August 30, 2018

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

(Sent by email)

Dear Mr. Poliquin,

Thank you for the opportunity to provide comment on the proposed rule changes for “Risked-Based Capital- (RBC) Supplemental Proposal”, which would move the asset threshold defining a complex credit union from $100M to $500M and delay RBC implementation until January 1, 2020. We agree with these changes and provide supportive commentary in this letter. Additionally, we provide discussion on the need for a more comprehensive and modernized regulatory and capital regime for credit unions.

Increase the Asset Size for Complex Credit Untion to $500 Million

i. Amending the Definition of complex

We agree with the proposal to raise the asset threshold to $500M in total assets to trigger risk based capital (RBC) coverage. In fact, this idea is overdue for implementation.

CUs with assets less than $500M (non-complex) are struggling to remain viable and would struggle unnecessarily to comply with RBC. At year-end 2017, non-complex CUs total approximately 5000 institutions. Sandler O’Neill research taken from call report data indicates that, for the 5 year period ended 2017, 25% of non-complex CUs experienced a negative ROA while 56% experienced a net loss of members (aggregate non-complex CU membership growth was 2.9%). Non-complex institutions cannot financially support the initiatives to achieve competitiveness, let alone fund compliance requirements for AML, BSA and cyber security, among other things.

CUs with assets greater than $500M (complex) represent 9% of all CUs and 75% of all assets and annually account for 75-85% of total industry net income. Complex CUs grew members 24% and shares 34% in the last 5 years.

CU regulation should consider these facts and move to a regulatory and capital regime that recognizes 2 types of CUs, those that are complex with assets greater than $500M and those non-complex. complex CUs have evolved to be different in many respects from the non-complex. As NCUA states in the proposed “Supplemental Rule”, the 540 CUs with assets greater than $500M are more likely to be engaged (and with a higher percentage of its assets) in more sophisticated investments, loans, borrowings and the sale of mortgage loans than the smaller CUs, among other things.

Complex CUs are now easy to distinguish from small CUs but difficult to distinguish from banks as United States Treasury has noted:

10 years ago, U.S. Treasury wrote in The Department Of The Treasury Blueprint For A Modernized Financial Regulatory Structure; "Congress established the FCU charter in 1934 to make credit available to people of small means through a national system of cooperative credit. Over time, a key aspect of the credit union system, the field of membership, has become less meaningful. Some credit unions have arguably moved away from their original mission of making credit available to people of small means, and in many cases they provide services which are difficult to distinguish from other depository institutions."

Importantly, in the September 2015 NCUA Board Meeting, Board Member Mark McWatters spoke to the definition of complex and the need to balance regulation amongst marketplace participants:

"We need to compare apples to apples…credit unions and banks – compete against each other in the financial services marketplace and, accordingly, should shoulder a distinctly similar regulatory burden absent objective evidence that a contrary treatment is justified. To address this regrettable imbalance, the NCUA should increase the small entity asset threshold under the RFA to $550 million, like the FDIC…"

Over the years, complex CUs have evolved to become more bank-like requiring a modernized system that recognizes the interconnectedness of share insurance, regulation and capital requirements. Some of the recent regulatory change, however, has had the unintended effect of upsetting the competitive balance amongst CUs and CUs with banks. We believe this imbalance requires immediate attention.

Delay the Effective Date of the RBC Final Rule to January 1, 2020.

We believe strongly that a speedy and more comprehensive change is in order, however we agree that implementation should not occur before January 1, 2020. This will provide NCUA time to adjust call report formatting while allowing newly minted complex CUs time to adjust to the RBC regime.

Restructure the Framework Governing Regulation, Capital Treatment and the Insurance Fund

i. NCUA should present a comprehensive restructure plan to Congress that allows legislators to finish work they (Congress) started with LID CUs, which has led to an environment that picks winners and losers. Specifically:
   a. **Low Income Designated (LID) Credit Unions Enjoy a More Robust "Charter Within The CU Charter"**. The LID charter has expanded rapidly since 2012. Just 5 years ago, there were about 900 LID CUs representing 15% of total CUs and with an average asset size

less than $50M. The largest LID 5 years ago was less than $600M in assets. Today, approximately 46% (2520+) of CUs have a LID charter. Average LID asset size is $177M and 122 have total assets greater $1B. The following discusses risk and competitive issues related to the LID and not meant to be a comment on the original policy intent.

i. LID CUs have a regulatory competitive advantage versus non-LID CUs, potentially distorting the competitive landscape by unintentionally picking winners and losers. Specifically:

ii. LID CUs can grow their concentration of "member business loan" (MBL) volume beyond the statutory 12.25% of assets, and can issue secondary capital in the form of subordinated debt. CUs without the LID do not have such powers.

iii. Here are some considerations that are representative but by no means a comprehensive look at the potential for risk and competitive imbalance created by the LID "charter within a charter".

b. ***MBL.*** A non-LID CU cannot build an MBL business with the same freedom (and economics) as a LID. Non-LID MBL volume is capped (by regulation) at 12.25% of assets. LID CUs have no such cap and therefore can keep more of their MBL originations and reap more income. Non-LID CUs near the cap have to either decline business (creating inconsistencies with their member base) or sell participation loans (retaining less income).

c. ***Secondary Capital.*** A LID CU can issue secondary capital to augment their organic growth plans. What's more, in competition with non-LID CUs to win a merger, a LID has a potentially material advantage. Board of directors contemplating a merger will evaluate potential merger partners based in part on which CU has the superior capital position (retained earnings plus access to secondary capital) to support offering value to members while providing for investment in technology and service.

A well-capitalized non-LID CU is disadvantaged in pursuit of merger versus a LID due to its inability to raise capital. For perspective, there are about 540 CUs with assets greater than $500M as of 1Q, 2018. Of those, about 200 are well capitalized but with a net worth ratio below 10%. Over 80 of the 200 have a LID, giving them an advantage in their bid to become a merger partner.

The extension of the low- income designation to more CUs has led to the unintentional consequence of creating an imbalance within the CU industry, which seems in direct contravention to the spirit and intent behind the above comment of Chairman McWatters.

Conclusions and Considerations

There is no legal, regulatory or policy reason justifying a material competitive advantage for 40% of complex CUs with a LID charter. The inconsistency is unfair and potentially unsafe should some institutions "stretch" in an effort to overcome their charter shortcomings. CUs and banks with assets greater than $500M "…should shoulder a distinctly similar regulatory burden absent objective evidence that a contrary treatment is justified". We believe this ***partial*** list of suggestions are appropriate for all complex CUs:

a. If not already doing so, NCUA could consider discussing with banking regulators if/how they plan to implement the "opt out of RBC" mechanism thru retention of a higher net worth ratio.
b. Eliminate the MBL cap for all complex CUs.
c. Allow all complex CUs to issue secondary capital in the form of sub debt
d. Transition to the performance based CAMELS approach for funding NCUSIF as proposed by NCUA as a "legislative priority" to Congress.*

Thank you again for considering our comments in this letter. Please call me at 212-466-7871 or email me at pduffy@sandleroneill.com if you would like to discuss further.

Respectfully,

Peter F. Duffy
Managing Director

Sandler O'Neill + Partners, L.P. is a full service investment-banking firm based in New York City. Sandler O'Neill is a leader in transacting with credit unions and banks on merger advisory, capital markets strategy and execution (secondary capital), and balance sheet management including asset liability analysis, investments, hedging strategies and loan sales. Sandler O'Neill has also been a leader in developing partnerships for credit unions (CUs) with fintech and residential solar programs.

*From NCUA:

1. "What is the low-income designation?

Low-income designation (LID) is a classification for credit unions that meet certain membership criteria. The classification entitles these credit unions to legislated benefits. A federal credit union qualifies for LID when a majority of its membership (50% + one member) qualifies as Low-Income Members.

"Low-income members" includes members with a family income 80% or less than the median family income for the metropolitan area where they live or national metropolitan area, whichever is greater. Members enrolled as students in a college, university, high school, or vocational school also qualify. For the full definition, refer to NCUA Rules and Regulation 701.34."

2. Larry Fazio, Director; Office of Examination and Insurance testimony to US Congress; February 2015.