/ inclusiv /

July 8, 2020

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

Re: Subordinated Debt (RIN: 3133-AF08)

Dear Mr. Poliquin:

Inclusiv appreciates the opportunity to provide comments on NCUA's Advance Notice of Proposed Rulemaking for Subordinated Debt.

Background on Inclusiv's Experience with Secondary Capital

Inclusiv is a dynamic, growth-oriented network of credit unions that provides safe and responsible financial services to underserved communities. Since 1974, Inclusiv has been promoting financial inclusion by organizing, supporting, and investing in community development credit unions (CDCUs), which specialize in serving populations with limited access to affordable financial services, including low-income wage earners, families, new immigrants, young people, and the growing number of Americans seeking financial independence through credit unions. Our network represents 300 diverse CDCUs with over $112 billion in community controlled assets. They provide financial and development services to 10 million people of modest means.

Inclusiv was instrumental in advocating for the establishment of secondary capital for low-income credit unions. As a CDFI intermediary and impact investor, Inclusiv is one of the first and only national lenders of secondary capital to credit unions and has been the industry's broadest and most consistent lender for more than 20 years. Inclusiv has originated more than $35 million in secondary capital lending over 70 transactions. Our loan sizes have ranged from $7,500 to $5 million. In 2019, Inclusiv led the creation of a $45 million secondary capital loan fund designed to promote economic mobility among low wealth and underserved communities, preserve and build diversity in community owned and controlled financial services, and increase the impact of scalable institutions throughout the American South.

Inclusiv's Capital Program invests in CDCUs to strengthen their financial position, grow their business and expand their impact on the low-income communities they serve. Our investments are designed to help CDCUs to grow safely and soundly, offer innovative and responsible loan products and help consumers to protect and build assets. Our research and experience strongly demonstrates the positive impact of secondary capital on the credit union industry and its potential to strengthen the financial performance and community impact of credit unions on underserved communities.

This advanced notice of proposed rulemaking is an opportunity to improve and codify many aspects of the subordinated debt instrument and process for all parties involved: borrowing credit unions, lenders, and NCUA.

Inclusiv appreciates the NCUA Board's comments and stated commitment to ensure the successful use of secondary capital by low-income credit unions to extend financial inclusion, delivering products and services to low-income and historically underserved communities. We recognize and appreciate the intent of this proposed rulemaking is to ensure that secondary capital can continue to grow and thrive. This is a timely undertaking, as the events of the past few months has catapulted interest among external social impact investors as the visibility of the critical role of CDFI and MDI credit unions to our economy has increased. This is the moment to make sure that investment tools to grow the industry are optimized to facilitate prudent pathways to growth.

Overall Comments

The proposed rules endeavor to tackle the path to capital raising for large, complex non-LICUs to address new and emerging risk-based capital standards. However, in attempting to alter the already existing secondary capital rules this proposed rule threatens to add burdens to credit unions while weakening rights of secondary capital investors. While there are some promising aspects to the proposed rulemaking, in its totality it is adverse to the purpose for which LICU subordinated debt was created and therefore will have a significant negative impact on LICU and CDFI credit unions.

Key issues and challenges:

- **General Framework**: The application of securities issuance across all acquisitions of subordinated debt by credit unions would be erroneous and overly expansive. Similarly, the stated goal of aligning with OCC presents some opportunities but is applied too broadly and is incongruent to the current structure of secondary capital.
- **Application and Approval process**: Proposed changes in both application and approval processes provide some welcomed clarity and transparency but may place excessive burdens for smaller credit unions raising modest amounts of secondary capital.
- **Prepayment Process**: We support the move toward greater clarity and objective measures in approval of prepayment. However, proposed changes to the structuring of the prepayment process and the accounting for remaining capital in net worth incorporates the problematic portions of the OCC framework without the benefits.

- **Transparency in Mergers and Liquidations**: This proposed rulemaking would be the ideal vehicle (specifically 185 – Part D) to clarify the accountability and objective steps that NCUA undertakes in assessing the allocation of secondary capital in an adverse event such as a credit union liquidation or forced merger.

Framework: Required Disclosures

The general application of a non-exempt securities issuance framework across all acquisitions of subordinated debt by credit unions would be a serious and erroneous change to the current process. It is clear from years of experience with secondary capital that not all subordinated debt loans are securities. And as NCUA is not a securities regulator, NCUA's statement of belief that subordinated debt notes are securities has no effect on the definition of such notes for securities law purposes. Further, the proposed rules "would require an Issuing Credit Union to prepare and deliver an Offering Document to potential investors even though there is no SEC-mandated disclosure requirements for offerings of securities pursuant to the Section 3(a)(5) exemption, and there generally are no SEC-mandated disclosure requirements for offerings of securities pursuant to the Rule 506 private placement exemption as long as all purchasers in the offering are 'accredited investors.'" The proposed rule would apply disclosure requirements to credit union issuances of subordinated debt that mimic the requirements of the federal securities laws, *even if those issuances would not be subject to such requirements under the securities laws themselves.* There already exists a U.S. securities law framework which applies to such exempt issuances, and that framework stipulates that registration and disclosure requirements are not necessary in these cases. It is unnecessary, improper, and unduly burdensome for NCUA to impose such requirements on exempt credit union issuers when U.S. securities law does not impose these requirements.

Inclusiv is a credit union membership network that makes secondary capital loans to its members only and has done so for almost 25 years. The vast majority of our member borrowers have applied to Inclusiv solely and have not solicited for any other lenders. Imposition of these requirements will cause serious harm to the LICUs that well use subordinated debt to further service delivery to their membership. These proposed changes would create serious challenges - and in many cases impossibly high hurdles - for smaller and less complex LICUs to access subordinated debt. The imposition of costs for counsel is but one material challenge for small and mid-size credit unions, and unnecessary for loan transactions of this type. Further, these proposed rules allow for far less regulatory flexibility than the OCC rules with which they purport to conform. OCC does not impose subordinated debt issuance requirements which differ from the regular standards of 3(a)(5) and Rule 506.

Application and Approval Framework and Processes

Some form of regulatory approval process for subordinated debt plans before the acquisition of this debt is valuable for all parties. However, a regulatory approval process for repayment of amortized portions of subordinated debt no longer included in net worth is, in most cases, unnecessary and not beneficial for any party. Regulatory approval for the repayment of subordinated debt portions no longer included in Tier 2 Capital is not required by OCC for bank issued subordinated debt. To the degree that repayment approval is employed, it must be restructured to allow for a simple, consistent, and timely repayment process.

Additional clarity and standardization of the preapproval application process is valuable. However, as with the disclosure requirements, the framework of the standardized application also reflects the use of a single structure for all subordinated debt requests. In many cases, especially for smaller credit unions and smaller loans, the requirements outlined in the ANPR are both unnecessary and overly burdensome. Inclusiv recommends that the NCUA focus on the continuance of its current secondary capital requirements and limit changes to supplemental enhancements, not a wholesale restructuring of the application.

Inclusiv strongly supports the agency's focus on a credit unions management's involvement in the creation of their subordinated debt plan. As a membership organization and a Community Development Financial Institution, Inclusiv may at times provide technical assistance to its members and applicants. Many forms of technical assistance can further strengthen a credit union's ability to develop both its business model and ability to execute on its long-term strategic goals. However, as a lender Inclusiv looks to the management of the credit union as the ultimate owners of its plan, and we underwrite our loans accordingly.

While the change of the approval decision deadline from 45 days to 60 days would be somewhat detrimental to the timeliness of the current lending process, the removal of automatic approval would be extremely detrimental to the process for both credit unions and lenders. If so implemented, the process would become open-ended with no the remedy for non-responsiveness by NCUA. Currently it is common for NCUA to respond to the credit union's approval request with additional questions at the very end of the 45 day period. A significant improvement to the current process would include a requirement that any questions of applicants be provided at least 15 days before the 45 day deadline.

Conditional approval of preapproval applications may appear to be helpful, but any conditional approval process would need far more clarity and boundaries than that provided in the ANPR.

39 Broadway Suite 2140, New York, NY 10006 | T. 212 809 1850
inclusiv.org | info@inclusiv.org

/ inclusiv /

Specific Comments on the Initial Application Components contained in § 702.408(b)

1) **A statement indicating how the credit union qualifies to issue Subordinated Debt given the eligibility requirements of § 702.403 with additional supporting analysis if anticipating to meet the 111 Proposed 702.403. 131 requirements of a LICU or Complex Credit Union within 24 months**

   The statement regarding the ability of credit unions to apply for approval of subordinated debt while applying for low-income designation is reasonable; however the eligibility of credit unions anticipating to meet the requirements of low-income status within the next 24 months is problematic. Inclusiv recommends that while these credit unions may apply for preapproval, it should be clear that only low-income designated credit unions are eligible to receive subordinated debt which is included in their regulatory net worth and therefore it may only count toward net worth upon receipt of low-income designation. This should not delay or adversely impact the ability of existing low-income credit unions to receive timely review and approval of their applications.

2) **The maximum aggregate principal amount of Subordinated Debt Notes and the maximum number of discrete issuances of Subordinated Debt Notes that the credit union is proposing to issue within the period allowed under subsection (k) of this section, which is one year from the approval of the initial application or Offering Document, depending on whether the investor is a Natural Person Accredited Investor or an Entity Accredited Investor.**

   Preapproval for a maximum aggregate borrowing limit is a valuable feature currently in practice throughout the system. In these cases it is common for the total amount of subordinated debt to be drawn down over a period of years as the credit union grows its assets and primary capital. Inclusiv recommends that the regulatory preapproval be valid for 36 months. Private lenders render their credit decisions based on current borrower information and are capable of determining material adverse changes in a credit union's condition.

3) **The estimated number of investors and the status of such investors (Natural Person Accredited Investors and/or Entity Accredited Investors) to whom the credit union intends to offer and sell the Subordinated Debt Notes.**

   This requirement is helpful only to the degree there is a both large request and broad solicitation of investors.

4) **A statement identifying any outstanding Subordinated Debt and Grandfathered Secondary Capital previously issued by the credit union.**

   This requirement is reasonable.

5) **A copy of the credit union's strategic plan, business plan, and budget, and an explanation of how the credit union intends to use the Subordinated Debt in conformity with those plans.**

6) **An analysis of how the credit union will provide for liquidity to repay the Subordinated Debt upon maturity of the Subordinated Debt.**

7) **Pro Forma Financial Statements (balance sheet, income statement, and statement of cash flows), including any off-balance sheet items, covering at least five years. Analytical support for key assumptions and key assumption changes must be included in the application. Key assumptions include, but are not limited to, interest rate, liquidity, and credit loss scenarios**

   These requirements are generally important and valuable in the preparation process for the acquisition of subordinated debt. However, not all plans are of the same type or character, and they should be treated accordingly. Credit unions which are adequately capitalized and seeking subordinated debt to support the growth of their organic business model present a far lower risk profile than institutions intending to use the capital for highly leveraged investment transactions or to engage in vastly new and unfamiliar lines of business.

   Scenario-based pro forma statements for small credit unions with a limited set of financial products need not be as complex or far reaching as for a large and complex credit union.

   Further, NCUA's review of a credit union's financial projections – particularly its liquidity projections – should be reasonable and informed by the above guidance. Historically credit unions that have requested secondary capital to support ongoing growth of their current business model have received from their regional office unreasonable and obstructive questions regarding the liquidity position of the credit union ten years into the future. This form of review is not one which supports a well-functioning application and approval process.

8) A statement indicating how the credit union will use the proceeds from the issuance and sale of the Subordinated Debt.

This requirement is currently in place and reasonable.

9) A statement identifying the governing law specified in the Subordinated Debt Notes and the documents pursuant to which the Subordinated Debt Notes will be issued.

10) A draft written policy governing the offer, and issuance, and sale of the Subordinated Debt, developed in consultation with Qualified Counsel.

11) A schedule that provides an itemized statement of all expenses incurred or expected to be incurred by the credit union in connection with the offer, issuance, and sale of the Subordinated Debt Notes to which the initial application relates, other than underwriting discounts and commissions or similar compensation payable to broker-dealers acting as placement agents. The schedule must include, as applicable, fees and expenses of counsel, auditors, any trustee or issuing and paying agent or any transfer agent, and printing and engraving expenses. If the amounts of any items are not known at the time of filing of the initial application, the credit union must provide estimates, clearly identified as such.

These requirements may pertain to a large issuance with broad solicitation of investors, but are not otherwise unnecessary for the vast majority of transactions.

12) In the case of a New Credit Union, a statement that it is subject to either an approved initial business plan or revised business plan, as required by this part, and how the proposed Subordinated Debt would conform with the approved plan. Unless the New Credit Union has a LICU designation pursuant to § 701.34, it must also include a plan for replacing the Subordinated Debt with Retained Earnings before the credit union ceases to meet the definition of New Credit Union in § 702.2 of this part.

13) A statement describing any investments the credit union has in the Subordinated Debt of any other credit union, and the manner in which the credit union acquired such Subordinated Debt, including through a merger or other consolidation.

These requirements are reasonable.

14) A signature page signed by the credit union's principal executive officer, principal financial officer or principal accounting officer, and a majority of the members of its board of directors. Amendments to an initial application must be signed and filed with the NCUA in the same manner as the initial application.

A signature page for the CEO and CFO is reasonable. A requirement for the signatures of a majority of the board of directors is unreasonable and obstructive. A standard board resolution to engage in a financing transition of this type is commercially standard practice and sufficient.

15) Any additional information requested in writing by the Appropriate Supervision Office.

This requirement is currently in place and reasonable if there is a specific characteristic of the applying credit union which requires further information. This requirement should not be abused for the purposes of obstruction.

As indicated above, a one size fits all approach as outlined in these proposed rules presents problems as there are considerable differences between complex CUs seeking subordinated debt for risk-based capital needs and that of low-income credit unions raising capital to grow and promote financial inclusion in underserved communities.

The proposed changes structure the process around the most complex, most broadly solicited acquisitions of subordinated debt. Current secondary capital processes can be incrementally improved; but wholesale reengineering of the process to manage the most uncommon cases of subordinated debt places burden and strains all to efficiently obtain the regulatory approval to raise and leverage capital.

NCUA is encouraged to avoid a one size fits all approach to the review of applications for preapproval and to recognize that private lenders are rendering their own credit decisions with respect to subordinated debt. To the degree that an institution may wish to use subordinated debt to support highly leveraged investment transactions which are not current part of a credit union's organic business model, these plans may require additional regulatory scrutiny. However, if the purpose for which the credit union is seeking subordinated is debt is the support of further growth in its organic business model then the added benefit of regulatory scrutiny is minimal. Private lenders are more than incentivized to perform their own due diligence and credit underwriting for subordinated debt financing.

Prepayment Process

The proposed changes to the prepayment structure will cause serious difficulties for all parties and create disadvantages and disruption relative to the current process. The current process can and should be improved to facilitate more clear, consistent, and timely prepayment of subordinated debt.

The current twenty percent amortization of capital in the final five years of a loan term is valuable in that there is not an extreme shock to the capital ratio of the borrower at maturity.

Further, the repayment of amortized portions of secondary capital is beneficial for all parties, both for credit union borrowers and NCUA in that it reduces a credit union's operating expense and increases their return on assets. For lenders it provides effective amortization of loan principal, which materially increases the attractiveness of subordinated financing and helps to grow the subordinated debt market over time.

The proposed changes to the prepayment process would incorporate the problematic portions of the OCC framework without incorporating the beneficial portions of the OCC framework.

The regulatory structure for banks (for the most part) allows prepayment without OCC approval of subordinated debt not included in Tier 2 Capital. Adequately capitalized credit unions should have the same ability to prepay, without regulatory approval, the portion of subordinated debt not included in net worth. The current process of prepayment approval is unnecessarily fraught and the does not conform consistently with the standards delineated in the National Supervision Policy Manual for Streamlined prepayment approval. Inclusiv has experienced many cases of borrowers with extremely strong capital and earnings waiting far beyond 45 days for their prepayment approval. In all of these cases the credit union met the streamlined approval standards of the National Supervision Policy Manual. Yet their approvals were significantly delayed. A well-functioning system will allow for unobstructed prepayment of debt for borrowers with adequate capital levels. Further, a clear and consistently applied process across NCUA regions will support all parties as capital amortizes in the final five years before maturity.

The proposed change to the prepayment process to reset the basis of the capital amortization schedule would be a material deterioration from the current rules. Under the bank framework, subordinated debt borrowers are incentivized to either prepay their subordinated debt in full when it reaches five years to maturity, or more likely, to continuously refinance the debt and maintain the full amount of regulatory capital. The proposed change would introduce far more volatility and cost, and far less certainty to the subordinated debt process and credit union capital levels than currently exists.

The major incentive for subordinated debt borrowers is to avoid paying premium rates of interest on debt which is not included in their regulatory net worth. Shifting to the bank framework would always necessitate that, with less than five years until maturity, some portion of the subordinated debt will not be included in regulatory capital. Hence the institutions' incentives to prepay in full or refinance. And credit unions will also be so incentivized, introducing the additional capital volatility, less certainty, as well as additional hard and soft costs of refinancing.

Retaining the current capital amortization structure will preserve the intended effects of declining capital rates in the final years of subordinated debt financing.

For any credit unions not adequately capitalized or not otherwise troubled which may need to request prepayment, the removal of automatic approval creates the same obstacles to a well-functioning system as with this removal for plan preapproval. Automatic approval at the end the review period is both the deterrent and remedy for non-responsiveness.

Transparency in Merger or Liquidation

Transparency to subordinated debt creditors in mergers and liquidations in critical. Often the trigger by which a credit union's net worth ratio falls to critically undercapitalized levels is an increase in the institution's allowance for loan loss account. Subordinated debt investors need to be provided with details of the assets and contra-asset allowance which caused the merger or liquidation, and their eventual unwind. It is important to note that bank subordinated debt is significantly different from credit union subordinated debt in this regard. The placement of subordinated debt in the capital structure of banks is quite different than its placement for credit unions. Banks have both common and preferred equity in addition to retained earnings in their capital stack. More importantly, in the priority of claims bank subordinated debt sits between preferred stock and unsecured senior debt - not behind the system's insurance fund. Bank subordinated debt is last in line among creditors, not all claimants. And its claims in a borrower bankruptcy are far stronger and more transparent.

Covenant Provisions

The ability of lenders to incorporate covenants into financing agreements is standard commercial practice. The inclusion of financial covenants requiring borrowers to maintain capital ratios that are at least "adequately capitalized" is reasonable and vastly increases the marketability of subordinated debt notes. As noted above, the risk of credit union subordinated debt is greater than that of banks given its relative position in the hierarchy of claims. Thus more flexibility for reasonable financial covenants - and select acceleration provisions with respect to those covenants – helps to balance the relative risk of the instrument and increases its marketability.

Availability to Cover Losses - Timing

The proposed change to this rule would materially change the nature of subordinated debt with respect to credit unions working through their approved plan of Prompt Corrective Action. Should a credit union merge or liquidate, the mark-to-market event currently occurs at such time that the credit union is no longer a going concern. This proposed change would introduce intermediate mark-to-market events, with no possibility of reversal should the credit union replenish its primary capital. The effect of such a rule change is not conducive to promoting the confidence of the private lenders in the credit union subordinated debt market.

Additional Recommendations

The following are recommendations for additional dialogue on rulemaking:

Credit Unions as both borrowers and lenders: Credit unions should be allowed to be both borrowers and lenders. Few institutions are better judges of a credit union's credit risk than another credit union.

Maturity Limit and Extensions: Long-dated maturities and automatic extensions are useful provisions of secondary capital and should be retained. Some of the highest impact community development credit unions rely upon very long-term patient capital from investors and partners on the social returns they seek. These patient, socially-motivated investors understand and acknowledge risks associated with longer maturities and are more than willing to take those risks. There is no reason for the regulator to limit this important source of capital for the handful of institutions that are able to secure it. The stated reason for the limitation on these features is merely to manage a transition of grandfathered secondary capital. Reducing the seismic shift in regulatory framework would eliminate the need for this unnecessary limitation.

Implementation Timeline: Implementation should be no earlier than January 1, 2023. An implementation timeline must allow all parties ample time to understand and adjust to new subordinated debt regulations.

Other and Requested Answers

There is a value in allowing FISCUs to innovate with respect to various forms of financing included in regulatory net worth. Inclusiv also notes that consistency of financing forms is valuable for a well-functioning market in subordinated debt.

No prescribed regulatory minimum is required or advisable for entity accredited investors.

Restricting investment in subordinated debt solely to US investors will not unduly limit the marketability and functionality of credit union subordinated debt.

Restricting investment in subordinated debt solely to Accredited Investors will not unduly limit the marketability and functionality of credit union subordinated debt.

The distinction between Entity Accredited Investors and Natural Person Accredited Investors significantly complicates the rules, though its ultimate effect on the marketability and functionality of credit union subordinated debt is unknown.

The restriction of investments by credit union insiders in subordinated debt is a prudent restriction.

The safe harbor provision for interest payments contained in Section 10. 702.410 is reasonable and the clarity is beneficial for investors.

No credit union should pay filing fees as a result of any proposed changes to the rules governing subordinated debt.

The proposed repudiation safe harbor is reasonable and supports a well-functioning market.

We appreciate the opportunity to share these comments and look forward to an engaged dialogue with both NCUA and our colleagues throughout the industry.

Sincerely,

Eben Sheaffer

Chief Financial Officer / Chief Investment Officer