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National Association of Federally-Insured Credit Unions

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Mr. Gerald Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

RE: Advance Notice of Proposed Rulemaking for Alternative Capital

Dear Secretary Poliquin,

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), the only national trade association focusing exclusively on federal issues affecting the nation's federally-insured credit unions, I would like to share with you our thoughts on the Advance Notice of Proposed Rulemaking for Alternative Capital. Consistent with our previous support of a supplemental capital framework for credit unions, NAFCU commends NCUA for initiating this rulemaking and exploring relief options for credit unions that must meet regulatory capital requirements. With respect to secondary capital, NAFCU welcomes the opportunity to suggest modest improvements, such as additional flexibility during the preapproval stage for issuing credit unions and broader call options to encourage investor interest.

Since the financial crisis tipped our country into recession, credit unions have served as a vital source of capital and market liquidity in local communities. Credit unions did not engage in the risky lending practices that led up to the crisis and have not cost taxpayers a dime. When sound small businesses and homebuyers were having trouble finding credit during the liquidity drought, credit unions filled that lending gap in many parts of the country. A regulatory capital framework that authorizes supplemental capital would grant credit unions an additional option to guard against risk, achieve growth, and ensure that our industry remains a bedrock of stability for the 106 million Americans who currently look to credit unions as a vital source of affordable financial services.

NAFCU's approach to alternative capital emphasizes the following general principles:

1. Preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions and ensure that ownership interest (including influence) remains with the members.

2. Ensure that the capital structure of credit unions is not fundamentally changed and that the safety and soundness of the credit union community as a whole is preserved.
3. Provide a degree of permanence such that a sudden outflow of capital will not occur.
4. Allow for a feasible means to augment supplemental capital.
5. Provide a solution with market viability.

NAFCU also believes that NCUA should develop its alternative capital framework through a pilot program, similar to what the NCUA Board implemented for the derivatives rule.[1] NAFCU believes that the use of a pilot program to measure well-capitalized, well-run credit unions' deployment of supplemental capital will yield best practices that could benefit the entire industry.

NAFCU understands that statutory amendments may be necessary to provide meaningful alternative capital options for all credit unions; however, a regulatory capital framework would still offer increased flexibility to credit unions that must meet NCUA's risk-based net worth requirement.

I. Supplemental Capital

NAFCU supports supplemental capital as an option for improving capital buffers, encouraging growth, and meeting regulatory capital requirements—so long as it is compatible with the not-for-profit, mutual and cooperative structure of credit unions. For example, NAFCU believes that supplemental capital structured as subordinated debt and possessing the same key features as secondary capital (with certain exceptions) is one option that ensures such compatibility. NAFCU also expects appropriately structured supplemental capital to compliment the mission and purpose of credit unions in a way that raises no question about the tax exempt status of credit unions.

In April 2010, NCUA published a "Supplemental Capital White Paper" (White Paper) that identified three capital instruments capable of meeting key public policy objectives outlined below. These instruments were Voluntary Patronage Capital (VPC), Mandatory Membership Capital (MMC), and Subordinated Debt. NAFCU believes that subordinated debt possesses characteristics that will guarantee compatibility with the FCU Act and also yield sufficient investor interest to develop a healthy supplemental capital market. Furthermore, NCUA's familiarity with secondary capital makes subordinated debt a logical regulatory capital option. While VPC, MMC or other forms of regulatory capital might offer similar (if not greater) utility, NAFCU believes that subordinated debt should be the focus of NCUA's preliminary efforts.

NAFCU also believes that NCUA possesses the legal authority to allow federally-chartered credit unions[2] to issue subordinated debt and count it towards risk-based net worth calculations. As the ANPR acknowledges, Congress has not defined risk-based net worth, which gives the Board "the latitude to include within that requirement items that would not meet the statutory

[1] *See* 12 CFR 703.113.

[2] The FCU Act places no restrictions on the ability of state-chartered credit unions to issue forms of supplemental capital otherwise authorized under state law; however, some offerings may be prohibited by NCUA through share insurance regulation.

definition of 'net worth' but otherwise serve as capital in protecting the Share Insurance Fund from losses when a credit union fails."[3] For example, subordinated debt would be subordinate to the Share Insurance Fund (SIF) and only count toward satisfying credit unions' risk-based net worth ratio. Accordingly, NCUA may permit this type of capital instruments consistent with credit unions' borrowing authority.

To the extent that NCUA seeks to allow natural person investors to purchase forms of supplemental capital, NAFCU welcomes efforts to promulgate rules that would clarify credit unions' borrowing authority. NAFCU also recommends that NCUA design these rules to specify what types of supplemental capital instruments may be sold to natural person investors, if any, and in what amount.

A. Prudential Safety and Soundness

In general, the ability to issue supplemental capital would help credit unions adjust to changing economic conditions more effectively. When a credit union's economic outlook fluctuates, either as a result of asset growth or declines in capital resulting from losses on loans or other assets, it must rely on retained earnings to satisfy regulatory capital requirements. Because retained earnings accumulate slowly, the present cost of ensuring future financial stability may necessitate less than desirable tradeoffs. For example, a credit union may need to offer less attractive rates in order to build retained earnings that will support future growth and guard against unexpected downturns. Supplemental capital would make this process of capital planning and adaptation more cost-effective and predictable.

The Risk-Based Capital Rule will go into effect January 1, 2019, establishing a risk-based capital ratio of 10 percent for complex credit unions to qualify as "well-capitalized." As NAFCU noted throughout the risk-based capital rulemaking process, many credit unions may struggle to achieve their desired capitalization level because they lack access to capital in the financial markets. As evidenced by experiences in the banking and thrift sectors, supplemental capital frameworks can provide important mechanisms by which financial institutions can raise capital outside of simply retained earnings. As opposed to slowly building up capital over the course of years, supplemental capital issuances can provide credit unions the ability to rapidly raise capital when the need or desire arises. For example, a complex credit union that issues supplemental capital may do so to strengthen its risk-based capital buffer and offset the acquisition or growth of riskier assets. Other issuers might leverage supplemental capital to expand services to untapped markets, such as underserved or low-income communities. NAFCU anticipates that supplemental capital can grant credit unions additional flexibility to meet risk based capital requirements and yield more effective capital planning strategies.

NAFCU understands that it may also be desirable to import certain features of NCUA's secondary capital framework to ensure that credit unions are adequately prepared to issue subordinated debt. At a minimum, NAFCU believes that credit unions should be adequately or well capitalized under Prompt Corrective Action (PCA) standards before receiving authorization to issue supplemental capital.

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[3] *See* Advanced Notice of Proposed Rulemaking, Alternative Capital, 82 Fed. Reg. 9691, 9695 (Jan. 2017).

Lastly, NAFCU agrees that subordinated debt is analogous to Tier 2 capital, and as such, NCUA should take into account the unique structure of credit unions when deciding whether to import capital limits derived from the Basel Committee or existing bank standards.

B. Preservation of Mutuality and Cooperative Structure of Credit Unions

Supplemental capital structured as subordinated debt is compatible with the mutual and cooperative structure of credit unions. Subordinated debt confers no voting rights, carries a fixed or floating interest rate, and would be subordinate to all other claims of the credit union (with the exception of secondary capital), including the claims of creditors and members. As a result, investors will not wield influence that interferes with member control of credit unions.

In addition, subordinated debt is capable of satisfying all of the key requirements that NCUA has identified in the ANPR; namely, that supplemental capital must be uninsured, subordinate to all other claims against the credit union—including the claims of creditors, members, and the National Credit Union Share Insurance Fund—available to cover operating losses in excess of the credit union's retained earnings (and to the extent supplied, not replenished), adhere to maturity limits as determined by the NCUA Board, and remain limited to those credit unions designated as sufficiently capitalized. These requirements are the same as those that apply to secondary capital, and as such, should raise no material concern about the cooperative status of credit unions.

As a matter of comparison, low-income designated credit unions have been able to count secondary capital toward net worth calculations since the passage of *Credit Union Membership Access Act of 1998* (CUMAA). Secondary capital resembles subordinated debt in all functional aspects and preserves the mutual and cooperative structure of credit unions. Accordingly, supplemental capital structured as subordinated debt should be viewed as equally accommodating so long as it avoids conflict with the FCU Act (i.e., only satisfies risk-based net worth requirements).

Supplemental capital will have no effect on credit unions' tax exempt status.

NAFCU believes that supplemental capital structured as a form of regulatory capital does not raise any question regarding the tax exempt status of credit unions. Subordinated debt would not convey voting rights and restrictions on covenants (similar to what exists for secondary capital) would easily limit interference with a credit union's governance and business planning. Other forms of supplemental capital, such as VPC or MMC, would be even less concerning because only credit union members would be able to purchase these instruments, thus ensuring that the cooperative principles of the credit union are not disturbed.

Section 122 of the FCU Act (12 U.S.C. 1768) confers tax exempt status to FCUs, whereas state credit unions are tax exempt by virtue of the Internal Revenue Code (Code) (Section 501(c)(14)(A)). Section 122 does not reference capital structure. In addition, Congress' findings in CUMAA have since clarified that credit unions receive a tax exemption because they are "member-owned, democratically operated, not-for-profit organizations generally managed by

volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers..."[4] Because alternative capital does not alter these essential features, it should be viewed as wholly compatible with the legislative rationale for the credit union tax exemption.

The PCA capital standards added by CUMAA acknowledge that "credit unions are not-for-profit cooperatives that—(i) do not issue capital stock (ii) must rely on retained earnings to build net worth; and (iii) have boards of directors that consist primarily of volunteers."[5] Despite the fact that PCA capital standards do not relate **in any way** to credit unions' tax exempt status, NAFCU believes that supplemental capital can conform to each of the three criteria.

First, it would be disingenuous to classify regulatory capital such as subordinated debt as "capital stock," based on the de minimis presence of equity-like features.[6] Neither the FCU Act nor the IRS Code define the term "capital stock;" however, based on extensive review of IRS guidance and court cases that have sought to distinguish between capital investments and debt for accounting purposes, NAFCU does not believe that subordinated debt constitutes a form of capital stock. The shared characteristics of subordinated debt and secondary capital also suggest that a similarly structured capital instrument should be fully compatible with the FCU Act. Second, supplemental capital would be a form of regulatory capital that would not alter the conventional reliance on retained earnings to build net worth. Supplemental capital would be limited to the numerator portion of the risk based capital ratio. Third, none of the forms of supplemental capital discussed in the White Paper would interfere with the control of the credit union by volunteer boards of directors. NCUA could also restrict covenants to adequately preserve the independent decision making of boards of directors.

NAFCU understands that NCUA may be considering other forms of supplemental capital such as VPC or MMC. NAFCU does not believe that these forms of supplemental capital would resemble stock in the traditional sense either.

Investor Safeguards

As a general principle, NAFCU believes that it would be appropriate for NCUA to seek investor safeguards in proportion to investor sophistication. NAFCU agrees with the sentiment expressed in the ANPR that a lack of disclosure in specific cases could produce litigation risk for credit unions that may not only harm the individual credit union, but might also pose significant harm to the Share Insurance Fund. To guard against these possible risks while simultaneously providing a straightforward and accessible approval process for issuers of supplemental capital, NCUA should afford credit unions the greatest flexibility possible in pursuing investors. Below, we discuss considerations related to the potential types of investors mentioned in the ANPR.

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[4] Pub. L. 105–219, § 2, Aug. 7, 1998, 112 Stat. 913.
[5] 12 U.S.C. § 1790d(b)(1)(B).
[6] The accounting treatment of secondary capital clearly indicates that subordinated debt is not regarded as a form of equity on a credit union's balance sheet *except* for regulatory accounting purposes. *See* NCUA Examiner's Guide, 16-6. In addition, GAO testimony before the House Committee on Ways and Means has also affirmed that secondary capital is debt-like in nature. "A 'secondary capital instrument' is either unsecured debt or debt that has a lower priority than that of another debt on the same asset." U.S. House of Representatives, Review of Credit Union Tax Exemption : Hearing Before the Committee on Ways and Means, No. 109-38, 38 n.42, (Nov. 3, 2005).

Non-Natural Person Investors

NAFCU believes that allowing non-natural persons (institutional investors) to purchase supplemental capital could be accomplished without introducing novel disclosure requirements. Institutional investors are not sensitive to the same risks as natural person investors and possess the experience and expertise necessary to evaluate a credit union's capital plan (as part of the preapproval process) and ascertain the risks associated with holding subordinated debt. Accordingly, NAFCU believes that institutional investors would be adequately protected by requiring credit unions to provide the same "Disclosure and Acknowledgment" form that is used for offerings of secondary capital.[7]

Natural Person Investors

As NCUA noted in the ANPR, natural person investors may range significantly with regard to their level of financial sophistication. While some individual investors, such as those who satisfy the definition of "accredited investor" under Regulation D, can be considered to be quite sophisticated, other individuals who lack such a designation may carry more risk. Again, NAFCU does not see a need to prohibit the sale of supplemental capital to non-members, so long as investors are educated on the risks of the instrument. The level of necessary disclosure to achieve this purpose would be commensurate with an investor's sophistication.

Natural person investors who satisfy the definition of an "accredited investor" are likely capable of evaluating the risks of supplemental capital investments based on a credit union's business plan for issuing the capital. Like institutional investors, they are presumed to have experience and sophistication gleaned from prior purchases of securities. For example, private placements to qualifying investors could benefit from certain exemptions provided in the Section 505 and 506 of Regulation D. NAFCU believes these exemptions could serve as an appropriate benchmark for investor sophistication and would support exemptions from disclosure requirements if offerings were made to this class of investors.

The ANPR also considered the possibility of allowing non-accredited natural person investors to purchase alternative capital from credit unions. In this case, it may be appropriate for NCUA to require credit unions to provide disclosures to investors and register the offering with the agency. Initial and ongoing costs of educating these types of investors would likely cause the cost of issuing the instrument to rise.

The ANPR noted that the sale of secondary capital was not originally permitted to natural-persons, accredited or not, because those consumers may be confused "given that the low-income designated credit union is federally insured."[8] NAFCU believes that this confusion could be remedied by using a model disclosure to specify that purchases of supplemental capital are not insured and subordinate to certain claims against the credit union.

Amount of Disclosure Necessary to Achieve Anti-Fraud Purpose

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[7] *See* Appendix to 12 CFR 701.34.

[8] *See* ANPR, Alternative Capital, 82 Fed. Reg 9698.

NAFCU understands that investors in supplemental capital must receive certain minimum protections embodied in Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act); however, NAFCU does not think that supplemental capital—in particular subordinated debt—must necessarily conform to Securities Exchange Commission (SEC) regulations. NAFCU believes that the timing, contents and frequency of investor disclosures should depend upon the nature of the investor.

With respect to consumer disclosures, NAFCU understands that any plan to allow non-institutional investors to purchase supplemental capital should necessitate a heightened degree of investor protection. NAFCU believes that if natural person investors are allowed to purchase alternative capital instruments, then NCUA should adopt the same disclosures used by the OCC for subordinated debt offerings. These disclosures are flexible insofar as they cross-reference the SEC's own safe-harbor language for accredited investors. NAFCU believes that NCUA could use these disclosures "out-of-the-box," reducing the need to develop new forms or rely on novel standards for meeting the investor safeguards and anti-fraud provisions described in §10(b) of the Exchange Act.

Treatment of Supplemental Capital as Registered Security

NAFCU believes that Section 3(a)(5) of the Securities Act would exempt credit unions from the SEC's registration and disclosure requirements when issuing supplemental capital. In addition Rule 506 of Regulation D would also provide an independent exemption for accredited investors. Although the ANPR mentions the possibility of registering supplemental capital offerings with NCUA, NAFCU does not believe that such a requirement would materially enhance investor protection. While the OCC requires national banks to register subordinated debt, the FDIC imposes no such requirement. NAFCU believes that credit unions should not be subject to registration requirements that community banks would not face when offering subordinated debt. Furthermore, NCUA has never imposed a registration requirement for secondary capital; there is no prospectus requirement and the only disclosure a LICU must provide is the Disclosure and Acknowledgment form.

NAFCU urges NCUA to craft a regulatory capital framework that does not impose burdensome registration requirements on credit unions that are disproportionate to the complexity and risk of supplemental capital offerings. NCUA should avoid any proposal that would require credit unions to register a prospectus with either the SEC or NCUA, and instead seek parity with the current model that LICUs use when issuing secondary capital. NAFCU believes that streamlining investor disclosures as much as possible is essential to reduce the cost of issuing alternative capital.

NAFCU also does not see why the ANPR raises the issue of broker-dealer registration when federal credit unions cannot register as broker dealers and have traditionally received an exemption from the SEC's registration requirements when selling non-deposit investments directly to members.[9] The SEC permits this activity through "networking" arrangements, where an affiliated or third-party broker-dealer provides brokerage services for the financial institution's

[9] *See* NCUA Letter to FCUs 10-FCU-03, Sale of Nondeposit Investments, December 2010.

customers, according to conditions stated in no-action letters.[10] The ANPR recognizes that credit unions still need to meet a due diligence requirement when selecting a broker dealer, but these requirements could be obviated if credit unions are limited to raising supplemental capital through non-member investors. In conversations with member credit unions, NAFCU has learned that non-member institutional investors could support a robust supplemental capital market. Nonetheless, NAFCU encourages NCUA to explore regulatory options that could reasonably permit member investments, and in doing so, clarify its position on broker-dealer registration by explaining how its previous guidance must be reconsidered.

In general, NAFCU would prefer for NCUA to identify a regulatory capital framework that does not force credit unions into a position where they must perform costly due diligence to take advantage of the broker-dealer exemption.

II. Secondary Capital

NAFCU supports modest changes to the approval and review of secondary capital issuers and recommends that NCUA offer low-income credit unions (LICUs) broader call options to relieve certain market inefficiencies. To the extent that the ANPR raises questions about the application of securities law to secondary capital and whether additional investor protections are required, NAFCU believes that the current framework for secondary capital adequately addresses those concerns. Likewise, NAFCU does not think that additional prudential restrictions on secondary capital are warranted.

A. *Impact of supplemental capital on market for secondary capital; suitability for natural person investors*

NAFCU is aware that secondary capital investors are sensitive to regulatory changes that would make secondary capital subordinate to supplemental capital. Because the FCU Act requires that secondary capital must remain the most subordinate form of debt on a credit union's balance sheet, NCUA should consider whether it would be advantageous to credit unions (for the purposes of preserving investor confidence) to segregate supplemental and secondary capital markets.

NAFCU does not see a significant benefit in allowing natural person investors to purchase secondary capital. The ANPR notes that when the secondary capital regulations were initially written, "the purchasers were presumed to be foundations and other philanthropic-minded institutional investors." Based on recent outreach, NAFCU believes that institutional investors will continue to represent the primary market for secondary capital purchases.

B. *Relaxed pre-approval standards for issuing secondary capital*

NAFCU has heard from low-income designated credit unions that the current preapproval process for obtaining authorization to issue secondary capital could benefit from additional streamlining to reduce the cost of funds. One credit union has informed NAFCU that the time

[10] *See* SEC "Guide to Broker - Dealer Registration" *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm).

spent waiting for NCUA to approve a secondary capital plan while investors wait raises the cost of funds by approximately 75-100 basis points. In order to reduce these costs, NAFCU suggests that NCUA consider a preapproval process whereby a credit union submits a capital plan that can be reused in subsequent offerings, provided that future offerings conform to the original plan in general size and scope. If the capital plan were to change materially, a credit union could amend its original capital plan and receive approval on an expedited basis, without having to submit a new plan for each new offering.

C. Need for broader call options

NAFCU has heard from investors that large national banks interested in purchasing secondary capital for *Community Reinvestment Act* credit are interested in expanding the volume of their investment activity. However, a limiting factor for these investments is the rate at which capital revolves into and out of secondary capital accounts. NCUA could ease this bottleneck by granting credit unions more flexible early redemption options and relaxing the preapproval process based on the remaining maturity of the capital account.

For example, a credit union that has previously issued secondary capital, maintained a status of well capitalized, and successfully obtained streamlined approval to redeem secondary capital early should not need to seek NCUA approval for redemption in the future. Additionally, NCUA should consider allowing credit unions to redeem secondary capital that has been on deposit for less than two years depending on the term to maturity and whether the credit union satisfies all other components of § 701.34(d)(1). NAFCU believes that granting LICUs flexibility when redeeming discounted secondary capital could yield additional market efficiency.

Secondary capital issuers could also benefit from improved clarity in NCUA's Supervision Policy Manual. NAFCU has heard that certain criteria used to determine whether a Secondary Capital Redemption (SCR) request qualifies for streamlined approval have been interpreted inconsistently. Specifically, the Supervision Policy Manual asks whether a credit union's "post-redemption capital level will remain sufficient relative to any extraordinary risks." NAFCU recommends that NCUA consider using more objective criteria to improve the consistency of SCR determinations.

D. Secondary capital must be examined consistently

NAFCU has heard from investors and LICUs that examination of credit union balance sheets has sometimes resulted in inconsistent treatment of secondary capital accounts. There is particular concern that some examiners may be subjectively evaluating a credit union's philosophy toward building and maintaining net worth, and that review of the credit union's capital position may not properly take into account principles of leverage. To ensure that a credit union's capacity to take on risk is objectively and consistently measured, NCUA should clarify in its examiner guide that a credit union may use secondary capital to execute growth-oriented strategies. NAFCU believes that this additional level of detail will result in a more objective process for evaluating perceived level of risk.

III. Conclusion

NAFCU has long supported regulatory reform that would authorize credit unions to issue supplemental capital and applauds NCUA on approaching the issue in a thoughtful, comprehensive fashion. NAFCU understands that the ANPR's vision for supplemental capital is confined by statutory definitions, and that the utility of subordinated debt or other regulatory capital instruments will be limited to the numerator of the risk-based net worth ratio. In conversations with our members, there is agreement that despite this limitation, supplemental capital can be a valuable tool for credit unions. On the other hand, there is also a need to take caution, as any potential form of supplemental capital must demonstrate complete compatibility with the mutual and cooperative structure of credit unions. NAFCU is confident that NCUA can identify a regulatory capital instrument that is consistent with the FCU Act.

NAFCU also supports amendments to Section 216(o)(2) of the FCU Act that would allow credit unions to include certain forms of supplemental capital as part of the net worth calculation. Although NCUA must proceed carefully with this rulemaking, that does not foreclose the possibility that Congress may yet recognize the challenges credit unions face when building net worth. NAFCU asks that NCUA recognize the need for an amendment to PCA standards in its rulemaking in order to encourage more effective capital planning. Access to capital markets is an important safety feature that guarantees that financial institutions can rebuild their capital after a crisis and support future growth. Unreasonable restrictions on credit union access to capital markets limits flexibility, depresses share rates, and exposes credit unions to greater risk in the event of an unexpected economic downturn.

NAFCU appreciates the chance to submit comments regarding NCUA's Advance Notice of Proposed Rulemaking on Alternative Capital. Should you have any questions or concerns, please do not hesitate to contact me or Andrew Morris, Regulatory Affairs Counsel, at amorris@nafcu.org or (703) 842-2266.

Sincerely,

Carrie R. Hunt
Executive Vice President of Government Affairs & General Counsel