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July 8, 2020

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

Re: Subordinated Debt

Dear Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to provide comments on the proposed rule, *Subordinated Debt*. This proposed rule expands the leverage powers of low-income credit unions, non-low-income complex credit unions, and non-low-income new credit unions by allowing them to issue subordinated debt instruments to certain accredited investors when specific conditions are met, including debt issued to other federally-insured credit unions². Subordinated debt, while meeting all of the characteristics to be defined as a long-term liability, would be permitted to be classified as regulatory capital to meet a credit union's net worth or risk-based capital requirements, as applicable.

ICBA continues to voice its longstanding concerns that credit unions of all shapes, sizes, and charter types are ill equipped to manage the various key risks associated with adding excessive

¹ The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. With more than 52,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 760,000 Americans and are the only physical banking presence in one in five U.S. counties. Holding more than \$4.9 trillion in assets, \$3.9 trillion in deposits, and \$3.4 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at www.icba.org.

² A low-income credit union is defined as a credit union where the majority of the membership qualifies as low-income, with members who earn 80 percent or less of the median family income or total median earnings for individuals for the metropolitan area where they live, or the national metropolitan area, whichever is greater. A complex credit union is defined as a credit union with total quarter-end assets that exceed \$500 million as reflected in the call report.

leverage to their balance sheets. The financial instruments being proposed for issuance are the very risky, low-quality debt products that drive these inexperienced entities to repeat the mistakes of the past like poor due diligence, lack of proper cost-benefit analysis, excessive concentrations of uninsured capital, and failure to recognize mounting losses in poorly performing programs such as lending collateralized by taxi medallions. As the National Credit Union Administration (NCUA) itself admits, such mistakes generate excessive losses, declines in operating revenues, and increased operating costs. The NCUA should limit the taxpayer exposure of credit unions to the activities that credit unions have historically carried out and ensure that these regulated institutions avoid the toxic consequences that can result from an improper use of excessive leverage. Because the interests of subordinated debt holders do not align with the depositor-owner interests in the credit union, the mutuality surrounding a credit union's basis for exemption from federal income taxes is no longer applicable. Therefore, credit unions who are eligible to issue subordinated debt should be subject to taxation in the same manner as community banks.

The Proposal

The NCUA currently permits low-income credit unions (LICU) to issue secondary capital in a limited manner to qualified individuals and groups when regulatory approval is achieved. LICU secondary capital is (1) uninsured, (2) subordinate to all other claims, (3) not collateralized, (4) only repaid at maturity, and (5) carries a minimum loan term of five years. LICU secondary capital is included in the risk-based net worth calculation of the LICU.

If this proposal becomes a final regulation, the ability to issue subordinated debt would be granted not only to LICUs, but also to existing non-LICU complex credit unions and non-LICU new credit unions, including credit unions that are state chartered but federally insured. Eligible non-LICU credit unions would be permitted to include issued subordinated debt in their risk-based capital calculations but not their net worth calculations. Subordinated debt would need to be issued in written note form with a fixed stated maturity of at least five years but no more than twenty years and would be required to be characterized as debt under U.S. generally accepted accounting principles. The NCUA estimates that approximately 285 credit unions would qualify to issue subordinated debt under the proposal.

The NCUA believes that issued subordinated debt instruments would meet the definition of a "security" under federal and state securities laws. However, registration with the Securities and Exchange Commission (SEC) under the Exchange Acts would not be required. In addition, state securities regulators would not be permitted to impose any registration, qualification, or pre-clearance requirements on the issuer or assess the merits of the issuer, the terms of the offering,

or the securities being offered. However, the marketing and sale of such securities would continue to be subject to the anti-fraud prohibitions of the Securities Exchange Act of 1934. This means that eligible credit unions would be required to meet the disclosure requirements of SEC Rule 10b-5 including the requirement that the credit union deliver a written disclosure document to all potential subordinated debt holders. Issuing credit unions would need to develop an array of policies and procedures to comply with ongoing disclosure and reporting needs of investors, broker-dealer requirements, and director and officer liability insurance coverage requirements.

With regard to credit unions purchasing the debt of other credit unions, NCUA proposes single-borrower and aggregate loan limits for investments in credit union subordinated debt. The single-borrower loan limit for federal credit unions making loans to other credit unions would be the greater of 15 percent of the issuing federal credit union's net worth or \$100,000, plus an additional 10 percent of the issuing federal credit union's net worth if that amount is fully secured at all times with a perfected security interest by readily marketable collateral. A federal credit union that lends to another credit union would need approval from its board of directors, as well as established policies to address the management of risk of its loans to credit unions with dollar limits.

Federal credit unions that invest directly or indirectly in the subordinated debt, secondary capital, or obligations insured by privately insured credit unions must be classified as well capitalized, must not have any outstanding subordinated debt or secondary capital with respect to which it was the issuing credit union, and is not eligible to issue subordinated debt or secondary capital pursuant to an unexpired approval from the NCUA. The aggregate loan limit is proposed to be the lesser of 25 percent of net worth and any amount of net worth in excess of 7 percent of total assets. The NCUA is also proposing to revise a federal credit union's borrowing authority to permit borrowing from any source.

NCUA is proposing an exception from the prompt corrective action requirements for new credit unions that have outstanding subordinated debt. To qualify for the exception, the new credit union would need to have a net worth ratio of at least one percent. The new credit union must have retained earnings of at least one percent in order to issue subordinated debt. Included in the proposal is a requirement that the ratio of the new credit union's net worth plus outstanding subordinated debt must be at least seven percent. For LICUs that maintain grandfathered secondary capital, the NCUA is proposing that the grandfathered secondary capital maintain its regulatory capital treatment for no more than 20 years from the effective date of the subordinated debt rule. Once the 20 years has passed, the grandfathered secondary capital would need to be replaced with subordinated debt.

The proposal seeks to grant subordinated debt issuance authority to both complex credit unions and new credit unions that are not already LICUs. Complex credit unions would be required to have a capital classification of at least undercapitalized with a maximum allowable aggregate amount of borrowings not to exceed 100 percent of net worth. New credit unions, which are defined as those that have been in operation for less than ten years and have \$10 million or less in total assets, must have retained earnings equal to or greater than one percent of total assets to be able to issue subordinated debt. Additionally, an ineligible credit union that can prove reasonable likelihood through pro forma analysis that it will be eligible to issue subordinated debt based on the results of the pro forma analysis within the next 24 months can seek approval to issue subordinated debt.

The NCUA is proposing a prohibition on credit unions both issuing and investing in subordinated debt with some limited exceptions. For example, a credit union that acquires subordinated debt or grandfathered secondary capital in a merger or other consolidation can still issue subordinated debt but cannot invest directly or indirectly in subordinated debt or grandfathered secondary capital of any other credit union while any issued subordinated debt is outstanding.

Subordinated debt will have specific note requirements when issued. Subordinated debt notes issued must be in the form of a written debt agreement. The notes must have a fixed, stated maturity of at least five years but no more than twenty years from issuance. Issued subordinated debt must be subordinate to all other claims in liquidation and have the same payout priority as all other subordinated debt including grandfathered secondary capital. Subordinated debt must be unsecured and without a sinking fund and a compensating balance arrangement. Subordinated debt will be required to cover retained earnings deficits on a pro rata basis among all holders of subordinated debt and grandfathered secondary capital of the issuing credit union. The subordinated debt note must be payable in full only at maturity. It can only be prepaid with prior written approval from NCUA.

Subordinated debt can only be issued to natural person accredited investors and entity accredited investors, with the qualification that no board member or senior executive officer, and no immediate family member of such board member or senior executive officer of the issuing credit union may purchase or hold any subordinated debt note issued by the credit union. Subordinated debt must not be insured by the NCUA and may not include any express or implied terms that make it senior to any other subordinated debt or grandfathered secondary capital. The issuing credit union may not exceed any federal or state borrowing limits and may not provide the investor with any management or voting rights in the issuing credit union. Subordinated debt

notes are not eligible to be pledged or provided by the investor as security for a loan from or other obligation owing to the issuing credit union. The note may not include any term or condition that would require a credit union to prepay or accelerate payment of principal or interest.

Subordinated debt would not be permitted to include any term or condition that would trigger an event of default based on the credit union's default on other debts. The terms of any subordinated debt issuance could not require the credit union to make any payment other than in cash. Subordinated debt may not contain covenants that require an issuing credit union to maintain a minimum amount of retained earnings or other financial performance provision or contain covenants that unreasonably restrict an issuing credit union's ability to raise capital through issuance of additional subordinated debt. Default could not be triggered by an issuing credit union's compliance with any law, regulation, or supervisory directive from the NCUA.

The NCUA would prohibit certain covenants that provide for default of the subordinated debt as a result of a change in the ownership, management, or organizational structure, or charter of an issuing credit union. The NCUA would prohibit covenants that provide for default of the subordinated debt as the result of an act or omission of any third party. Subordinated debt notes with default covenants would be required to include a reasonable cure period of not less than 30 calendar days. Minimum denomination for natural person accredited investors would be \$100,000. Resales of subordinated debt notes could be made in increments of \$10,000 to natural person accredited investors. There would be no minimum denomination requirements for subordinated debt notes sold to entity accredited investors.

ICBA's Comments

ICBA has significant concerns about the excessive leverage that would result among credit unions if this proposal becomes effective. Allowing credit unions to utilize financial instruments that balloon their balance sheets with large amounts of debt with no real need for leverage expansion are a recipe for disaster when economic conditions do not favor such a bullish attempt at growth. These institutions lack the economic sophistication to manage thin levels of core equity capital that are the only source of loss absorption when credit losses increase through the economic cycle. When coupled with credit union reliance on a long-term, low-interest rate environment simply to survive, and aggressive maneuvers into non-core commercial lending, the future of credit union solvency should certainly be questioned.

Quite simply credit unions are falling into a trap by filling a lending void that community banks choose not to participate in because it leads to insolvency. Allowing credit unions to issue

subordinated debt to expand their footprint in these activities will only accelerate reckless risk-taking measures that ultimately lead to heavy credit losses. Without proper supervision that considers the risks to the credit unions that take on subordinated debt, and without proper awareness by the NCUA of the current financial condition of a credit union that seeks to issue subordinated debt to avoid insolvency, taxpayers will be forced to backstop this experiment when it goes wrong.

The NCUA notes in the proposal that past experiences with secondary capital by LICUs have not been positive. The NCUA cites past egregious sins such as poor due diligence and strategic planning, failure to adequately perform a prospective cost-benefit analysis, premature and excessive ambitious concentrations to support unproven or poorly performing programs, and failure to realistically assess and timely curtail programs that face mounting losses. Yet the NCUA does not address how these problems occurred and which steps will be taken to make sure that they do not happen again. NCUA makes its own case as to why credit unions fail at properly maintaining capital.

The NCUA fails to highlight the fact that by allowing non-LICU complex credit unions to issue subordinated debt, the amount of credit union industry assets exposed to the leverage risks associated with such issuance would increase by approximately \$730 billion, which is over 100% greater than the current industry assets that could be exposed to subordinated debt leverage. Because there would be such a large increase in the risk profile of the credit union industry to taxpayer bailouts with the advent of subordinated debt, ICBA requests that the NCUA conduct an analysis of the current share insurance fund viability in the face of increased losses that could occur if too many credit unions begin to issue subordinated debt and how the NCUA will adjust share insurance fund premiums to further protect the taxpayer from bailing out excessive credit union leverage in the future. Such analysis should provide multiple stress scenarios of potential macroeconomic events like the ones observed during the financial crisis of 2008-2009 and how such excessively leveraged credit unions would behave today with the current loss-absorbing capital they have available. Taxpayers should also be made aware how much share insurance proceeds would need to be collected from federally insured credit unions to ensure that such a taxpayer bailout would not be needed.

NCUA believes that past problems with secondary capital by LICUs would be avoided in the future by requiring prior approval of a capital plan. Through such prior approval, supervisory oversight and detection of lenient practices will be strengthened by preventing LICUs from accepting and using secondary capital for improper and unsound purposes, ensuring that capital plans are evaluated and critiqued before being implemented, documenting parameters to guide the proper implementation of secondary capital, and to measure the progress and performance of

a LICU. But the NCUA has not demonstrated that it has the experience or the means to perform the supervisory actions necessary to ensure that such a risk management platform could be instituted effectively. Without due consideration of all risk factors that should be considered with excessive leverage, and a solid understanding of what brings about the failure of once sound lending institutions, we are all at the mercy of the NCUA to bring whatever supervisory experience it has available to protect against future losses.

ICBA questions whether the NCUA has properly considered the fact that subordinated debt holders, as stakeholders in the credit union that has issued the subordinated debt, have an interest in the credit union that is not aligned with the depositor-owners of the credit union. Because subordinated debt stakeholder interests are not insured, and their interests are subordinate to all other claims including those of depositors, the fact that a credit union has subordinated debt stakeholders calls into question the mutual nature of the credit union organization as a whole. Supporters of the credit union industry claim that their mutuality is maintained because they hold true to their mutual and cooperative principles with democratic control of the enterprise resting with the depositors. Clearly subordinated debt holders will be primarily, if not solely concerned with receiving contractual payments due per the terms of the note. Contrast this with the depositor-owners, who have an opportunity to share in the success of the credit union through the organic growth that occurs when their deposits are used to expand the impact of the credit union on the community. Subordinated debt holders will directly conflict with the interests of the depositor-owners because the credit union will be forced to cater to the posturing requirements of firms used to market subordinated debt notes in the capital markets. Thus depositor-owner interests will fall behind the immediate demands of liquidity providers as they dictate to the credit union how to maximize borrowing opportunities. The end result of this conflict is the loss of mutuality and the cooperative traits that allow a credit union to avoid federal taxation. Therefore, credit unions that engage in subordinated debt issuance should lose their tax-exempt status and be subject to federal taxation.

ICBA believes that the NCUA has not adequately addressed how it will collect and make publicly available reports by eligible credit unions that issue subordinated debt, how NCUA will collect data on credit unions that issue subordinated debt, and how the overall monitoring process of the health of credit unions that issue subordinated debt will be accomplished. When will the NCUA consider a credit union with subordinated debt to be overleveraged and what steps will NCUA take to force the troubled credit union to correct its liquidity and capital position? Will NCUA institute an early warning system for credit unions to follow in order to prevent a credit union from applying excess leverage at exactly the wrong time?

In addition to the multitude of concerns about the safety and soundness of credit unions if such reckless subordinated debt leverage practices expand, ICBA questions whether the NCUA has considered the legitimacy of allowing subordinated debt, a long-term liability, to be included as regulatory capital in the risk-based capital ratio for complex credit unions. A key determination by federal bank regulators on the viability of an issued financial instrument as regulatory capital for a community bank is the indefinite term of the instrument issued. A bank's core regulatory capital definition requires that the common equity tier 1 capital not contain features that would limit the life of the financial instrument or require that the financial instrument be put back to the issuer or redeemed in a date certain manner. Common equity tier 1 capital does not constrain the issuer with regard to redemption provisions that could require their repayment when the issued subordinated debt is needed to cover expected credit losses. Therefore, ICBA repeats its longstanding request that NCUA draft regulatory capital rules and an overall capital framework that is no less stringent than the Basel III regulatory capital framework that is currently imposed on community banks.

Because credit unions have very little experience with issuing healthy levels of secondary capital that can be proven to succeed during periods of economic stress and uncertainty, ICBA opposes the issuance of subordinated debt by all credit unions regardless of industry classification or size. Credit unions do not maintain the excessively high net worth ratios and do not exhibit a lending discipline that reflects prudent credit risk management practices needed to issue subordinated debt. Preventing the proliferation of subordinated debt issuance by all credit unions will ensure that threats to the credit union industry due to large increases in leverage will not occur and credit unions that are facing imminent insolvency will be deterred from trying to issue subordinated debt as a last effort to remain viable.

ICBA appreciates the opportunity to comment on this proposed rule and request for comment. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 821-4364 or james.kendrick@icba.org.

Sincerely,

/s/

James Kendrick
First Vice President, Accounting and Capital Policy

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