OLDEN LANE

July 23, 2019

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

Re: Comments on Public Unit and Nonmember Shares Proposed Rule: RIN 3313-AF00

Dear Secretary Poliquin,

We are pleased to offer this Comment Letter in support of the proposed changes to the National Credit Union Administration's ("NCUA") treatment of public unit and nonmember shares embodied in Section 701.32 of the Rules and Regulations accompanying the Federal Credit Union Act ("FCU Act").[1] In short, we view the proposed changes as a logical next step of the NCUA – building on lessons learned and strengthening credit union liquidity risk management.[2] And, we offer this Comment Letter to provide additional context and to further highlight the strength of the proposal.

Today, Section 107(6) of the FCU Act allows a federal credit union to receive payment on shares from nonmembers under certain circumstances, including (1) from other credit unions and (2) from nonmember public units and their political subdivisions. Low-income designated credit unions (LICUs) are afforded several forms of regulatory relief under the NCUA's rules and regulations.[3] Among the most important, LICUs are subject to a more permissible nonmember regime, as they may receive payment on shares from any source regardless of membership.

[1] *See generally Public Unit and Nonmember Shares,* National Credit Union Administration, 84 FR 25018 (May 30, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-05-30/pdf/2019-11296.pdf (hereinafter "Nonmember Shares Release").
[2] *See generally Guidance on How to Comply with NCUA Regulation §741.12 Liquidity and Contingency Funding Plans*, National Credit Union Administration, 13-CU-10 (Oct. 2013) (hereinafter "13-CU-10").
[3] Section 701.34 of the NCUA's regulations defines a "low-income member" as, among other things, a member "whose family income is 80 [percent] or less than the median family income for the metropolitan area where [the member] live[s] or [the] national metropolitan area, whichever is greater." Alternatively, a "low-income member" is a member "who earn[s] 80 [percent] or less than the total median earnings for individuals for the metropolitan area where [the member] live[s] or [the] national metropolitan area, whichever is greater."

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In any case, the current Section 701.32 of the NCUA's Regulations serves to limit the total amount of nonmember shares to 20 percent of a credit union's total shares, or $3 million, whichever is greater.[4] According to the NCUA, this 20 percent limitation was originally imposed in response to a series of asset/liability management problems related to these shares which arose at certain credit unions several years ago. Unfortunately, the problems led to material losses for the National Credit Union Share Insurance Fund (NCUSIF).[5]

Hopefully, such a situation is less likely today. As the NCUA's proposal concedes, the business plans of a growing universe of credit unions currently provide for several potential sources of funding. Typically, such plans include a vibrant non-core wholesale funding strategy to handle opportunities where price, availability and/or maturity issues are important to the credit union. One observer recently described the industry's ongoing transition to better liquidity management:

> "[o]nce largely thought of as taboo, the use of external funding is now widely accepted throughout the credit union industry. In fact, the NCUA has required all credit unions to seek multiple liquidity sources and document those sources in their liquidity policy."[6]

As the acceptance of external funding has gained hold, credit unions are increasingly sourcing funds from several different channels, including the Federal Home Loan Bank System, the corporate credit union network, and several non-member deposit channels.[7] In particular, many credit unions strategically pursue non-member deposits as an additive funding source from outside the industry. Non-member deposits also provide a measure of stability – as they are not subject to the same liquidity strains that can beset a homogeneous field of membership. Additionally, they can mitigate the seasonality of consumer deposits and support core deposit metrics of member shares. Non-member deposits generally offer a ready source of term funding providing a means for credit unions to extend liabilities and introduce funding with predictable maturities for more reliable interest rate risk assessment. Non-member deposits can also offer flexibility for credit unions pursuing a matched book asset liability strategy, as the amount and term of a non-member deposit can be structured to closely match a member business loan origination. Or, the deposits can be used to fund an unsecured loan portfolio or a specific vintage of loans.[8]

In recent years, liquidity management has become a priority at the NCUA. In 2010, for example, the agency joined all federal bank regulators in issuing a call for diversified funding strategies in an *Interagency Policy Statement on Funding and Liquidity Risk Management*. The Policy Statement offered that:

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[4] This limit also applies to public unit shares regardless of whether the public unit is a member of the credit union. And, the regulation makes an exception for shares that are U.S. Treasury accounts or matching funds accounts required by the NCUA's Community Development Revolving Loan Fund Program.

[5] *See Nonmember Shares Release, supra* note 1, at 25019.

[6] See Perry Jones, *Yes, Your Credit Union CAN Use Public Fund Deposits To Fund Assets*, Credit Unions.com (May 14, 2018), available at https://www.creditunions.com/articles/yes-your-credit-union-can-use-public-fund-deposits-to-fund-assets/#ixzz5hQRRtvzi

[7] *See, e.g. Some Thoughts on Liquidity*, Credit Union Whitepaper Series – Paper No. 1, Olden Lane, available at https://oldenlane.egnyte.com/dl/y1KvloDt1m/ (describing the various sources of funding accessed by today's credit unions).

[8] *See generally* Jones, *supra* note 6.

> "[a]n institution should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with fund providers to promote effective diversification of funding sources. An institution should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid."[9]

Recognizing the critical need for credit unions to maintain a sound policy and process for managing liquidity risk, the NCUA also adopted Regulation 741.12, requiring federally insured credit unions to take specific steps to ensure appropriate risk management and access to liquidity.

Effective in March 2014, the NCUA's Liquidity and Contingency Funding Plan Rule imposed requirements on credit unions, based on total asset size. Under the Rule, credit unions with less than $50 million in total assets are required to maintain a basic written liquidity policy. Credit unions with between $50 million and $250 million of total assets must also maintain a written contingency funding plan. Finally, credit unions with more than $250 million of total assets are also required to establish access to at least one other contingency federal liquidity source: the Discount Window or the NCUA Central Liquidity Facility (CLF).

The guidance accompanying Section 741.12 articulates the NCUA's concern "about the largely diminished liquidity protection for the credit union system" before bucketing the key sources of liquidity into three categories: (1) on-balance sheet liquidity, (2) access to market sources of funds, and (3) contingent federal liquidity providers.[10] As the NCUA further observes in its guidance, "[g]enerally, a credit union responding to liquidity demands will work through these sources in the above order" and "[f]or most credit unions, the first two sources of liquidity are already integrated into their day-to-day operations."[11]

Two observations are important here. First, the most mission driven credit unions are constantly balancing the need for prudent liquidity management against the desire to further facilitate the lending needs within their field of membership. Today's loans-to-shares ratios at historic highs across the industry are a testament to this balancing act.[12] Second, because the third source of liquidity identified by the NCUA (federal contingent liquidity providers) is intended to be accessed only in exigent circumstances, the most prudent credit unions are careful not to exhaust all of the available capacity in the first two categories.

At a minimum and regardless of a credit union's size, best practices dictate that a credit union's program and processes should include the following:

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[9] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, the Office of Thrift Supervision (OTS), and the National Credit Union Administration, *Interagency Policy Statement on Funding and Liquidity Risk Management* (Mar. 17, 2010), at 8.

[10] *See* 13-CU-10, *supra* note 2.

[11] *Id*.

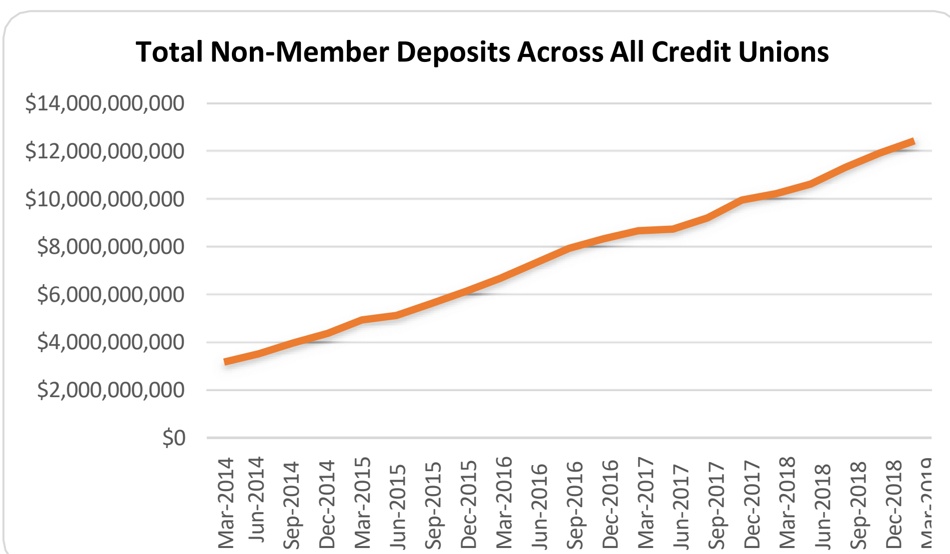
[12] *See generally Some Thoughts on Liquidity,* Credit Union Whitepaper Series – Paper No. 1, Olden Lane, available at https://oldenlane.egnyte.com/dl/y1KvloDt1m/, (observing that "[a]t year-end 2018, U.S. credit unions reported an average loan-to-share ratio of 85.48%.").

- An appropriately tailored set of strategies, policies, procedures, and limits.
- A comprehensive system of liquidity risk measurement and monitoring.
- A diverse mix of sources of funding, both existing and potential.
- Adequate levels of liquid, marketable securities.
- A comprehensive plan to sufficiently address adverse liquidity scenarios.
- Internal controls.

Building on the improvements ushered in with the Liquidity and Contingency Funding Plans Rule, the NCUA's most recent Proposed Rule seeks to change the limitations of Section 701.32. We view this as a welcomed step in the right direction. At Olden Lane, we are engaged every day in an effort to open channels of liquidity traditionally beyond the reach of credit unions. To our knowledge, we are the only firm whose underwriting efforts are aimed exclusively at the share certificate needs of credit unions. Through our efforts at education and the general availability of our various programs, we are proud to play our small part in encouraging credit unions to more responsibly approach liquidity management. And, we are encouraged that there is already evidence that the efforts of the NCUA to spur more diverse funding sources is taking hold.

We offer the following analysis to provide additional context to the current proposal and its likely effects. Again, we think that the agency's efforts come at a particularly important time for credit unions. We believe that they will be liquidity enhancing – providing credit unions additional flexibility in managing the liquidity needs of their respective institutions. As Chart [1][13] below illustrates, the total number of non-member shares, across the industry, increased approximately four-fold over just the past five years.

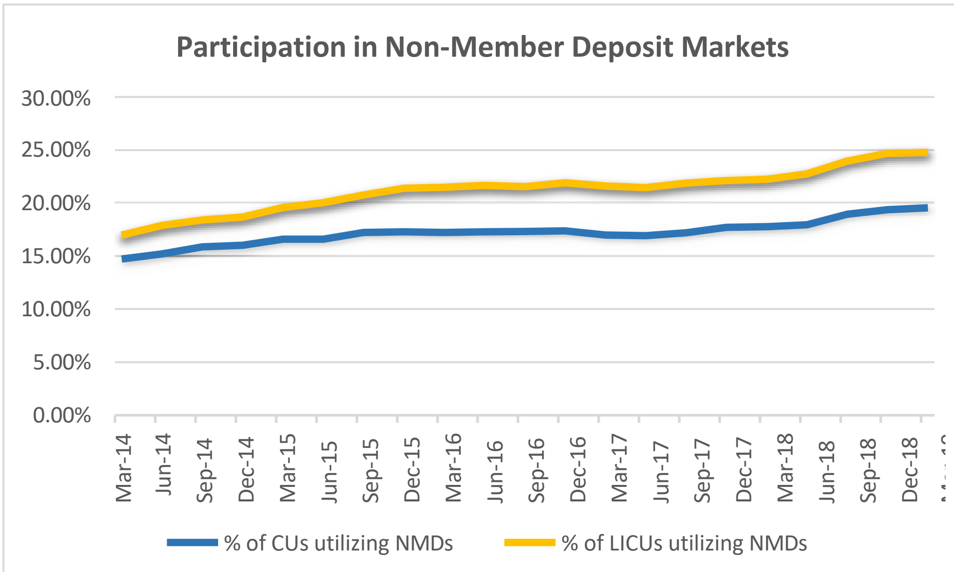
Chart [1].



[13] Unless otherwise specified, the data incorporated in each of the charts in the Comment Letter have been obtained from 5300 Call Reports, as compiled by Callahan and Associates' Peer-to-Peer software.

While the growth in nonmember deposits is encouraging, their use remains far from broad-based. In fact, as Chart [2] below illustrates, only approximately twenty percent (20%) of credit unions utilize some sort of non-member deposit funding – a figure that has grown from approximately fifteen percent (15%) five years ago. LICUs are more likely to utilize non-member deposit funding than non-LICUs. Approximately twenty-five percent (25%) of LICUs currently participate in non-member deposit markets, up from seventeen percent (17%) five years ago. As of March 31, 2019, LICUs account for just over 53% of the industry's total non-member deposits.

Chart [2].



Notably, in recent years, those credit unions that have employed non-member deposits have tended to be more active lenders than those credit unions not utilizing non-member deposits. For example, as Charts [3] and [4] highlight, the group incorporating non-member deposits as part of their overall strategy have achieved higher loan growth in aggregate and enjoy higher loans to asset ratios than credit unions than do not employ non-member deposits.

Chart [3].

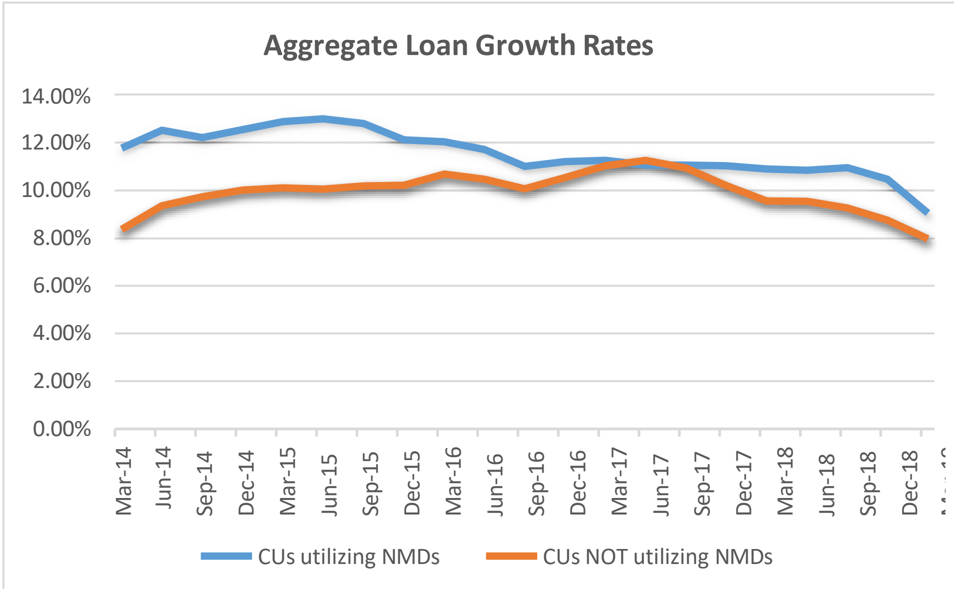
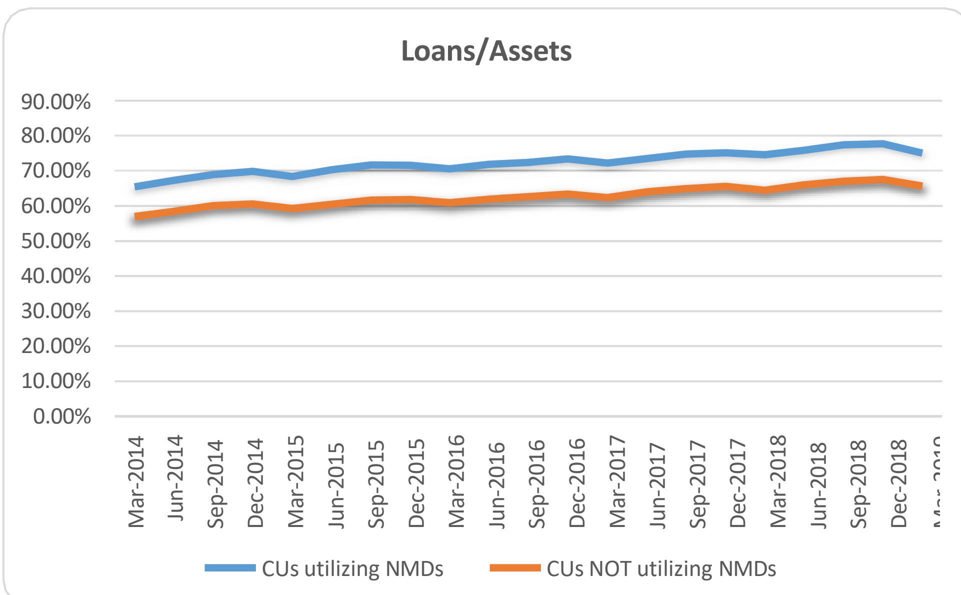
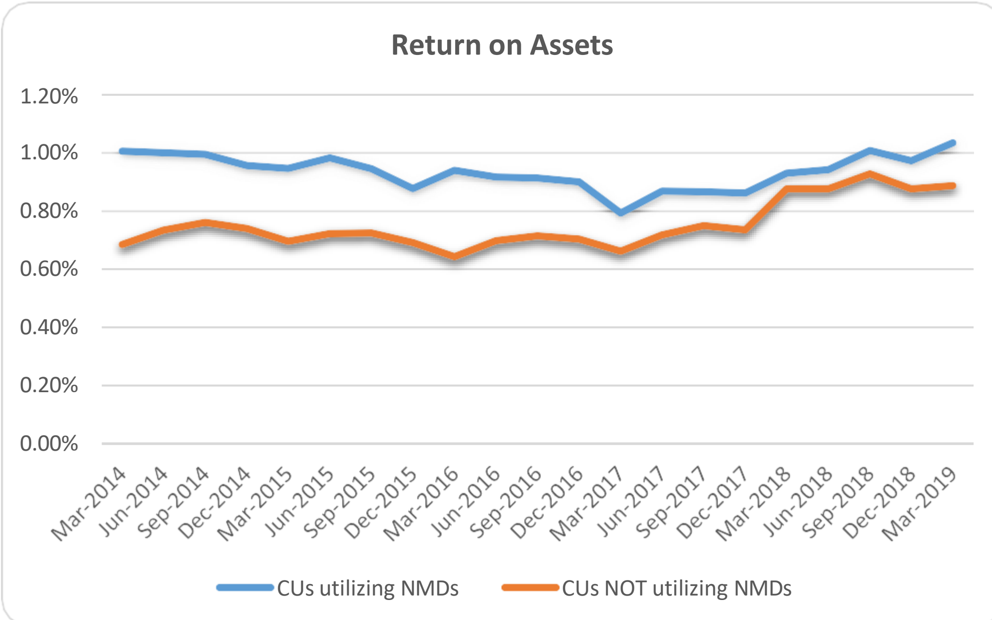


Chart [4].



As a result of the expanded lending activity – funded in part by non-member deposits – those credit unions employing non-member deposits generally achieve better earnings on average than their peers that do not, as illustrated in Chart [5] below.

Chart [5].



In light of the added flexibility offered by the proposal and the performance highlighted by the charts above, we wholeheartedly endorse the NCUA's efforts to relax the current limitations of Section 701.32. This change will result in additional capacity for credit unions and will encourage credit unions to prudently tap this source of funding.

The proposed changes are based on the Final Report of the NCUA's Regulatory Reform Task Force (the "Task Force"). As the NCUA's release suggests, the Task Force viewed public unit and nonmember shares "as the functional equivalents of borrowings."[14] As such, the Task Force reasoned that such shares should be subject to the borrowing limit set out in Section 107(9) of the FCU Act, which permits a federal credit union to borrow from any source up to 50 percent of its paid-in and unimpaired capital and surplus, subject to such rules and regulations as the Board may prescribe.[15] The proposed rule is faithful to the Task Force's recommendation by allowing a credit union to receive payment on shares from public unit and nonmember shares up to 50 percent of its paid-in and unimpaired capital and surplus less any public unit and nonmember shares from public units and nonmembers, without requesting a waiver from the appropriate Regional Director.[16]

Here, the Task Force is onto something very important. Indeed, absent a proposal of the type being considered, the existing regulatory framework will continue a preference for borrowings over other non-core funding sources. In fact, the current limitations allow credit unions two and a half times more capacity to borrow than to tap nonmember deposits. Such a preference makes little sense in the face of efforts to encourage prudent risk management and to offer credit unions the flexibility to tailor a funding strategy to their particularized needs. Maintaining such a preference seems at odds too with the predilection for

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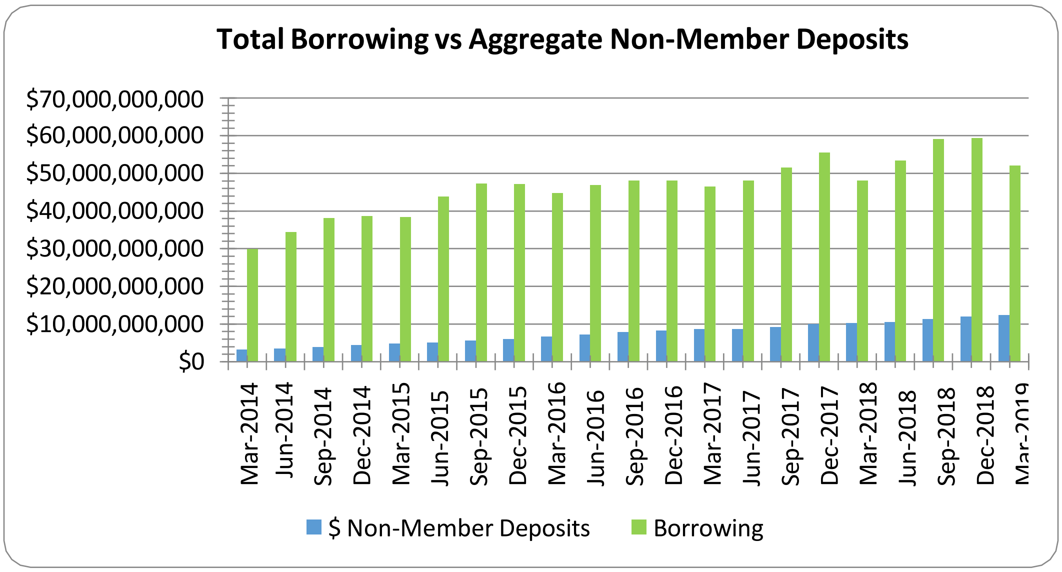
[14] *See Nonmember Shares Release, supra* note 1, at 25019.
[15] This limitation does not apply to discounts or sales of eligible obligations to any federal intermediate credit bank or loans from the Central Liquidity Facility.
[16] The proposed rule also requires a federal credit union to develop and maintain a written plan if its public unit and nonmember shares, taken together with borrowings, exceed 70 percent of paid-in and unimpaired capital and surplus.

diversification articulated in the *Interagency Policy Statement on Funding and Liquidity Risk Management*. The data animate the fact that credit unions have noticed the difference in limitations and have adjusted their sources of funding accordingly. Traditionally, credit unions borrow an aggregate amount that is four to six times the size of aggregate non-member deposits. Chart [6], below, illustrates this reality.

Chart [6].



While banks do not have members as credit unions do, they also enjoy a very different mix of deposits and borrowings. In fact, earlier this year, their chief regulator, the Federal Deposit Insurance Corporation issued a Notice of Proposed Rulemaking "undertaking a comprehensive review of the regulatory approach to brokered deposits."[17] According to the Release, "[a]s of September 30, 2018, insured depository institutions held $986 billion in brokered deposits, which amounted to 8.0 percent of the $12.3 trillion in industry domestic deposits."[18] This compares to FHLB borrowings by commercial banks of less than half that number ($421 billion as of March 31, 2019).[19] By contrast, as Chart [6] further illustrates, in the most recent quarter, credit unions had borrowings from the FHLB ($50.7 billion) at more than four times their nonmember deposits ($12.4 billion).

Unlike non-member deposits, credit union borrowings generally require a pledge of assets to secure repayment far in excess of the borrowed amount. Notably, this pledged collateral is available to the lender with priority over any claim by the NCUSIF. And, a considerable and growing portion of credit union assets are currently encumbered, as illustrated in Charts [7] and [8]. As of March 31, 2019, for example, over $337 billion of credit union assets were pledged to secure borrowings. This amounts to approximately 22% of total credit union assets. We expect that the NCUA's proposal will encourage

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[17] *See Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions,* Federal Deposit Insurance Corporation, 84 FR 2366 (Feb. 6, 2019).
[18] *Id.* at 2368.
[19] *See* Federal Home Loan Bank Combined Financial Report for the Quarter Period Ending March 31, 2019, at 12.

greater balance between these two sources of alternative funds and result in a larger percentage of unencumbered assets across the industry. This should have desirable effects for both credit unions and the NCUSIF.

Chart [7].

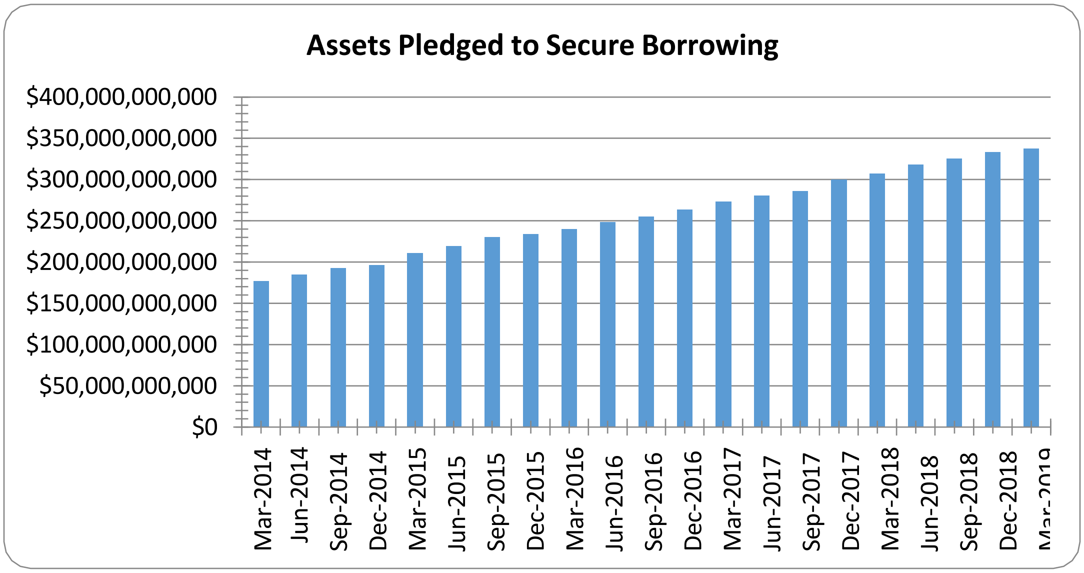
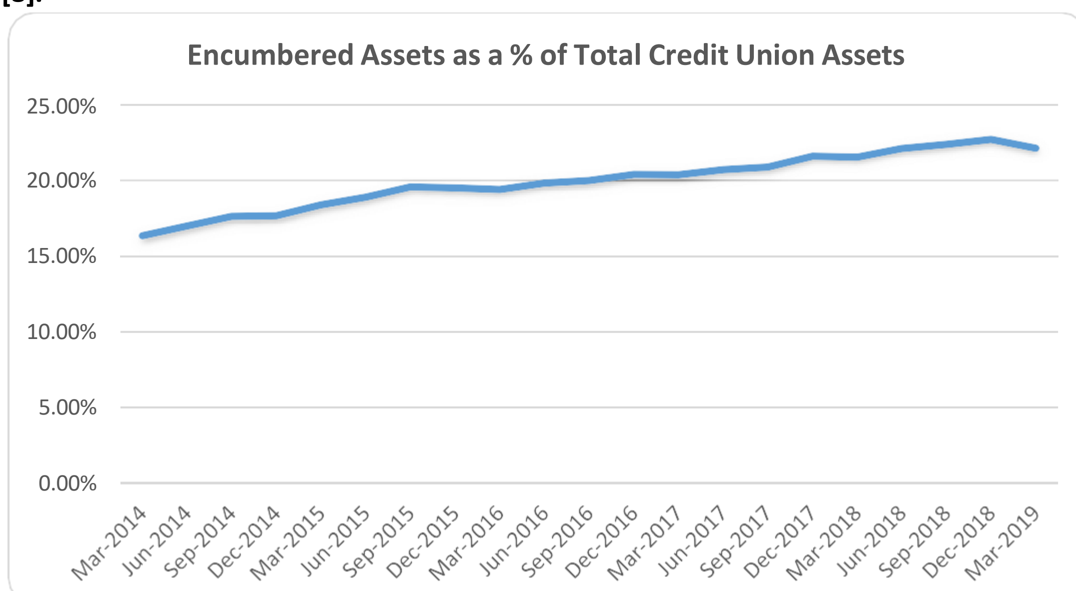


Chart [8].



As the NCUA has pointed out, the proposed rule "simplifies the current regulatory framework in § 701.32(b)."[20] The NCUA admitted that the current 20 percent of total shares limit was set based "on industry practices in 1988."[21] And, as the agency concedes and we have outlined above, the credit union industry has undergone significant changes in the three decades since this limit was adopted.

[20] *Nonmember Shares Release, supra* note 1, at 25020.
[21] *Id.*

The NCUA described the rationale for the change as follows:

> The change in standard from 'total shares' to 'paid-in and unimpaired capital and surplus less any public unit and nonmember shares' provides credit unions with greater ability to accept public unit and nonmember deposits because undivided earnings are included in the measurement of a credit union's paid-in and unimpaired capital and surplus. The proposed rule does not include public unit and nonmember shares in the calculation of its unimpaired capital and surplus for purposes of this 50 percent limit. This restriction provides a meaningful limit on the ability of a credit union to increase its leverage indefinitely, which could pose a clear risk to credit unions and the NCUSIF. The Board believes that this balanced approach provides an FCU with greater flexibility to determine an appropriate funding structure to support ongoing credit union operations in a prudent manner.[22]

To appreciate the magnitude of these proposed changes for the typical credit union, we engaged in a simple experiment. We calculated the nonmember borrowing capacity under the current regime and compared it to the capacity under the proposed regime. While this is a crude generalization that does not address the particular situation of any single credit union, nevertheless, we believe that the exercise is informative to some degree.

According to aggregate credit union 5300 data as of March 31, 2019 and as sorted by Callahan & Associates, the average credit union (a hypothetical "Average CU") had $279.6 million in assets and $236.3 million in total shares (including member and nonmember shares). Under the current version of Section 701.32, before any change, "Average CU" would be limited to $47.3 million of nonmember deposits, representing 20% of its total shares. According to the same data, Average CU today employs $2.3 million of nonmember deposits. Therefore, our hypothetical typical credit union would have additional capacity of $45 million. Notably, Average CU also has $9.2 million in total borrowings, which do not count against the nonmember shares cap under the current regime. While this simple analysis uncovers significant available capacity within the current regulatory framework, there is ample anecdotal evidence that credit unions avoid taking nonmember shares to a level anywhere near the current limitation. Instead, consistent with the approach that the NCUA described upon adopting the changes to Section 741.12, credit unions have been careful to retain a cushion of additional nonmember share capacity in the event that their liquidity situation deteriorates quickly.

Using the same data for Average CU, we can also assess the hypothetical firm's position vis-a-vis the proposed regime. The breakdown is as follows:

[22] *Id*.

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Total Member and Nonmember shares: 236.3 million
Undivided Earnings: 22.4 million
Paid In and Unimpaired Capital and Surplus (PIUCS): 258.7 million

Public Unit and Nonmember shares (PUNMD): 2.3 million

50% x (PIUCS – PUNMD) = 128.2 million

As the example shows, the proposed change tends to be liquidity enhancing – at least with respect to our "Average CU." While each credit union's situation is unique, the above illustration shows that the change from a "total shares" standard to one that measures "paid-in and unimpaired capital and surplus less any public unit and nonmember shares" should offer the typical credit union greater ability to accept public unit and nonmember deposits. Moreover, it provides significant additional capacity for the typical credit union, allowing additional deposits to be raised without threatening the maximum level or compromising the safety and soundness of the institution. And, it affords credit unions the ability to optimize their sources of funds as, in some instances, "nonmember shares can be a more stable and cost-effective source of funding than borrowing."[23] Furthermore, the proposed change retains enough flexibility to encourage each credit union to devise its own funding structure tailored to its needs. Finally, the proposed rule maintains an appropriate limit on leverage, ensuring the safety and soundness of the credit unions and protecting the share insurance fund.

We also agree with the Board's observation that nonmember shares have certain unique features, particularly with respect to their sensitivity to interest rate fluctuations. At the same time, they are, in many other respects, the functional equivalent of other types of short-term borrowings. As such, a transition to allowing a credit union to receive public unit and nonmember shares up to 50 percent of paid-in and unimpaired capital and surplus, less any public unit and nonmember shares, is a preferable approach to the current 20 percent of total shares limit currently set out in Section 701.32(b).

Our single point of disagreement with the Public Unit and Nonmember Shares Proposed Rule concerns the notion that the proposed "50 percent of paid-in and unimpaired capital and surplus less any public unit and nonmember shares" regulatory limit is sufficiently high so as to render the currently available alternative $3 million dollar limit unnecessary. As the Board concedes, some smaller credit unions may be adversely impacted by the elimination of the alternative $3 million dollar limit. We are particularly concerned that the elimination of the $3 million alternative test will be difficult on: (1) LICUs that rely on large volumes of nonmember shares as a necessary source of funding, or (2) newly chartered credit unions that have not yet reliably defined their liquidity parameters.[24] As such, we are very much in favor of one (or both) of the alternatives contemplated by the NCUA – (1) retention of the $3 million dollar limit, or (2)

[23] *Id.*
[24] *See generally,* Letter to Larry Fazio from CUNA Small Credit Union Committee (Apr. 2019) (noting that "[s]mall and large credit unions with tight liquidity, or those looking to make investments with excess liquidity, or those who struggle to raise deposits in general, could benefit from raising the maximum level allowed.").

a special exemption for small LICUs that demonstrate a need for large volumes of nonmember shares. And, we encourage the adoption of at least one of these alternatives as a protection for those mission driven credit unions which already struggle without the economies of scale enjoyed by their larger contemporaries.

Again, we applaud the Board for its hard work on this issue and its thoughtful proposal. We are grateful too for the opportunity to comment on the proposed amendments. We look forward to the adoption of the Proposed Rule because it is both liquidity enhancing and the natural extension of the NCUA's thoughtful liquidity management efforts to date.

Should you have any questions regarding our comments, please feel free to contact the undersigned at 908 679-9037 or mmacchiarola@oldenlane.com.

All the best,

/s/Michael C. Macchiarola
Chief Executive Officer
Olden Lane LLC