OLDEN LANE

October 19, 2021

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

Re: Comments on Subordinated Debt Proposed Rule: RIN 3313-AF38

Dear Secretary Conyers-Ausbrooks,

We are pleased to offer this Comment Letter in support of the proposed changes to the National Credit Union Administration's ("NCUA") Subordinated Debt rule.

Olden Lane operates a SEC registered broker-dealer (Olden Lane Securities LLC) active in the share certificate market and the market for credit union subordinated debt. We also operate an SEC registered investment advisor (Olden Lane Advisors LLC) that assists credit unions with capital planning, balance sheet management, hedging and investments. We regularly help credit unions to properly identify appropriate objectives for capital and in connection with the proper maintenance of safety and soundness. As an advisor to many credit unions, including several participating in the U.S. Treasury's Emergency Capital Investment Program ("ECIP"), we offer this Comment Letter to provide additional context and to suggest certain considerations which might strengthen the Rule as proposed.

The low-income designated credit unions (LICUs) that are eligible to participate in this program because of their status as either a Minority Depository Institution (MDI) or Community Development Financial Institution (CDFI) are excited to pursue this special opportunity to obtain a secondary capital loan at the below-market rates offered by the ECIP. For our credit union clients, ECIP affords the opportunity to accelerate their social impact, capacity, sustainability, and profitability into the future.

As a general matter, we agree with the proposed amendment to the definition of "Grandfathered Secondary Capital" to accommodate those credit unions that have (1) completed an extensive ECIP application, (2) gained a NCUA approval to treat the ECIP funds as secondary capital and (3) are awaiting the funding from the U.S. Treasury. In such cases, the investor (U.S. Department of Treasury) has had a fulsome opportunity to perform all appropriate diligence to its liking and will award the funding to each ECIP participant based upon its chosen level of comfort and satisfaction with the materials presented during an extensive application process.

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Absent the change proposed by the NCUA, the simple fact that the mechanics of the funding may not be completed before the new year would warrant a brand-new pre-approval of an application to issue Subordinated Debt. We agree with the NCUA's approach – essentially, waiving that requirement under the proposed rule – for these limited circumstances.

We are concerned, however, that the NCUA is unwilling to entertain a subordinated debt investment from the federal government for longer than 20 years. While the NCUA is willing to make accommodation for the special circumstances of an emergency program in the context of the preparation of offering materials, curiously, the agency's view is more entrenched in the somewhat arbitrary view that secondary capital can only "count as regulatory capital for up to 20 years from the date of issuance."[1] Importantly, the NCUA's insistence of a 20-year maximum on subordinated debt instruments might equate to a 15-year maximum within the context of the ECIP. As of today, the Treasury Department has only offered credit unions instruments with a 15-year or 30-year maturity. If that does not change, the NCUA 20-year maximum will equate to a 15-year maximum for ECIP participants.

In our view, the insistence of a 20-year maximum in this context is frustrating to the intent of Congress in including ECIP as part of the CARES Act. Moreover, it will have a direct impact, cutting by one-third (in a temporal sense) the aid that Congress intended to provide for low- and moderate- income communities. Congresswoman Maxine Waters articulated the program's noble goals shortly after its adoption:

> "This Congress, my Committee has prioritized the importance of diversity and inclusion, seeking ways to ensure the financial system is more inclusive and gives a fair chance for all consumers to own a home or start a small business… A good example of this is our work on minority depository institutions (MDI) and community development financial institutions (CDFI), which are financial institutions that play a critical role as lenders in low- and moderate-income (LMI) and communities of color. These institutions are on the front lines of meeting the financial needs of communities that are disproportionately underserved by traditional financial institutions and are primary lenders to LMI and communities of color, including during the COVID-19 pandemic. CDFIs and MDIs assist minority entrepreneurs that are overlooked by traditional financial institutions."

As the NCUA reconsiders this important decision, we hope it appreciates its magnitude in terms of the opportunities that will be lost across the communities that the nation's credit unions serve. We also respectfully ask that the agency reconsider the 20-year maximum against the backdrop of the significant effort in time and resource of each of the credit union participants in preparing exhaustive submissions for both the NCUA and the Treasury. Finally, we ask that you weigh the wisdom of the insistence on a shorter program against the challenge offered by NCUA Chairman Harper shortly after the program's adoption:

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[1] *Subordinated Debt*, National Credit Union Administration, 86 FR 53567 (Sep. 28, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-09-28/pdf/2021-21055.pdf (hereinafter, the "Proposed Rule"), at 53568.

> "As our nation continues to grapple with the COVID-19 induced economic crisis, I again encourage eligible credit unions to *step in* and *step up* by participating in the Treasury's Economic Capital Investment Program to support the communities that they serve and that have been disproportionately affected by the pandemic. The NCUA is here to facilitate the efforts of our nation's financial first responders in bettering the lives of people living in underserved areas."[2]

To better illustrate the ramifications of denying those credit unions that have stepped in and stepped up from entering the 30-year instrument that the program offers, we estimated ECIP's likely ten-year impact, beginning in the year 2042. Having advised many of the program's qualifying credit unions through the process, we believe that Olden Lane is uniquely suited to offer this analysis.

We based our model on the update provided by the Department of Treasury on September 24.[3] According to the data provided, the program was oversubscribed, with financial institutions applying for $12.8 billion of $8.75 billion in available ECIP funds. If the Treasury allocates ratably between credit unions and other institutions, we expect the $3.1 billion in credit union demand to equate to just over $2.1 billion in funding through the program. Applying an average benchmark net worth of LICUs with greater than $100 million in assets, we estimate that the capital provided by ECIP would be cycled into an increase of more than $20 billion of assets on credit union balance sheets. And, after applying an average loans-to-assets level, we expect the increase to stimulate roughly $14 billion in additional loan production of which more than $10.5 billion would be to low- and moderate- income borrowers and other disadvantaged populations targeted by the program.

If the NCUA were to require that these funds exit the market ten years earlier than Congress has offered, it would mean that a full decade worth of loans that this capital could support would simply become unavailable. Based on average attrition estimates and applying adjustment factors for average loan size and inflation, our model suggests that the elimination of the final ten years would be significant. More precisely, we estimate a loss of almost $48 billion worth of loan activity across the credit unions participating in the program. As troubling, almost $37 billion of that lost loan activity would have been provided to the low- and moderate- income borrowers and other disadvantaged populations targeted by the program. It our estimation, this equates to a loss of more than 725,000 loans, almost 560,000 of which would have been aimed at that same cohort of targeted borrowers.

In this Proposed Rule, the NCUA dismisses the possibility of allowing a debt investment of longer than 20 years with the simple conclusory statement that "the maximum 20-year maturity was necessary to help ensure Subordinated Debt was not considered equity, which is an impermissible issuance for federal credit unions."[4] And, the agency cites to its previous rulemaking, which contained even less by way of analysis

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[2] NCUA Chairman Todd M. Harper, Statement on the Emergency Capital Investment Program (Feb. 18, 2021), available at https://www.ncua.gov/newsroom/speech/2021/ncua-chairman-todd-m-harper-statement-emergency-capital-investment-program.

[3] *See Treasury Sees Robust Demand for Emergency Capital Investment*, U.S. Department of Treasury, available at https://home.treasury.gov/system/files/136/ECIP-Demand-Announcement-9-24-2021.pdf.

[4] *Id.*, at 53568 *et seq*.

as to why 20 years should serve as the maximum maturity of a debt instrument.[5] Notably, the Original Subordinated Debt Proposed Rule, from January 2020, offered the 20 year limitation to "help ensure the Subordinated Debt is properly characterized as debt rather than equity."[6] The Original Subordinated Debt Proposed Rule further proclaimed that "[g]enerally, by its nature, debt has a stated maturity, whereas equity does not."[7] While those statements are entirely reasonable, the next part of the NCUA's analysis is suspect:

> "The proposal is consistent with the OCC's subordinated debt regulation for a minimum maturity of five years, although that regulation does not have a maximum. Because U.S. national banks can issue equity, the distinction of a debt versus equity characterization for subordinated debt under the OCC's regulations is not as critical as it is for FCUs."[8]

To hold the ECIP participants to a 20-year limitation based on this wholly conclusory statement is inappropriate. On the one hand, the NCUA claims fidelity to bank subordinated debt regulation. On the other hand, it cherry picks the sections to which it maintains allegiance. This type of regulation is both unpleasing and unfair. Today, 30-year debt obligations are quite common.[9] In fact, credit unions themselves, despite the 15-year limit in Section 1757(5) of the Federal Credit Union Act, regularly hold mortgages up to 40-years on their balance sheets.[10]

Of course, the classification of an instrument as debt or equity can be a minefield to navigate. And, we do not suggest that the NCUA entertain allowing credit unions beyond those participating in ECIP to issue debt instruments longer than 20 years. As such, we do not suggest that the agency revisit its analysis beyond those ECIP-related secondary capital plans it intended to aid with the most recent rulemaking proposal. Given the contained and well-defined circumstances related to ECIP, however, we would encourage the NCUA to reconsider whether the ECIP cohort of grandfathered secondary capital might be allowed to issue debt instruments to the U.S. Treasury of up to 30 years. After all, the Treasury Department has offered. And, as part of an emergency program, no less.

Over the years, the subject of a debt / equity classification has been fodder for much case law. All the while, the subject has managed to retain an impressive level of opacity. Here, however, the NCUA insistence on a 20-year limitation on the term of the debt is arbitrary based on the facts and circumstances

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[5] *See, e.g., Proposed Rule, Subordinated Debt, National Credit Union Administration, (Jan. 23, 2020), available at https://www.ncua.gov/files/agenda-items/AG20200123Item4b.pdf (hereinafter, the "Original Subordinated Debt Proposed Rule"); Final Rule, Subordinated Debt, National Credit Union Administration, (Dec. 17, 2020), available at https://www.ncua.gov/files/agenda-items/AG20201217Item5b.pdf.*

[6] *See* Original Subordinated Debt Proposed Rule, *supra* note 5, at 94.

[7] *Id.*

[8] *Id.*

[9] Other than for a four-year period between 2002 and 2006, the U.S. Treasury has issued a 30-year Treasury bond continuously since 1977, when the 30-year bond replaced the 25-year bond issues. *See generally History of U.S. Treasury Bonds,* Treasury Direct, available at https://www.treasurydirect.gov/indiv/research/history/histmkt/histmkt_bonds.htm#:~:text=In%201974%2C%2025%2Dyear%20bond,May%2C%20August%2C%20and%20November.

[10] *See, e.g.* 12 CFR 701.21(g) (allowing credit unions to hold long-term mortgage loans with maturities up to 40 years).

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at hand. First, and most importantly, the U.S. Department of Treasury has offered a term sheet with the option of a thirty-year maturity. That term sheet was the product of several rounds of draft and refinement and the finished result of much consideration by many professionals both in and out of the government. Moreover, it was intended to reflect the express intent of Congress in response to a national emergency. In offering the ECIP investments, Congress hoped to encourage low- and moderate-income community financial institutions to augment their efforts to support small businesses and consumers in their communities. Notably, that same thirty-year term is being offered simultaneously to other forms of community financial institutions participating in the ECIP.

With both the U.S. Treasury, as lender, and the credit union, as borrower, willing to execute a thirty-year debt arrangement, the intent of the parties could not be any clearer. Moreover, the desire of the NCUA to upend that proposed relationship seems needlessly intrusive. Making the position of the NCUA more curious is the fact that the shorter term equates to an early repayment schedule and, at least marginally, increases risk to the National Credit Union Share Insurance Fund ("NCUSIF") it manages.

In reviewing the guidance on the classification of an instrument as debt or equity, we can identify several factors that courts have employed to inform such a decision. While most experts agree that no single factor should be dispositive, an examination of those factors in this context is enlightening – especially because most favor an interpretation that would allow the instrument proposed here to be debt.

In *Estate of Mixon*, for example, the Fifth Circuit summarized one of the most obvious factors in determining the character of an instrument, observing that "[t]he issuance of a stock certificate indicates an equity contribution; the issuance of a bond, debenture, or note is indicative of a bona fide indebtedness."[11] In the instant case, the very title of the term sheet makes the intent of the U.S. Department of Treasury very clear: "Emergency Capital Investment Program Credit Union Subordinated Debt Term Sheet" (emphasis ours).[12] Further, the term sheet goes offers, very clearly, a thirty-year option to qualifying credit unions in the definition of "Maturity":

> "The date ("Maturity Date") that is either fifteen or thirty years from the Investment Date, as selected by the issuer, and all Subordinated Debt issued to Treasury by the issuer must carry the same Maturity Date. On the Maturity Date, the issuer shall repay to Treasury the principal amount together with all accrued and unpaid interest on the Subordinated Debt."[13]

Aside from the plain terms of the instrument offered by the U.S. Department of Treasury, there are several additional attributes of the ECIP arrangement which favor a debt characterization, despite the proposed 30-year term. These include the following:

- **Fixed maturity date:** "The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same on the other hand would indicate

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[11] *See Estate of Mixon,* 464 F.2d 394 (5th Cir. 1972).
[12] *Emergency Capital Investment Program Credit Union Subordinated Debt Term Sheet*, United States Department of Treasury, (Aug. 11, 2021), available at https://home.treasury.gov/system/files/136/Subordinated_Debt_Term_Sheet_for_Credit_Unions.pdf.
[13] *Id.*, at 4.

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that repayment was in some way tied to the fortunes of the business, indicative of an equity advance."[14]

- **Payments not dependent upon earnings:** A bona fide debt is one that arises from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[15] By contrast, "where repayments depend on future corporate success, an equity investment may be indicated,"[16] and "where prospects for repayment are questionable because of persistent corporate losses, an equity investment may be indicated."[17] With respect to the ECIP, qualifying credit unions will have satisfied a significant process of application and investigation by both the U.S. Department of Treasury and the NCUA. Moreover, state-chartered credit unions participating in the program will have also satisfied a state regulator by the time an investment is awarded. Subject to such a regime of pre-clearance, it seems unlikely that repayments can be deemed to be questionable.

- **No management participation:** Increased management rights typically support an equity characterization.[18] Again, it seems unlikely that the ECIP investments will fall anywhere close to the line here, as the program's term sheet goes to great lengths to avoid any creditor rights that could be characterized as exerting influence over a borrowing credit union's management. For example, only upon a credit union's failure to make five quarterly interest payments in full will the U.S. Treasury gain "the right, but not the obligation, to appoint a representative to serve as an observer on the issuer's board of directors." And, in any case, the term sheet qualifies that such an observer "will not have any rights granted to board members under the Federal Credit Union Act and/or the NCUA's regulations or the Credit Union's bylaws." In the aggregate, these rights steer well clear of anything that exerts any participation rights in the management of the credit union. Again, an equity characterization seems wholly inapplicable.

- **Use of proceeds:** Here, the proceeds of the ECIP are required to be used to "provide loans, grants, and forbearance for small businesses, minority-owned businesses, and consumers, especially in low-income and underserved communities, that may be disproportionately impacted by the economic effects of the COVID-19 pandemic."[19] In other words, the funds are intended to allow the credit union to do more of the business of the credit union. As one court observed, when "[I]t appears that the advances were used to meet the daily operating needs of [the company]," a "bona fide indebtedness" is indicated.[20]

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[14] *Id.*, at 404. *See also Debt vs. Equity: Form & Substance Matter,* Farrell Fritz P.C. (Sep. 25, 2017) ("A fixed maturity date is indicative of an obligation to repay, which supports characterizing an advance of funds as debt."), available at https://www.taxlawforchb.com/2017/09/debt-vs-equity-form-substance-matter/.
[15] *See generally Debt vs. Equity: Form & Substance Matter,* Farrell Fritz P.C., *supra* note 14.
[16] *Id.*
[17] *Id.*
[18] *See, e.g.* Jeff Borghino, *Debt v. Equity in the Tax Court,* The Tax Adviser (Feb. 1, 2013), available at https://www.thetaxadviser.com/issues/2013/feb/clinic-story-01.html.
[19] *See generally,* Emergency Capital Investment Program Website, available at https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program.
[20] *Stinnett's Pontiac Serv., Inc.*, 730 F.2d 634, 640 (11th Cir. 1984).

- **Reasonable expectation of repayment:** In a recent case, the Tax Court expounded that "[w]hether an advance gives rise to a bona fide debt for Federal tax purposes is determined from all the facts and circumstances," adding that "[t]o constitute a bona fide debt, at the time of the transfer there must be a real expectation of repayment and an intent on the part of the purported creditor to secure repayment."[21] Here, such an expectation of repayment must be assumed, as there would be no reason for the requirement of an NCUA approval of the secondary capital plan otherwise.[22]

As we consider the primary factors described in the relevant case law, we find the NCUA's proposal to be unfounded in the instant case. To the extent the NCUA's 20-year limitation position is based on the advice of outside counsel, we encourage the NCUA to revisit that determination or consult another counsel for its opinion. The NCUA insistence on a 20-year maximum has material consequence for impacted credit unions and their members. The proposal will limit credit unions' participation in ECIP to 20-year subordinated debt investments when other financial institutions will participate in the very same program for up to 30-years. As a result, the related credit union lending growth among LMI, minority and other historical disadvantaged borrowers can be expected to be less over time than what could otherwise have been achieved had full credit union participation in 30-year investments been permitted. In our view, the significant cost of this result merits careful reconsideration.

Conclusion

We thank the NCUA Board and Staff for the consideration of this Comment Letter. And, we are grateful for the opportunity to share our views on the proposed amendments. While we look forward to the adoption of the Proposed Rule, we respectfully request that the NCUA give serious thought to allowing the MDI and CDFI credit unions taking part in the ECIP to provide the benefits of the program to their communities for the longer 30-year period. It is consistent with the intent of Congress. As importantly, it will make a meaningful difference in the lives of countless low- and moderate- income credit union members across the country.

Should you have any questions regarding our comments, please feel free to contact the undersigned at 908 432-6819 or mmacchiarola@oldenlane.com.

All the best,

/s/
Michael C. Macchiarola
Chief Executive Officer
Olden Lane Inc.

[21] *See 2590 Assocs., LLC v. Commissioner,* T.C. Memo. 2019-3, at *21.
[22] *See, e.g.,* 12 CFR 701.34(b)(1)(iii), (requiring that, before accepting secondary capital, a qualifying low-income credit union "[e]xplains how the LICU will provide for liquidity to repay secondary capital upon maturity of the accounts").