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National Association of Federally-Insured Credit Unions

July 8, 2020

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

RE: Subordinated Debt (RIN: 3133-AF08)

Dear Mr. Poliquin:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to express our support for the proposed rule to grant certain credit unions the authority to issue subordinated debt. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 120 million consumers with personal and small business financial service products. For credit unions that are low-income designated (LICUs), complex, or new credit unions, the proposal generally affords greater capital flexibility and has the potential to enhance the stability of the credit union industry as a whole. However, the proposal does impose costly procedural requirements for issuers of subordinated debt that could dampen important benefits and disrupt existing secondary capital markets—particularly for smaller LICUs who might otherwise use subordinated debt to improve services in underserved communities. NAFCU urges the NCUA to reconsider these new procedural requirements which are likely to discourage eligible issuers from accessing a critical capital tool.

The current market for secondary capital is one where sophisticated investors already exercise due diligence to assess the health of the issuing credit union, and disclosure-related obligations can easily be tailored to the size and scope of the offering based on the needs of the parties. Additionally, the NCUA's role overseeing the safety and soundness of these transactions is in no way limited by the current rule, which grants virtually unlimited discretion with respect to approving the contents of a secondary capital plan. The success of this framework is acknowledged in the preamble. The proposal notes that "[s]ince the NCUA began requiring LICUs to obtain prior approval before issuing secondary capital, the Board is not aware of material losses to the NCUSIF resulting from the mismanagement of secondary capital."[1] Such a record should prompt the NCUA to reconsider the necessity of introducing costly securities-like reporting and disclosure requirements.

While NAFCU sees room for improvement in a final rule, our recommendations should not detract from what we regard as the core benefits of this proposal: better options to guard against risk, a path to safely manage asset growth, and regulatory capital flexibility that contributes to credit

[1] Subordinated Debt, 85 Fed. Reg. 13982, 13984 (March 3, 2020).

unions' competitive viability, particularly in an environment where banks have long had the ability to issue subordinated debt and use these accounts to satisfy leverage ratio requirements.

General Comments

NAFCU has long supported granting all credit unions the authority to issue subordinated debt with appropriate safeguards to maintain the safety and soundness of the credit union system. The proposal represents a meaningful first step towards achieving that goal and NAFCU will continue to advocate for necessary legislative changes to accommodate capital flexibility for all credit unions. In the interim, NAFCU believes the proposal can facilitate an expansion of the current secondary capital market, provided the NCUA is willing to streamline onerous procedural requirements that might otherwise discourage credit unions who are eager to leverage subordinated debt in ways that will directly benefit their members.

In general, subordinated debt offers credit unions an additional source of capital to manage risk, achieve growth, and maintain liquidity during times of economic uncertainty. In good times, subordinated debt can help credit unions embrace organic asset growth without fear of diluting net worth—a problem that is magnified in the credit union industry due to heavy reliance on retained earnings. During economic downturns, subordinated debt can serve as a buffer against capital losses, strengthen the resilience of both individual credit unions and the National Credit Union Share Insurance Fund (NCUSIF), and accelerate recovery.

For credit unions that are designated as "complex" or low-income, NAFCU agrees that subordinated debt should be treated as a form of regulatory capital. As proposed, subordinated debt would contribute to the risk based capital numerator, and potentially the net worth numerator if the issuing credit union is a LICU. For new credit unions, subordinated could also serve as a safe source of early funding to facilitate growth as new deposits are generated, and NAFCU supports provisions aimed at accommodating more flexible prompt corrective action (PCA) treatment for these types of issuers.

As expressed in our comments to the 2017 ANPR on Alternative Capital, NAFCU has proposed a general framework for the agency to consider as it develops its subordinated debt rule. The framework incorporates the following core principles:

- Preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions and ensure that ownership interest (including influence) remains with members.
- Ensure 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.
- Provide a degree of permanence such that a sudden outflow of capital will not occur.
- Provide a capital solution with market viability.

In recognition of the economic aftershocks caused by the COVID-19 pandemic, NAFCU proposes a fifth item: the need to issue a final rule as soon as practicable. Subordinated debt can help eligible credit unions quickly adjust to significant share growth resulting from members' flight to safety during the pandemic. Looking ahead, the rule will also help complex credit unions better manage the transition to the NCUA's risk based capital rule (RBC Rule) which will become effective in 2022. In anticipation of this transition date, NAFCU urges the NCUA to approve a final rule well in advance of the RBC Rule's effective date so that complex credit union are able to take full advantage of new flexibility to meet regulatory capital requirements. However, to minimize disruption to existing LICU issuers, the NCUA should consider a phased implementation approach that allows LICUs to issue subordinated under existing rules for secondary capital for a reasonable period of time of at least one year after publication of a final rule. Given the complexity of the proposed application and offering requirements, such a transition period is critical for LICUs that might incur significant costs to pause future secondary capital offerings that support ongoing asset growth.

Incorporating the recommendations expressed below, NAFCU believes that the NCUA is fully capable of designing a final rule that fulfills each of the five principles expressed above.

The NCUA Should Not Classify Subordinated Debt as a Security.

NAFCU recommends that the NCUA simplify or eliminate many of the complex procedural requirements that govern the application and offering process. Many of these requirements derive from the NCUA's conclusion that subordinated debt would be regarded as security under state and federal securities law. NAFCU disagrees with this broad conclusion as do experienced secondary capital market participants who have stated that these transactions should not be regarded as securities transactions. At the very least, the NCUA should recognize that not all subordinated debt notes will qualify as securities and should adjust expectations accordingly.

Currently, the issuance of secondary capital is largely accomplished through what is best described as bilaterally negotiated lending transactions. The NCUA has not suggested that this practice would be discontinued in the case of subordinated debt, and it is reasonable to believe that many market offerings would continue to be conducted in this way. Without any precedent for finding that subordinated debt issued by a credit union is unequivocally a security, the NCUA should refrain from a blanket classification of these instruments. Whether a contract is a security within the meaning of federal or state securities law depends on the facts and circumstances and the NCUA should not limit this interpretive flexibility in a final rule.[2]

The NCUA also acknowledges in the preamble that secondary capital accounts have been managed well and there have been no instances where mismanagement led to material loses to the NCUSIF.[3] Furthermore, based on NAFCU's research, there does not appear to be any instance in which a secondary capital investor pursued claims against a credit union issuer by asserting a cause of action derived from securities law or regulations issued by the Securities and Exchange Commission (SEC). Accordingly, the purported basis for treating subordinated debt as a security to prevent confusion among already sophisticated investors or potential fraud claims does not align with the conduct observable in the existing secondary capital market. In fact, such an assertion

[2] *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946) ("[F]orm [is] disregarded for substance and the emphasis [is] on economic reality.")
[3] Subordinated Debt, 85 Fed. Reg. 13982, 13984 (March 3, 2020).

could expose credit unions to greater risk by suggesting the availability of securities-related causes of action which are by no means certain.

Given the NCUA's lack of authority in the field of federal securities law, NAFCU recommends that the agency refrain from including in a final rule a blanket determination that subordinated debt is a security. Additionally, the NCUA should not suggest that the basis for any particular requirement in a final rule derives from such classification.

Appropriate Restrictions on Subordinated Debt

In general, NAFCU is supportive of reasonable restrictions on subordinated debt to ensure that these uninsured instruments are properly characterized as debt under U.S. Generally Accepted Accounting Principles (GAAP). Subordinated debt must be clearly distinguishable from equity to ensure that there is no risk to the mutual, cooperative character of credit unions. Accordingly, NAFCU agrees with adopting minimum and maximum maturities for subordinated debt, as these limits are important features which distinguish debt from equity.

NAFCU also agrees that subordinated debt should not bear restrictive covenants that limit the control or discretion of credit union management. Likewise, NAFCU agrees with restrictions that clarify that an investment in subordinated debt confers no voting, management or ownership rights with respect to the issuing credit union. Again, these restrictions preserve the mutual, cooperative structure of credit unions and help distinguish subordinated debt from equity.

NAFCU agrees that certain restrictions on affirmative covenants are appropriate. NAFCU believes that for less than well capitalized credit unions, a restriction on any term or condition that would require prepayment or accelerated payment of principal or interest affords greater certainty that subordinated debt will operate as a source of stable regulatory capital and sudden changes in market conditions will not place the credit union at greater risk of default. However, for credit unions that are well capitalized, the NCUA should consider a more flexible approach for agreements to prepay principal. Accommodating these types of agreements would be consistent with the current secondary capital rule and could improve the marketability of subordinated debt. While such agreements can create risk, the NCUA should aim to evaluate the appropriateness and benefits of prepayment covenants based on the health and experience of the credit union.

NAFCU agrees that the maximum aggregate amount of issued subordinated debt may not cause a credit union to exceed the borrowing limit in § 701.38 for FCUs or, for a FISCU, any more restrictive state borrowing limit. Such a limit would be consistent with section 107 of the FCU Act and an appropriate safety and soundness safeguard. As explained in further detail below, NAFCU regards the issuing limit in conjunction with reasonably tailored concentration limits for investors as sufficient to protect the credit union system from potential risk transmitted through subordinated debt markets.

NAFCU generally agrees with the proposed measures for calculating the aggregate limit on FCU investments in subordinated debt, grandfathered secondary capital, or PICU subordinated debt. The proposal states that the aggregate limit is the lesser of either 25 percent of net worth or the amount of net worth in excess of 7 percent. NAFCU believes the first of these measures (the 25 percent limit) could be increased given the inclusion of the second, stricter limit. Limiting aggregate investments to the amount of net worth in excess of 7 percent provides the greatest protection to the NCUSIF since it ensures that a credit union's PCA classification cannot possibly fall below "well-capitalized" even if the entire subordinated investment is lost. With such a backstop in place, it is less necessary to conservatively tailor the 25 percent limit since it is unlikely that credit unions will target high net worth ratios just to finance large subordinated debt investments. Considering the approach taken with the 7 percent limit, the prohibition against investors having outstanding subordinated debt is also unnecessary, as described below.

The NCUA should not prohibit credit unions from being both issuers and purchasers of subordinated debt.

As proposed, credit unions that wish to invest in subordinated debt must meet certain eligibility requirements in new § 701.25(c). One condition placed on the investor is that the credit union must not have any outstanding subordinated debt or grandfathered subordinated debt. NAFCU believes that is an unreasonable constraint and does not reflect the low risk of contagion for subordinated debt transactions within the credit union system. In fact, it is likely that the limitation would undercut the risk-mitigating effects subordinated could otherwise offer.

Removing the restrictions in proposed § 701.25(c)(1)(ii) and (iii) would allow well capitalized credit unions to leverage their strength as both issuers and purchasers. Credit unions that have surplus capital may be reluctant to invest in subordinated debt if they anticipate future restrictions on their ability to issue subordinated debt, particularly when there is an expectation of future growth. While it is true that the proposed restriction would reduce the *potential* for loss transmission in the credit union system, the NCUA should not consider only the aggregate effects of failure in a worst case scenario. On an individual basis, credit unions that are able to issue subordinated debt will have greater loss absorbing capacity and will make the credit union system more resilient. By contrast, the proposal assumes that the benefits of such resiliency and mutualization of risk are overshadowed by the potential for cascading failures among issuer and investor credit unions; but there is no discussion of the likelihood of such widespread capital deterioration.

NAFCU believes that absent more compelling evidence of why the proposed restriction is necessary, particularly when investors will face aggregate limits on subordinated debt investments, credit unions should be able to participate as issuers and investors simultaneously. This would not only improve resiliency at the individual credit union level, but also encourage larger, experienced issuers to mentor smaller credit unions that are new to subordinated offerings. In this context, larger, experienced credit unions could actually reinforce supervisory discipline by exercising due diligence as an investor that is intimately familiar with credit union operations and business plans.

Application Process Should Be Streamlined

The proposed application, preapproval and filing processes depart significantly from the NCUA's comparatively streamlined secondary capital rule. NAFCU believes that the existing "application" contents specified for secondary capital plans in 701.34(b)(1) are sufficient to communicate the essential details of a subordinated debt offering for review purposes.

Under existing § 701.34(b)(1), a credit union's secondary capital plan consists of five items rather than fifteen—and while these represent a minimum number, they have not impaired the NCUA's ability to review secondary capital applications or request additional clarification. Both the existing rule and proposed rule allow NCUA to request additional information as needed. Accordingly, the NCUA should prefer a simpler application and only require additional documentation (e.g., the proposed schedule of expenses expected to be incurred in connection with the offering, expanded legal and analytical support documents) if they are necessary to evaluate known material risks.

NAFCU believes that the proposed requirement to develop issuing policies in consultation with "qualified counsel" as part of the application process unnecessarily raises the cost of subordinated debt transactions. The proposed policies would need to address a variety of securities law concepts that would be mismatched to the nature of a typical subordinated debt transaction. Furthermore, providing a statement on governing law would again require the attention of specialized counsel—possibly raising costs further.

The cost of hiring a securities attorney to assist in the development of new policies and disclosures would likely be disproportionate to the value of a small offering that is designed to manage moderate deposit growth at a small LICU. Furthermore, such a requirement ignores the fact that existing secondary capital issuers have responsibly managed the offering process under a far less prescriptive set of standards.

<u>The NCUA Should Accelerate Review of Subordinated Debt Applications and Disfavor Open-Ended Deadlines</u>

Under the proposal, credit union issuers would submit their subordinated debt application to the appropriate NCUA supervision office, which would aim to complete an evaluation within 60 days. This timeframe is longer than the 45-day period that is currently used for approval of secondary capital plans. Unlike the current rule, the NCUA's failure to approve or disapprove a subordinated debt application would not permit the issuing credit union to proceed under the terms of its plan.

NAFCU believes that the proposed timeframe for reviewing subordinated debt applications could yield protracted evaluations and discourage investors and issuers who are wary of open-ended processes. Extending the review window while simultaneously eliminating the NCUA's responsibility for providing feedback on the application within a defined period is likely to create uncertainty and frustration for credit unions that are likely to use subordinated debt in conjunction with time-sensitive business plans. Furthermore, the open-ended approval deadline could promote a less than efficient process for reviewing subordinated debt transactions and potentially increase costs for issuers that must effectively pay to hold investor funds in anticipation of future deployment. One credit union member measured the cost of delayed approval of a secondary capital plan as potentially adding as much as 75-100 basis points to the total transaction cost.

NAFCU recommends that the NCUA preserve its existing timeframe for evaluating applications (45 days) and retain the automatic approval language in the current secondary capital rule. NAFCU believes that this model will ultimately prove beneficial for all parties. The NCUA will be incentivized to provided actionable feedback regarding the sufficiency of subordinated debt applications and not develop a backlog, credit unions will become more experienced issuers with timely feedback, and investors will not grow discouraged from long periods of silence in connection with the status of an application. Most importantly, time critical elements of business plans that rely on subordinated debt will not be jeopardized by unnecessary delay.

NAFCU also asks that the NCUA consider a process for expediting the approval of applications that conform to already approved subordinated debt plans in terms of the size of the offering, number of investors, and planned use of the proceeds as long as the credit union's financial condition has not undergone any material adverse change. Providing an accelerated review under these conditions would reduce the cost of the transaction for credit unions and potentially attract greater investor interest where there is a desire to repeatedly deploy capital at a credit union with a proven track record.

The NCUA Should Not Arbitrarily Limit the Viability of Subordinated Debt Applications

Under the terms of the proposal, an issuer would have a year to act upon an approved subordinated debt application involving institutional accredited investors, or the "approved for use" date listed in an offering document to natural person accredited investors. These requirements place pressure on the credit union to deploy funds within an arbitrary timeframe that may fail to align with desired market conditions or key elements in a business plan. A credit union that uses subordinated debt to manage asset growth may not always be in a position to deploy funds immediately. Business strategies that rely on subordinated need to be responsive to market conditions given that asset growth does not necessarily occur at an even pace. Furthermore, when conditions for growth are present, the arbitrary termination of an approved plan could extinguish momentum that would otherwise catalyze long term gains in revenue.

The NCUA asserts that the proposed limit on the longevity of approved subordinated debt plans anticipates that after a year the financial condition of a credit union could change in a material way. NAFCU regards this assumption as extreme. While financial conditions may change, most credit unions in a position to offer subordinated debt will be healthy and have an incentive to maintain the condition of the credit union after expending resources to arrange a subordinated debt offering. Furthermore, the NCUA does not explain why a one year period is appropriate but not a two year period—the timeframe is arbitrary.

NAFCU recommends that the NCUA adopt a longer period of viability for approved plans (at least 24 months) as well as a more responsive mechanism for addressing old plans. Given that the NCUA is able to review credit union Call Report data, a more appropriate way to deal with old plans would be to permit the agency to disapprove the plan upon a determination that there has been a material adverse change in the financial condition of the credit union. With access to a wealth of supervisory and call report data, the NCUA does not need to set arbitrary limits on the longevity of a subordinated debt plan and can instead adopt a more incremental and tailored approach.

<u>Offering Documents and Disclosure Requirements</u>

NAFCU regards the proposal's complex offering and disclosure requirements as unnecessary additions to the regulatory framework that exists under the established secondary capital rule in 12 CFR § 701.34. To the extent that they are derivative of rules promulgated by the Office of the Comptroller of the Currency (OCC), they are even less flexible and provide fewer exemptions for offering requirements than the law would otherwise permit.

In general, the proposed requirements for providing Offering Documents are not effectively tailored given the relatively small and sophisticated market for subordinated debt transactions. Although subordinated debt would be exempt from registration requirements under applicable SEC rules and would qualify for similar exemptions under state securities laws, the proposal requires preparation of offering documents that would need to be prepared by outside counsel—raising the cost for small issuers and potentially shutting them out of subordinated debt markets.

One industry stakeholder that assists credit unions with secondary capital offerings has estimated that the cost of developing a subordinated debt prospectus in line with the proposed requirements could result in a 68 basis point tax based on the size of today's average offering (4.4 million). The relative cost is even greater when considering that offerings of less than $1 million account for over half of the participation in the current secondary capital market.

If the NCUA does not regard the current secondary capital rule's disclosure standards as sufficient, then NAFCU would propose in the alternative that offering documents should not always be required in recognition of available exemptions under federal securities law. For accredited investors, NAFCU recommends that the NCUA permit greater flexibility with respect to offering documents depending on the size of the offering, and the number and sophistication of the investors involved, similar to what is permitted under OCC rules.[4]

NAFCU anticipates that the market for subordinated debt will bear close resemblance to the existing market for secondary capital. Specifically, investors in subordinated debt will tend to be sophisticated institutional entities already familiar with secondary capital transactions and offerings will generally be small and nonpublic. To the extent the proposal anticipates future natural person investors, these would be restricted to accredited investors. With these limits in place, there is no reason to adopt rules that demand offering documents in every instance.

The NCUA should note that the OCC's requirements for subordinated debt offerings of national banks are not as restrictive as what is being proposed for credit unions. Section 16.5 of the OCC's Securities Offering Disclosure Rule contains several exemptions to the OCC's prospectus delivery requirement, including exemptions for nonpublic offerings and small issues offered pursuant to

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[4] *See* 12 CFR 16.5. The OCC exempts delivery of a registration statement and prospectus for nonpublic offerings (12 CFR § 16.7) and small issues (12 CFR § 16.8) offered pursuant to SEC Regulation A.

SEC Regulation A.[5] NAFCU anticipates that most subordinated debt transactions would qualify for a prospectus delivery exemption under OCC rules assuming the nature of the offering aligns with what is typical in secondary capital transactions. However, the NCUA's rule provides no exception for the requirements to provide offering documents—both to the investor and to the NCUA for preapproval (if offering to a natural person accredited investor). The NCUA's review of these documents would likely be redundant given that virtually all investors in subordinated debt would be highly discerning and exercise extensive due diligence before agreeing to a proposed offering.

Given that the OCC's rules generally provide exemptions for subordinated debt offerings that are non-public and made to accredited investors, the NCUA should reconsider how it has tailored its own expectations for credit unions. The OCC oversees a much larger market of subordinated debt transactions ($70 billion issued to date) that has far more participants (two thirds of banks with outstanding subordinated debt compared with sixty eight credit unions at the end of 2019), yet effective oversight of these transactions has not necessitated stricter than necessary disclosure requirements. The NCUA should also seek to accommodate greater flexibility in a final rule by providing a complete exemption for offering documents in smaller issues under $10 million and treating compliance with the existing Appendix to § 701.34 as sufficient. To the extent the NCUA remains worried that sophisticated investors may be disadvantaged, the agency should monitor the market for subordinated debt to determine whether investors would materially benefit from offering documents.

<u>Limits on Interest Payments are Appropriate for Critically Undercapitalized Credit Unions</u>

Proposed § 702.410 contains prohibitions on interest payments for critically undercapitalized credit unions, consistent with new § 702.109, but allows interest to continue accruing in accordance with the terms of the subordinated debt note when certain conditions are met. New § 702.410(c) also provides a safe harbor for investors: the NCUA will not impose supervisory action that requires an issuing credit union with a net worth classification greater than "critically undercapitalized" to suspend interest payments, so long as the issuer is in compliance with Subpart D rules and there was a bona fide, arms-length transaction.

NAFCU agrees with the proposed safe harbor approach for investors. Ensuring a minimum level of viability for subordinated debt offerings requires some measure of investor confidence that the credit union will continue to be able to make interest payments. However, for critically undercapitalized credit unions, the NCUA must prioritize actions that will speed restoration of net worth. NAFCU anticipates that these actions will be rare as the likelihood that an issuing credit union's financial condition deteriorating to critically undercapitalized will be low—particularly when subordinated debt occupies a first loss position.

<u>Limiting Offerings to Accredited Investors is Appropriate</u>

The proposal would permit offerings of subordinated debt to both entity accredited investors and natural person accredited investors, subject to specific standards for disclosure and offering

[5] *See id*.

documents. NAFCU believes that the addition of accredited natural person investors is a reasonable expansion of the current secondary capital rule, which currently limits offerings only to institutional investors. In general, natural person accredited investors would receive greater protections, under the proposal even if they are unlikely to represent a significant share of the subordinated market in the near future.

NAFCU recognizes that individual natural person investors may differ significantly in terms of their sophistication and understanding of subordinated debt transactions, but accredited investors will tend to have greater sophistication. Furthermore, given that existing secondary capital transactions are generally conducted as bilateral lending arrangements, it is unlikely that individual natural person investors will play a significant role in future subordinated debt markets.

Limiting offerings to accredited investors, as the term is defined in Regulation D of the SEC's rules, will help manage costs for marketing subordinated debt since non-accredited natural persons would likely require enhanced disclosures and demand greater care on the part of securities law specialists. These costs could also be transmitted to the NCUA if additional oversight is required to oversee non-accredited offerings. Recognizing that the NCUA's internal capacity to administer a final rule is not limitless, NAFCU recommends that the final rule restrict subordinated debt offerings to accredited investors at first. However, the NCUA should commit to reviewing the necessity of this limitation after observing how the subordinated debt market evolves in response to a final rule.

Grandfathered Secondary Capital and Treatment of Secondary Capital as Subordinated Debt

While NAFCU supports grandfathering existing secondary capital accounts to avoid disruption, NAFCU disagrees that the procedures for LICUs to issue subordinated debt (which replaces secondary capital) must incorporate new complex disclosure requirements. As stated previously, NAFCU believes that the procedures for issuing subordinated debt can be simplified for all credit unions, both in terms of application and offering requirements.

For LICUs issuing subordinated debt as part of a small offering ($10 million or less), the proposed requirement to prepare offering documents should be waived. LICU issuers have a record of responsibly offering secondary capital and the imposition of new procedural requirements would not meaningfully enhance a process that is already vetted heavily by both the NCUA and investors. Furthermore, smaller LICUs may lack the capacity to absorb significant compliance costs when preparing a subordinated debt offering. Based on NAFCU's outreach, a prospectus for a subordinated debt offering prepared by experienced counsel would likely cost between $20,000 to $30,000—a figure that would contribute significantly to the overall cost of offerings less than $10 million.

Given that the most LICUs with outstanding secondary capital have never issued more than $1 million, requiring compliance with the offering requirements as proposed could greatly discourage these credit unions from accessing subordinated debt markets. Even if LICUs are otherwise equipped to safely leverage additional capital to achieve growth, such as by expanding access to underserved areas, the high cost of the offering itself could prove to be a barrier. For LICUs that are experiencing sudden asset growth due to pandemic-related increases in savings rates, having access to the existing secondary capital offering process is critical to avoiding disruption and future net worth deterioration. NAFCU recommends that the NCUA adopt less burdensome application and disclosure requirements for LICUs to improve smaller institution access to capital, ease pandemic related disruption, and incentivize expansion of service in underserved communities.

The final rule also provides that a credit union that acquires subordinated debt or Grandfathered Secondary Capital in a merger or other consolidation, may still issue Subordinated Debt, but may not be an investor while its subordinated debt notes are outstanding. Consistent with our view that the general prohibition on credit unions acting as both issuers and investors is unnecessary and counterproductive, we regard this limitation as similarly flawed. Credit unions that issue or acquire grandfathered secondary capital should not be prohibited from investing in subordinated debt.

<u>The NCUA should not impose additional burdens on FISCUs</u>

The proposal requires federally insured, state-chartered credit unions (FISCUs) to submit both a regular application under proposed 702.408 and, if applicable, additional tax-related documentation under proposed 702.409(b) to both the Appropriate Supervision Office (i.e., regional office or ONES) and its state supervisory authority (SSA) before issuing subordinated debt. A FISCU may need to furnish a legal opinion if the appropriate Supervision Office has reason to believe that an issuance of subordinated debt by a FISCU could subject it to federal income taxation. In such circumstances, the Appropriate Supervision Office may require the FISCU to provide either a legal opinion indicating whether the proposed subordinate debt would be classified as capital stock for federal income tax purposes or financial statements showing what the impact of federal taxation would be on the FISCU over five years. NAFCU regards these requirements as excessive given that subordinated debt does not bear any of the key characteristics of “capital stock” (i.e., no equity, control or management interest).

FISCUs are currently permitted to issue secondary capital if allowed under state law (consistent with NCUA rules), but not required to supply a legal opinion or financial analysis regarding the hypothetical loss of tax exempt status. Secondary capital issued by FISCUs has never been regarded as “capital stock” and states that do authorize secondary capital accounts do so by referring to the NCUA’s regulations, which do not currently require a legal opinion or the financial modeling contemplated in proposed § 702.409(b). Furthermore, the suggestion that subordinated debt, which is functionally similar in all relevant aspects to secondary capital, might now be treated as capital stock is never explained in the proposal. After considering all the restrictions placed on subordinated debt, if there is still any possible doubt that the instrument is not distinguishable from capital stock, resolution of the matter should be left to the states—not coded into the NCUA’s own regulations. Deferring to state authorities in this context is appropriate given that the most likely barrier to a FISCU issuing subordinated debt will involve state law, which will typ.[6]

[6] See e.g., Mich. Comp. Laws § 490.361(2) (authorizing secondary capital that is not capital stock subject to the approval of the Director of the Michigan DIFS).

Although the proposal shifts the ultimate responsibility for rendering a decision on a FISCU's subordinated debt application to the NCUA, NAFCU understands that this is mainly a procedural change. The preamble notes that the NCUA will not render an approval without the concurrence of the SSA. NAFCU does not object to this arrangement but asks that the NCUA adopt a reasonable timeframe for awaiting the SSA's concurrence. In the absence of the SSA approving or denying the application, the NCUA should proceed with its own determination.

NAFCU Supports Additional Flexibility to Prepay Subordinated Debt Prior to Maturity

The proposal introduces new provisions that would allow an issuing credit union to prepay (in whole or in part) the subordinated debt note by exercising a call option if it is disclosed in the offering document and the issuer obtains NCUA approval. To obtain approval, the issuing credit union must apply with the contents required in new § 702.411(d). The NCUA would approve or reject the prepayment request within 45 days; however, there are no longer automatic approvals as exist under § 701.34(d)(2) of the current secondary capital rule.

NAFCU generally supports changes that allow an issuing credit union to prepay a portion of the subordinated debt prior to maturity. The proposal expands an eligible credit union's authority to prepay any portion of the subordinated debt because there is no longer a requirement that the redeemable amount be drawn from already discounted capital (i.e., capital no longer recognized as net worth, as described in § 701.34(d)). However, NAFCU believes that the NCUA should strive to respond to these requests within a shorter timeframe of 30 days as well as provide greater flexibility for credit unions that are well capitalized.

A shorter timeframe may help credit unions react more quickly to changing economic conditions and improve investor confidence that the prepayment process is not subject to unreasonable delay. Thirty days is also the period the OCC uses. Furthermore, well capitalized credit unions that are well managed should not necessarily need to wait for the NCUA's preapproval if no decision has been rendered, provided that the prepayment of subordinated debt prior to maturity will not have any adverse effect on the credit union's net worth classification. Such flexibility could operate similarly to the way OCC relaxes preapproval requirements for eligible banks looking to prepay subordinated debt.[7]

The NCUA Should Not Impose Additional Restrictions on Loans to Other Credit Unions

The proposal introduces a new single borrower limit for loans to other credit unions: the greater of 15 percent of a federal credit union's (FCU) net worth or $100,000, plus an additional 10 percent of the FCU's net worth if that amount is fully secured at all times with a perfected security interest. The limit would apply to subordinated debt and grandfathered secondary capital and would go beyond the aggregate limit on such loans specified in the FCU Act.

NAFCU regards the new single borrower limit as an unnecessary burden at a time when credit unions may require greater access to liquidity—not less—as the economy recovers from the

[7] See 12 CFR § 5.47(f)(2)

COVID-19 pandemic. The proposal notes that the single borrower limit is "consistent" with the limit applicable to commercial loans and asserts that credit unions "share many similarities with traditional corporate borrowers." NAFCU believes that the risks of lending to other credit unions is comparatively lower. Credit unions are supervised and examined institutions that are held to a greater degree of accountability than non-financial institution corporate borrowers.

The proposal also requires FCUs lending to other credit unions to establish written policies addressing risk and dollar limits. The NCUA indicates that loans to other credit unions should be subject to the same policy requirements as any other loan or investment; however, there is little discussion of how these policies might be evaluated when the credit union purchases subordinated debt. As proposed, the requirement to establish investment policies addressing loans to other credit unions is not on its face unreasonable; however, the burden of such a requirement will depend on how the agency evaluates these new policies. A policy addressing investments in subordinated debt should not be subject to the same level of scrutiny as a subordinated debt plan and the NCUA should take care not to discourage a healthy market of credit union investors.

Technical Amendments

NAFCU supports technical changes in the rule that would clarify that an FCU's borrowing authority under § 701.38 permits borrowing from any source and that borrowing must be evinced by a "written contract" (as opposed to the more restrictive "promissory note" currently used in § 701.38). NAFCU believes that these changes will support FCUs' legal authority to issue subordinated debt, which may be documented in contracts other than promissory notes.

Conclusion

The proposal offers much needed capital flexibility to credit unions that are eager to leverage subordinated debt to improve resiliency, manage asset growth, and improve member service, such as through expansion in underserved communities. Depending on how quickly the NCUA acts to finalize a proposal, subordinated debt could also play a significant role in helping credit unions and their members recover from the disruption caused by the COVID-19 pandemic. Access to additional capital, from any source, will provide the credit union system with additional lending capacity that can facilitate economic recovery in America's Main Street communities.

As the NCUA considers potential changes in a final rule, NAFCU would like to emphasize the following recommendations:

- The process for issuing subordinated debt should be simplified and modeled after the existing framework for secondary capital.
- The evaluation of subordinated debt applications should occur within a shorter, definite timeframe.
- Approved subordinated debt applications should not be arbitrarily limited to a one year "use-by" date.
- The NCUA should not prohibit credit unions from being both issuers and purchasers of subordinated debt.

While we urge the NCUA to consider other technical improvements described in our comments, these core recommendations will help ensure that potential issuers are not discouraged by the high cost of adopting inflexible, securities-like requirements for offerings or a potentially lengthy, open-ended review process. Removing these barriers will yield a proposal that is viable for all parties to subordinated debt transactions while preserving the safeguards that have contributed to the success of the NCUA's secondary capital rule.

Lastly, NAFCU hopes the NCUA will support amendments to the FCU Act that would accommodate widely accessible supplemental capital that can contribute to net worth. While such action is beyond the scope of the current rulemaking and would require Congressional action, NAFCU continues to educate lawmakers about the challenges credit unions face when building net worth and why a heavy dependence on retained earnings severely impairs the industry's competitive standing, depresses share rates, and limits credit unions' ability to respond effectively during economic downturns.

NAFCU appreciates the opportunity to comment on the NCUA's subordinated debt proposal. Should you have any questions or require additional information, please do not hesitate to contact me at (703) 842-2266 or amorris@nafcu.org.

Sincerely,

Andrew Morris

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