OLDEN LANE

July 7, 2020

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on Subordinated Debt – RIN 3133-AF08

Dear Secretary Poliquin,

We are pleased to offer this Comment Letter in support of the proposed changes to the National Credit Union Administration's ("NCUA") regulations to permit low-income designated credit unions ("LICUs"), Complex Credit Unions, and New Credit Unions to issue subordinated debt for purposes of regulatory capital treatment. As proposed, the rule would create a new subpart in the NCUA's final risk-based capital rule (RBC Rule) addressing the requirements for Subordinated Debt and its corresponding regulatory capital treatment. This new subpart would define the eligibility to issue Subordinated Debt and establish the requirements related to applying for the authority to issue Subordinated Debt. In addition, the proposed changes would address prepayments, disclosures, securities laws, and the economic terms of a Subordinated Debt Note.

We view these proposed changes as a logical extension the the existing secondary capital framework that already exists for today's LICUs. While we are convinced that the industry has not taken full advantage of the secondary capital regime to date, we nonetheless applaud the NCUA for having the foresight to build on many of the secondary capital successes of the past several years.

Olden Lane is a registered SEC broker-dealer active in the market for credit union secondary capital. We have participated in raising $50 million of secondary capital since November 2017. We also assist credit unions to properly identify appropriate objectives for secondary capital and form robust capital plans to conform to use of secondary capital to principles of safety and soundness. Half of all secondary capital plans approved by the NCUA since December 2018 have been developed in consultation with Olden Lane. As an advisor to many of the credit unions that have successfully managed the secondary capital process since 2018[1], we offer this Comment Letter to provide additional context and to suggest certain considerations which might strengthen the Rule as proposed.

[1] Across a series of Freedom of Information Act requests, Olden Lane has obtained data in respect of the number of secondary capital plans approved by the Regional Offices of the NCUA during the period between January 2019 and April 2020. Of the sixteen (16) secondary capital plans approved during the period, Olden Lane advised the credit union in respect of eight (8) of these plans.

At its January 23, 2020 meeting, the NCUA Board proposed an extensive set of amendments to existing regulations to expand access to alternative forms of capital for two new subsets of credit unions. Since 1996, the NCUA's regulations have permitted LICUs to accept uninsured secondary capital from non-natural person members and nonmembers, including corporations and other institutions.[2] Such uninsured secondary capital is intended (i) to provide an alternative – beyond setting aside a portion of earnings – for these credit unions to build capital to support more lending and financial services in their communities and (ii) to absorb potential losses, thereby reducing the potential for a credit union to fail. As proposed, the new amendments would allow two new categories of credit union to raise subordinated debt. In the process, the rule would harmonize the new "subordinated debt" regime with today's rules for secondary capital.

As proposed, the changes will allow Complex Credit Unions – those with greater than $500 million in assets – and New Credit Unions to issue subordinated debt for purposes of regulatory capital treatment. If adopted, the amendments will (1) drastically alter the rules and procedures that govern the current issuance of secondary capital under NCUA regulation 701.34 and (2) significantly expand the universe of credit unions permitted to source alternative forms of capital beyond retained earnings.

The proposed rule release extends to 277 pages and covers much ground. The proposed changes contain an assortment of new permissions that appear to expand the credit union industry's access to additional capital in the form of subordinated debt. However, the proposal would also add a number of burdensome requirements, including a significant expansion of the application standards that were updated in a 23 page Supervisory Letter as recently as September of last year.

This memorandum addresses specific concerns about the rule proposal and suggests improvements. The changes are intended to create a more practical framework for credit union access to supplement capital.

1) **The NCUA incorrectly asserts an unequivocal conclusion that "any Subordinated Debt Note would be deemed to be a 'security' for purposes of federal and state securities laws."[3]**

This conclusion provides the basis for many of the procedural requirements related to the offerings of subordinated debt addressed in the proposed rule.

Most of the subordinated debt being issued under today's secondary capital rules are likely not "securities." Section 3(a)(10) of the Securities Exchange Act of 1934 defines a "security" to include a "note" "unless the context otherwise requires."[4] As "notes" are one of the enumerated categories of a "security," courts generally begin their analysis with the presumption that all notes are "securities." As the plain language of the Act provides, however, this presumption may be rebutted, where the context indicates that the specific note to be analyzed is not of a type that should be treated as a security.[5]

Typically, the determination of whether to treat a loan as a "security" is made by reference to the following non-exclusive factors: (i) the motivations of the parties to the transaction; (ii) the plan of

[2] 12 CFR 701.34(b).
[3] 85 Federal Registrar 13987.
[4] 15 U.S.C. § 78c(a)(10).
[5] *See, e.g.* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 (1975) (noting that "[t]he task has fallen to the Securities and Exchange Commission (SEC), the body charged with administering the Securities Acts, and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of thee statutes.").

distribution (e.g., a widely distributed instrument, as to which there is likely to be trading interest after the completion of the distribution, is more likely a "security"); (ii) the expectations of the parties as to whether the transaction is subject to the securities laws; and (iv) whether the instrument is otherwise subject to a comprehensive scheme of regulation.[6]

The transactions in today's secondary capital note market tend to be characterized by bilaterally negotiated lending transactions between two institutions. The typical plan of distribution lacks the breadth of a securities offering, as these arrangements are generally not sold or distributed as securities. Additionally, to date, no regular secondary trading market has developed for these notes. Typically, secondary capital transactions are documented as loans and are understood by the parties as such. Finally, this market is subject to a robust alternative scheme of regulation by the NCUA and certain state regulators. Such regulation includes (1) a fulsome pre-approval process related to each secondary capital plan, (2) limitations and requirements with respect to the note's terms and its accounting and regulatory treatment, (3) ongoing monitoring by the agency and its examiners throughout the term of the note, and (4) a requirement to gain the regulator's permission to effect any repayment of principal. Additionally, to the extent that a financial institution is the lender to a borrowing LICU (i.e. other credit unions or banks), these institutions too are subject to their own comprehensive regulation.

We are aware of written legal opinions from leading securities law firms concluding that secondary capital notes should not be considered "securities."

It is not advisable for the NCUA to offer a blanket assessment of the security status of a Subordinated Debt Note without regard to an analysis of the specific facts of any individual offering. By doing so, the NCUA likely influences the securities law analysis to subject certain transactions to securities laws that would not otherwise be so.

Recommendation:

The NCUA should acknowledge that the "security" status of a Subordinated Debt Note is a facts and circumstances analysis that defies the blanket conclusions asserted in the proposed rule. Further, the agency should not insist that every issuance of a Subordinated Debt Note would be deemed a security.

2) **Many of the Proposed Rule's Procedural Requirements are overly burdensome when considered in light of current market activity in secondary capital and similar debt offering frameworks of other federal agencies.**

The proposed rule's procedural prescriptions borrow heavily from the OCC's regulatory framework for the issuance of subordinated debt securities by banks. There is no corresponding acknowledgement, however, that banks participate in a much more substantial and mature subordinated debt market and regularly issue debt in larger quantities than do credit unions. Even so, where the NCUA departs from the OCC framework, it tends to favor additional requirements and stricter application. As a result, the costs of the various new procedural requirements the rule prescribes will far outweigh the benefits when applied to nearly all the existing market activity in secondary capital.

As of year-end 2019, sixty-eight (68) credit unions had outstanding subordinated debt of $301 million, in aggregate. The average amount of subordinated debt across these 68 credit unions was $4.4 million. Together, the state and federally chartered Self-Help credit unions account for $138 million of the

[6] *See generally Reves* v. Ernst & Young, 494 U.S. 56 (1990).

outstanding subordinated debt, representing approximately 45% of the total market. Excluding these two credit unions, the average amount of subordinated debt issued by the other 66 credit unions falls to $2.4 million.[7]

By contrast, the nation's banks have issued almost $70 billion of subordinated debt. Moreover, the average amount of subordinated debt among banks with outstanding subordinated debt is $752 million. More than 2/3rds of the banks with outstanding subordinated debt have at least $12 million outstanding. Only 8% of credit unions that issued outstanding subordinated debt have $12 million or more outstanding.[8] By contrast, where credit unions have expressed interest in larger offerings, the NCUA has generally discouraged these plans, as applications to offer more than $10 million of secondary capital are denied by the agency far more often than they are approved.[9]

In sum, the market for credit union subordinated debt is vastly different than the market for bank subordinated debt. The credit union subordinated debt market is generally comprised of micro-offerings of less than $10 million. Broadly distributed securities-style offerings are exceedingly rare, and secondary capital offerings tend to involve a single institutional investor or a small group of no more than three institutions. Investors conduct due diligence that often includes a review of publicly available information (i.e. call reports), additional document requests and interviews with the credit union's management. Investors often comment on loan terms offered by the credit union and request changes. As such, the current market for credit union subordinated debt is more akin to the typical individual lending transactions between institutional parties.

As a practical matter, regulatory procedures designed to govern broadly distributed securities offerings would provide little protection for the participants in this market. However, such procedures would add a new layer of costs and a significant burden to credit union issuers. Moreover, these costs could significantly impede the proper development of the market for credit union subordinated debt that has proven far more sporadic than its architects had hoped or anticipated – and remains nascent after almost 25 years.

The following prescriptions in the proposed rule appear inconsistent with a reasonable cost benefit analysis when applied to the existing market for credit union subordinated debt.

- *Prospectus Delivery Requirement*: The proposed rule would require a credit union to prepare and deliver an Offering Document to potential investors for each subordinated debt offering. This insistence seems odd when one considers that there are no SEC-mandated disclosure requirements for offerings of such securities pursuant to available exemptions.[10] In contrast to the OCC prospectus delivery rule, which is subject to a variety of exemptions, the proposed NCUA rule offers no exemptions to the prospectus delivery requirement. Section 16.5 of the OCC's Securities Offering Disclosure Rule, for example, contains several exemptions to the OCC's prospectus delivery requirement,[11] including exemptions for nonpublic offerings[12] and small

[7] Information obtained from Callahan & Associates.
[8] Information obtained from Callahan & Associates.
[9] National Credit Union Administration Office of General Counsel, Letter to Michael C. Macchiarola RE: 19-FOI-00082 (September 30, 2019) (on file with the author).
[10] 85 Federal Register 13989.
[11] 12 CFR 16.5.
[12] *See also* 12 CFR 16.7.

issues offered pursuant to SEC Regulation A.[13] As currently conducted, nearly every offering of existing secondary capital would presumably qualify for a prospectus delivery exemption were it subject to the existing OCC framework.

As described above, today's secondary capital sales cycle provides a reasonable opportunity for due diligence, whereby a small number of institutional investors can request documents and lightly negotiate contract terms. Once final terms are agreed upon, the transaction is set forth in written contracts signed by both parties. In almost all instances, this process would simply not benefit from an offering document. The institutional investors in the secondary capital market are mostly other lending institutions that engage in a much more probing examination of the credit union than the review of an offering document would provide. In fact, the use of an offering document is likely to confine the offering terms to those provided by prospectus and offer less opportunity for the negotiation of terms between the parties. The "take-it-or-leave it" posture of a typical securities offering would alter the current practices in the secondary capital market without any evident benefit for market participants.

In this case, the availability of regular financial data should also be considered. Of course, all credit unions are required to file quarterly 5300 data in a robust and standardized presentation that is publicly available shortly after each quarterly reporting period. Such information would allow a discerning lender to perform financial-related due diligence and ascertain financial comparisons and trends across time.

Our firm has sought quotes from qualified law firms for the preparation of a subordinated debt prospectus for a credit union offering. Estimates range from $20,000 to $30,000, meaning that these additional costs would represent a material burden for an offering of less than $10 million. On today's average offering ($4.4 million), a $30,000 legal bill would equate to a 68 bp tax to the borrower.

Over half of the credit unions with outstanding secondary capital have issued less than $1 million. The costs related to preparing an offering document for a secondary capital transaction of less than $1 million are entirely impractical. The impact of this burden is considerable when one considers that such offerings account for over half of the participation in the current secondary capital market.

- *Policies and Procedures Requirements*: The proposed rules also require that credit unions intending to issue subordinated debt draft written policies addressing a variety of subjects related to the offering. Such subjects include:
    - securities law compliance and risk management,
    - investor relations and communications plans, and
    - implications for Directors & Officers Liability insurance requirements.[14]

  Requiring written policies on such topics drafted in consultation with outside counsel is excessive in cases of micro-offerings, as these typically concern a few million dollars or less and involve no more than a few institutional investors. Such regulatory burdens are unnecessary based on the composition of the current secondary capital market where practically none of the credit unions

[13] *See also* 12 CFR 16.8.
[14] 85 Federal Register 13990.

are engaged in broadly distributed securities offerings or issue subordinated debt to more than a few investors. Additionally, the proposed requirement of ongoing disclosure for subordinated debt issuers is overly burdensome and creates an unnecessary uncertainty. Again, such requirements are wholly unnecessary when one considers that credit unions are subject to a robust and ongoing quarterly reporting regime. While we certainly understand the desire of the NCUA to encourage a regime that protects lenders, we are concerned that this proposal seeks to achieve those protections by imposing cumbersome costs on the credit union borrowers. If, in fact, this proposal is meant to encourage credit unions to seek alternative capital, when appropriate, the agency should steer clear of imposing such a stifling burden on a process that already requires a significant (and growing) amount of energy and resources by its credit union borrowers.

- *Required statement identifying the governing law specified in the Subordinated Debt Notes*: The proposed rule requires a credit union to identify the governing law in respect of the Subordinated Debt Notes in its application to issue subordinated debt.[15] As most secondary capital is distributed in small amounts of a few million dollars to no more than a few institutional investors, the current market practice is generally for the governing law and jurisdiction preferred by the lender to apply to a given secondary capital transaction. This practice is due to the fact that most outstanding secondary capital results from written loan agreements between the parties following a negotiated arrangement rather than a broadly distributed securities offering. In fact, governing law provisions and choice of dispute resolution forums are among the most often negotiated terms in a typical secondary capital transaction. This type of negotiation is generally within the reasonable competency of most credit unions.

  The proposed rule would interfere with current market practice in favor of the standards more typical of a broadly-distributed securities offerings. This is in marked contrast to what takes place in the existing market for credit union subordinated debt. By doing so, the proposed rule may negatively impact investor appetite in this market, which is already limited and growing only slowly. It may also result in the selection of less practical or more distant choice of law or forum with universal recognition (i.e. New York or Delaware), which again could equate to additional costs for borrowers and lenders alike.

To characterize the proposed rule as a corollary to existing OCC rules, we believe the framework proposed by the NCUA contains certain imprecise summaries of OCC subordinated debt rules. In fact, the OCC's framework generally exempts bank offerings of subordinated debt from its disclosure rules and prospectus requirements if the offering is a non-public offering only to accredited investors in accordance with SEC Regulation D[16] or offered solely to qualified institutional buyers in accordance with Rule 144A.[17] This is consistent with SEC regulations that apply to debt offerings of other corporate entities. Conversely, the NCUA's proposal offers no exemptions whatsoever from the framework it puts forward. Actually, if the offering framework were adopted as proposed, it would represent perhaps the most burdensome of any debt offering framework subject to federal regulation. The necessity of such regulatory burden in respect of a small debt market currently comprised solely of institutional participation simply eludes us.

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[15] 85 Federal Register 14010.
[16] See 12 CFR 16.7.
[17] See 12 CFR 16.5(e)

Recommendation:

The NCUA should incorporate reasonable exemptions from the proposed offering rules. For instance, a simple exemption might be adopted for small offerings of $10 million or less sold to no more than five (5) institutional accredited investors. The burdens of the proposed rules in such circumstances far outweigh any benefits. Even after incorporating such an exemption, the scope of exemptive relief in the NCUA debt offering framework would be much more limited than either of the related OCC or SEC frameworks.

3) **The proposed rule incorporates unreasonable changes to the review period and decision process for subordinated debt applications.**

The NCUA proposes to increase the review time of the initial application for subordinated debt to 60 days from the current Secondary Capital Rule's 45-day cycle. The proposal also makes the length of this review period uncertain, despite its prescribed timeframe. The proposed rule removes the automatic approval provision which exists under the current Secondary Capital Rule in circumstances in which an applicant is not notified by the NCUA of an approval decision within the 60-day review period. Under the proposed regime, the Regional Office will be permitted to extend the deadline for the review of an initial application in cases where the agency has requested additional documents or has determined that the application is incomplete.[18]

Currently, the OCC reviews bank subordinated debt applications in a prescribed period of 30-days. An application is deemed approved by the OCC as of the 30th day after the application is received by the agency, unless the OCC notifies the bank prior to that date that the filing presents a significant supervisory, or compliance concern, or raises a significant legal or policy issue.[19] Without ample justification, the NCUA here proposes to grow by 33% the time it takes to review today's secondary capital application. Moreover, if adopted as proposed, the regulation would permit the NCUA twice the length of time it takes the OCC to review a similar application relative to OCC standards. While this pushout in timing is concerning for those seeking the capital, the removal of the automatic approval provision presents an even more ominous concern. Essentially, this change creates an open-ended review period. These proposed changes introduce significant uncertainty as to the length of the process to successfully issue subordinated debt.

These proposed changes are particularly troubling when considered against the evolution of the secondary capital regime. In February 1996, the Board established Section 701.34 of the NCUA Regulations, entitled *Designation of low-income status; receipt of secondary capital accounts by low-income designated credit unions*. This regulatory provision added significant detail to the limited authority for secondary capital accounts stated in the Federal Credit Union Act. Section 701.34 states the means by which secondary capital is recognized as net worth and provides the specific conditions precedent to a credit union's acceptance of secondary capital accounts.

Initially, Section 701.34 (b) established that a LICU planning to accept secondary capital accounts must simply submit a written plan to the appropriate regional director, describing the use of funds. During the first decade of the secondary capital regime, no prior agency approval of such a plan was required. In

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[18] 85 Federal Register 14011.

[19] 12 CFR § 5.47(g)(2).

January 2006, however, Section 701.34 (b) was amended to require the prior regulatory approval of the appropriate NCUA Regional Director.

At the time, the NCUA described the change as an effort to quash “an emerging pattern of lenient practices that frustrate LICUs’ good faith use of USC” which, when they occur, “contribute to excessive net operating costs, high losses from loan defaults, and a shortfall in revenues” at offending credit unions.[20] The NCUA also asserted that the approval requirement would “strengthen supervisory oversight and detection of lenient practices.”[21]

As a catalyst for the change, the NCUA listed four specific “lenient practices,” which had been observed. These included:

- Poor due diligence and strategic planning in connection with establishing and expanding member service programs;
- Failure to adequately perform a prospective cost/benefit analysis in connection with such programs;
- Overly ambitious use of secondary capital to support unproven or poorly performing programs; and
- Failure to realistically assess or timely curtail underperforming programs.[22]

Notably, there is no evidence that any such lenient practices persist today. In fact, in the proposed rule, the NCUA admits that “most LICUs that have issued secondary capital generally have managed such capital well,” adding that “[s]ince the NCUA began requiring LICUs to obtain prior approval before issuing secondary capital, the Board is not aware of material losses to the NCUSIF resulting from the mismanagement of secondary capital.”[23] And, this track record should only improve, as the NCUA’s recent Supervisory Letter increases the likelihood that any lenient practices will be rooted out in the agency’s more fulsome review of submitted plans.

In 2006, during the comment period following publication of the proposed secondary capital rule amendments, the NCUA was challenged with the notion that a change from the regulation’s original default position of permissibility would cause unnecessary delay for applying credit unions. At the time, the NCUA Board responded:

> “Finally, to the extent that obtaining prior approval adds a step that might cause undue delay, possibly discouraging potential investors from entering the USC market, the final rule provides a backstop. A Regional Director has 45 days from the date a USC Plan is submitted to approve or disapprove it. However, the final rule provides that if a Regional Director fails to act on a USC Plan within that period, the Plan is approved by default and ‘the LICU may proceed to accept secondary capital accounts pursuant to the plan.’”[24]

The attempt to abandon such a hard deadline in this latest proposal illustrates the idea that creeping regulatory burdens can change the nature of a regulation’s intent incrementally. Also, where regulatory delays are invited into a process, they tend to become a permanent fixture. We expect these changes will

[20] 71 FR 4234, 4236 (Jan. 26, 2006).
[21] 71 FR 4234, 4236 (Jan. 26, 2006).
[22] 71 FR 4234, 4236 (Jan. 26, 2006).
[23] 85 Federal Register 139894.
[24] 71 FR 4234, 4237 (Jan 26, 2006).

result in review periods for subordinated debt applications that routinely exceed the 60-day review period. This possibility will introduce a serious challenge for capital planning and undoubtedly exasperate the current frustrations with the uneven nature of the secondary capital application process.[25] This extended review period, the uncertainty as to its ultimate end date and the additional expense of time and cost will undoubtedly discourage credit unions from pursuing additional capital in the form subordinated debt, thereby frustrating the proposed rule's purpose. In this way, the proposed rule presents a significant setback to credit unions' ability to access supplemental capital.

Recommendation:

The NCUA should not revise the existing review period. Instead, the agency should work within the existing framework for reviewing secondary capital applications, within a 45-day period. The additional costs, delays and uncertainty introduced by the proposed rules are far too discouraging of credit unions access to supplemental capital.

4) **The prohibition on (1) issuing subordinated debt if a credit union invests in another credit union's subordinated debt, and (2) investing in subordinated debt if a credit union has issued subordinated debt itself, is unduly burdensome and discourages positive market activity without reasonable grounds.**

The proposed rule bars credit unions from participating as both an issuer and investor/lender in the subordinated debt of another credit union. The NCUA cites two specific grounds for the blanket prohibition. First, the NCUA explains that, if it does not restrict 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 Subordinated Debt Note). As the NCUA describes it, this inter credit union exposure results in an imprudent transmission of losses because a single loss can impact both institutions rather than the issuer alone. The NCUA believes that failing to prohibit inter credit union subordinated debt transactions will create an unsafe and unsound condition for the National Credit Union Share Insurance Fund ("NCUSIF").[26]

This analysis is suspect. It remains an unequivocal fact that the magnitude of any loss cannot be increased by the inter investment of credit unions among themselves. Instead, such an investment allows for the loss to be spread across multiple institutions – thereby mutualizing the risk of loss. Additionally, the investment of one credit union in the subordinated debt of another is likely to be optimizing for the overall system, as it is foreseeable that credit unions with higher net worth ratios will be investing in those with lower net worth ratios.

The NCUA is correct that inter investment among credit unions may promote the transfer of loss from one credit union to another. However, as a result of inter credit union investment, institutions that receive additional capital from their peers will be more resilient. Credit unions that invest responsibly will bear

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[25] Based on information obtained from Freedom of Information Act requests, we are aware that most applications for permission to utilize secondary capital are denied. The rate of denials is increasing since the middle of 2019. The process is daunting and difficult as indicated by data. Delaying the NCUA's decision-making in this respect to an uncertain length of time will frustrate the pace at which credit unions receive feedback on inadequate plans, interpret such feedback and design a process to address it. Delay is the last thing this already difficult process stands to benefit from.

[26] 85 Federal Register 13992.

losses only up to the amount of their investment. Therefore, prudent concentration limits will contain the magnitude of loss transfer and avoid a level of contagion that would threaten the soundness of multiple institutions.

The proposed rule adopts specific concentration limits on investment in subordinated debt of other credit unions. Such investments are limited in aggregate to an amount equal to the lesser of (A) 25% of net worth, and (B) any amount of net worth in excess of 7% of total assets. This proposed limit is designed to ensure that total potential losses from subordinated debt would not lower a credit union's Net Worth to below seven percent of assets, which is the threshold for a "Well Capitalized" classification.[27] In light of these measures, the additional prohibition on credit unions participating as both issuer and investor in the subordinated debt market is superfluous and excessive. Moreover, the prohibition serves to (1) suppress the express statutory authority "to make loans . . . to other credit unions" enshrined in Section 107 of the Federal Credit Union Act, (2) frustrate the time honored fraternity of the credit union movement and (3) stifle the positive aspects of inter credit union investments.

The authors have observed that investments in credit union subordinated debt by other credit unions serve a variety of useful purposes, including:

A. *Transmission of surplus capital to useful purposes at another credit union*:

   Credit unions with a large amount of surplus capital may earn yield in excess of the existing yield on earning assets by investing in growing credit unions that seek additional capital to support their growth. This generally promotes efficient use of capital across the industry and encourages diversification for the investing credit union. For example, a large Texas credit union with excess capital and a concentrated mortgage book might be able to gain both geographic and asset diversification by investing in the secondary capital notes of a California credit union with a concentration in auto loans. If such a loan is properly diligenced, it is difficult to understand the agency's motivation for the proposed blanket prohibition. We fear credit unions with abundant surplus capital may hesitate to invest in other credit unions if it means exclusion from issuing subordinated debt for a prolonged period. Instead, many credit unions may prefer to retain the flexibility to issue subordinated debt in the uncertain future despite enjoying a current surplus of capital. In such case, capital will be employed less efficiently as a result of the proposed rule's restrictions. And, with the absence of a significant number of credit unions as potential lenders, the cost of capital for the borrowers will also increase.

B. *Facilitates strategic relationships between credit unions*:

   Larger, more experienced credit unions often invest in smaller, less experienced credit unions to support their smaller peers and provide them a strategic relationship that can be a source of advice and counsel on managerial subjects. The investments involved are typically quite small in proportion to the size of the investing credit union. Therefore, the risk to the investing credit unions tend to be nominal in these circumstances. Denying credit unions that invest in subordinated debt of their peers, no matter how small the investment, the flexibility to issue subordinated debt pursuant to an otherwise sound and appropriate capital plan, will result in

[27] *Id.,* at 13993.

absurd consequences and an unreasonable restriction on many substantial credit unions that have proportionally very small investments in subordinated debt.

C. *Protects the National Credit Union Share Insurance Fund by creating a certain degree of loss mutualization among credit unions educated on a particular business plan.*

All credit unions collectively act as a backstop to absorb losses that exceed a particular credit union's net worth through the NCUSIF. When credit unions invest in one another, they provide for mutualization of losses among them and protect the NCUSIF from losses that may be absorbed by the collective participation of subordinated debt market participants. To the extent a credit union with a higher net worth provides capital to a credit union with a lower net worth, the mutualization of losses can also be characterized as an optimization of the system's total available capital.

The second grounds for the prohibition on issuing and investing in subordinated debt is the NCUA's belief that inter credit union investment causes the level of Net Worth in the credit union system to appear to increase, while the actual loss-absorbing capacity of the system remains unchanged.[28]

This is primarily a reporting issue easily addressed by adding a new item to the Call Report to report Net Worth excluding all amounts invested in the subordinated debt of other credit unions. This will provide a proper measure of the industry's total loss absorbing capacity. Additionally, the NCUA should carefully consider that the industry may more efficiently employ that total loss absorbing capacity through market-based transactions in subordinated debt.

The NCUA describes a hypothetical to illustrate its concern:

> "For 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 Subordinated Debt 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 (ten percent) in Net Worth for the credit union system, and would increase potential loss transmission between the two credit unions as explained in the prior paragraph."[29]

The NCUA is correct that the total loss absorbing capacity of the two credit unions is $20 million, not $22 million. However, both credit unions have an individual loss absorbing capacity of $11 million following the transaction. That is an economic fact. In this sense, both credit unions are now more resilient for having partnered in this way. This is a tangible benefit of inter credit union investment. Let's assume one of these credit unions becomes subject to an $11 million loss. A loss of $1 million that would otherwise be the responsibility of the NCUSIF will be transferred to the remaining credit union. That credit union's net worth will be reduced to $10 million as it was in the beginning of the hypothetical. When you follow the NCUA's hypothetical to examine the real impact of inter credit union investment, the benefits of this arrangement are evident. The NCUA should complete its analysis of hypothetical circumstances to specifically illustrate the benefits of such a sweeping prohibition that will come at great cost to the industry.

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[28] *Id.*
[29] *Id.*

Additionally, while we understand the agency's motivation, in this instance, it is inexact to think of the risks to the NCUSIF in the aggregate. Failures that ultimately lead to an NCUSIF loss can only come at the individual credit union level. In a sense, therefore, the sensitivity to loss for the NCUSIF is best understood by the riskiness of the weakest link(s) in its chain and not be the average across all credit unions. In this analysis, the flow of excess capital from a very well capitalized credit union to a less well capitalized credit union is both efficient and risk reducing.

Recommendation:

It would be both unfortunate and a mistake to discourage inter credit union investment with a sweeping prohibition of this sort. At a minimum, the NCUA should consult with independent economists on the benefits and risks of inter credit union investment. Any prohibition on such activity should limit a credit union from issuing and investing in subordinated debt only to the extent that the credit union's net worth less the amount of any investments in subordinated debt is below a reasonable prescribed threshold.

5) **The proposed expiration of the authority to issue subordinated debt after a one-year period following approval unnecessarily denies the credit union important flexibility and could likely result in rushed decisions to issue subordinated debt.**

The NCUA proposes to expire a credit union's authority to issue subordinated debt one year from the later of (1) the date the credit union received NCUA approval of its initial application, if the proposed offering is to be made solely to institutional accredited investors, or (2) the "approved for use" date of the applicable Offering Document if the proposed offering will include any natural person accredited investors. The stated intention of this proposed expiration is to ensure that the credit union does not offer and sell subordinated debt following a material change in the information on which the NCUA relied in approving the issuance. [30]

The one-year expiration period creates an arbitrary time-frame that unnecessarily restricts the business judgment of a credit union's management team in deciding the appropriate time and conditions in which to issue subordinated debt. Credit unions facing expiration of the one-year period may consider issuing the subordinated debt irrespective of any doubts about the appropriateness of the current timing and conditions in order to avoid expiration of an authority that required a heavy investment of time and resources to secure in the first place. While the proposed rule offers credit unions the ability to apply for an extension of the expiration period for good cause, we expect that credit unions are unlikely to rely on the outcome of another application process. Rather, credit unions may proceed with an issuance solely in reaction to the artificial pressure caused by an imminent expiration date.

The pressure of an expiration date is compounded by the fact that the period of time it will require to identify willing investors is uncertain and depends on a variety of factors. Today, a typical subordinated debt offering can take a period of weeks up to a few months to complete. Therefore, the practical period to initiate an issuance of subordinated debt would be approximately nine months or less to comfortably complete the offering prior to expiration.

Moreover, the one-year period is completely arbitrary. There is no reason to anticipate that a credit union's financial condition will have deteriorated materially in this time period. A credit union's investment of time and cost to obtain subordinated debt approval is significant. There is simply no need

[30] 85 Federal Registrar 14014.

for a litany of new requirements and procedures in the proposed rule. The authority to issue subordinated debt should not be rescinded, rendering the credit union's investment and effort a lost cause, based solely on expiration of an arbitrary timeframe without regard to the actual existence of material changes in financial condition.

In addition, some purposes for issuing subordinated debt take longer to unfold. A period of nine to twelve months may not be a long enough to develop the conditions for an appropriate issuance of subordinated debt in such cases. For instance, subordinated debt issued to offset capital dilution expected to result from a merger or acquisition will often be subject to the timing of the related transaction. Mergers and acquisitions may become subject to delays or take a protracted period to complete for any variety of reasons. The timing pressure and uncertainty created by an arbitrary expiration date for issuing subordinated debt introduces an unwelcome complication in such circumstances.

Recommendation:

The NCUA purpose is better served by a standard that would allow the NCUA to rescind its authority after a one-year period only if it determines that a "material adverse change in financial condition" has occurred in respect of the credit union since it first gained its approval to issue subordinated debt. A "material adverse change in financial condition" means any material adverse change in the business, results of operations, assets, liabilities, or financial condition of the credit union. This determination may be informed by Call Reports and supervisory exams. This approach accomplishes the NCUA's stated purpose with far less unnecessary interference with the credit union's business judgment. In such case, a credit union will be able to control the determination of the optimal timing and conditions for its issuance, absent the pressure of an arbitrary expiration date.

Again, we applaud the Board for its hard work on this issue and its thoughtful proposal. We are grateful too for the opportunity to comment on the proposed amendments. We look forward to the adoption of the Proposed Rule because, if adopted with the discreet recommendations set forth above, it will be both capital enhancing and the natural extension of the NCUA's thoughtful efforts to date.

Should you have any questions regarding our comments, please feel free to contact the undersigned at dprezioso@oldenlane.com.

All the best,

/s/
Daniel Prezioso
Partner
Olden Lane LLC