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National Association of Federally-Insured Credit Unions

December 5, 2022

Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Subordinated Debt
RIN: 3133-AF43

Dear Ms. Conyers-Ausbrooks,

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the National Credit Union Administration's (NCUA) proposal to amend the Subordinated Debt Rule to accommodate a longer maximum maturity for grandfathered secondary capital (GSC) and adjust certain technical requirements for issuers. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 133 million consumers with personal and small business financial service products.

NAFCU supports the NCUA's decision to eliminate the maximum maturity requirement in the Subordinated Debt Rule and replace it with a more reasonable standard which considers whether an issued note is debt. NAFCU also appreciates the Board's decision to adjust the regulatory capital treatment of GSC to fully accommodate the maximum permissible maturity of notes issued under the U.S. Department of Treasury's (Treasury) Emergency Capital Investment Program (ECIP). NAFCU requested both changes in prior comments and has consistently advocated for a regulatory framework that allows credit unions to fully leverage investments made through the ECIP.[1]

General Comments

The proposed adjustments to the current Subordinated Debt Rule's treatment of maturity limits will help all eligible credit unions take advantage of longer-term capital investments that support economic development activities. For low-income designated credit unions (LICUs) participating in the ECIP, the proposed changes will ensure that government capital investments can be counted as regulatory capital for the full term of the note rather than arbitrarily truncated to a period of twenty years.

[1] Joint Letter to NCUA re: Subordinated Debt, RIN: 3133-AF38, available at https://www.nafcu.org/joint-letter-ncua-subordinated-debt-File.

As NAFCU has noted previously, limiting the regulatory capital treatment of ECIP investments in accordance with the current rule's twenty-year maximum maturity would impair the impact of the funding in low- and moderate-income communities that need longer term capital infusion. Additionally, failure to recognize thirty-year ECIP investments as GSC for the full term of the note would place LICUs at a disadvantage relative to banks and other eligible institutions that face no equivalent limits on their ability to leverage ECIP funding.

The NCUA correctly acknowledges that "[c]apital with longer maturities helps credit unions make more loans to underserved communities and improve the economic well-being in these areas."[2] The $9 billion in ECIP funding authorized by the Consolidated Appropriations Act of 2021 represents one significant source of long-term capital accessible to eligible CDFI and MDI credit unions with notes having a maximum maturity of thirty years. As documented by the U.S. Department of Treasury (Treasury), ECIP funding has already helped credit union participants reach minority communities through the extension of affordable home and small business loans.[3]

Strong credit union participation in the ECIP was encouraged by NAFCU-supported amendments to the Subordinated Debt Rule in 2021 which allowed credit unions to apply for ECIP funding using the agency's more streamlined secondary capital application, and through a supervisory letter which permitted eligible credit unions to accept thirty-year ECIP notes despite the Subordinated Debt Rule's shorter maturity limit.[4] The NCUA's remaining work should now focus on maximizing the usefulness of those investments as regulatory capital and reducing arbitrary administrative barriers present in the current Subordinated Debt Rule.

The NCUA Should Not Impose a Maximum Maturity for All Subordinated Debt Notes

To accommodate longer term issuances of subordinated debt that would exceed the current rule's twenty-year maturity limit, the NCUA has presented a revised analysis of the factors that might bear upon the question of whether a subordinated debt note is in fact "debt." NAFCU agrees with the NCUA's assessment that "a fixed stated maturity date is but one factor in a debt versus equity analysis" and the agency's recognition that "courts have never set a strict limit on the length of a fixed stated maturity for purposes of a debt versus equity analysis."[5] While differentiating between debt and equity is necessary given statutory constraints on the organization of credit unions and their capital structure, the NCUA's more refined analysis appropriately supports elimination of a maximum maturity and the creation of a more flexible

[2] NCUA, Subordinated Debt, 87 Fed. Reg. 60326, 60328 (October 5, 2022).
[3] *See* U.S. Department of the Treasury, "Biden-Harris Administration Announces Over $8.28 Billion in Investments in Community Development Financial Institutions and Minority Depository Institutions through the Emergency Capital Investment Program," (September 21, 2022), available at https://home.treasury.gov/system/files/136/ECIP-Press-Release.pdf.
[4] *See* Letter to Credit Unions 21-CU-11, Emergency Capital Investment Program Participation and enclosed Supervisory Letter No. 21-02 (Oct. 20, 2021).
[5] 87 Fed. Reg. 60326 at 60328.

standard through which credit unions may demonstrate that a particular subordinated debt instrument conforms with the Federal Credit Union Act (FCU Act).

As noted in the proposal, courts have traditionally listed multiple factors to be evaluated when determining whether an instrument is debt or equity.[6] In *Estate of Mixon v. United States*, 464 F.2d 394, 402-403 (5th Cir. 1972), the court enumerated thirteen factors but began its analysis with the name given to the instrument itself—observing that the "the issuance of a bond, debenture, or note is indicative of a bona fide indebtedness." NAFCU understands that secondary capital offerings made under the NCUA's prior rule as well as those made under the Subordinated Debt rule are generally completed with the issue of a promissory note which both parties understand to be evidence of a debt. ECIP funding is also clearly structured as debt—a fact articulated in the Securities Purchase Agreement participating credit unions must sign with Treasury.[7]

While the Supreme Court has stated that "no one characteristic . . . can be said to be decisive in the determination of whether obligations are risk investments in the corporations or debt," it is noteworthy that among the characteristics noted by the Court in *John Kelley Co. v. Commissioner*, 326 U.S. 521, 530 (1946) the only one to address the maturity of an instrument focused on whether the maturity was *definite*—not whether it was of a particular duration.[8] Likewise, in *Mixon*, the court described the maturity factor as the "presence or absence of a fixed maturity date" without devoting attention to the length of the term.[9] Accordingly, the proposed elimination of the Subordinated Debt Rule's maximum maturity limit can be accomplished in a way that is fully consistent with the predominant analytical framework used for evaluating the debt versus equity question.

The proposed standard—which permits a credit union to explain why a particular subordinated debt instrument is debt even if its maturity exceeds twenty years—offers a more flexible approach that can accommodate a broader range of potential capital instruments in the future. To the extent that future government stimulus may take the form of subordinated debt during periods of economic crisis, the proposal proactively removes a barrier that might otherwise impair the usefulness of government funding as regulatory capital. As noted in prior comments, it would be inefficient for the NCUA to impose a one-size-fits-all maturity limit for all subordinated debt, and then, when confronted with future periods of economic stress or attendant capital assistance programs, need to amend its rules to accommodate specific government investment parameters as it has for the ECIP.

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[6] *See e.g.*, *Hewlett-Packard Co. v. Comm'r of Internal Revenue*, 875 F.3d 494 (9th Cir. 2017); *Recklitis v. Comm'r of Internal Revenu*e, 91 T.C. 874, 91 T.C. No. 55 (T.C. 1988).
[7] U.S. Department of Treasury, Credit Unions – Securities Purchase Agreement (March 29, 2022) ("WHEREAS, the Credit Union intends to issue in a private placement *subordinated debentures*") (emphasis added), available at https://home.treasury.gov/system/files/136/Credit-Unions-Securities-Purchase-Agreement.pdf.
[8] *Kelley Co.* v. *Comm'r,* 326 U.S. 521, 526, 530 (1946)
[9] *Mixon*, 464 F.2d at 402.

Other Technical Changes

NAFCU supports the NCUA's other changes to the Subordinated Debt Rule that are aimed at reducing administrative burdens shouldered by credit union issuers. Most significant among these technical improvements is clarification of a provision related to an issuer's obligation to consult qualified counsel to comply with application preapproval requirements. Currently, § 702.402 defines "Qualified Counsel" as "an attorney licensed to practice law in the relevant jurisdiction(s) who has expertise in the areas of Federal and state securities laws and debt transactions similar to those described in this subpart." The new definition of "Qualified Counsel" omits the phrase "in the relevant jurisdiction(s)." By clarifying the jurisdictional scope of the qualified counsel requirement, the NCUA will remove doubt about the selection of appropriate local counsel to assist in a subordinated debt offering. As noted in the preamble, it was never the NCUA Board's intention "to mandate that 'Qualified Counsel' be licensed to practice law in every jurisdiction that may be relevant to the issuance."[10]

NAFCU also encourages the NCUA to explore options for making small issuances of subordinated debt (whether limited in value or in terms of number of investors) more affordable for smaller LICUs that cannot justify the cost of retaining specialized legal counsel for a simple offering to sophisticated investors. The current rule requires credit unions to hire counsel to prepare offering documents, develop detailed policies and procedures governing the issuance, and potentially address supervisory concerns related to whether a particular instrument might be mistaken as capital stock. These formal requirements were not part of the NCUA's prior secondary capital regulation and although the NCUA has previously rationalized their complexity as necessary to "avoid legal challenges from investors," the agency's analysis of LICU issuers in its 2020 proposed Subordinated Debt Rule did not identify particular secondary capital instruments as the target of securities litigation.[11]

As noted in NAFCU's comments to the NCUA's 2020 Subordinated Debt proposal, the OCC's requirements for subordinated debt offerings of national banks include an agency registration exemption that is generally designed to reduce administrative barriers. For example, the OCC's Securities Offering Disclosure Rule contains several exceptions to the OCC's prospectus delivery requirement that take advantage of relevant exemptions found in SEC regulations.[12] The NCUA's Subordinated Debt Rule provides no comparable regulatory tailoring.[13] To support smaller offerings of subordinated debt, the NCUA should invite comment on whether a more streamlined application may be appropriate, particularly when such offerings involve sophisticated investors

[10] 87 Fed. Reg. 60326 at 60329
[11] *See* NCUA, Subordinated Debt, 85 Fed. Reg. 13982, 13984 (March 3, 2020); *see also* NCUA, Subordinated Debt, 86 Fed. Reg. 11060, 11063 (February 23, 2021).
[12] *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).
[13] *See* 86 Fed. Reg. 11063 ("[T]he Board views the Offering Document process as helping Issuing Credit Unions navigate complex disclosures and anti-fraud laws [….] However, the Board notes that the Offering Document is independent of and, in some cases, additive to any requirements imposed by applicable securities laws.").

who have prior experience investing in secondary capital. Doing so would help support a more robust subordinated debt market, improve smaller institution access to capital, and support greater investment in underserved and historically marginalized communities.

Conclusion

NAFCU supports the NCUA's proposal which would (1) adopt a more flexible standard for determining the maximum permissible maturity of a subordinated debt note and (2) extend the regulatory treatment of ECIP investments as GSC. NAFCU also welcomes technical changes and clarification to the Subordinated Debt that would ease administrative costs for credit union issuers.

NAFCU and its members appreciate the opportunity to comment on the NCUA's proposed rule. Should you have any questions or require any additional information, please contact me at amorris@nafcu.org or (703) 842-2266.

Sincerely,

Andrew Morris
Senior Counsel for Research and Policy