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July 25, 2019

Filed Electronically
Gerald Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Delay of Effective Date of the Risk-Based Capital Rules (RIN 3133-AF01)

Dear Mr. Poliquin:

I appreciate the opportunity to comment on the National Credit Union Administration's (NCUA) proposal on Delay of the Effective Date of the Risk-Based Capital Rules. I am a credit union regulatory attorney who practices law in the Washington, DC metro area. The agency's proposal to delay the effective date of the Risk-Based Capital rules until January 1, 2022 would allow the NCUA Board to holistically and comprehensively evaluate capital standards for federally insured credit unions.

I support this proposal because the Federal Credit Union Act's high "Net Worth Ratio" leverage ratio requirements under Section 216(o) of the Act are significantly higher than the leverage ratio requirements applicable to banks and also because the current version of the Risk-Based Capital Rules do not give federally insured credit unions the full range of capital options available to banks.

A delay in the effective date of the rules would allow the Board time to develop new capital options for federally insured credit unions that are modeled on corporate credit union Perpetual Contributed Capital (PCC) instruments under Section 704.3 of NCUA rules and are consistent with the "Basel Framework" (i.e. Basel III)[1] on which the agency's Risk-Based Capital Rules are based. Credit unions in jurisdictions such as Australia, Canada and the United Kingdom as well as European co-operative banks already have legal authority to issues Basel Framework-compliant PCC-style investment shares.

The NCUA Board as part of its review should expand the authority of credit unions to issue PCC-style investment shares in a manner consistent with the Basel Framework as well as the regulatory capital rules applicable to credit unions and co-operative banks in Australia, Canada, the United Kingdom and the European Union.

All federally insured credit unions would be able to count PCC-style investment shares as regulatory capital under the Risk-Based Capital Rules and low-income designated credit unions (LICUs) could also include PCC-style investment shares as a form of secondary capital for Net Worth Ratio purposes.

[1] Basel Committee on Banking Supervision, *The Basel Framework* (2019), *available at* https://www.bis.org/basel_framework/.

1. *Credit Unions and Co-operative Banks in Other Jurisdictions Already Issue PCC-Style Investment Shares*

Credit unions and similar co-operative depository institutions in other jurisdictions, such as Australia, Canada, the United Kingdom and the European Union, already have legal authority to issue perpetual capital shares similar to corporate credit union PCC instruments that qualify as "common equity Tier 1" capital under the Basel Framework, which is the same capital category as retained earnings.

The NCUA Board has statutory authority under the Federal Credit Union Act to allow federal credit unions to issue PCC-style investment shares as well as to allow federally insured credit unions to count PCC-style investment shares as regulatory capital for Risk-Based Capital purposes. In addition, the NCUA Board has statutory authority to authorize LICUs also to count PCC-style investment shares towards their Net Worth Ratios as a form of secondary capital.

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) Capital Adequacy Requirement (CAR) Guideline section 2.1.1.1(5) authorizes Canadian federal credit unions to issue Basel Framework-compliant capital shares to investors that are a different class of shares from membership shares.[2]

These Canadian federal credit union PCC-style investment shares are perpetual in duration, absorb losses on a going-concern basis once retained earnings are exhausted, are uninsured, are non-withdrawable, can pay a dividend up to a contractual cap, are redeemable for cash at the credit union's option with prior supervisory approval, and are the most subordinated claims on the credit union (and the PCC-style investment shares only have a claim on the liquidation corpus in an amount up to their par value, with the credit unions' membership shares having the claims on the credit union's residual assets).[3]

Similarly, the Australian Prudential Regulation Authority (APRA) has issued APRA Prudential Standard 111 (APS 111) that authorizes Australian credit unions and mutual banks to issue Basel Framework-compliant PCC-style shares to investors under essentially the same terms and conditions as apply to Canadian federal credit union PCC-style investment shares.[4] The Bank of England Prudential Regulation Authority also authorizes British credit unions to issue PCC-style investment shares called "deferred shares"[5] and the European Union authorizes European co-operative banks to issue PCC-style investment shares as well.[6]

2. *The Federal Credit Union Act Gives the NCUA Board Authority for Natural-Person Federal Credit Unions to Issue PCC-style investment shares for Risk-Based Capital Purposes*

Section 107(6) of the Federal Credit Union Act gives the NCUA Board broad authority to authorize all federal credit unions to issue perpetual PCC-style investment shares and Section 216(d) of the Act would

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[2] Office of the Superintendent of Financial Institutions (OSFI) of Canada, Capital Adequacy Requirements (CAR) Chapter 2, § 2.1.1.1 (2018).
[3] *Id.*
[4] *See* Australian Prudential Regulation Authority, *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (2017).
[5] *See* Credit Unions Act 1979 [United Kingdom], § 31A.
[6] European Commission, *Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds requirements for institutions*, 2014 O.J. (L 74) 8, 17-18.

allow the Board to define PCC-style investment shares as regulatory capital for purposes of the Risk-Based Capital Rule. As part of its review of the Risk-Based Capital Rules, the Board should use its Federal Credit Union Act Section 107(6) authority to authorize all natural-person federal credit unions to issue perpetual capital shares, in addition to issuing subordinated debt under federal credit unions' Section 107(9) borrowing authority. This is the risk-based capital approach envisioned by the Basel Framework and these PCC-style investment shares are already authorized for credit unions in Australia, Canada and the UK as well as for European co-operative banks.

Section 107(6) of the Act gives the NCUA Board broad discretion to authorizes federal credit unions to issue "shares" which are defined as "representing equity" within a regulatory framework "prescribed by the [NCUA] Board."[7] Under Section 107(6), credit union members, other credit unions, Federal, Indian tribal, State, or local governments and, in the case of LICUs, nonmembers could invest in these PCC-style investment shares.

The NCUA Board authorizing natural-person federal credit unions to issue PCC-style investment shares would also authorize most state-chartered credit unions to issue PCC-style investment shares under state credit union acts' "wildcard" provisions that grant state-chartered credit unions parity with federal credit unions.

Congress intended for the NCUA Board to have broad discretion with respect to the regulation of natural-person federal credit union shares by stating expressly in Section 107(6) that federal credit union shares are subject to "limitations prescribed by the [NCUA] Board."[8] This means that an NCUA regulation on natural-person federal credit union PCC-style capital shares issued pursuant to Section 107(6) would receive significant judicial deference because the Board would be filling a legislative "gap" in the statute under the *Chevron* Doctrine. The Supreme Court has held that such legislative delegations of authority for administrative agencies to fill a "gap" in the statute give an agency's statutory interpretations "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[9]

Section 207(k)(1)(C) of the Act also gives the Board broad authority make exceptions from share insurance coverage under which the Board can exempt such PCC-style investment shares from federal share insurance coverage so that they would be able to absorb losses on a going-concern basis.[10]

Congress has given the NCUA Board broad authority to define the instruments that qualify as regulatory capital under its Risk-Based Capital Rules because the Act's Section 216(d) provisions on risk-based capital give the Board another legislative "gap" to fill. Most courts will give the Board's interpretations concerning which instruments qualify as regulatory capital for risk-based capital purposes "controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute" under the *Chevron* Doctrine[11] because Section 216(d) states that federally insured credit union risk-based capital rules will be "defined by the Board based on the portfolios of assets and liabilities of credit unions."[12]

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[7] 12 U.S.C. § 1757(6).
[8] *Id.*
[9] *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 843-44 (1984).
[10] 12 U.S.C. § 1787(k)(1)(C) ("The Board may define, with such classifications and exceptions as it may prescribe, the extent of share insurance coverage provided for member accounts, including member accounts in the name of a minor, in trust, or in joint tenancy.").
[11] *Chevron*, 467 U.S. at 843-44.
[12] 12 U.S.C. § 1790d(d).

These PCC-style investment shares would also reasonably qualify as capital for Risk-Based Capital Rule purposes since they would meet the Basel Framework's definition of "Common Equity Tier 1" capital—the same class of capital as retained earnings—and would be equivalent to the PCC-style investment shares issued by credit unions in Australia, Canada, and the UK as well as those issued by co-operative banks in the European Union.

Providing credit unions with expanded authority to build capital would also help promote a safe and sound, well-capitalized credit union system by increasing credit unions' ability to protect their members' savings and the National Credit Union Share Insurance Fund from losses.

3. LICUs Can Also Count PCC-style investment shares Toward the Net Worth Ratio

The NCUA Board has broad discretion to authorize LICUs to issue PCC-style investment shares that would qualify towards LICUs' net worth ratios as a form of "secondary capital" as well as for the agency's Risk-Based Capital Rules. PCC-style investment shares would help provide LICUs with a stable, long-term source of secondary capital.

Section 216(o)(2)(C) of the Act gives NCUA broad discretion over the features of LICU secondary capital accounts qualifying as Net Worth so long as the secondary capital accounts are: (1) uninsured; and (2) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the National Credit Union Share Insurance Fund (i.e. those that are not also a type of "secondary capital" account as defined by the Board). PCC-style investment shares would be uninsured and subordinate to all other claims against the credit union in a manner consistent with Section 216(o)(2)(C).

Giving LICUs the option to accumulate capital through PCC-style investment shares would also be good public policy because it would give LICUs a more stable capital base than subordinated debt. PCC-style investment shares would be perpetual in duration whereas most subordinated debt accounts amortize over a five-year period, which reduces the amount of capital available to the credit union each year.

PCC-style investment shares would be especially useful for de novo chartered LICUs because they would give the LICU a stable, long-term source of secondary capital on which to add retained earnings. In contrast, subordinated debt accounts, while useful, typically lose capital value just as the credit union is trying to grow, which gives the de novo credit union a limited period to get up to scale and replace the subordinated debt through earnings retention. This can require the LICU to spin down its assets just as it is getting up to the scale needed to achieve meaningful earnings retention, which can contribute to the de novo LICU failing to achieve the net income necessary to create the retained earnings level necessary for long-term sustainability.

In addition, PCC-style investment shares can benefit established LICUs by providing a perpetual secondary capital base that would allow the LICU to replace losses or expand its operations on an economically sustainably basis in a more stable and efficient manner than is possible with subordinated debt. Many more LICUs are likely to thrive if the Board authorizes LICUs to issue PCC-style investment shares that qualify as regulatory capital under both the Risk-Based Capital Rules and for purposes of the Net Worth Ratio.

I appreciate the opportunity to comment on the National Credit Union Administration's proposal on Delay of the Effective Date of the Risk-Based Capital Rules. Please feel free to contact me at 240-685-

1480 or by email at medwards@creditunionslaw.com should you have any questions about my comments or would like any additional information.

Sincerely,

Michael S. Edwards
Attorney-at-Law