**World Council of Credit Unions**

February 2, 2015

***Sent via email***
Mark Carney
Chair
Financial Stability Board
Bank for International Settlements
CH-4002
Basel, Switzerland
fsb@bis.org

Re: Consultative Document: *Adequacy of loss-absorbing capacity of global systemically important banks in resolution*

Dear Mr. Carney:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Financial Stability Board's (FSB) *Adequacy of loss-absorbing capacity of global systemically important banks in resolution* consultative document.[1] World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are 57,000 cooperatively owned credit unions in 103 countries with US$ 1.7 trillion in total assets serving 208 million natural person members.[2]

World Council is generally supportive of the proposed framework's goal of eliminating the implicit public subsidy enjoyed by global systemically important banks (G-SIBs). Applying these Total Loss Absorbing Capacity (TLAC) rules to non-G-SIBs, however, will not achieve that objective because they are not beneficiaries of any such implicit subsidy. Applying TLAC to non-G-SIBs would also likely have negative competitive consequences by imposing unjustified capital costs on credit unions and other non-G-SIBs.

We therefore do not support applying the proposed Minimum External TLAC rules to non-G-SIB credit unions because these TLAC rules would likely require credit unions to issue debt instruments that do not have a ready market and which are not easily compatible with credit unions' cooperative structure. Please find World Council's detailed comments in response to the questioned posed by the FSB in this consultation beginning on page 2 of this letter, below.

Credit unions are not generally regarded as G-SIBs and typically have much less risky and less complex operations than commercial banks. Credit union supervisors sometimes apply standards originally developed for G-SIBs to large credit unions, however, based on those institutions' large size compared to the jurisdiction's other local credit unions, or based on those

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[1] Financial Stability Board, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution: Consultative Document* (Nov. 2014), *available at* http://www.financialstabilityboard.org/2014/11/adequacy-of-loss-absorbing-capacity-of-global-systemically-important-banks-in-resolution/.
[2] World Council of Credit Unions, *2013 Statistical Report* (2014), *available at* http://www.woccu.org/publications/statreport.



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credit unions' large size relative to the capitalization of the local deposit insurance fund or stabilization fund for credit unions.

In the United States of America, for example, National Credit Union Administration (NCUA) regulations require all credit unions with more than US$ 10 billion in assets to undergo stress testing based on the agency's finding that these credit unions "pose the greatest risk to the [National Credit Union] Share Insurance Fund," the savings guarantee fund for US credit unions.[3] Similarly, the Department of Finance Canada has recently consulted on a "Taxpayer Protection and Bank Recapitalization Regime" for Canadian domestic systemically important banks which would likely apply to large credit unions chartered by the Canadian federal government.[4]

## World Council's Detailed Comments

***Question 1: Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?***

Minimum TLAC requirement of 16 – 20% of RWAs

World Council supports a minimum TLAC requirement for G-SIBs but does not support a minimum TLAC requirement for non-G-SIB credit unions. We do not support a minimum TLAC requirement for non-G-SIB credit unions because there may not be a market for credit union TLAC instruments and because credit unions are member-owned cooperatives, meaning that it would be difficult or impossible for credit unions to grant a contingent equity interest in the institution to external investors. We are also concerned that some supervisors may view a TLAC requirement, or the trigger event which impairs TLAC instruments, as requiring credit unions to demutualize into joint-stock banks.

We strongly support the ability of credit unions to issue capital instruments such as non-withdrawable capital shares and subordinated debt. Requiring credit unions to issue such instruments as part of a minimum TLAC regime, however, would likely be difficult and unreasonably expensive.

Not all credit unions have the legal authority under the applicable credit union rulebook to sell to external parties the types of instruments that could qualify as TLAC. Those credit unions

[3] Capital Planning and Stress Testing, 79 Fed. Reg. 24311, 24312 (Apr. 30, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-04-30/pdf/2014-09814.pdf.

[4] World Council supports the views expressed by Credit Union Central of Canada regarding a "bail in" requirement for Canadian domestic systemically important banking institutions in its *Submission to the Department of Finance on The Taxpayer Protection and Bank Recapitalization Regime: Consultation Paper* (Sep. 2014), *available at* http://www.cucentral.ca/GovernmentRelations/140912%20Submission%20to%20Finance%20on%20The%20Taxpayer%20Protection%20and%20Bank%20Recapitalization%20Regime%20Consultation%20Paper.pdf.

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which do have the legal authority to issues potential TLAC instruments like subordinated debt also often struggle to find external investors willing to buy these instruments at reasonable yields. It is therefore very likely that a credit union which is required to issue TLAC would: (a) struggle to find investors interested in buying credit union TLAC instruments because there is no ready market for these investments; and (b) those investors may require a high rate of interest that would be difficult for a credit union to afford.

<u>6% Leverage Ratio for G-SIBs</u>

We support the proposed minimum leverage ratio for G-SIBs of 6 percent (i.e. double the 3 percent Basel III leverage ratio requirement) relative to total assets because it is logical to require G-SIBs to hold at least as much capital relative to total assets as non-G-SIB credit unions must hold. Further, a leverage ratio requirement is the best way to ensure that a G-SIB has sufficient capital to absorb losses as a going concern because it limits the opportunities for capital arbitrage.

The proposed minimum 6 percent leverage ratio is similar to the leverage ratio requirements for non-G-SIB credit unions in many jurisdictions. For example, US credit unions are already subject to a 6 percent leverage ratio requirement to be adequately capitalized,[5] and credit unions in the Republic of Ireland have a 10 percent minimum leverage ratio requirement.[6]

Credit unions performed better than banks during the financial crisis because of their high levels of capitalization compared to banks as well as credit unions' relatively more conservative lending and investment profiles.

In the world's largest credit union system, the United States of America, between 2008 and 2013 there were 485 failures of U.S. banks compared to 136 credit union failures[7] even though there are similar number of U.S. banks (currently 6,489[8]) and U.S. credit unions (currently 6,543[9]).

Only 26 of these credit unions had over US$ 50 million in assets and, unlike banks, credit unions were not generally eligible for public open bank assistance from the U.S. Treasury's TARP Program.[10]

[5] *See* 12 C.F.R. § 702.102 ("[A] federally-insured credit union shall be classified . . . Adequately capitalized if it has a net worth ratio of six percent (6%) or more but less than seven percent (7%), and also meets any applicable risk-based net worth requirement . . ."), *available at* http://www.law.cornell.edu/cfr/text/12/702.102.
[6] *See, e.g.*, Registry of Credit Unions, *Regulatory Reserve Requirement for Credit Unions* (2009), *available at* https://www.centralbank.ie/regulation/industry-sectors/credit-unions/Documents/Regulatory%20Reserve%20Ratio%20-%20August%202009.pdf
[7] *See* Credit Union National Association (CUNA), *NCUA Proposed Rule: Prompt Corrective Action–Risk-Based Capital* at 10 (May 28, 2014), *available at* http://www.cuna.org/Legislative-And-Regulatory-Advocacy/DownLoads/rcl_rbc_052814/.
[8] "FDIC: Institution Directory;" https://www2.fdic.gov/IDASP/ (last visited Feb. 2, 2015).
[9] CUNA, *Monthly Credit Union Estimates* at 5 (November 2014), *available at* http://www.cuna.org/Research-And-Strategy/DownLoads/mcue/.
[10] *Id.*

***Question 6: Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?***

The proposal would require TLAC instruments to absorb losses by either: (a) being permanently written down; or (b) by being converted to equity. We believe that it is essential that TLAC instruments be compatible with the cooperative structure of credit unions and cooperative banks, and request the FSB to state expressly that TLAC issuance does not require a change in an institution's legal form even in the event of the TLAC's impairment by losses.

Credit union secondary capital instruments are typically subject to permanent write-down if they absorb losses because it is difficult or impossible for external investors to take an equity position in a credit union. To compensate for the risk of write-down, however, investors in these instruments typically demand a high rate of interest unless the investor is a foundation or similar donor organization that is more interested in promoting the expansion of credit union services to people of modest means than getting a return. Often the high yields required by non-philanthropic investors and the attendant cost of capital are not affordable for credit unions.

TLAC instruments which are convertible to equity can allow investors to accept a lower coupon rate, but convertibility to equity is not necessarily compatible with credit unions' cooperative structure.

Although some mutual institutions have developed capital instruments such as capital core deferred shares (CCDS) for British building societies[11] or a similar instrument authorized by the Australian Prudential Regulation Authority for Australian mutuals (where impaired secondary capital instruments can be exchanged for a Common Equity Tier 1 instrument),[12] considerable regulatory uncertainty remains in this area for credit unions because of limitations on who can hold equity in a credit union.

A credit union is owned by its customers, who are the members of the credit union and each of whom owns at least one share in the credit union. Who may become a member-shareholder of a credit union is also typically limited by the credit union's common bond requirement; for example, a credit union's common bond may limit membership to employees of a particular business, government agency personnel, members of a specific trade or profession, or people who live or work in particular geographic area (such as a particular city or rural district).[13]

A non-member, external investor therefore may not be eligible to hold an equity interest in a credit union because he, she or it does not fall within the common bond. Further, credit union shares are typically issued and traded at par (unless the par value is impaired by losses) meaning

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[11] For more information about the CCDS form of equity, see Nationwide Building Society, "Core Capital Deferred Shares (CCDS);" http://www.nationwide.co.uk/about/investor-relations/capital-securities/ccds-market-data-and-investor-information (last visited Feb. 2, 2015).

[12] Australian Prudential Regulation Authority, *Prudential Standard APS 111: Capital Adequacy: Measurement of Capital* (Apr. 2014), *available at* http://www.apra.gov.au/adi/prudentialframework/documents/120928-aps-111_final.pdf.

[13] *See, e.g.*, Organization and Operations of Federal Credit Unions; Underserved Areas (IRPS 08–2), 73 Fed. Reg. 73392 (Dec. 2, 2008), *available at* http://www.ncua.gov/Legal/Documents/IRPS/IRPS2008-2.pdf.

that the potential return on investments in credit union shares is typically only in the form of dividends even if the shares' terms and conditions do qualify them as Common Equity Tier 1 instruments.

***Question 8: Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?***

World Council supports the proposal to include "credible ex-ante commitments" to recapitalize G-SIBs as a form of TLAC. Credit union federations and regulatory agencies often operate stabilization funds and/or deposit insurance funds capitalized by their member credit unions and to which these credit unions are obligated to make additional contributions in the event of losses to the fund. These industry-financed funds are typically one of the few established avenues for recapitalizing troubled credit unions.

We believe that credible ex-ante recapitalization commitments from these industry-financed funds should qualify as TLAC whether or not the funds are considered "external" or "internal" under this framework, and whether or not the fund is administered by a credit union federation or a government agency.

***Question 9: Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?***

We urge the FSB to include uninsured deposits within the definition of "eligible external TLAC." The FSB notes on page 7 of the proposal that "liabilities that are not eligible as TLAC or that are not included in a G-SIB's TLAC remain subject to potential loss in resolution . . ." and we believe that all liabilities that are subject to potential loss in resolution should be considered TLAC, including uninsured deposits, because these funds are in fact available to protect the interests of the institution's more senior creditors.

Section 11 requires external TLAC to have minimum remaining maturity of at least one year and section 12 specifically excludes "insured deposits" and "any liability that is callable on demand without supervisory approval" from the definition of eligible external TLAC. Sections 11, 12 and 13, however, do not address uninsured deposits per se even though a bank or credit unions' uninsured deposits are at risk for loss in a failure.

We urge the FSB to clarify that uninsured deposits qualify as eligible external TLAC because uninsured deposits are a form of loss absorbing capacity that virtually all credit unions currently have, and which are indeed at risk of loss in a failure.

We also urge the FSB to include all uninsured term deposits within the definition of eligible external TLAC so long as the term deposits are subject to a penalty for early withdrawal even if the remaining maturity on the term deposit is less than 1 year. While we agree that TLAC should not include liquid deposits, we believe that credit union term deposits' early withdrawal penalties make these deposits sufficiently sticky so that the vast majority of uninsured term deposits would be available to help absorb losses in a failure.

***Question 10: Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?***

World Council does not support integrating the TLAC requirement for G-SIBs with Basel III because integrating the TLAC requirement into Basel III increases the likelihood that national and provincial supervisors will apply the TLAC rules to non-G-SIB credit unions. Although the FSB does not appear to intend to apply the TLAC requirements to non-G-SIBs, integrating the TLAC regimes into Basel III would mean that at least some credit union supervisors would likely believe that it was necessary or prudent to apply TLAC requirements to large non-G-SIB credit unions in their jurisdiction.

We also believe that that the minimum Pillar 1 TLAC requirement of 16 percent to 20 percent should include the Basel III capital buffers as well as the Basel III minimum capital requirements in the numerator of the Pillar 1 TLAC ratio.

The proposal's term sheets demonstrates that an institution's actual TLAC could in fact be considerably higher than 16 to 20 percent: with a standard 2.5% conservation buffer and a 1% surcharge, the TLAC could come in between 19.5% and 23.5%.

In Canada, the proposed equivalent to TLAC—"Higher Loss Absorbing Capacity" (HLAC)—is proposed as a range of 17% to 23% including the Basel III conservation buffer and applicable surcharges. We believe that the Canadian ranges are more appropriate because they take into account all of the institution's loss absorbing capacity.

***Question 17: Do you have any comments on any other aspects of the proposals?***

FSB plans to analyze the potential consequences of a TLAC requirement for state-owned banks, as stated on page 8 of the proposal. We do not support extending the TLAC framework to state-owned entities.

While the extension of TLAC to state-owned banks could be interpreted as positive discipline on the actions of state-owned banks, we are concerned that in some instances the application of these rules could have negative unintended consequences in relation to competition and institutional diversity in the financial sector.

Specifically, by creating a class of potential equity owners, state-owned banks could feel pressured to compete more aggressively for the less risky part of the lending market. This was the experience in Canada when, in the early 1990s, some Crown financial institutions were mandated to operate on a "commercial basis" and become self-sustaining. As a result, some of these institutions began to distance themselves from the public policy roles they initially were intended to play, and this new competition from state-owned enterprises eroded the institutional diversity in the market. The maintenance of institutional diversity in the financial sector is an important consideration both for financial stability in general and for the credit union system in particular since credit unions are much smaller than G-SIBs.

Further, TLAC for state-owned enterprises could also lead to a privatization of these state-owned entities, creating new—and very large—competitors for credit unions.

World Council appreciates the opportunity to comment on the Financial Stability Board's *Adequacy of loss-absorbing capacity of global systemically important banks in resolution* consultative document. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
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World Council of Credit Unions