



December 5, 2022

Melane Conyers-Ausbrooks  
Secretary of the Board  
National Credit Union Administration  
1775 Duke Street  
Alexandria, Virginia 22314-3428

RE: Proposed Rule on Subordinated Debt (RIN 3133-AF43; Docket NCUA-2022-0138)

Dear Board Members:

Thank you for the opportunity to submit comments on the National Credit Union Administration's (NCUA) proposed updates to the subordinated debt rule. Although a small step in the right direction, the proposed rule falls far short of the significant changes needed to undo the harms the current subordinated debt rule has caused to small and mid-sized Low-Income Designated (LICU), Minority Depository Institution (MDI), and Community Development Financial Institution (CDFI) credit unions.

The current rule effectively cuts off these smaller, financial inclusion focused credit unions from accessing subordinated debt and using it to support their growth by exponentially increasing the cost of compliance and by requiring a process that is far too complex for smaller institutions and their boards to manage. The NCUA should exempt credit unions with less than \$500 million in assets—those under the NCUA's "complex" credit union threshold—seeking to enter into bilateral loan agreements, like those permitted under the previous secondary capital rule, from the subordinated debt rule. This approach would be consistent with the NCUA's practice of adjusting its supervision and oversight based on risk. In addition to exempting smaller credit unions from the rule, the NCUA should also update the rule to remove unduly burdensome requirements that do not meaningfully contribute to the safety and soundness of credit unions using subordinated debt to fill the role previously played by secondary capital.

#### **About Inclusiv**

Inclusiv is the national network of community development credit unions committed to promoting financial inclusion and equity through credit unions. The Inclusiv network represents more than 495 credit unions serving more than 18 million people in predominantly low-income urban, rural, and reservation-based communities across 47 states, Washington DC, the U.S. Virgin Islands and Puerto Rico. Inclusiv channels capital to and the builds capacity of these institutions that are dedicated to serving low-income people and redlined and disinvested communities. We design, implement, and track numerous initiatives aimed at enabling credit union members to use their credit unions to build wealth and assets.

Inclusiv began making secondary capital loans in 1998, and has deployed more than \$120 million directly into community development credit unions. Moreover, Inclusiv has led educational and advocacy efforts to grow investment from the public and private sectors to enable credit unions serving low-income and communities of color to grow and serve their communities. In the aftermath of the 2008 financial recession, Inclusiv led the effort to ensure that credit unions were included in the CDCI program under ARRA. Our analysis of that program

showed that capital deployed in CDCUs during the five-year period was leveraged and deployed 60 times over in new lending among CDCU recipients. All secondary capital investments are made as loans with clear terms, interest rates and maturity dates explicitly stated in loan agreements and closing documents.

### **Background on Secondary Capital**

In 1996, the NCUA Board finalized § 701.34 of the NCUA's regulations to permit low-income credit unions to borrow secondary capital to build regulatory capital to: (1) support greater lending and financial services in the low-income communities; and (2) absorb losses to prevent the low-income designated credit unions from failing.

In 1998, as part of the Credit Union Membership Access Act, Congress amended the definition of "net worth" in the Federal Credit Union Act (the FCU Act) to include secondary capital issued by a LICU, provided the secondary capital was uninsured and subordinate to all claims against the LICU, including the claims of creditors, shareholders, and the National Credit Union Share Insurance Fund (Share Insurance Fund). While this legislation could set a limit on the maximum term or maturities for this secondary capital, Congress did not do so. This change supported the growth of many LICUs and MDI credit unions that did not previously have meaningful opportunities to increase their net worth and expand their services and lending.

In 2006, the NCUA Board further amended § 701.34 to require regulatory approval of a low-income credit union's secondary capital plan before the credit union could accept the secondary capital. This tightening of the review and approval process did not restrict the length or term of secondary capital loans.

In December 2020, NCUA passed a new subordinated debt rule enabling large, complex credit unions to raise subordinated debt to count toward new risk-based capital standards that apply only to credit unions with more than \$500 million in assets. The Agency swept secondary capital into that rule despite substantial differences in the nature and intent of these two instruments. This new rule was hastily considered and approved over many concerns raised in comments from industry leaders, including Inclusiv, on the ANPR. These concerns include the NCUA's treatment of secondary capital, a debt instrument, as equity; the rule treating simple, bilateral credit agreements the same way as complex subordinated debt packaging from multiple investors; and limiting the term of subordinated debt to 20 years, which prevents credit unions from matching long-term assets and liabilities and limits secondary capital's effectiveness in supporting affordable mortgage lending.

The proposed updates to the subordinated debt rule will effectively address several discrete issues with the December 2020 version of the rule, including allowing Emergency Capital Investment Program investments to be considered Regulatory Capital for the full 30-year term; removing the firm 20-year cap on the maturity of subordinated debt notes, and clarifying the legal licensing and statement of cash flow requirements. None of these improvements, though necessary and helpful, address the major structural issues with the rule discussed in this letter.

In issuing the current subordinated debt rule, the NCUA has significantly undermined Congress' intent to allow Low-Income Designated credit unions to include secondary capital in their net worth in its efforts to allow non-LICUs to issue subordinated debt—a practice Congress never intended. Compliance with the rule is prohibitively expensive and unduly burdensome for small credit unions and it is a mistake to require that institutions seeking to enter into simple, bilateral loan agreements comply with rules that were designed for complex securities. Indeed, these simple transactions with accredited investors are not subject to securities disclosures under the

standard exceptions afforded by Congress under 3(a)(5) of the Securities Act of 1933. Despite this clear exemption, the NCUA has decided to require unnecessary securities disclosures, which are expensive, complex, and effectively bar less-resourced credit unions from borrowing subordinated debt.

### **The Subordinated Debt Rule Has a Disparate Impact on MDI Credit Unions**

MDI credit unions are led by and serve people and communities of color and work effectively in historically redlined and disinvested neighborhoods. They currently comprise about 10% of all federally-insured credit unions and 81% have assets of less than \$100 million.<sup>1</sup> According to Chairman Harper, “many MDI credit unions provided the only source of insured financial services in their communities.”<sup>2</sup> Unfortunately, the number of MDI credit unions has dropped precipitously in recent years: there were 805 MDI credit unions in 2013, compared to 509 MDI credit unions in 2021, a decline of more than 35%.<sup>3</sup>

MDI credit unions have long relied on secondary capital to support their growth and serve more members and the NCUA should not create and enforce rules that unfairly restrict MDI credit unions’ ability to grow. Given the small average size of MDI credit unions (about \$116 million in assets<sup>4</sup>), it was inevitable that the NCUA’s complex subordinated debt rule that requires costly legal counsel, securities issuance expertise, and a 5-month planning and approval process would have a disparate impact on these critically-needed but under-resourced institutions. Indeed, Inclusiv’s experience as a secondary capital provider bears this out. Inclusiv raised \$20 million for a racial equity focused secondary capital fund to support MDIs and has not been able to deploy a single dollar of those funds since the NCUA’s subordinated debt rule went into effect, despite making \$5 million in loans in the year prior to the rule change and engaging in vigorous outreach and providing technical assistance to interested credit unions since the rule change. As soon as small credit unions understand the NCUA’s approval process, they make the rational decision that subordinated debt is not meant for them. Although some MDI credit unions received Emergency Capital Investment Programs investments, less than 9% of Inclusiv’s MDI members received such investments and will need to access subordinated debt to support their future growth.

The NCUA’s decision to effectively bar small credit unions, among which MDI credit unions are disproportionately represented, from accessing subordinated debt will have a profound effect on the future growth of MDI credit unions and will harm the people and communities they serve.

The subordinated debt rule will also block MDIs from benefitting from impact investments in the credit union sector. For example, the newly announced Economic Opportunity Coalition (EOC) will align public and private investment to “address economic disparities and accelerate economic opportunities in communities of color and other underserved communities.”<sup>5</sup> MDI credit unions are already doing exactly this work in their communities and EOC investments in the form of subordinated debt could support their growth. Under the current rule,

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<sup>1</sup> <https://www.ncua.gov/support-services/credit-union-resources-expansion/resources/minority-depository-institution-preservation/mdi>

<sup>2</sup> <https://www.ncua.gov/files/publications/2021-mdi-congressional-report.pdf>

<sup>3</sup> <https://www.ncua.gov/files/publications/OMWI-MDI-Congressional-Report20131024.pdf>

<sup>4</sup> *ibid*

<sup>5</sup> <https://www.whitehouse.gov/briefing-room/statements-releases/2022/07/28/fact-sheet-vice-president-announces-new-private-and-public-sector-efforts-to-align-tens-of-billions-in-investments-in-underserved-communities/>

however, it is extremely likely that MDIs will be limited to accepting deposits, which do not have the same potential to catalyze credit union growth and economic opportunity in the communities credit unions serve.

### **Amending the Subordinated Debt Rule Could Support Small Credit Unions in Managing Climate Risk**

The recently passed Inflation Reduction Act (IRA) includes approximately \$374 billion in cost saving incentives for clean energy, energy efficiency and climate resilience over the next 10 years. Many of these incentives are designed to target low- and moderate-income households to help reduce their energy costs, increase climate resilience in their communities and pave the way for them to access the clean energy transition by helping to reduce the cost of purchasing new or used electric vehicles, energy efficiency home improvements and home solar energy systems. In addition, the IRA's \$27 billion investment in green lending through Greenhouse Gas Reduction Fund can support deeply needed green projects and provide equitable access to the clean energy transition for low- and moderate-income communities and communities of color.

Credit unions are eligible "indirect recipients" of Greenhouse Gas Reduction Fund investments, which may take the form of grants, subordinated debt, or non-member deposits. Green lending, especially when supported by federal resources from the Greenhouse Gas Reduction Fund, can help credit unions diversify their lending portfolios and manage climate risk—a key priority identified by the NCUA. It is critical that the NCUA address the barriers to small credit unions taking on subordinated debt before Greenhouse Gas Reduction Fund funding is allocated in 2023 to ensure that credit unions can participate meaningfully in this program that has the potential to support credit union financial sustainability and climate resilience for both credit unions and the communities they serve.

### **Although Wholly Insufficient, the Proposed Changes Are a Step in the Right Direction**

The NCUA has proposed important changes to the subordinated debt rule that will resolve a few of the outstanding issues with the previous version of the rule.

#### *Regulatory Capital Treatment for Grandfathered Secondary Capital (GSC)*

The NCUA's proposal to allow GSC to receive Regulatory Capital treatment for a period of 30 years to allow credit unions to treat their Emergency Capital Investment Program (ECIP) investments as Regulatory Capital for the full term of the investments is a critically needed adjustment to the rule. This change will ensure that credit unions participating in ECIP can take full advantage of the investment, particularly to support home mortgage programs, and will ease concerns about asset/liability management planning.

#### *Maximum Maturity of Notes*

The NCUA's decision to remove the maximum maturity limit of 20 years is an important step in the right direction as the 20-year limit was inconsistent with other banking agencies' treatment of subordinated debt issuance, disadvantaging credit unions, and did not have a strong legal basis. Indeed, the proposed provision that credit unions will need to provide an analysis or qualified legal opinion to be permitted to issue subordinated debt with a term of more than 20 years is still unduly onerous compared to the requirements of the banking regulators. Thirty-year debt instruments are common in the market and a 30-year term alone would not indicate that an instrument is equity. The SEC, for example, has found that an instrument with a 50-

year term was not an equity security and the IRS has made similar determinations.<sup>6</sup> The OCC has explicitly stated that instruments with a perpetual term may qualify as debt.<sup>7</sup> Indeed, there is no set term at which debt becomes equity and the determination of whether an instrument is debt or equity is generally a balancing test of several factors, which include term, though term is often not a primary factor.

#### *Qualified Counsel*

Removing the phrase “in the relevant jurisdiction(s)” from the definition of “Qualified Counsel” is helpful in clarifying that the rule does not require that attorney(s) are licensed to practice in every jurisdiction that may be relevant to the issuance. However, the rule’s overall complexity and inconsistency with other prudential regulators’ subordinated debt rules means that there is a limited pool of attorneys qualified to assist credit unions with subordinated debt issuance, and these attorneys are both too expensive for many LICUs and often geographically inaccessible for credit unions outside of major financial centers.

#### *Statement of Cash Flows*

The NCUA’s proposal to no longer require a statement of cash flow but instead accept cash flow projections is a helpful clarification that will support credit unions in accessing subordinated debt.

#### *Filing Requirements and Inspection of Documents*

The NCUA’s updated requirement that credit unions submit documents to the Appropriate Supervision Office rather than via the NCUA’s website may reduce confusion for credit unions, but will also continue the practice of disparate treatment of similarly situated credit unions. Regional offices can vary greatly in their timeliness of review and amenability to the financial instrument itself. A centralized analysis would increase fairness in the approval process.

#### **Additional Changes Are Needed to Support Access to Subordinated Debt**

If the NCUA chooses not to exempt credit unions with less than \$500 million in assets from the subordinated debt rule, the agency should begin another rulemaking to address additional outstanding issues with the rule. The NCUA should address the following problems with the current rule.

#### *Credit Union Subordinated Debt Is Legally Exempt from Securities Disclosures*

The NCUA’s decision to treat credit union subordinated debt as non-exempt securities is unduly burdensome to credit unions entering into simple, bilateral loan agreements. The current rule applies disclosure requirements to credit union issuances of subordinated debt that mimic the requirements of the federal securities laws, even if the credit unions’ issuances to accredited investors 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. NCUA must allow low-income designated credit unions offering smaller, single investor issuances to rely on the standard

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<sup>6</sup> SEC No-Action Ltr., National Rural Utilities Coop. Fin. Corp. (Feb. 7, 1972)

<sup>7</sup> OCC Interpretive Letter No. 1115 (Apr. 3, 2009).

exceptions afforded to them by Congress under 3(a)(5) of the Securities Act of 1933, consistent with the Office of the Comptroller of the Currency's practice of allowing banks to rely on the 3(a)(5) exemption.

In addition to being unnecessary and out of step with other federal prudential regulators, the NCUA's securities disclosures requirement increases the cost of subordinated debt markedly. Comparing the closing fees Inklusiv charged credit unions for secondary capital before the rule change and the fees credit unions are being quoted by investment banks now shows that the cost of securing this capital has, for some credit unions, increased more than 25-fold.

#### *Discounting of Amount Treated as Regulatory Capital: Use Initial Aggregate Principal Amount, Not Outstanding Amount*

The updated rule's approach to calculating Regulatory Capital during the last 5 years of a subordinated debt loan term now mirrors the approach of the bank subordinated debt market, which is not an improvement compared to the prior secondary capital rule, and effectively shortens the term of loans as credit unions will be strongly incentivized to fully repay or refinance the loan with 5 years left in the term. This new approach harms credit unions, their lenders and the NCUA by increasing net worth volatility and transaction costs to credit unions.

The previous secondary capital rule reduced Regulatory Capital by 20% of the original loan balance each year, which let credit unions step down from 100% Regulatory Capital to 0% over the last 5 years of the loan, avoiding any shocks to the capital ratio of the borrower at maturity. Now, the rule reduces Regulatory Capital by 20% of the outstanding loan balance each year, accelerating the reduction of Regulatory Capital when credit unions prepay the balance of their loan that is no longer considered Regulatory Capital. This penalizes prepayment and incentivizes credit unions to refinance the loan or repay it in full when there are 5 years left in the loan term.

In the bank market, lenders structure subordinated debt around these incentives and notes typically carry fixed-to-floating rate terms, with the floating rate in effect in the last five years of the loan term. This further incentivizes refinancing, costing credit unions more in transaction fees and increasing net worth volatility for credit unions that do not refinance or repay early. The NCUA should update the rule to reduce Regulatory Capital based on the original loan balance and not the current loan balance.

#### *Prepayment Processes*

The NCUA has removed the criteria for "streamlined" prepayment approval that was previously incorporated in the National Supervisory Policy Manual. We urge NCUA to create written, publicly available, simple, reasonable, and objective prepayment approval criteria. Investors cannot make large, long-term investments without such information.

The NCUA's subordinated debt rule retained the provision that a credit union must receive prior approval, and creates a 45-day timeframe for the NCUA to approve the application. Although the 45-day approval timeframe is similar to the previous secondary capital rule, the Board eliminated the provision for automatic approval if a credit union is not notified of a decision by the Appropriate Supervision Office within 45 days. This leaves credit unions in limbo should their decision take longer than 45 days. Subordinated debt investors require certainty and consistency in the application of prepayment approval. NCUA must provide written guidance to its regional offices concerning the objective criteria upon which credit unions

will be evaluated for prepayment approval. The absence of such written criteria is a material barrier to subordinated debt investments.

*Allow Covenant Provisions*

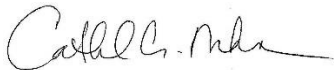
The ability of lenders to incorporate covenants into financing agreements is standard commercial practice and the NCUA's decision to not allow covenants in subordinated debt transactions limits lenders' willingness to lend.

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. 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.

If a lender and credit union agree that the credit union will make amortizing payments in the last 5 years of the loan term, the lender may not make those payments mandatory and may not even require the credit union to apply for prepayment approval from the NCUA. This will limit the amount lenders are willing to lend and the loan terms they will offer.

Thank you for the opportunity to comment. Inclusiv looks forward to engaging with the NCUA to resolve these issues and ensure the subordinated debt rule does not undermine LICUs, especially MDIs, from accessing subordinated debt to grow and better serve their communities. Please contact Alexis Iwanisziw, SVP Policy and Communications ([aiwanisziw@inclusiv.org](mailto:aiwanisziw@inclusiv.org)) with any questions about these comments.

Sincerely,



Cathie Mahon  
CEO/President, Inclusiv