services Committee on the Final Risk-Based Capital Rule," NCUA (2015), at p. 126.

[4] *Id.* at pp. 125-26.

[5] NCUA White Paper at p. 13.

- The rule should establish appropriate limits on how much and to whom it can be issued with appropriate suitability standards followed (other than small issuances).

The remainder of this letter will address these principals further and respond to various questions posed in the ANPR.

Tax exemption & the mutual nature of credit unions

"Any offering must preserve the cooperative, mutual nature of credit unions, and not alter the fundamental structure of the credit union."

An alternative capital rule must not, in any way, jeopardize the tax-exempt status of credit unions. That fundamental issue is our primary concern, and it's likely to be the key worry for many credit unions, too. As one commenter recently pointed out, "No doubt some commenters will see the taxation threat as a 'third rail' that justifies the avoidance of all exploration of alterative capital."[6] The NCUA's Supplemental Capital Working group explained in 2010 that "some credit unions have expressed concern that supplemental capital could … come with other risks to all credit unions (e.g., taxation), while only benefiting a small number of primarily larger credit unions."[7] The ability of any credit union to issue supplemental capital cannot be allowed to expose the credit union movement as a whole to the potential loss of its tax exemption.

We do not believe that the risk to tax exemption is so great as to warrant scuttling the alternative capital rulemaking altogether. Supplemental capital can be allowed, so long as its risks are properly managed. We urge the NCUA to thoughtfully craft a rule that prioritizes the protection of credit unions' tax-exempt status.

As the ANPR explains, the FCUA exempts FCUs from taxation by the United States or by any state or local taxing authority (except real and personal property taxes). FISCUS, on the other hand, must look to §501(c)(14)(A) of the Internal Revenue Code, which exempts them from federal income taxes so long as they 1) are chartered as credit unions under state law, 2) do not issue "capital stock," and 3) are "organized and operated for mutual purposes without profit." An alternative capital rule must be written with each "prong" of this test in mind (though the first seems obvious).

As to the second prong of the IRS test (on not issuing "capital stock"), neither the Internal Revenue Code nor IRS regulations define the term, but generally, the less a supplemental capital offering resembles "equity" and the more it resembles "debt," the safer it should be for credit unions. The relatively few published court opinions on the subject suggest that the absence of certain features make an instrument more debt-like as opposed to resembling capital stock. The Filene Research Institute explains:

> Typical stock features are voting rights, distributions at the discretion of the issuer, appreciation in the instrument's value in accordance with the issuer's profitability, and participation in the residual interests of the issuer at the time of liquidation. Debt instruments, in contrast, usually include repayment of the face amount at a certain maturity date and a fixed or variable return not tied to issuer profitability.[8]

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[6] "Alternative Capital vs. the Tax Exemption: A False Choice," Francois Henriquez, Credit Union Times, March 1, 2017.

[7] NCUA White Paper, p. 15, fn. 46.

[8] "Alternative Capital for U.S. Credit Unions? A Review and Extension of Evidence Regarding Public Policy Reform," Robert F. Hoel, PhD, Filene Research Institute (2007), at p. 39, citing 2005 IRS private letter ruling issued to State Employees' Credit Union of North Carolina.

As to the third prong of the IRS test (operation for "mutual purposes without profit"), two IRS general counsel opinions are helpful. A 1971 memorandum explained that "'for mutual purposes' connotes an identity between lender and borrower." That is, the depositors and the lenders at a credit union are the same group of people: the members.[9] A 1980 memorandum (which dealt with the exempt status of a central credit union) stated that "membership control of a credit union is characteristic of the members' mutuality of interest."[10] Essentially, mutuality means that a credit union's savers and borrowers are also its owners and controllers. Those who use the credit union's services, as a group, are also those who own and control it.

It is clear that credit unions can issue supplemental capital without endangering their tax-exempt status, so long as they tailor their offerings to preserve the cooperative, mutual nature of credit unions and not alter the fundamental structure of the credit union as member-controlled.

While the risk of losing tax-exempt status may be incentive enough for credit unions to avoid risky elements in their offerings, additional safeguards seem appropriate to protect the movement as a whole and to prevent credit unions from inadvertently issuing instruments that have characteristics of capital stock. For example:

- The rule should explicitly prohibit credit unions from offering supplemental capital instruments that give an investor any governance or voting rights or any ability to control or influence the credit union.

- The rule should require advance NCUA approval of a detailed plan before any credit union can accept supplemental capital. The rule should be similar to the requirement that LICUs submit a Secondary Capital Plan,[11] but in addition, it should require (at least) an analysis from the credit union of the plan's tax exemption implications. Preferably, the rule could require credit unions to obtain an opinion from tax counsel that the offering will not endanger the credit union's tax status. The plan should also address the credit union's compliance with any applicable state "blue sky" laws that may require, e.g., registration with the state, payment of fees, or specific anti-fraud disclosures.

    - The rule could exempt credit unions from having to seek NCUA plan approval in appropriate circumstances, such when that have previously obtained NCUA authorization for a supplemental capital offering and are contemplating a new offering with similar or substantially similar terms. The rule could similarly provide streamlined reviews for plans that are similar to those already approved for other credit unions.

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[9] See "Proposed Revenue Ruling and Supporting Memorandum on Unrelated Business Income Tax Issues of State-Chartered Credit Unions," CUNA (2004) at p. 13, quoting IRS General Counsel Memorandum 34612 (Sept 14, 1971). Similarly, in State ex rel. Leach v. Price, 156 N.E.2d 316, 318 (Ohio 1959), the court, in considering the characteristics of a state-chartered credit union for non-tax purposes, emphasized: "The operation of a credit union, the purchase of shares and the borrowing of money are limited to members of the credit union and its monetary benefits inure solely to its members."

[10] *Id*. at p. 13, quoting IRS General Counsel Memorandum 38345 (Apr. 17, 1980) (emphasis added).

[11] Under NCUA Regulations §701.34(b)(1), such a plan must, at a minimum: (i) state the maximum aggregate amount of uninsured secondary capital the LICU plans to accept; (ii) identify the purpose for which the aggregate secondary capital will be used, and how it will be repaid; (iii) explain how the LICU will provide for liquidity to repay secondary capital upon maturity of the accounts; (iv) demonstrate that the planned uses of secondary capital conform to the LICU's strategic plan, business plan and budget; and (v) include supporting pro forma financial statements, including any off-balance sheet items, covering a minimum of the next two years.

- We do not believe that it is necessary, nor practical, to require credit unions to obtain a formal IRS opinion before an offering, since such a requirement could lead to undue delays and hamper the ability of credit unions to meet current market demands.

- The rule should explicitly affirm the tax-exempt status of state-chartered credit unions. In fact, we would support the suggestion of the NCUA Supplemental Capital Working Group that legislation be sought to amend the FCUA in this regard:

  > [A] new subsection should be added to [§1790d(p)] to make it clear that nothing will affect the federal income tax exemption granted state-chartered credit unions under Section 501(c)(14) of the Internal Revenue Code. Such a change would be intended to clarify that authorization of state-chartered credit unions to offer contributed capital account that qualify as "net worth" will not jeopardize their federal income tax exemption.[12]

- It may be prudent (even necessary) to limit supplemental capital to subordinated debt to avoid endangering credit unions' tax exemption. The NCUA has explored whether other broad types of supplemental capital – namely "Voluntary Patronage Capital" and "Mandatory Membership Capital" – could also be allowed.[13] We urge the NCUA to carefully consider the equity characteristics of these alternative types of capital instruments and their potential impact on credit unions' tax exemption.

Flexible approach & broad prudential standards

"The specific instrument used, whether an equity instrument, paid-in capital or another form of subordinated debt, should be flexible and not prescribed in the rules such that a credit union can best take advantage of the market and have the flexibility to structure the offering in a cost-efficient manner."

"The instrument will be uninsured and subordinate to other claims and available to cover operating losses and only issued pursuant to regulatory approval; a credit union should have an appropriate policy or plan in place prior to obtaining regulatory approval."

We agree with CUNA's comments that an alternative capital rule should be flexible, giving credit unions the freedom to explore alternative capital approaches and to gauge market demand. A complex set of inflexible regulatory requirements could prematurely stifle innovation and dissuade credit unions from even considering supplemental capital. Further, trying to formulate a complex regulatory regime at this time could delay this rule beyond the January 2019 effective date for the RBC rule. It would be a mistake to create rules now that limit too narrowly the types of permissible supplemental capital, especially since no one knows what precisely what types of instruments credit unions might develop in the coming years.

However, we also caution that it may be prudent (even necessary) to limit supplemental capital to subordinated debt to avoid endangering credit unions' tax exemption. In fact, as the ANPR points out, the FCUA only gives FCUs borrowing authority. As a result, "they could only issue supplemental capital as subordinated debt." We are aware of no other FCUA provisions that could provide alternative authority for FCUs to issue supplement capital as equity. Wisconsin law does not appear to address the issue squarely. Like the FCUA, Wis. Stats. §186.112 provides broad borrowing authority: "The board of directors may borrow money from any source…" in accordance with rules promulgated by the state regulator.

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[12] NCUA White Paper at p. 26.

[13] NCUA White Paper at pp. 19-22.

However, Wis. Stats. §186.01(4) defines “net worth” for Wisconsin state-chartered credit unions as: “the aggregate of retained earnings of a credit union, as determined according to generally accepted accounting principles, <u>and other forms of capital approved by the director of the office of credit unions.”</u> Arguably, this provision could open the door for our state regulator to allow supplemental capital not limited to subordinated debt.

Even where equity-like instruments are available to FISCUs under applicable state law, a supplemental capital rule should still address the extent to which the NCUA will permit them, given the potential risk to credit unions’ tax-exempt status. At a minimum, if equity offering are permitted, the agreements and disclosures must clearly state that they give non-members no ownership interests or governance rights over the credit union and that they give members no additional interests or rights.

Certainly, the NCUA’s rule should include basic substantive requirements, but it should also allow credit unions and the market to explore the types of offerings and terms that best suit credit unions’ and investors’ needs. The NCUA can later tailor its rules to address issues that arise, but at first it may be best to adopt a general framework of prudential standards, mirroring the requirements in NCUA Regulations §701.34(b) for LICUs and addressing the “guiding principles” suggested by CUNA. For example:

- *Tax exemption protection*. Supplemental capital instruments must not give an investor any governance or voting rights, or any ability to control or influence the governance of the credit union.

- *Minimum maturity.* The maturity of the supplemental capital must be a minimum of five years.

- *Uninsured.* The supplemental capital instrument will not be insured by the NCUSIF or any governmental or private entity.

- *Subordination.* A supplemental capital investor’s claim against the credit union must be subordinate to all other claims, including those of shareholders, creditors and the NCUSIF.

- *Availability to cover losses.* Supplemental capital must be available to cover operating losses realized by the credit union that exceed its net available reserves.

- *Contract agreement.* A supplemental capital agreement must reflect the terms and conditions mandated by the NCUA rules and any other terms and conditions not inconsistent with them.

- *Disclosure and acknowledgement.* The credit union and investor each must execute a “Disclosure and Acknowledgment” document (as discussed later in this comment letter).

- *Capitalization.* The rule must limit the ability of a credit union to raise capital from this type of transaction if it is less than adequately capitalized or faces other known or pending losses.

- *Approval.* An NCUA-approved Supplemental Capital Plan must be a prerequisite to any offering.

- *Policy.* A credit union must have an appropriate policy in place, addressing such issues as compliance with relevant anti-fraud requirements under state and federal law, the maintenance of adequate directors and officers liability insurance coverage, and due diligence for any third-party brokerage arrangements.

- *Presumption.* Supplemental capital offered pursuant to an NCUA-approved plan should be presumed to be eligible for inclusion in the credit union's RBC calculations.

Disclosures & protections

"Proper consumer protection, securities/anti-fraud provisions, and disclosure requirements should be provided, with proper suitability standards followed."

While it appears that credit unions would be exempt from having to register with the Securities Exchange Commission (SEC) and issue SEC-mandated disclosures, it also appears that SEC anti-fraud rules would still apply, as would similar state laws. As a result, it is imperative that the NCUA's rule require appropriate disclosures and advertisement restrictions to ensure that any investor (whether member or non-member, consumer or non-natural person) understands the nature and riskiness of the transaction.

A "Disclosure and Acknowledgment," similar to that now required by the LICU Secondary Capital Rule, would be appropriate for supplemental capital. The disclosure should be based on SEC regulations and corresponding state blue sky laws, with appropriate additional provisions to address the unique nature of credit unions. It appears that the FDIC[14] and OCC[15] follow this approach. By providing a disclosure consistent with SEC regulations (but with added credit-union-specific components), the disclosure requirement would be no more burdensome than other financial institutions face. Disclosure requirements could be scalable, depending on the relative sophistication of the investor (institutional investors, accredited investors, and member or non-member individual investors).

To answer another question the ANPR posed: If credit unions are required to submit a Supplemental Capital Plan for NCUA approval, then it would be redundant also to require them to register with the NCUA. (However, credit unions should be required to notify the NCUA of any subsequent supplemental capital offering that is based on a previously approved Supplemental Capital Plan.)

Investor suitability

"The rule should establish appropriate limits on how much and to whom it can be issued with appropriate suitability standards followed (other than small issuances)."

Under NCUA regulations, LICU secondary capital can only be purchased by non-natural persons. The ANPR asks whether both secondary capital and supplemental capital should be made available to other investors, such as accredited investors and individual consumer generally. We believe the answer is yes: The rule should allow individuals (both members and non-members) to purchase supplemental and secondary capital. As we have said, supplemental capital agreements and disclosures must clearly state that they give non-members no ownership interests or governance rights over the credit union and that they give members no additional interests or rights. In addition, disclosures (and

[14] "It is the FDIC's goal to have banks comply with the antifraud provisions of the federal securities laws in a manner which meets the needs of investors, depositors and issuers." "Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities" FDIC (1996).

[15] "Any registration statement filed pursuant to this part [of the OCC regulations] must be on the form for registration (17 CFR part 239) that the national bank or Federal savings association would be eligible to use were it required to register the securities under the Securities Act and must meet the requirements of the SEC regulations referred to in the applicable form for registration." OCC regulations, 12 CFR §16.15.

agreements) must address that the instruments are cancellable without triggering default, so as not to impede NCUA or state regulators' authority to take supervisory action. If disclosures are adequate and can be made sufficiently clear for consumers, then offerings need not be limited to institutional or accredited investors.

Conclusion

We commend the NCUA for pressing forward with this ANPR. Allowing non-LICUs to use supplemental capital would benefit credit unions, their members and the NCUSIF. However, any such rule must be drafted carefully. In particular, it must not, in any way, jeopardize the tax-exempt status of FCUs or FISCUs. The rule should be flexible, giving credit unions the freedom to explore alternative capital approaches and to gauge market demand while operating within a basic framework of prudential requirements. Appropriate disclosure rules can help protect credit unions and investors, whether they are institutional, accredited, or individual members and non-members, while recognizing the unique nature of credit unions as member-owned financial cooperatives.

Sincerely,

Paul Guttormsson
Vice President of Legal & Compliance
The Wisconsin Credit Union League