July 2, 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 America’s credit unions, I am writing in support of the National Credit Union Administration’s (NCUA) notice of proposed rulemaking on subordinated debt (SD Proposal). We appreciate the lengthy comment period the NCUA provided to ensure the public and other interested parties had sufficient time to weigh in on this proposal. The Credit Union National Association (CUNA) represents America’s credit unions and their 115 million members.

CUNA supports the authority of credit unions to build additional capital, either from members or nonmembers, in a way that does not dilute their cooperative ownership and governance structure. This additional capital should be subordinate to credit unions’ share insurance funds, so credit unions have the financial base to offer member services and adjust to fluctuating economic conditions.¹

CUNA appreciates the NCUA’s work in the area of subordinated debt (SD). We understand the complexities such an undertaking entails and thank the agency for dedicating the time and resources necessary to pursue a rulemaking in this area. We have long supported credit unions’ ability to utilize supplemental capital (such as SD) as an important tool, allowing them to augment the only current source of capital they have, which is retained earnings.

1) **Background on Subordinated Debt Proposed Rule**

The SD Proposal would amend various parts of the NCUA’s regulations to permit low-income designated credit unions (LICUs), complex credit unions, and new credit unions\(^2\) to issue SD for purposes of regulatory capital treatment, including for purposes of complying with the NCUA’s new risk-based capital requirement.

Specifically, the NCUA’s new risk-based capital rule (RBC Rule) imposes a requirement on credit unions pursuant to the Federal Credit Union Act’s (FCUA) risk-based net worth mandate for complex credit unions.\(^3\) This requirement is part of the prompt corrective action (PCA) section of the FCUA, which was added to the FCUA by the Credit Union Membership Access Act of 1998. The PCA section established the net worth and capital requirements for credit unions. The PCA section defines five net worth categories for purposes of PCA:

- **Well Capitalized**: net worth ratio of not less than 7% and meets the applicable risk-based net worth requirement.
- **Adequately Capitalized**: net worth ratio of not less than 6% and meets the applicable risk-based net worth requirement.
- **Undercapitalized**: net worth ratio of less than 6% or fails the applicable risk-based net worth requirement.
- **Significantly Undercapitalized**: net worth ratio of less than 4%; or net worth ratio of less than 5% and fails to submit an acceptable net worth restoration plan or materially fails to implement a net worth restoration plan accepted by the NCUA.
- **Critically Undercapitalized**: net worth ratio of less than 2%.

The PCA section specifically defines “net worth” as retained earnings plus section 208 assistance. Additionally, for LICUs, net worth also includes secondary capital that is uninsured and subordinate to all other claims against the credit union.

However, the PCA section does not define the “risk-based net worth requirement.” Instead, the NCUA is directed to “design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.”\(^4\) That is, the PCA section delegates to the NCUA the authority to “design” the risk-based capital requirement, to account for any material risks a 6% net worth ratio (i.e., the net worth ratio for an adequately capitalized credit union) may not adequately protect against. The NCUA accomplished this through its RBC Rule, which the SD Proposal would amend. The amendment would permit credit unions to include SD in the numerator of the risk-based capital ratio. Thus, SD would count toward a credit union’s risk-based net worth.

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\(^2\) A “new credit union” is a federally insured credit union that has both been in operation for less than ten years and has no more than $10,000,000 in total assets.


In addition to authorizing the issuance of SD, the proposed rule contains a series of requirements pertaining to SD notes, disclosures and offering materials, and repayment (including prepayment). It also includes an application procedure for both the issuance and repayment of SD notes. In addition, the NCUA has proposed requirements related to the securities laws applicable to the offer, issuance, and sale of SD notes.

The SD Proposal also makes various additions and amendments to other parts and sections of the NCUA’s regulations. Specifically, the SD Proposal would include: a new section addressing limits on loans to other credit unions; a grandfathering of any secondary capital issued before the effective date of a final SD rule; an expansion of the borrowing rule to clarify that federal credit unions (FCU) can borrow from any source; revisions to the RBC Rule and the payout priorities in an involuntary liquidation to account for SD and grandfathered secondary capital; and cohering changes to Part 741 to account for other proposed changes that would apply to federally insured, state-chartered credit unions (FISCU).

We support the proposed rule and appreciate the agency’s work to develop this important tool for credit unions. As discussed below, we offer several suggestions to improve the rule to make it more appealing to credit unions and less operationally burdensome.

2) Authority to Issue Proposed Rulemaking

a. NCUA’s Stated Authority for FCUs to Issue Subordinated Debt

The NCUA states that the FCUA grants FCUs broad power to borrow, enter into contracts, and exercise incidental powers necessary to enable FCUs to effectively conduct their business.5

The NCUA points out that, other than its regulations regarding borrowed funds from natural persons, nothing in the FCUA “appears to impose any specific restrictions or limitations on the mechanisms FCUs may employ to borrow, through the use of specific limiting language, examples or illustrative transactions or situations, or otherwise.”6

Based in part on the FCUA’s silence, and FCUA section 1757(9)’s broad language allowing FCUs to borrow “from any source,” the NCUA concludes “that borrowings need not be limited to the types of arrangements typically entered into with banks, other credit unions, and other financial institutions—namely, loans, lines of credit, and similar arrangements.”7 And, coupled with the FCUA’s section 1757(1) power to contract, FCUs “have the power to enter into a variety of different arrangements with respect to borrowing.”8 Further, because there are no specific restrictions or limitations on FCU borrowing, “the ‘incidental powers’ granted to FCUs . . . give significant discretion to FCUs with respect to how borrowings are effected.”9

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6 Id. 13,985–13,986.
7 Id. 13,986.
8 Id.
9 Id.
b. NCUA’s Stated Authority for Subordinated Debt to Count Toward Risk-Based Capital

Relying on the PCA section and its risk-based net worth requirement for complex credit unions, the NCUA states it has broad discretion to design risk-based net worth standards.\textsuperscript{10} The NCUA correctly points out that “Congress did not restrict the types of instruments the Board may include in its calculation of risk-based net worth.”\textsuperscript{11}

The NCUA acknowledged, however, that it does not have the authority to alter the statutory net worth definition in FCUA section 1790d(o)(2).\textsuperscript{12} That definition currently only allows secondary capital issued by a LICU that is uninsured and subordinate to all other claims against the LICU to be included in the LICU’s net worth calculation. A LICU may include SD in its risk-based capital ratio and its net worth; a complex FCU that is not a LICU may include SD in its risk-based capital ratio; and a new credit union that is not a LICU may use SD to avail itself of various benefits.

c. NCUA Has Authority to: (i) Authorize FCUs to Issue Subordinated Debt and (ii) Include Subordinated Debt in Risk-Based Capital

Since any challenge to the NCUA’s authority would likely be brought under the Administrative Procedure Act (APA), this letter examines how a court is likely to review the SD rule under the APA. The APA provides that a reviewing court shall hold unlawful and set aside agency actions that are “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law,”\textsuperscript{13} or “in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.”\textsuperscript{14} A court will review the SD rule “in accordance with the familiar Chevron doctrine, a two-prong test for determining whether an agency ‘has stayed within the bounds of its statutory authority’ when issuing its action.”\textsuperscript{15}

i. NCUA Has the Authority to Authorize FCUs That Are Non-LICUs to Issue Subordinated Debt

This section addresses arguments that certain FCUA provisions prohibit the NCUA from providing FCUs with the authority to issue SD. These arguments are primarily directed at step one of the Chevron analysis, namely that Congress, through the FCUA, has unambiguously foreclosed any further action by the NCUA to authorize FCUs from issuing SD.\textsuperscript{16} The clarity of congressional intent on SD is discussed in the Chevron step-one analysis below. We conclude that the FCUA explicitly grants FCUs the power to borrow, including through SD. At worst, however, the FCUA is ambiguous on the

\textsuperscript{10} Id.
\textsuperscript{11} Id.
\textsuperscript{12} Id.
\textsuperscript{13} 5 U.S.C. § 706(2)(A).
\textsuperscript{14} Id. § 706(2)(C).
\textsuperscript{15} Am. Bankers Ass’n v. NCUA, 934 F.3d 649, 662 (D.C. Cir. 2019).
question, and the NCUA’s reasonable interpretation will be afforded deference under step two of *Chevron*.

**Chevron Step One.** To complete *Chevron’s* step-one analysis, a court must first identify the applicable statutory provisions to determine whether Congress has directly spoken to the NCUA’s authority to authorize FCUs (both LICUs and non-LICUs) to issue SD. The NCUA primarily relies on 12 U.S.C. § 1757(9), which grants FCUs the power to borrow in accordance with the NCUA’s rules and regulations. That provision reads,

A Federal credit union shall have succession in its corporate name during its existence and shall have power—

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(9) to borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III, 50% of its paid-in and unimpaired capital and surplus: Provided, That any Federal credit union may discount with or sell to any Federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital . . . .

First, subsection (9) evidences Congress’s clear grant of power to FCUs to borrow money—from any source—not to exceed 50% of the FCU’s paid-in and unimpaired capital and surplus. Second, while Congress granted statutory borrowing power to FCUs, it likewise circumscribed that power by giving the NCUA authority to adopt “rules and regulations” otherwise consistent with the statute. As such, if the issuance of SD by FCUs is properly considered a transaction to “borrow,” then subsection (9) not only sanctions the activity, but it also conveys the NCUA authority to regulate it consistent with the statute.

Therefore, we believe the NCUA correctly identifies 12 U.S.C. § 1757(9) as the source of its authority to authorize the issuance of SD by FCUs. That provision grants FCUs the power to “borrow” from any source, and delegates to the NCUA authority to adopt rules and regulations governing such borrowing.

**Chevron Step Two.** Once the court is satisfied that Congress did not intend to prohibit FCUs from issuing SD, the court then “determine[s] ‘whether the agency’s answer’ to the question ‘is based on a permissible construction of the statute.’” As previously noted, we believe the FCUA grants FCUs (including non-LICUs) the power to borrow, which extends to SD. Nonetheless, even if the FCUA is ambiguous on whether complex FCUs that are non-LICUs may issue SD, the NCUA’s interpretation of section 1757(9) of the FCUA to authorize complex FCUs to “borrow” through issuance of SD is a permissible reading of the statute.

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17 *See id.* at 842–843 & n.9.
19 *Am. Bankers Ass’n*, 934 F.3d at 662.
First, it cannot be denied that the FCUA contemplates FCUs’ use of SD. Indeed, the FCUA’s PCA section states that LICUs’ secondary capital accounts—which must be uninsured and subordinate to all other claims—may be included in the numerator of the LICU’s net worth ratio. While the reference to secondary capital, which includes SD, may not grant LICUs the power to issue SD, it is strong evidence that the FCUA permits LICUs to issue SD. Otherwise the inclusion of secondary capital and SD in the PCA net worth ratio would be—at best—superfluous.20 Cross-referencing the powers that Congress did convey to FCUs,21 the most obvious source of LICUs’ power to issue SD is subsection (9) on borrowing. And, unlike other subsections in section 1757, subsection (9) does not limit FCUs’ power to borrow based on the type of FCU. Compare section 1757(9) (stating FCUs may “borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source”), with section 1757(6) (distinguishing powers of LICUs from other FCUs for purposes of receiving payments representing equity). Thus, the NCUA’s interpretation harmonizes different provisions of the FCUA, which provides support for the reasonableness of its interpretation.

Second, the NCUA’s characterization of SD as a debt security consistent with “borrowing” is in accord with U.S. Generally Accepted Accounting Principles (GAAP). The Financial Accounting Standards Board (FASB) requires “significant categories of borrowings shall be presented as separate line items in the liability section of the balance sheet,” and states the credit union may “present debt based on the debt’s priority (that is, senior or subordinated).”22 This is consistent with the NCUA Examiner’s Guide, which provides guidance to credit union examiners.23

The accounting industry’s and NCUA’s consistent understanding of SD as a debt instrument properly categorized as a liability on the balance sheet is further evidence of the reasonableness of the NCUA’s interpretation of borrowing.24

We believe a court would conclude that the FCUA grants FCUs the power to borrow, including through SD. If, however, a court finds that the FCUA is ambiguous on the question, the court would defer to the NCUA’s reasonable interpretation under step two of Chevron.

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20 See Antonin Scalia & Bryan A. Garner, Reading Law: The Interpretation of Legal Texts 176 (2012) (“If possible, every word and every provision is to be given effect. . . . None should be ignored.”).
22 FASB, ASC 942-470-45-1 (Borrowings).
23 See NCUA Examiner’s Guide 16-6 (June 2002).
24 As additional support, Black’s Law Dictionary defines the verb to “borrow” as “1. To take something for temporary use. 2. To receive money with the understanding or agreement that it must be repaid,” Borrow, Black’s Law Dictionary (11th ed. 2019); and it defines “subordinate debt” as “[a] debt that is junior or inferior to other types or classes of debt,” which “may be unsecured or have low-priority claim,” Subordinate Debt, Black’s Law Dictionary (11th ed. 2019).
ii. NCUA Has the Authority to Include Subordinated Debt in Risk-Based Capital for Complex Credit Unions

Chevron Step One. The FCUA requires the NCUA to “design the risk-based net worth requirement” for prompt corrective action of undercapitalize, complex credit unions.\(^25\) Congress’s express delegation of definitional power to the NCUA to design a risk-based capital requirement for the FCUA’s PCA section is unmistakable and gives the NCUA broad discretion in crafting the requirement.\(^26\)

Specifically, 12 U.S.C. § 1790d(d) instructs that the prompt-corrective-action regulations required by subsection (b)(1) “shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the [NCUA] based on the portfolios of assets and liabilities of credit unions.” It follows by empowering the NCUA to “design the risk-based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.” In turn, the NCUA-designed risk-based capital requirement is incorporated into the PCA section’s net worth categories for well capitalized, adequately capitalized, and undercapitalized credit unions. For example, for a complex credit union to be considered “well capitalized,” it must have a net worth ratio of not less than 7\% and satisfy the risk-based capital requirement. Likewise, for a complex credit union to be considered “adequately capitalized,” it must have a net worth ratio of not less than 6\% and satisfy the NCUA’s risk-based capital requirement.\(^27\)

Although the PCA section specifically defines the net worth ratio, the statute leaves it to the NCUA to define the separately required risk-based capital requirement for complex credit unions.\(^28\) The express grant of definitional authority should easily satisfy step one of Chevron.\(^29\)

Several banking groups commented in response to the NCUA’s 2017 advance notice of proposed rulemaking on supplemental capital that section 1790d(d)’s use of the term “net worth” for the “risk-based net worth requirement” implicitly imported the PCA section’s net worth definition into the risk-based capital requirement. That definition limits net worth to retained earnings, section-208 assistance, and, for LICUs, secondary capital accounts that are uninsured and subordinate to all other claims. The credit union’s net worth is then used to compute a net worth ratio by dividing net worth by the credit union’s total assets. Thus, these commentators claim that, because both sections 1790d(o)(3) and 1790d(d) reference the term net worth, the numerator for the net worth ratio and the risk-based capital ratio must the same. And, by allowing complex credit unions to count SD in the numerator of the risk-based capital ratio, the NCUA is impermissibly expanding the statutory meaning of net worth.

\(^{26}\) See Am. Bankers Ass’n, 934 F.3d at 663.
\(^{27}\) 12 U.S.C. § 1790d(c)(1).
\(^{28}\) See id. § 1790d(d)(2).
\(^{29}\) See Am. Bankers Ass’n, 934 F.3d at 663 (“To hold otherwise at the first Chevron step would ‘undermine’ the ability of Congress to delegate definitional power.”).
This argument is based on the flawed premise that Congress’s reference to net worth in the “risk-based net worth requirement for complex credit unions” limits the NCUA authority to design the risk-based capital requirement. But the D.C. Circuit, in a case involving the NCUA’s definitional authority, recently reminded that “[a]n express delegation of definitional power ‘necessarily suggests that Congress did not intend the [terms] to be applied in [their] plain meaning sense,’ that they are not ‘self-defining,’ and that the agency ‘enjoy[s] broad discretion’ in how to define them.”30 That is, “Congress through explicit language ‘has directly spoken to the precise question’ of whether the identified terms must carry certain meanings. The answer is no.”31 Accordingly, that Congress used “net worth” to describe the risk-based capital requirement for complex credit unions does not undermine or place definitional limits on the NCUA’s delegated authority to design a “risk-based net worth requirement” for complex credit unions to account for material risks that the net worth ratio for an adequately capitalized credit union does not. To be sure, risk-based adjustments are made both to the numerator and the denominator (risk-weighted assets) for the risk-based ratio, and Congress did not restrict the types of instruments that may be included in the calculation of risk-based net worth, except that such calculation must take account of material risks that a 6% net worth ratio alone may not protect against. Indeed, without the adjustments, the risk-based ratio would mirror the net worth ratio.

To conclude, in terms of Chevron step one, we believe the FCUA conveys broad authority to the NCUA to design and define the risk-based capital requirement for complex credit unions required in section 1790d(d)(2).

*Chevron Step Two.* The NCUA’s proposal to revise the RBC Rule to include SD (and grandfathered secondary capital) in the numerator of the risk-based capital ratio is neither arbitrary, capricious, nor manifestly contrary to the FCUA. The RBC Rule currently includes secondary capital accounts in the risked-based capital numerator.33 The SD Proposal would amend this section of the RBC Rule to clarify that SD also may be included in the numerator of the risk-based capital ratio.34 The reason for this amendment is “the [NCUA] believes Subordinated Debt will be an additional tool that accounts for material risks faced by credit unions against which the Net Worth Ratio alone may not protect.”35

To that, the statutory objective of prompt corrective action is “to resolve the problems of insured credit unions at the least possible long-term loss to the [National Credit Union Share Insurance Fund (NCUSIF)].” And the PCA section instructs the NCUA to “carry out the purpose of this section by taking prompt corrective action to resolve the problems of

30 See id. at 663 (citations omitted).
31 Id.; see also Buongiorno v. Sullivan, 912 F.2d 504, 509 (D.C. Cir. 1990) (Thomas, J.) (“When Congress expressly delegates the authority to fill a gap in a statute, Congress speaks, in effect, directly, and says, succinctly, that it wants the agency to annotate its words.”).
32 See 12 C.F.R. § 702.104.
33 See id. § 702.104(b)(iv)(vii).
35 Id. 13,986.
insured credit unions.” The PCA scheme is supported by five net worth categories, which assist the NCUA in identifying credit unions that are not sufficiently capitalized and most in need of prompt corrective action. Since its inception in 2001, the risk-based capital requirement has included secondary capital issued by LICUs. This is so, because (1) the FCUA in fact identifies qualifying secondary capital as part of the LICU’s net worth; and (2) the capital is uninsured and subordinate to all other claims (including those of shareholders, creditors, and the NCUSIF), has a minimum maturity, and the funds are available to cover operating losses that exceed net available reserves. As the NCUA reported to Congress, “[s]econdary capital issued under NCUA’s rules provides protection to the [NCUSIF] because it includes maturity requirements and is subordinate to all other claims of creditor, shareholders, and the [NCUSIF]. Secondary capital is comparable to subordinated debt, which the other banking agencies include as Tier 2 regulatory capital when it meets certain requirements.”

The same applies for the SD contemplated by the SD Proposal. Among other things, allowable SD would:

- Have a maturity of at least five years and not more than 20 years from issuance;
- Be subordinate to all other claims in liquidation and have the same payout priority as all other outstanding SD and grandfathered secondary capital;
- Be unsecured; and
- Be available each fiscal year to cover any deficit in retained earnings on a pro rata basis among all holders of the SD and grandfathered secondary capital.

Accordingly, like secondary capital for LICUs, SD issued under a SD rule would be a critical tool for complex credit unions to use to shore up their regulatory capital positions and protect against long-term losses to the NCUSIF. In that way, the lack of a statutory prescription for the risk-based capital requirement in 12 U.S.C. § 1790d(d)(2), gives the NCUA the flexibility to include within the standard items that would not meet the statutory definition of “net worth” but otherwise serve as capital in protecting the NCUSIF from losses when a credit union fails. Because the NCUA’s proposal is consistent with the PCA section’s statutory directive, and because it mirrors the risk-based capital treatment of secondary capital issued by LICUs, the NCUA’s proposed amendment to its RBC Rule to include SD in the numerator of the risk-based capital ratio satisfies step two of Chevron.

We believe a court would conclude the FCUA grants the NCUA broad authority to design the risk-based capital requirement for complex credit unions, and that the NCUA’s inclusion of SD in the numerator of the risk-based capital ratio should be given controlling weight under step two of Chevron.

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37 Id. § 1790d(o)(2)(C).
38 12 C.F.R. § 701.34(b)(4)–(7).
3) Benefits of Subordinated Debt for Credit Unions

CUNA has advocated for access to alternative forms of capital for many years—redoubling efforts in the wake of the 2008 Financial Crisis and Great Recession. As discussed below, the Financial Crisis demonstrated the need for and showed how credit unions would use alternative capital; there are many reasons for the NCUA to move forward with this rule. However, we do not need to complicate the argument with a litany of reasons and uses of alternative capital. The reason to move forward with a SD rule is as simple as the fact that the FCUA gives the NCUA Board authority to authorize this rule and credit unions have a need, as do all financial institutions, for alternative forms of capital. We trust that the NCUA knows the contours of their authority under the FCUA well, which has been demonstrated by a recent string of court victories against banking trade associations trying to limit or invalidate recent member business lending and field of membership rules.40

Our members have mentioned the importance of alternative capital as another source of capital for various liquidity needs, giving credit unions flexibility for their day to day operations as they grow and become more sophisticated. Regardless of how a credit union utilizes alternative capital, our members have consistently emphasized that a chief lesson from the Financial Crisis is that capital is king. While credit unions as a whole remain well capitalized, credit unions are the only financial institutions with no ability to raise capital other than through retained earnings. However, the SD Proposal would go a long way toward allowing credit unions to raise additional capital and thereby minimize any risk to the NCUSIF.

The Financial Crisis saw several credit unions approach (or exceed) the PCA. At the beginning of Great Recession, aggregate credit union net worth stood at nearly 11.5% but fell to 9.8% by year-end 2009—a massive two-year, 1.6 percentage point decline that arose due to the combination of fast asset growth and a steep decline in earnings.

In the ensuing years—as the economy recovered—the aggregate credit union net worth ratio increased by only two-tenths of a percentage point per year in 2010, 2011, and 2012 (Figure 1).

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The movement-wide net worth ratio did not reach pre-Great Recession levels until 2019, a full decade after the recession ended.

In 2007, the credit union aggregate net worth ratio stood over one percentage point higher than the banking industry equity capital ratio. But at the end of 2012, the credit union ratio was one percentage point lower than the banking industry average. Bank access to equity markets was a distinct advantage.

Many individual credit unions reflected great stress. At year-end 2007 (the start of the Great Recession), 90% of U.S. credit unions were “very well” capitalized (CUNA’s term) with PCA net worth of 9% or greater (i.e., 7% “well” plus a two-percentage point buffer). At the end of 2012, three-and-one-half years after the economic recovery began, only 75% of credit unions were “very well” capitalized.

Rebuilding capital positions took time because the only option credit unions had to build capital was retained earnings, and earnings were depressed well after the recession ended. In fact, return on assets (ROA) did not reach pre-recession levels until 2012 (Figure 2).

Indeed, at the end of 2012, CUNA estimated that roughly 3,000 credit unions were “in need” of capital reform—including roughly 300 credit unions (representing 4% of all credit unions) that reported less than 7% net worth; nearly 1,500 credit unions (representing 21% of all credit unions) that reported between 7% and 9% net worth (i.e., a “buffer” over well of less than 2 percentage points; and as well as over 1,100 credit unions (representing 16% of all credit unions) that then had between 9% and 12% net worth but had seen their ratio decline by at least two percentage points since the start of the Great Recession.

Against this backdrop, credit union leadership demanded change. CUNA’s 2013 Credit Union Political Action Survey found that 84% of credit union CEOs agreed that “credit unions need flexibility to raise alternative/supplemental capital.”

But of course, little was done. And history is now repeating itself.
Just three short weeks ago, CUNA published its April Monthly Credit Union Estimates (MCUE) report. The MCUE provided the industry with a comprehensive look at impacts on U.S. credit unions during the first full month of the COVID-19 crisis.

Those effects have clearly been significant—and reflect trends and stresses that were prevalent during the Great Recession. They include challenges wrought by immense fiscal and monetary policy responses. Specifically, the data shows massive growth in credit union savings balances—due mostly to a flood of government stimulus deposits that greatly magnified normal seasonal savings inflows.

**Overall, CUNA estimates credit union savings balances grew 4.7% in April, an astonishing 56% annualized pace and the largest one-month increase in the 30+ years that CUNA has collected MCUE data.** Savings growth registered an (unannualized) 7.0% during the first four months of the year and 13.8% over the past 12 months.

While savings balances ballooned, anxiety related to the fast-spreading pandemic and a shocking wave of over 30 million job losses had most credit union members hunkered down. Beyond stockpiling necessities, consumers were generally reluctant to spend or borrow: overall, credit union loan balances were up only 0.1% in the month (an annualized pace of just 1.2%).

Loans increased 1.0% during the first four months of the year and 6.8% over the year ending April 2020. Loan balances declined across all but two portfolio segments in April.

Fast savings growth and weak loan growth pushed the credit union movement’s loan-to-share ratio down from 84.4% at the start of the year to a three-year low of 78.1%. No four-month period in MCUE’s 30-year history reflects a decline as severe as this 6.3 percentage point slide. Of course, declining loan-to-share ratios are typically associated with falling net interest margins and weaker bottom-line results.

Dollar delinquency as a percent of loans increased modestly—from 0.59% in April 2019 to 0.69% in April 2020. However, total dollar delinquencies increased by 10% in April and by 23% compared to year-ago levels. Loan losses are expected to increase perhaps as early in October 2020 (reflecting a decline in government support for the unemployed at the end of July).

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41 MCUE results are reported to describe general trends, challenges and opportunities. They are reported as movement-wide averages, which often hide substantial variation in results by asset size, strategic orientation, geographic area of operation, and field of membership among other factors. MCUE data is derived from a monthly sample of several hundred credit unions with results asset-weighted back to the industrywide distribution. CUNA MCUE, available at https://www.cuna.org/mcue.

42 CUNA’s June Economic and Credit Union forecast (available at https://www.cuna.org/economics) calls for credit union earnings (net income as a percent of average assets or ROA) to fall from 0.93% in 2019 to only 0.40% in 2020 and 0.19% in 2021—in part reflecting this trend of fast growing deposits deployed in low-yielding, short-term investments. But also reflecting a fall-off in non-sufficient funds (NSF) income (due to fewer purchases and more fee waivers) and a decline in interchange income (again, reflecting a lower volume of consumer purchases).
The bottom line: Fast asset growth and more obvious earnings pressures combined to push the aggregate credit union capital-to-asset ratio down from 11.2% at the start of 2020 to 10.7% at the end of April 2020. That 0.5% decline, in just four months, is the most severe since the Great Recession.

At the moment, aggregate credit union capitalization levels are substantially higher than the 7.0% level seen as “well capitalized” by the NCUA. And credit unions remain generally well-positioned to continue to serve members in the downturn.

However, looking forward, it is clear that many credit unions will be forced to put the brakes on growth through a variety of counterproductive maneuvers. All else equal, if individual credit unions are each assumed to experience the 14% asset growth reflected in the CUNA’s MCUE national norm, nearly 850 credit unions (about half LICU and half non-LICU) will fall below “very well” capitalized (i.e., below 9% net worth-to-assets) by the end of 2020. Further strong asset growth in 2021 will increase those numbers, perhaps substantially.

To avoid this fate, many credit unions will contemplate reducing dividend rates, eliminating dividend advantages for large deposits, eliminating short term certificates for new members, halting all non-loan related marketing efforts, and asking large depositors to take funds elsewhere. None of this is good for members. Some (if not many) credit unions will once again be prevented from capitalizing on timely strategic growth opportunities.

CUNA urges the NCUA to seize the opportunity to give credit unions the tools they need to help average consumers avoid this fate.

4) Proposed Rulemaking

a) Securities Law Issues

Under the SD Proposal, any SD note would be deemed a “security” for purposes of federal and state securities laws. In reaching this conclusion, the NCUA relies on several sources, such as the Securities Act of 1933 (Securities Act) and the U.S. Supreme Court, both of which broadly define the term, as well as interpretations of the term by the Securities and Exchange Commission (SEC).43

While we do not necessarily disagree with the NCUA’s conclusion that any SD note would be deemed a “security” for purposes of federal and state securities laws, we do ask the agency to further analyze this determination. The NCUA’s conclusion that all SD notes would be “securities” is critical, as it provides the basis for many of the procedural requirements included in the proposed rule. Therefore, the agency should ensure whether it is appropriate for all SD notes to be considered “securities.” Some have argued that the characteristics of current secondary capital offered by LICUs are such to not lend

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themselves to “securities,” as that term has traditionally been defined, including in the proposed rule.

Section 5(a) of the Securities Act requires any offers and sales of securities to be registered with the SEC, unless an exemption applies. According to the NCUA, a credit union that issues SD (Issuing Credit Union) will be able to rely on one of the following exemptions and therefore not be required to register an offering with the SEC under the Securities Act:

- **Section 3(a) of the Securities Act** provides an exemption for securities issued “by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.” The NCUA anticipates that nearly all Issuing Credit Unions would rely on the Section 3(a) exemption from the registration requirements in the Securities Act.

- **Rule 506 under Regulation D**, promulgated under Section 4(a)(2) of the Securities Act, provides an exemption for offerings that are either (i) not made via any means of general solicitation or advertisement and where the number of purchasers who are not “accredited investors” is limited to no more than 35, or (ii) made via general solicitation or advertisement but where all purchasers are “accredited investors.” This is referred to as the “private placement” exemption.

While the NCUA anticipates Issuing Credit Unions will be exempt from the Section 5(a) registration requirements, the proposal includes a regulatory framework for the offer, issuance, and sale of SD notes. This framework is independent of any available exemptions from the registration requirements of Section 5(a). For example, the NCUA is proposing that every planned issuance of SD notes would require an Issuing Credit Union to prepare and deliver an Offering Document to potential investors even though there are 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.”

According to the NCUA, such a regulatory framework would benefit both Issuing Credit Unions and investors, as the framework would provide potential investors information that is important to making a decision to invest in SD notes and would clearly define the obligations of the related Issuing Credit Unions. The NCUA believes these are important benefits that can reduce the possibility of investor confusion or misunderstandings and assist an Issuing Credit Union in defending against claims by investors.

We appreciate the NCUA’s effort to avoid possible confusion or misunderstandings among investors in SD. Credit unions have long prided themselves on taking necessary steps to work with members to ensure they are well informed ahead of participation in any significant credit union loan or product. Likewise, it is important that investors in

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SD—while typically more sophisticated than the average credit union member—are able to make investment decisions based on adequate, accurate information. However, we are concerned that some of the proposed rule’s procedural requirements may be overly burdensome.

According to the NCUA, the proposed disclosure requirements generally align with those provided in the Office of the Comptroller of the Currency’s (OCC) subordinated debt regulations. While we believe review of the OCC’s related requirements is a good starting point, we question instances where the requirements proposed by the NCUA exceed those required for banks under the OCC’s rules. This is particularly vexing when considering the credit union SD market is likely to be a fraction—in terms of the number of Issuing Credit Unions, the amount offered by Issuing Credit Unions on a per credit union basis, and the amount offered in the aggregate—of that provided by banks. Such a disconnect may result in excessive costs to credit unions that choose to offer SD and/or to potential investors of credit union SD.

As noted above, the proposed rule would require a credit union to prepare and deliver an Offering Document to potential investors. Unlike the OCC prospectus delivery rule, which is subject to a variety of exemptions, the NCUA’s proposed rule does not appear to provide any exemptions from the Offering Document delivery requirement. We are concerned that the perceived benefits of additional information to investors may be outweighed by the definite costs necessary to prepare and deliver certain disclosures, such as the Offering Document. Thus, we ask the NCUA to consider whether it would be appropriate to allow exemptions from the proposed offering rules in limited circumstances, such as for small offerings under a certain dollar threshold or to a limited number of institutional accredited investors. Similarly, we ask the NCUA to consider flexibility in complying with these strict disclosure requirements for LICUs. We are concerned that the new prescriptive requirements included in the SD Proposal could disadvantage LICUs, particularly those of relatively smaller asset size.

While, as stated above, according to the NCUA, credit unions will likely be exempt from the registration requirements of the Securities Act, the marketing and sale of securities remain subject to the anti-fraud prohibitions of the Securities Exchange Act of 1934 (Exchange Act).

The Exchange Act’s general anti-fraud prohibitions are embodied in section 10(b), which generally prohibits the use of manipulative or deceptive devices or contrivances that violate SEC rules in connection with the purchase or sale of securities.

The NCUA is proposing that every planned issuance of SD notes would require the preparation and delivery of a written disclosure document, each of which must meet the standards of Rule 10b–5. For any disclosure document to meet the standards of Rule 10b–5, the disclosure included in the document generally must:

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49 17 C.F.R. § 240.10b–5.
• Not contain any untrue statement of a material fact, and
• Not omit to state a material fact the absence of which renders any disclosure already being made misleading.

To accomplish those ends, the disclosure must be clear, accurate, and verifiable. In addition, the disclosure should cover topics that are typically important to investors in making an investment decision.

We appreciate the value of the anti-fraud prohibitions included in Rule 10b-5. Such provisions are important to prevent fraud, deceit, and incorrect or misleading statements or omissions in an offering of SD. However, we question instances where NCUA is proposing requirements, as it acknowledges, that in some cases are in addition to those requirements imposed by applicable securities laws.\textsuperscript{50} In these instances, we encourage the NCUA to adopt requirements laid out in established sources, such as the Exchange Act.

\textbf{b) Part 702—Capital Adequacy}

A major component of the SD Proposal is that it would expand those credit unions eligible to offer SD, which is currently restricted to LICUs (that offer secondary capital). The proposed rule increases the current eligibility beyond LICUs to also include non-LICU complex credit unions and new credit unions. The NCUA is also proposing to grant eligibility to credit unions that anticipate being designated as a LICU or non-LICU complex credit union within 24 months following their planned issuance of SD. The agency believes these proposed changes will allow additional credit unions to issue SD that would count as regulatory capital, which could help them comply with PCA requirements.

\textit{i) Eligibility (§ 702.403)}

Under the proposed rule, section 702.403 would provide a blanket prohibition on a credit union both issuing and investing in SD.\textsuperscript{51} At the time of issuance of any SD, an Issuing Credit Union may not have any investments, direct or indirect, in SD (or grandfathered secondary capital) of another credit union. If a credit union acquires SD in a merger or other consolidation, the Issuing Credit Union may still issue SD, but it may not invest in the SD of any other credit union while it has SD notes outstanding.\textsuperscript{52}

According to the NCUA, an Issuing Credit Union should not provide regulatory capital to other natural person credit unions. In addition, the NCUA states that the potential to transmit losses between multiple Issuing Credit Unions that have both issued SD and invested in SD (loss transmission) could increase the risk of credit union failure and increase the risk to the NCUSIF. For example, if an Issuing Credit Union both purchased

\textsuperscript{50} 85 Fed. Reg. 13,990.
\textsuperscript{51} Id. 13,999.
\textsuperscript{52} Id.
and issued SD, losses from the SD purchased by the Issuing Credit Union could create losses on the SD issued by the Issuing Credit Union, thereby creating a potential loss transmission from the purchased SD to the issued SD. The NCUA is concerned that, if it does not restrict covered credit unions in this way, a loss incurred by an Issuing Credit Union would simultaneously transmit to an investing credit union (the credit union that is the purchaser of the issuer’s SD note). The NCUA believes that failing to prohibit inter credit union SD transactions will create an unsafe and unsound condition for the NCUSIF.53

We ask the NCUA to reexamine its conclusion regarding an increase of risk to the NCUSIF in such scenarios. The magnitude of a loss cannot be increased by the inter investment of credit unions among themselves. Instead, the loss may be spread across multiple institutions thereby mutualizing the risk of a loss. Further, the investment of one credit union in the SD of another could benefit the credit union system overall since it is likely, or at least possible, that credit unions with higher net worth ratios will invest in those with lower net worth ratios.

We agree with the NCUA that inter investment among credit unions may cause a loss to transfer from one credit union to another. However, as a result of inter credit union investment, a credit union that receives additional capital from fellow credit unions will be more resilient. A credit union that invests responsibly will bear losses only up to the amount of its investment. Thus, appropriate concentration limits will contain the extent of loss transfer and avoid losses to a degree that could threaten the soundness of multiple institutions.

Additionally, the NCUA proposes a blanket prohibition on a credit union both issuing and investing in SD to avoid a situation where the level of net worth in the credit union system appears to increase, while the actual loss-absorbing capacity of the system remains unchanged. The NCUA offers the following example: two LICUs each have $10 million in net worth, so the total net worth between the two credit unions is $20 million. If each credit union issued $1 million in SD and then sold it to the other, the net worth between the two credit unions would be $22 million. This would result in an artificial $2 million increase in net worth for the credit union system, and would increase potential loss transmission between the two credit unions.54

To address a scenario where the net worth of the system appears to increase while the actual loss-absorbing capacity remains unchanged, the NCUA could add a line item to the Call Report to exclude all amounts invested in the SD of other credit unions. Since this is primarily a reporting issue, adding a new item to the Call Report to reflect such investments would properly reflect the loss-absorbing capacity of the credit union system.

Therefore, we ask the NCUA to reconsider its proposed blanket prohibition on a credit union both issuing and investing in SD. The benefits of allowing a credit union to both issue and invest in SD are real, while the perceived risks are less certain. If the NCUA

53 Id. 13,992–13,993.
54 Id. 13,993.
believes a restriction in this area is appropriate, we ask the agency to consider a threshold limit on a credit union’s ability to issue and invest in SD rather than a blanket prohibition.

**ii) Preapproval to Issue Subordinated Debt (§ 702.408)**

Under the proposed rule, an Issuing Credit Union’s authority to issue SD would expire one year from the later of: (1) the date the Issuing Credit Union received NCUA approval of its initial application, if the proposed offering is to be made solely to Entity Accredited Investors, or (2) the “approved for use” date of the Offering Document if the proposed offering will include any Natural Person Accredited Investors. According to the NCUA, this one-year limit is intended to ensure that an Issuing Credit Union does not sell SD following a material change in the information the NCUA relied in issuing its approval.

We caution the NCUA from imposing a timeframe that could force a credit union to make a rushed decision to issue SD. While one year may sound like a sufficient amount of time to accomplish most tasks, we are concerned that it fails to account for the myriad issues and considerations that complicate a credit union’s decisions with regard to issuance of SD. Further, the NCUA offers the period of one year as a timespan during which the condition of an applying credit union may materially change. Such a timeframe appears arbitrary, as there is no supporting evidence to show that a material change would be expected to occur within one year.

Rather than implementing a one-year timeframe before rescinding approval of a credit union to issue SD, we favor an approach that affords credit unions greater flexibility. We ask the agency to consider a standard that would allow the NCUA to rescind its authority after a one-year period only if it determines the financial condition of the credit union has in fact experienced a materially adverse change. Such an approach accomplishes the NCUA’s stated purpose while providing the credit union with much greater flexibility, allowing it to determine optimal timing and conditions for issuance of SD without the pressure of an arbitrary expiration date.

**5) Conclusion**

On behalf of America’s credit unions and their 115 million members, thank you for considering our comments on the agency’s SD Proposal. If you have questions about our comments, please do not hesitate to contact me at (202) 508-6743.

Sincerely,

[Signature]

Luke Martone
Senior Director of Advocacy & Counsel

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55 *Id.* 14,014–14,015.