



May 9, 2017

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

Re: Advance Notice of Proposed Rulemaking – Alternative Capital

Dear Mr. Poliquin:

The Michigan Credit Union League (MCUL), the statewide trade association representing 100% of the 244 credit unions located in Michigan and their five million members appreciates the opportunity to comment on the National Credit Union Administration’s (NCUA) Advanced Notice of Proposed Rulemaking and Request for Comment regarding Alternative Capital. We urge the NCUA to allow credit unions to innovate, within appropriate limits in this space. Specifically, we support the development of a framework that recognizes supplemental capital for risk-based capital purposes.

Access to supplemental capital, outside of the credit union low-income designation, is especially important given the NCUA’s final rule on Risk-Based Capital. The final rule may require some credit unions to increase capital above the seven percent net worth leverage ratio, which under current rules, may only be accomplished through retained earnings.

Alternative Capital could provide a viable means of meeting the regulatory requirement under the NCUA’s Risk-Based Capital rule while minimizing any potential risk to the share insurance fund. Furthermore, a financially strong, well-capitalized credit union might in fact be discouraged from growth because of a concern of diluting net worth ratios that may trigger supervisory concerns. To that end, the MCUL is encouraged by this ANPR and urges the NCUA to allow credit unions to accept supplemental capital to count towards the risk-based net worth requirement.

The MCUL, agrees with Credit Union National Association (CUNA) and their comments, and also urges the NCUA to create an environment for experimentation by credit unions in the creation of supplemental capital instruments, limited in amount so as to not expose the share insurance fund to undue risk, but flexible as to allow the development of the most appropriate instruments that will be useful and cost effective for credit unions. The NCUA should consider, in its rulemaking, developing a number of specific requirements that any capital instrument would have to comply with. Additionally, any issuance of such an instrument should be subject to regulatory approval prior to issuance, similar to the initial approach taken by the NCUA with derivatives. After some

time and implementation the NCUA could rethink the rule and further shape the parameters of alternative capital based on the collective experience of preliminary credit union offerings.

NCUA's Capital Structure

The Credit Union Membership Access Act of 1998 (CUMAA)¹ provided for a system of prompt corrective action for federally insured credit unions incorporating capital standards in five categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The capital level is based on a net worth ratio requirement for all credit unions and a risk-based net worth requirement for complex credit unions. The Federal Credit Union Act (FCUA) provides the definition of net worth as follows:

1. The retained earnings balance of the credit union, as determined under GAAP, together with any amounts that were previously retained earnings of any other credit union with which the credit union is combined;
2. Secondary capital of a low-income designated credit union that is uninsured and subordinate to all other claims of the credit union, including the claims of creditors, shareholders, and the Share Insurance Fund; and
3. Certain assistance provided under section 208 of the Act pursuant to NCUA regulations.

Per the Act, secondary capital is currently only permissible for low-income designated credit unions and may be counted toward the net worth ratio and for the risk based net worth ratios, but the Board has broad discretion to allow credit unions without the low-income designation to issue alternative capital instruments to satisfy the risk-based net worth requirements, even if that capital cannot be counted toward net worth requirements. We recognize that allowing alternative capital for purposes of net worth would require a change in statute.

Global Acceptance of Alternative Capital

It should be acknowledged that most credit cooperatives, including credit unions, in most developed nations enjoy a broader array of capital formation options than that of credit unions in the United States. A study from the Filene Research Institute analyzed capital access to credit cooperatives globally, and found, unlike credit unions in the U.S. most cooperatives globally are not constrained by field of membership requirements. According to the study, European credit cooperatives are permitted to attract capital and deposits from members outside their target market, enabling others the opportunity to invest funds that otherwise would not have if field of membership restraints were in place.²

Alternative/Supplemental Capital

Access to alternative or supplemental capital has been a hotly debated topic for several years with a number of arguments presented in favor of and opposed to the concept.

¹ <https://www.ncua.gov/Resources/Documents/LCU1998-16.pdf>

² See *Alternative Capital for U.S. Credit Unions? A review an Extension of Evidence Regarding Public Policy Reform*, Robert F. Hoel, PHD (https://filene.org/assets/pdf-reports/145_Hoel_AltCapital.pdf)

The Filene study referenced above also discusses the need for alternative capital, listing six negative consequences of prohibiting the acquisition of alternative capital by U.S. credit unions:

- Slower recovery from financial setbacks.
- Fewer new credit unions
- Limitation on growth and the addition of new services
- Difficulty in achieving economies of scale.
- Conversion of credit unions to bank and thrift charters
- Overcapitalization³

These negative outcomes individually make a case for the development of a broad-based allowance for supplemental capital. In concert, they should make public policymakers very concerned about the long term financial resiliency of the credit union movement without the availability of supplemental capital instruments.

The NCUA has asked if supplemental capital should be included in the risk-based capital numerator and how including such capital would protect the NCUSIF from losses. The answer to this question is yes. While supplemental capital cannot be included in net worth for most credit unions without a change in federal law, there is nothing in the Federal Credit Union Act or GAAP that would prevent the NCUA from including supplemental capital in the numerator of the risk-based capital ratio for RBC, which already includes items that are not part of the net worth.

The NCUA should call on Congress to pass a legislative solution that modernizes capital standards and allow supplemental capital authority as well as direct the NCUA Board to design a risk-based capital regime for credit unions that ultimately takes into account material risks instead of the current capital proposal.

Guiding Principles on Supplemental Capital

The development of supplemental forms of capital would need to adhere to certain principles. The MCUL agrees with CUNA in that the NCUA should adopt or allow supplemental capital that can be used for net worth purposes for non-low income designated credit unions on an experimental basis. As previously stated, credit unions offer a cooperative ownership structure, unique to credit unions.

The ownership of the credit union must remain in the hands of its members, regardless of whether they have provided any supplemental capital (i.e. additional membership shares). In the event supplemental capital is provided by non-members, it can confer no ownership rights. Therefore, common stock would not be a source of supplemental capital for credit unions and without common stock, no debt or hybrid instrument could be convertible to common stock. Any agreement or disclosure should be in writing, properly executed and contain clear language that no ownership interest is created or does not confer any membership or governance rights.

³ https://filene.org/assets/pdf-reports/145_Hoel_AltCapital.pdf

Governance of the institution must continue to be driven by one member, one vote, with no additional voting rights for providers of supplemental capital. In the event supplemental capital is issued to non-members of the credit union, it should not be granted governance or voting rights.

Additionally, because credit unions would not want supplemental capital to in any way jeopardize their not for profit status, supplemental capital would need to be authorized and implemented in a way that has no adverse effect on the not for profit status of credit unions. This would be accomplished, in part, by meeting the previous criteria on ownership and governance. The preservation of the not for profit status would best be reinforced by a statement in enabling legislation that such capital does not in any way change not for profit status of credit unions.

- Supplemental capital instruments should include protection of the National Credit Union Share Insurance Fund. Disclosures to investors in credit union supplemental capital must provide a clear picture of any risks. Supplemental capital must be practical for credit unions to acquire and not a one-size fits all approach. There must be vehicles for smaller credit unions to reasonably gain access to alternate capital if they wish to do so. Finally, supplemental capital should be optional for credit unions. For those credit unions who are willing and able to operate with only retained earnings, there should be no requirement to acquire alternative forms of capital.
- The specific instrument used, whether an equity instrument, paid in capital or another form of subordinated debt should be flexible and not prescribed in rule 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. Circular and disclosure similar to those currently provided by the Low-Income Secondary Capital Rule are appropriate, but any securities disclosures should be governed by Securities/SEC rules and regulations and corresponding state law.
- 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 MCUL agrees with CUNA and recommends initial volume limits based on a proportion of assets or a proportion of total capital, which standards could be loosened after the industry and the NCUA gain experience in this field. A limit of 25% of retained earnings or 2% of total assets, whichever is greater, would be appropriate.

Potential Tax Implications

Implementation and adherence to appropriate guiding principles as detailed above would permit the NCUA to consider a broad range of supplemental capital instruments for approval. However, it is important to address the potential tax implications such capital could have upon credit unions. Particularly state chartered credit unions. Sixty percent of the 244 credit unions in the state of Michigan are state chartered.

The ANPR includes a section on “potential taxation implications,” particularly for state-chartered credit unions. Noting that federal law provides a tax exemption for state credit unions that are “without capital stock” (and “organized and operated for mutual purposes without profit”), it also notes that – under current regulations – “there does not appear to be an established definition of ‘capital stock’ used by the IRS.” (There is no similar qualification in the tax exemption for federal credit unions.)⁴

“It is possible federally insured state chartered credit unions in some states will have broad authority to issue supplemental capital instruments that have the characteristics of capital stock, and by doing so could subject themselves to taxation,” the agency states.

While this is a legitimate concern the Agency notes in the ANPR that the number of credit unions that will likely issues supplemental capital is relatively small. Second, provided the NCUA adopts a rule that requires advance approval of any new offering, the NCUA will be in a position to scrutinize instruments that may be perceived to pose a risk.

Additionally, the risks of having an instrument classified as capital stock will likely provide sufficient incentive for credit unions to avoid questionable offerings. To address potential tax implications and concerns regarding the preservation of mutual ownership structure, the NCUA’s rule should make explicit, as previously addressed, that any issuance under the supplemental capital rule be structured to preserve the cooperative nature of credit unions, including explicit prohibitions that capital instruments will not provide voting rights or otherwise convey a participating equity interest in the credit union.

Congress provided the credit union system with a federal tax-exemption due to the not-for-profit, cooperative structure of credit unions, and the special mission credit unions have to serve their communities. The credit union tax status is based on the credit union one member, one vote corporate structure with volunteer boards and is not based on the products and services it offers. The recommendations found herein do not alter the structure of credit unions and the MCUL, together with CUNA, requests disclosures and prohibitions on conferring any governance rights or ability to control the credit union based on an investment in supplemental capital. Allowing supplemental capital should not in any way affect the federal tax exemption for credit unions.

Conclusion

The MCUL is encouraged to see the NCUA Board’s willingness to seriously consider allowing credit unions to accept alternative capital to count towards the risk-based net worth requirements under the NCUA’s Risk-Based Capital rules. If structured appropriately, acceptance of alternative capital

⁴ <https://www.gpo.gov/fdsys/pkg/FR-2017-02-08/pdf/2017-01713.pdf>

will enhance the safety and soundness of credit unions further protecting the NCUSIF from potential losses. With careful consideration, development and implementation this can be accomplished without altering the cooperative structure of credit unions.

Sincerely,

A handwritten signature in black ink, appearing to read 'DA', with a long horizontal flourish extending to the right.

Dave Adams
CEO, Michigan Credit Union League and Affiliates