May 9, 2017

Mr. Gerald Poliquin, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428
By Email: regcomments@ncua.gov

Re: Comments on Advance Notice of Proposed Rulemaking for Alternative Capital

Dear Mr. Poliquin:

On behalf of the companies of CUNA Mutual Group, we are pleased to provide comments on the National Credit Union Administration's ("NCUA") proposed rulemaking for alternative capital. We support the NCUA's efforts to expand the alternative capital options available to credit unions and appreciate the opportunity to provide our comments.

For over 80 years, CUNA Mutual Group has been the nation's leading provider of insurance and other financial products and services to credit unions and credit union members. We have a breadth of experience in dealing with the capital needs of credit unions and other cooperative financial institutions. In 2006, we helped more than 20 Australian credit unions raise approximately AU$100 million of subordinated capital through an innovative structure that allowed participating credit unions to work together.[1] The structure attracted significant institutional investor interest, which enabled the participants to obtain credit on better terms, and with lower costs, than would have been available if they acted alone. Over the last 15 years, we have invested millions of dollars in secondary capital notes issued by various low-income designated credit unions ("LICUs") in the United States.

Furthermore, in 2010, we raised $85 million in surplus notes for our primary life insurance company. Surplus notes are a form of subordinated debt that fall at the very bottom of an insurance company's capital structure. They are issued primarily by cooperatively owned and controlled mutual insurance companies. Surplus notes are debt-like in that they pay a coupon and have a finite maturity. However, state insurance regulators typically allow insurance companies to classify the capital raised via surplus notes as "surplus" because surplus note holders are last in line to make a claim on the issuer's assets in an insolvency, much like where equity holders reside in a traditional stock company. The motivation for mutual companies to issue these instruments was to raise surplus (or equity) in response to new risk-based capital guidelines developed for insurance companies in the 1990s. Because mutual companies are owned by policyholders, not shareholders, there was no alternative method to raise surplus or equity.

[1] "CUNA Mutual Capital Project Named One Of Australia's Best," *Credit Union Times*, (October 18, 2006). http://www.cutimes.com/2006/10/18/cuna-mutual-capital-project-named-one-of-australias-best

We believe these experiences as arranger, investor and issuer of alternative capital for cooperatively owned financial institutions make CUNA Mutual Group uniquely suited to comment on this ANPR.

Historically, credit unions could only look to their retained earnings to absorb potential losses. In the 1998 Credit Union Membership Access Act (P.L. 105-219), LICUs were allowed to bolster their loss absorbing capability, through the issuance of subordinated debt in the form of "secondary capital". Now the NCUA is considering whether other credit unions should be afforded the right to issue capital instruments to investors.

In our view, the NCUA should provide credit unions the flexibility to issue a broad range of capital instruments so long as the terms of those instruments do not violate cooperative principles, and would not cause the issuer to violate relevant IRS rules, such as Internal Revenue Code Part 7, Chapter 25, Section 14, which "provides exemption from federal income tax for credit unions without capital stock which are organized and operated for mutual purposes and without profit."

We believe that capital is the critical foundation on which all member value, assets, innovation and risk management are built. Expanding capital regulations to provide credit unions additional options to manage their capital, while adhering to cooperative principles, would bring several benefits to credit unions, including:

- Enhanced ability to manage growth
- A market-driven risk assessment
- Creating additional member value and improved efficiencies
- Supporting the formation of de novo credit unions
- Promoting investment and innovation
- Reducing systemic risks within the system

We support the NCUA's efforts to create supplemental capital and applaud steps taken to modernize the risk based net worth requirement for complex credit unions in a way that reflects the unique characteristics of the US credit union system. We also appreciate the opportunity to provide the Board input on the existing secondary capital framework. This is an important first step towards expanding the tools that credit unions may use to manage capital and better serve their members.

We encourage the NCUA to consider alternatives that would reward a credit union for issuing supplemental capital that increases the credit union's own, as well as the credit union system's, loss absorbing capacity. In considering whether to issue supplemental capital a credit union would need to consider the potential effects the capital raise would have on both its net worth and RBC ratios. Under the proposed guidelines, supplemental capital would not count towards the net worth ratio and, as a result, would actually worsen the ratio for any credit union that does not qualify as a LICU. For example, a $500M credit union with a 10% net worth ratio that issues $10M of alternative capital – if issued as secondary capital, its net worth ratio would rise to 11.76%, but if issued as supplemental capital, its net worth ratio would fall to 9.80%. In both cases, the credit union has an increased ability to fund loans and serve its members, and an additional layer of capital to protect its members and the Share Insurance Fund from losses, but in the latter case, its net worth ratio would not reflect its improved capital position. Consequently, we believe that only well-capitalized credit unions are likely to pursue supplemental capital, even though supplemental capital would, in all cases, protect a credit union's members from losses, and increase the credit union's loss absorbing capacity. Given the benefits that supplemental capital would provide, we encourage the NCUA to consider incentives that, under the NCUA's existing statutory authority, could be offered to credit unions that secure supplemental capital. For example, the Board might allow credit unions to take supplemental capital into account when considering its ability to engage in certain investment activities (and absorb potential investment losses), or otherwise when evaluating a credit union's overall financial health.

We urge the NCUA to continue to consider the relationship between supplemental capital and secondary capital. We support the NCUA continuing dialogue on alternative capital with the ultimate goal of defining capital types that complement one another. Over time, as the supplemental capital marketplace evolves, we support the NCUA studying potential changes to Rules and Regulations Part 702 as a part of this process.

Our comments to the NCUA's ANPR are offered below, and are organized in two parts:

1) Responses to the six questions on alternative capital the Board asked as part of the risk-based capital rulemaking process
2) An appendix containing responses to numerous questions posed within the ANPR

Core Questions

1. <u>Should additional supplemental forms of capital be included in the RBC numerator and how would including such capital protect the Share Insurance Fund from losses?</u>

   We support the proposed creation of supplemental capital and believe that supplemental capital should be included in the RBC numerator. Consistent with other regulated financial institutions throughout the U.S. and across the globe, credit unions should have a diverse way to manage their capital as part of a risk based capital regulatory framework. We believe that any supplemental capital issued by a credit union should be junior in priority to the claims of the Share Insurance Fund -- the key factor is the subordination of the instrument to claims of the Share Insurance Fund, not the type of instrument. Subordination of the instrument will fortify the loss-absorbing capability of the issuing credit union. Additionally, raising supplemental capital from outside the system will reduce systemic risk.

2. <u>If yes, what specific criteria should such additional forms of capital reasonably be required to meet to be consistent with Generally Accepted Accounting Practices (GAAP) and the Act, and why?</u>

   We are not aware of any existing authority under the Act that would allow federally-chartered credit unions to issue capital stock or other equity instruments. Therefore, until the Act is amended, we assume supplemental capital will be issued by federally-chartered credit unions in the form of subordinated debt. As such, we recommend that the criteria for supplemental capital and secondary capital be largely harmonized. Having consistent and clear parameters would allow investors to become familiar with the types of instruments offered by credit unions, enhancing the development of a robust and predictable market.

We recommend the NCUA adopt the following four guidelines for instruments to qualify as capital:

- Do not alter the cooperative, member-owned and controlled nature of the credit union;
- Uninsured, unsecured and subordinate to claims against the credit union, including claims of creditors, members, and the Share Insurance Fund;
- Are available to cover operating losses in excess of retained earnings and, to the extent so applied, will not be returned to the investor;
- If they have a stated maturity, have an initial maturity of at least five years.

3. <u>If certain forms of certificates of indebtedness were included in the risk based capital ratio numerator, what specific criteria should such certificates reasonably be required to meet to be consistent with GAAP and the Act, and why?</u>

   They should meet the same criteria outlined above.

4. <u>In addition to amending NCUA's RBC regulations, what additional changes to NCUA's regulations would be required to count additional supplemental forms of capital in NCUA's RBC ratio numerator?</u>

   Capital is the core foundation of a financial institution and has broad impacts. We recommend the NCUA continually take RBC into consideration when completing the rolling three year reviews of regulations.

5. <u>For state-chartered credit unions, what specific examples of supplemental capital currently allowed under state law do commenters believe should be included in the RBC ratio numerator, and why should they be included?</u>

   The key consideration is not the type of instrument, but its priority. Any instrument issued by a credit union that is subordinated to the Share Insurance Fund would increase the credit union's loss absorbing capacity, protect the Share Insurance Fund, and (if properly structured) should be permitted as supplemental capital. It should not matter whether a state chartered credit union elects to issue capital in the form of subordinated debt or some kind of equity instrument.

6. What investor suitability, consumer protection, and disclosure requirements should be put in place related to additional forms of supplemental capital?

   Investor suitability, consumer protection and disclosure requirements should be calibrated to match the type of offering and investors. We believe that the Board should primarily focus its concerns on protecting individual consumers who might elect to invest in an unregistered securities offering. We do not believe that the Board should primarily focus its rule-making on offerings to sophisticated investors. These investors are typically institutional buyers such as pension funds, endowments, insurance companies and asset managers, with disciplined approaches to investment diligence, risk analysis and diversification.

   Given the nature of the securities offerings sophisticated investors participate in, these investors can be reasonably expected to be protected by market standard disclosure requirements.

CUNA Mutual Group is supportive of the expansion of alternative capital options available to credit unions and thanks the NCUA again for providing us with the opportunity to comment.

Sincerely,

Michael F. Anderson
Senior Vice President and Chief Legal Officer

Theran Colwell
Vice President, Product Executive

Appendix

Current Secondary Capital Standards

Whether or not to permit a low-income designated credit union to sell secondary capital to non-institutional investors and whether this would be for members only or any party.

As stated in our answer to question 6 in the core question section, if the Board allows LICUs to expand their potential base of investors, we believe investor suitability, consumer protection and disclosure requirements should be calibrated to match the type of offering and investors.

Allowing for broader call options for the low-income designated credit union, other than just the portion no longer counting as net worth and subject to NCUA approval, if provided for in the secondary capital contract.

The NCUA should allow secondary capital to be called by the issuer, if it has five years or less in maturity and obtains regulatory approval to do so. This is a common provision in the private placement market for financial institution subordinated debt. Allowing the credit union to call the note once it starts amortizing will help enhance the prospects of execution at the optimal point in the macroeconomic cycle. For example, consider a credit union with $10 million of outstanding secondary capital. If the secondary capital were to amortize in equal installments over a 5 year period, it might take several years before the credit union had a large enough issuance target to justify the time and effort of executing a new issuance. During that time, capital market conditions (including interest rate spreads) could fluctuate significantly. Allowing a credit union more flexibility to redeem a secondary capital issuance will enhance execution, and could substantially reduce its long-term interest costs.

Relaxation of pre-approval of issuing secondary capital if a low-income designated credit union meets certain conditions such as being at least adequately capitalized and having prior experience issuing secondary capital.

If a credit union is adequately capitalized and has prior experience issuing secondary capital, subsequent issuances by that credit union should pose low risk to the credit union or the Share Insurance Fund. We welcome efforts by the Board to streamline the approval process for such repeat issuers.

Inclusion of more flexibility to fund dividend payments as an operating loss if provided for in the contract.

We believe individual credit unions and their investors should be allowed the flexibility to decide whether subordination of secondary capital to dividend payments is an acceptable credit risk, and is worth any potential tradeoff in interest rate cost.

Any other revisions to the existing secondary capital regime that should be considered.

Having now participated in several offerings involving secondary capital, we would encourage the NCUA to consider the following changes to the existing rules governing secondary capital:

- Clarification of the restriction in NCUA Rules and Regulations 701.34(b)(8). We request that this section be modified to read as follows, to permit an investor to pledge its secondary capital account to a party that is not affiliated with the credit union:
    - "(8) Security. The secondary capital account may not be pledged or provided by the account investor as security on a loan or other obligation with the LICU or any other party affiliated with the LICU."
    - Expanded pledge and assignment rights would enable use of securitization structures that have brought significant efficiencies to the capital markets, to the benefit of both issuers and investors.
- Clarification of the restriction in NCUA Rules and Regulations 701.34(b)(9). We request that this section be modified to read as follows, to grant investors and credit unions the discretion to determine whether to redeem a secondary capital account in the event of a merger:
    - "(9) Merger or dissolution. In the event of a merger or other voluntary dissolution of the LICU, other than a merger where the surviving entity qualifies as a LICU and an investor agrees to retain its investment in the secondary capital account, the secondary capital accounts will be closed and paid out to the account investor to the extent they are not needed to cover losses at the time of merger or dissolution."
    - Under current regulations, in the case of a merger between a LICU and a non-LICU, where the surviving entity still qualifies as a LICU, the credit union would nevertheless be obligated to repay the secondary capital account. We believe the credit union and its investors should have the right to evaluate the circumstances, and elect to keep the secondary capital outstanding in such circumstances. In addition, the current regulations would not permit repayment of a secondary capital account where two LICUs merge, even if the credit risk of the investment has changed substantially as a result of the merger. Failure to allow for investor protections in such circumstances could inhibit a credit union's ability to access credit, or cause an investor to include a risk premium charge in its credit spread. We recommend that investors and credit unions be given more flexibility on redemption decisions in the event of a merger between two LICUs.

Current and Prospective Use of Alternative Capital

Comments concerning projections on the volume of supplemental capital that credit unions would be likely to issue.

There are a variety of micro and macro-economic factors that would influence the potential volume of alternative capital. According to the FDIC Q3 2016 quarterly banking profile, there is currently $87 billion in outstanding subordinated debt for banks. From a ratio standpoint this is 0.52% of total assets and 4.61% of total equity. Applying these same ratios to the credit union system would result in an implied market of $6.5-$6.9 billion.

Looking at the 2016 Annual Information Statement of the Farm Credit System, there is currently $1.4 billion in outstanding additional paid in capital. Applying a similar ratio methodology as we did above would result in an implied credit union market of $3.8-$5.8 billion.

While there have not been many issuances of secondary capital, we sense there is a growing interest in and awareness of the benefits of alternative capital. This is driven by the growth in the number of LICUs and the upcoming RBC requirements for complex credit unions.

Effectively and safely introducing around $6 billion in alternative capital, or about half the current total assets of the Share Insurance Fund, would provide additional layers of protection, growth and innovation in the system.

Comments on why credit unions will issue alternative capital, and how it fits into the credit union business model.

We see a number of potential benefits from alternative capital:

Promote investment, innovation and improved efficiencies
Product and channel advancements can have significant costs and credit unions should not be limited in funding them purely out of retained earnings. Competition is requiring higher levels of investment and innovation. Alternative capital can help fund investments in innovations, improve efficiencies and increase member value.

Reduce risks within the system and provide a market-driven risk assessment
If structured properly, capital instruments can increase a credit union's loss-absorbing capacity without impairing its cooperative nature. Alternative capital raised from outside the system fortifies the loss-absorbing capability of both the issuing credit union and the Share Insurance Fund. Given the Share Insurance Fund is cooperatively owned, outside capital would act as an additional loss buffer. In addition, the price that sophisticated investors are willing to accept for a credit union's alternative capital instruments would give the NCUA an indication of how investors evaluate an issuer's risk level.

Provide another tool in the formation of de novo credit unions and encourage credit unions to maintain their current charter

Limited access to capital is often cited as the biggest challenge in forming a new credit union. Today, this typically requires a large gift or significant subsidies from a sponsoring institution or special employee group. Interestingly, limited access to capital is also the common reason why some credit unions have sought or converted to a bank charter.

Provide more sustainable asset growth

Unlike commercial banks, subchapter S banks, and other cooperative financial institutions throughout the world, America's credit unions can only grow their capital through net income. This unique and narrow restriction limits the rate at which credit unions can grow sustainably, to a rate equal to their return on equity (ROE). Growing assets below its ROE will build capital, while growing assets at a rate above its ROE will erode capital. For example, if a credit union has a 7% ROE, it can grow its assets by 7% or less without negatively impacting its capital position. Giving credit unions the ability to issue and retire capital, just like banks and other cooperative financial institutions, will provide another lever to manage growth outside of earnings.

<u>Comments about who will purchase supplemental capital.</u>

Assuming a pragmatic balance between issuer and investor needs, limited regulation and low issuances costs, we see a number of potential purchasers of supplemental capital, ranging from existing members of credit unions to sophisticated investors. On the sophisticated investor side, we believe there would be interest from insurance companies, pension funds, asset managers and other institutional investors.

We also see market demand growing from institutional investors that have participated in the subordinated bank debt market. We expect these kinds of investors will assess the available FDIC (failed bank list) and NCUA (NCUSIF reports showing failed credit unions) data from 2008 to Q1 2017 and see there were 3X more bank failures than credit union failures. The credit union market is relatively predictable, stable, and, in our view, offers a strong risk-adjusted return for potential institutional investors.

<u>Comments on how any regulations should address the issue of the cost of the instrument and any items that may be helpful in reducing the costs associated with issuing supplemental capital while maintaining adequate protection for investors and the Share Insurance Fund.</u>

In the case of securities offerings to Institutional Investors, an issuer's costs can be reduced (and deal terms and execution will frequently be improved) through the use of pooled or securitization structures similar to the pooling structure we used for Australian credit unions in 2006, or similar structures used by small-midsize community banks in 2015. As noted above, the Australian structure allowed over 20 Australian credit unions to pool together to issue subordinated capital. Each of the participating credit unions raised between AU$2-16 million, through a cost-effective securitization structure that allowed investors to invest in a diversified mix of both large and small credit unions.

A similar structure came to our attention last year. According to the January 11, 2016, issue of *The American Banker*, pooling structures were used in 2015 to raise several hundred million dollars of subordinated debt and other statutory capital for 58 community and regional banks. According to published reports, use of pooling structures allowed participants to spread issuing costs and fees across the group and raise capital on favorable terms.

We believe similar pooling structures could enable U.S. credit unions to work together to raise capital, and should be permitted by the Board. Credit unions have a history of working together cooperatively, and we believe this tradition could carry over to capital raising, if permitted by the Board. We encourage the Board to allow secondary and supplemental capital to be issued by credit unions as part of a multi-issuer offering, and to allow for typical securitization features.

Potential for Credit Unions' Use of Supplemental Capital

Comments on whether credit unions that are not designed as low-income use of supplemental capital could affect the availability of secondary capital for low-income designated credit unions. If so, are there any measures the Board could take to protect against this?

Allowing for a broad pool of potential credit union issuers will help grow investor knowledge and comfort. As noted above, we believe the market is deep, which will support both types of capital.

Comments on the potential effect supplemental capital may have on the mutual ownership structure and governance of credit unions.

Maintenance of cooperative principles is essential for both the preservation of a credit union's unique character and to avoid unintended tax or other consequences. If supplemental capital is structured appropriately, it would not diminish the member-ownership structure or governance of credit unions and would not extend ownership rights to investors. There are numerous examples in the United States, in which the mutual ownership structure is preserved in capital raises, including mutual savings banks, agricultural cooperatives, mutual insurance companies and rural utility cooperatives.

Securities Law Applicability

How could NCUA protect the Share Insurance Fund against potential anti-fraud claims that could impair the alternative capital's ability to cover losses?

In an offering of securities to institutional investors, the investors or deal arranger will have an opportunity to conduct due diligence, which should reduce fraud risk; in addition, debt instruments, by their very nature, typically offer more limited potential gains to investors than do equity instruments, which should reduce the investors' expected returns (a common measure of damages).

Comments on if the Board should mandate that credit unions certify that they have evaluated their Director and Officer Liability policies and have sufficient coverage before beginning secondary or supplemental capital activities.

We believe that the Board should encourage the evaluation of Director and Officer Liability policies to ensure sufficient coverage before beginning secondary or supplemental capital activities. Similar to any type of new initiative a credit union may decide to pursue, the review should take place in the context of other key business decisions, as part of their overall enterprise risk management framework, and would encourage Director's oversight as it relates to capital activities. The review should take into account the additional exposure resulting from the new set of investors and the potential for an increase to policy premiums related to these changes in exposure. The Board's level of oversight of Director and Officer Liability coverage could be driven by the materiality of a transaction with the most significant transactions requiring the most stringent review.

Other Investor Considerations

Comments on whether the sale of secondary and supplemental capital should be limited to only institutional investors, include accredited investor, or allow for anyone to purchase.

We do not believe the available universe of investors should be limited by regulation, but recognize that unsophisticated investors require more protections than do institutional or accredited investors who are regular participants in the capital markets and frequently are able to conduct their own due diligence.

Comments on the extent to which credit unions should be allowed to sell alternative capital with equity like characteristics to nonmembers, and if so, what controls are necessary to preserve the mutual ownership structure and democratic governance of credit unions.

We believe mutuality should be preserved regardless of the capital characteristics.

Prudential Standards for Issuing and Counting Alternative Capital for Prompt Correction Action

Comments on how to maintain protection of the Share Insurance Fund while minimizing the impact the criteria would have on the cost and marketability of the alternative capital instruments.

We believe that the subordination and loss absorbing capacity of supplemental capital should provide the Board comfort around the protection of the Share Insurance Fund. We also believe that institutional investors will require standard market terms and protections. As a result, we do not believe that detailed, prescriptive requirements on the terms of supplemental capital issued to institutional investors should be a priority for the Board.

<u>Comments on the utility of a prior approval process and a post-issuance notification process. And, under what conditions prior approval would not be necessary, such as credit unions that are well capitalized with a successful history of issuing alternative capital.</u>

We believe the NCUA should focus on a streamlined governance process that distinguishes between credit unions based on their level of capitalization and experience as issuers.

Subordination

<u>Comments on whether authorizing supplemental capital regulations should contain any restrictions on payment priority options, and if so, what should they be.</u>

We recommend that the Board provide enough flexibility to allow a market to develop over time. This will be especially important when structuring multiple classes of alternative capital.

We also recommend the Board allow secondary and supplemental capital to be pledged by the account investor as security for a loan or other obligation with any party other than credit union or a credit union affiliate. This would allow investors to utilize securitization structures, for example, issuing senior and junior tranches of alternative capital. This would allow investors to participate in multiple ways, which broadens the overall investor base and allows credit unions more flexibility in bringing offerings to market. CUNA Mutual used a similar approach in 2006 when we helped arrange the offering by over 20 Australian credit unions.

<u>Comments on the topic of prepayment and call provisions for alternative capital and how the Board should structure any related requirements.</u>

Prepayment and call provisions are important levers for issuers and investors and should be allowed but not required. Balancing issuer and investor rights will be critical in allowing the market to clear. For example, if issuers are allowed call provisions, investors should be allowed to negotiate a make-whole call. Or the issuer could include this type of provision when it first approaches investors, as a sweetener to make the note more marketable. In a make-whole call, the borrower has to make a lump sum payment to the investor based on an agreed upon formula of the future interest payments not paid because of the call.