July 8, 2020

VIA EMAIL ONLY
Mr. Gerard Poliquin, Secretary of the Board
National Credit Union Administration
1775 Duke Street,
Alexandria, Virginia 22314-3428
Docket No: RIN 3133-AF08
www.regulations.gov

RE: Subordinated Debt: Docket No: RIN 3133-AF08

Dear Mr. Poliquin,

The Wisconsin Bankers Association (WBA) is the largest financial trade association in Wisconsin, representing approximately 220 state and nationally chartered banks, savings banks, and savings and loan associations located in communities throughout the State. WBA appreciates the opportunity to comment on the National Credit Union Administration's (NCUA's) proposal to permit credit unions to issue subordinated debt for purposes of regulatory capital treatment.

NCUA has proposed to allow a low-income credit union (LICU) to include subordinated debt in its risk-based capital (RBC) ratio as well as in its net worth requirement. Also, the proposal allows a Complex Credit Union that is not an LICU to include subordinated debt in its RBC ratio and allows a New Credit Union that is not an LICU to use subordinated debt to comply with NCUA's prompt corrective action regulations. The proposal also extends the eligibility to issue subordinated debt to credit unions that anticipate being designated as an LICU or non-LICU Complex Credit Union within 24-months following the credit union's planned issuance of the debt.

WBA is gravely concerned over the proposal. It is a fundamental position of WBA that all supervisory agencies need act within the scope given the agency pursuant to federal and/or state law and it is with extreme frustration that WBA need point out that *once again* NCUA has proposed a rule which is beyond its given authority.

In addition to proposing a rule for which the Federal Credit Union Act (FCUA) does not give NCUA the authority to promulgate, NCUA's proposal fails to impose a reasonable limit on the amount of subordinated debt a credit union may issue, fails to prescribe a limit on the use of the funds, and permits credit unions to purchase subordinated debt of other credit unions. Such unchecked and unlimited activity is in direct conflict with NCUA's very mission to provide a safe and sound credit union system.

NCUA stated the purpose of its proposal is to permit LICUs, Complex Credit Unions, and New Credit Unions to issue subordinated debt to meet regulatory capital needs. However, based upon NCUA's own annual report data, credit unions are not in need of the proposal for regulatory capital needs. NCUA's data reflects that nearly all credit unions currently meet applicable thresholds to be classified as well-capitalized. NCUA's data also reflects that nearly all Complex Credit Unions even meet their well-capitalized threshold for RBC rules not effective until January 2022. In addition, NCUA's data reflects very few LICUs have exercised their existing authority to issue secondary capital—making NCUA's actions all that more suspicious as to its true motivation behind issuing the proposal. Sadly, WBA believes NCUA's proposal is yet another example of a veiled attempt by NCUA to pander to the desires of its largest credit unions, the Complex Credit Unions, for further expansion of loan growth.

For the reasons set forth below, WBA requests NCUA withdraw its subordinated debt proposed rule.

The Federal Credit Union Act Does Not Authorize the Proposed Rule

WBA reminds NCUA that only Congress has the authority to permit subordinated debt to count towards credit union capital requirements. In 1998, as part of the Credit Union Membership Access Act (Membership Act), Congress amended FCUA Section 216 to permit LICUs to count "secondary capital accounts" toward their net worth requirements. Congress did so by defining the term "net worth" to mean retained earnings as measured by GAAP for all insured credit unions, other than for an LICU, which could treat "secondary capital accounts" that are uninsured and subordinated to other claims as net worth. See 12 U.S.C. §1790d(o)(2).

The Membership Act also directed NCUA to require Complex Credit Unions to meet a risk-based net worth requirement (12 U.S.C. §1790d(d)), and to prescribe a system of prompt corrective actions for New Credit Unions (12 U.S.C. §1790d(b)(2). Those provisions are also based upon the statutory definition of "net worth." Thus, under FCUA Section 216, the ability to count subordinated debt as part of a credit union's capital requirement applies only to LICUs, and only for the purpose of net worth requirements. It does not authorize the issuance of subordinated debt by credit unions for the purpose of RBC requirements or prompt corrective action determinations.

NCUA has not based its proposed rule on the net worth provisions under FCUA Section 216 but has instead contorted its rationale into its position that the proposed activity is permissible under credit unions' borrowing authority under FCUA Section 107(9). (see Section I.B. of the proposal.) WBA believes the contortion an unauthorized and irresponsible stretch by a supervisory agency.

The section NCUA relies upon does not authorize the issuance of debt for capital purposes. The provision distinguishes between debt and capital by using capital as a limit to the amount of debt that can be issued by a credit union. If debt and capital are equivalent, the limit in the statute would make no sense. The capital requirements applicable to credit unions appear in an entirely different section of FCUA, Section 216. See 12 U.S.C. §1790d.

In past legislative actions, a bill was introduced (H.R. 3993, 112th Congress, 2nd Session) to amend FCUA Section 216 to authorize "sufficiently capitalized and well-managed" credit unions to issue subordinated debt. The bill, however, was not enacted into law, and as recently as 2015, NCUA acknowledged that it lacked the express authority to permit credit unions to issue subordinated debt.

Further, in connection with the issuance of the RBC rule for Complex Credit Unions, several commenters urged NCUA to authorize supplemental capital to count toward the proposed RBC requirements. NCUA declined to do so given the lack of express statutory authority under FCUA. See 80 Fed. Reg. 4883 (January 27, 2015).

WBA believes NCUA's authority is limited to permit only LICU's to count subordinated debt instruments toward the net worth requirement. WBA believes Congress has not given NCUA the authority to allow for issuance of such instruments for any other purpose.

The Proposal Negates Basis for Tax Exemption for State-Chartered Credit Unions

Section 704.404 of the proposed rule requires that subordinated debt be first applied to cover any deficit in retained earnings, and then the amount so applied shall no longer be due and payable to the subordinated debt holders. The requirement is intended to make subordinated debt more "capital-like" by putting the holders of subordinated debt at risk for operating losses. WBA believes this limitation raises the question of whether a state-chartered credit union will still be entitled to the tax exemption found in the

Internal Revenue Code (Code).

FCUA Section 122 states that federal credit unions are exempt from all taxes except for local real property and personal property taxes. Section 501(c)(14) of the Code provides an exemption for state credit unions "without capital stock organized and operated for mutual purposes and without profit."

The term "capital stock" is not defined in the Code or implementing regulations; however, in IRS Notice 94-47, the Internal Revenue Service (IRS) stated that certain instruments that are designed to be treated as debt for tax purposes, also may be treated as equity for the purpose of meeting regulatory capital requirements. The IRS warned that it will scrutinize instruments of that this type to determine if they should be treated as debt or equity instruments, such as stock.

In IRS Chief Counsel Advice Memorandum 200932049 (2009), IRS reiterated that the characterization of an instrument for federal income tax purposes as "debt" or "equity" depends upon the terms of the instrument and all surrounding facts and circumstances analyzed in terms of its economic or practical realities. A main factor to be considered in making the determination is whether there is an unconditional promise to pay a sum certain and whether the holder of the instrument has the right to enforce such payment. It is also important whether the instrument is intended to be treated as equity for regulatory purposes, as is the case with the proposed rule. Several court cases have taken a similar approach, holding that in determining whether an instrument constitutes debt or equity, the investment should be analyzed in terms of its economic or practical realities.

In the proposed rule, the subordinated debt is required to have features to make it more "capital like" so that it may be treated as regulatory capital by credit unions. The proposed rule attempts to make the subordinated debt to have more of a characteristic of real capital. WBA believes the more conditions placed on the subordinated debt, such as those required in the proposed rule, the more likely IRS will conclude that it is capital. Such conclusion would threaten the tax exemption for state-chartered credit unions.

The Proposal Causes Significant Safety and Soundness Concerns

As mentioned above, the proposed rule imposes no reasonable limits on the amount of subordinated debt that a credit union may issue nor does the rule prescribe a limit on the use of the funds. This will no doubt result in rapid growth by credit unions which will jeopardize the safety and soundness of the credit union system. WBA is perplexed why a supervisory agency would propose such unfettered limits—given the agency's mission.

By permitting credit unions to raise funds from outside investors, the proposed rule removes an inherent safety feature of the credit union system: reliance upon retained earnings to support new loans. NCUA acknowledges there is risk when it acknowledged that some LICU failures were due to rapid growth around the time secondary capital was issued. See 85 Fed. Reg. 9694 (February 8, 2017).

As a way to manage risk, banking regulators have placed limits on the amount of subordinated debt that banks can count as capital. Under Basel III bank capital rules, subordinated debt can only be used to satisfy supplementary, or Tier 2 capital. Furthermore, Tier 2 capital can only be used to satisfy 2 percent of the 8 percent total minimum capital requirements, and subordinated debt cannot be used at all in complying with Tier 1 capital ratio of 6 percent. Banking regulators have established these limits because subordinated debt lacks the loss absorption capacity of common equity. WBA believes the 2007 financial crisis certainly illustrated the limitations of subordinated debt for capital purposes. Many banking regulators have made similar conclusions.

NCUA does not include the Basel III limitations on the amount of subordinated debt that can count towards a credit union's capital requirements despite NCUA acknowledging in the proposal that there is a difference between common equity and subordinated debt and despite NCUA conceding in the proposal that subordinated debt is "a lower quality form of capital." Incredibly, a Complex Credit Union would be permitted to use the subordinated debt equal to 100 percent of its net worth to meet the RBC requirement.

WBA also believes the proposal is unclear that there is any limitation on the amount of subordinated debt an LICU can use to meet its capital requirements. The issue is not addressed directly in the proposed rule. By NCUA grounding its proposal on the statutory borrowing authority of a credit union, the proposed rule limits the issuance of debt to 50 percent of a credit union's "capital." WBA questions what is meant by this limit. NCUA should have provided greater clarity to avoid a situation whereby a credit union is able to structure the issuance of subordinated debt where it can ladder its issuances to issue almost as much as the credit union's "real capital," nearly doubling the credit union's risk weight capital amount. Again, WBA is perplexed why a supervisory agency would propose such unfettered limits.

NCUA has also failed to set a limit on a credit union's use of funds derived from the issuance of subordinate debt. WBA believes NCUA should specifically identify how such funds may be used.

NCUA also need reconsider the limit on how much subordinated debt a credit union may purchase from another. As proposed, NCUA's rule creates systemic risk to the safety and soundness of the industry due to the interconnectedness of credit unions because of this purchase activity. The proposed rule provides that credit unions may invest in subordinated debt of another credit union up to an aggregate amount of 25 percent of net worth. Conversely, under Basel III bank capital rules, banks are required to deduct investments in the capital instruments of other financial institutions (that are not subsidiaries), if the investment exceeds 25 percent of the investing bank's common equity Tier 1 capital. See 12 CFR 217.22. The bank must also assign a risk-weight of 250 percent to the portion of the investment that is not deducted. NCUA's limit is a much larger proportion of total capital than 25 percent of common equity Tier 1. WBA believes the higher limit creates significant concerns about the degree of interconnectedness through cross-capitalization that would be permissible under the proposal.

Conclusion

WBA believes NCUA's authority is limited under the FCUA to permit only LICU's to count subordinated debt instruments toward the net worth requirement. WBA believes Congress has not given NCUA the authority to allow for issuance of such instruments for any other purpose.

In addition, NCUA's proposal fails to impose a reasonable limit on the amount of subordinated debt a credit union may issue, fails to prescribe a limit on the use of the funds, and permits credit unions to purchase subordinated debt of other credit unions. Such unchecked and unlimited activity is in direct conflict with NCUA's very mission to provide a safe and sound credit union system.

NCUA's stated purpose for the proposal is contradicted by its own credit union data which instead reflects that nearly all credit unions currently meet applicable well-capitalized thresholds and nearly all Complex Credit Unions meet the RBC threshold for being well-capitalized even though the RBC rules are not in effect until January 2022. Due to the requirements set forth in the proposal, surprisingly, NCUA is even willing to go so far as to quite possibly cause a state-chartered credit union to lose its tax-exempt status should the credit union implement the rule.

It is also important to note, that the inability of credit unions to access capital markets is part of the reason Congress has granted a tax exemption to credit unions. In 1951, Congress removed the tax exemption

from thrift institutions because they had stated to operate more like commercial banks. If credit unions are given access to funding other than through retained earnings, the rationale for the tax exemption, especially for state-chartered credit unions, will be eliminated. Through the proposed rule, credit unions are taking yet another step toward being indistinguishable from banks and should carry the same responsibilities as banks, including paying taxes.

For the reasons, WBA requests NCUA withdraw its subordinated debt proposed rule.

Once again, WBA appreciates the opportunity to comment on NCUA's proposal.

Respectfully,

Rose Oswald Poels
President/CEO