July 8, 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 the 2.2 million credit union members we represent, the Heartland Credit Union Association (HCUA) appreciates the opportunity to comment on the National Credit Union Administration’s (NCUA) notice of proposed rulemaking on subordinated debt (SD Proposal).

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 to issue SD for purposes of regulatory capital treatment, including for purposes of complying with the NCUA’s new risk-based capital requirement.

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. 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 categories and capital requirements for credit unions.

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.

Although the PCA section does not define the “risk-based net worth requirement”, 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. 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.

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).
Subordinated Debt allowed to be issued by NCUA’s Authority

The FCUA grants FCUs broad power to borrow, enter into contracts, and exercise incidental powers necessary to enable FCUs to effectively conduct their business. 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. Further, because there are no specific restrictions or limitations on FCU borrowing, the 'incidental powers' granted to FCUs which gives significant discretion to FCUs with respect to how borrowings are effected.

Subordinated Debt May 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. The NCUA points out that Congress did not restrict the types of instruments the Board may include in its calculation of risk-based net worth.

The NCUA acknowledged, however, that it does not have the authority to alter the statutory net worth definition in FCUA section 1790d(o)(2). 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.

Analysis

The Chevron doctrine is a two-prong test for determining whether an agency has stayed within the bounds of its statutory authority when issuing its action. We believe that the FCUA explicitly grants FCUs the power to borrow, including through SD. The NCUA primarily relies on 12 U.S.C. § 1757(9), which grants FCUs the power to borrowing accordance with the NCUA’s rules and regulations. 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.

In addition, we believe the FCUA grants FCUs (including non-LICUs) the power to borrow, which extends to SD. 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. 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). This is consistent with the NCUA Examiner’s Guide, which provides guidance to credit union examiners.

Although the PCA 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. The express grant of definitional authority should easily satisfy step one of Chevron.

The NCUA’s RBC Rule currently includes secondary capital accounts in the risked-based capital numerator. 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. The reason for this amendment is that 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.
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 the Chevron doctrine.

Benefits of Subordinated Debt for Credit Unions

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.

Securities Law Issues

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.

Capital Adequacy Eligibility

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.

NCUSIF Risk

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. 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.

In conclusion, HCUA 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.

As always, we appreciate the opportunity to review this issue. We will be happy to respond to any questions regarding these comments.

Sincerely,

Brad Douglas
President/CEO