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December 5, 2022

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

RE: SUBORDINATED DEBT PROPOSED RULE [DOCKET NO: NCUA–2022–0138; RIN 3133–AF43]

To whom it may concern,

The Independent Community Bankers of America (ICBA)[1] appreciates this opportunity to respond to the National Credit Union Administration's (NCUA) proposed amendments to the Subordinated Debt rule.[2] We strongly oppose the Board's proposal to remove the maximum maturity limit of 20 years from § 702.404(a)(2) of the NCUA regulations. Allowing credit unions to issue subordinated debt with maturities longer than 20 years blurs the line between debt and equity financing and allows credit unions to engage in aggressive expansion that is not related to serving their members of modest means.

Background

In December of 2020, the NCUA finalized a Subordinated Debt rule that became effective on January 1, 2022. That rule permitted Low-Income Credit Unions (LICUs), complex credit unions, and new credit unions to issue Subordinated Debt for purposes of Regulatory Capital treatment.[3] Subordinated Notes issued pursuant to this rule would be required to have a minimum maturity of 5 years and a maximum maturity of 20 years. The rule included a grandfathering provision that allowed LICUs to treat secondary capital previously issued by LICUs as Grandfathered Secondary Capital (GSC). This GSC would continue to receive Regulatory Capital treatment for a period of 20 years from the effective date of the final rule.

In 2021, in response to the COVID pandemic, Congress created the Emergency Capital Investment Program (ECIP). Pursuant to the ECIP, Treasury was authorized to "provide up to $9 billion in capital

[1] The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. ICBA is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education, and high-quality products and services. With nearly 50,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 700,000 Americans and are the only physical banking presence in one in three U.S. counties. Holding more than $5.8 trillion in assets, over $4.8 trillion in deposits, and more than $3.5 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at www.icba.org
[2] 87 FR 60326, available at: https://www.federalregister.gov/documents/2022/10/05/2022-20926/subordinated-debt.
[3] *See* 86 FR 11060.

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directly to depository institutions that are certified Community Development Financial Institutions (CDFIs) or minority depository institutions (MDIs) to, among other things, 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."[4] Federally insured credit unions that are minority depository institutions or community development financial institutions are eligible to receive ECIP investments in the form of subordinated debt. Treasury offered either 15 or 30 year maturities for investments in eligible credit unions.

In October of 2021, the NCUA issued a Letter to Credit Unions that permitted LICUs participating in ECIP to issue 30-year subordinated notes.[5] The NCUA is now proposing to permit GSC to receive Regulatory Capital treatment for a period of 30 years from the later of the date of issuance or January 1, 2022. The agency argues that this change would allow credit unions to receive the "maximum benefit of the ECIP" because "[c]apital with longer maturities helps credit unions make more loans to underserved communities."[6] In addition, the NCUA is proposing to remove the maximum maturity limit of 20 years for subordinated notes issued by LICUs. Instead, when credit unions seek to issue subordinated debt with a maturity of greater than 20 years, they will be required to submit to the Appropriate Supervision Office one of more of the following: (1) a written legal opinion from a Qualified Counsel; (2) a written opinion from a licensed CPA; or (3) an analysis conducted by the credit union or independent third-party.

ICBA Position

The changes proposed by the NCUA are inappropriate because they are not narrowly tailored to allow eligible credit unions to fully participate in ECIP. Instead, they broadly expand the power of LICUs to issue subordinated debt with long maturities that blurs the line between debt and equity funding. This expansion of powers will not encourage credit unions to make more loans in underserved communities, as intended by Congress. It will instead allow credit unions to fund irresponsible growth, including through the acquisition of community banks. Therefore, we offer the following specific recommendations:

1) **Explicitly prohibit credit unions from using proceeds from the issuance of subordinated debt to purchase the assets of FDIC insured banks.** Credit unions are the beneficiaries of an exemption from federal taxation because Congress intended for them to serve the public purpose of serving the "productive and provident credit needs of individuals of modest means" within their field of membership.[7] Meeting the needs of individuals of modest means should be especially important for credit unions with the low-income designation. Aggressive expansion through the purchase of taxpaying banks is not an appropriate way for credit unions to meet

[4] U.S. Department of the Treasury, "Emergency Capital Investment Program" (accessed Oct. 27, 2022), available at: https://home.treasury.gov/policy-issues/coronavirus/assistance-for-small-businesses/emergency-capital-investment-program/.
[5] Letter to Credit Unions 21-CU-11, Emergency Capital Investment Program Participation and enclosed Supervisory Letter No. 21-02 (Oct. 20, 2021), available at https://www.ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/emergency-capital-investment-program-participation.
[6] 87 FR 60328.
[7] Pub. L. 105–219, §2, Aug. 7, 1998, 112 Stat. 913.

their statutory purpose, and credit unions should not be permitted to utilize money raised from private creditors through the issuance of subordinated debt to do so.

2) **Continue to limit the maturity of credit union subordinated debt to 20 years.** The 20 year limitation was created after the NCUA concluded that such a limitation would ensure that courts consider credit union subordinated debt to be debt rather than equity. This prevents credit unions from exceeding their statutorily permitted powers. There is no evidence that the risk of long duration subordinated notes being classified as equity has decreased, and therefore no justification for the NCUA Board to reverse its previous decision.

3) **In the alternative to Recommendation (2), only permit credit unions to issue subordinated debt with a maturity of longer than 20 years when the creditor is the United States Government.** This compromise would allow credit unions to participate in the ECIP and any federal stimulus programs.

4) **Require Credit Unions to submit a written legal opinion from a Qualified Counsel and a written Opinion from a licensed CPA to the Appropriate Supervision Office before issuing subordinated debt.** Determining whether an instrument constitutes debt or equity is not a simple matter, particularly when evaluating notes with long maturities. The Bureau's proposal potentially allows a credit union to issue subordinated debt with a maturity longer than 20 years after submitting only "an analysis conducted by the credit union or independent third-party."[8] Allowing credit unions to issue subordinated debt securities without, at a minimum, the advice of outside legal counsel and an independent CPA, increases the risk that credit unions will impermissibly issue equity securities.

<u>Discussion</u>

Long duration notes, particularly when they are subordinated to the interests of other creditors, run the risk of being held by courts to be equity securities, regardless of the stated intention of the issuing party. While we agree with the NCUA's observation that "courts have never set a strict limit on the length of a fixed stated maturity for purposes of a debt versus equity analysis,"[9] we nevertheless believe that that a longer maturity may tend to indicate that an instrument is equity rather than debt. Because credit unions are member-owned non-profit organizations, they are legally prohibited from selling any equity interest. The NCUA's regulations should air on the side of caution, rather than encouraging credit unions to push the envelope of what is legally permissible.

There is no bright line that determines whether a security constitutes debt or equity. Congress delegated authority to the IRS to prescribe regulations necessary "to determine whether an interest in a corporation is to be treated … as stock or indebtedness (or as in part stock and in part indebtedness)" but the IRS has not yet done so.[10] Congress proposed that such regulations may include, among other factors:

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[8] 87 FR 60329.
[9] 87 FR 60328.
[10] 26 U.S.C. 385.

1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
2) whether there is subordination to or preference over any indebtedness of the corporation,
3) the ratio of debt to equity of the corporation,
4) whether there is convertibility into the stock of the corporation, and
5) the relationship between holdings of stock in the corporation and holdings of the interest in question.[11]

In absence of any more specific guidance from the IRS, different jurisdictions have adopted their own multi-factor tests to determine whether a debtor-creditor or a corporation-shareholder relationship exists. In general, these tests are highly complex, ranging from 11 to 16 factors. Factors used by courts have included the intent of the parties, the presence or absence of a fixed maturity date, the source of interest payments, the status of the contribution in relation to regular corporate creditors (i.e., whether they are subordinate to other creditors), the extent to which the advance was used to acquire capital assets, and so on.[12] When courts apply these tests, no one factor is dispositive and not all factors are weighted equally. Ultimately, in every case, the decision whether an instrument constitutes debt or equity is determined by a totality of the circumstances analysis.

This places issuers in a difficult position because – even when an issuer has a bona fide intention to issue a debt security – a court may later conclude, based on the characteristics of that instrument, that the issuer has issued equity. For a credit union, which legally cannot issue equity securities, this creates the risk of exceeding the limit of their statutorily permitted powers. It is ill-advised, therefore, for the NCUA to amend its rules in a manner that allows credit unions to issue long duration subordinated debt because courts have been more likely to classify notes with long durations as equity. The NCUA's current policy of limiting the maturity of subordinate debt to 20 years was implemented for the explicit purpose of helping to "ensure the Subordinated Debt is properly characterized as debt rather than equity."[13] This is a sensible policy that overtly acknowledges that a longer maturity will increase the likelihood of equity classification, and we see no sufficient justification for abandoning it.

In an attempt to demonstrate that notes with long maturities can be considered as debt rather than equity, the NCUA cites *Monon Railroad v. Commissioner of Internal Revenue*, where the court holds a 50 year note to be debt.[14] However, in that case, the court indicates that under other circumstances it might have ruled differently. For example, the opinion says that "we must take into consideration the substantial nature of the petitioner's business, and the fact that it had been in corporate existence since 1897, or 61 years prior to the issuance of the debentures."[15] It further contrasts its opinion with its previous decision in *Swoby Corporation v. Commissioner of Internal Revenue*, where it held that a 99-year debenture issued by a newly formed company to purchase an office building represented invested rather than borrowed capital.[16]

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[11] *Id*.
[12] *See Est. of Mixon v. United States,* 464 F.2d 394, 402 (5th Cir. 1972).
[13] 85 FR 13892.
[14] 87 FR 60328.
[15] *Monon R.R. v. Comm'r of Internal Revenue*, 55 T.C. 345, 359 (1970).
[16] *See Swoby Corp. v. Comm'r,* 9 T.C. 887, 888 (1947), *supplemented,* 10 T.C. 129 (1948).

While the *Swoby* case is an extreme example, it illustrates that, even in cases if a note is structured as a debenture with a fixed maturity, there is no guarantee that courts will hold it to be debt, particularly if it is issued by a newly formed company and has a maturity that seems unreasonable ("It must be seriously doubtful, to say the least, whether such a maturity date, definite though it may be, can be thought of as falling 'in the reasonable future.'")[17]

Under the NCUA's proposed rule, there is nothing that would preclude a newly formed LICU from issuing notes with 50 year maturities, 99 year maturities, or even 150 year maturities. All that would be required to satisfy the letter of the proposed regulation is an analysis conducted by the credit union itself stating that the note should be considered debt and not equity and the approval of the Appropriate Supervision Office. This is not sufficient to prevent credit unions from issuing securities that are nominally debt but are, in substance, an impermissible equity interest.

Credit union subordinated debt is already equity-like under the current rules. For example, in *United States v. Snyder Brothers Company*, the Fifth Circuit concluded that 20-year debentures that were subordinated to all other indebtedness of the issuer and where there was no limitation as to payment of dividends or provision for any sinking fund or reserve did not constitute "indebtedness," despite the intention of the issuer.[18] The *Snyder Brothers* court held that while subordination alone or a long term alone would not preclude classification as debt, those factors together, as well as the lack of any sinking fund or reserve, tended more "towards eliminating any difference between the holders of these debentures and preferred stockholders than any case that has been called to our attention."[19]

It is not clear what, in the current rules, would prohibit a credit union from issuing a security identical to that in the *Snyder Brothers* case – a security which was held to be an equity investment. Indeed, NCUA regulations explicitly state that credit union subordinated notes must be subordinate to all other claims in liquidation,[20] be unsecured, including, without limitation, prohibiting the establishment of a sinking fund or reserve,[21] and may have a maturity of up to 20 years.[22] A note that meets these conditions would appear substantially identical to the debentures that the *Snyder Brothers* court found to be an equity interest. Lengthening the maturity of these notes would make credit union subordinated debt even more equity-like. In addition, the outstanding principal amount of subordinated debt is treated as regulatory capital for purposes of calculating net worth. This is another trait more typical of equity.

Finally, we have seen courts consider instances when funds are "utilized to provide working capital for the day-to-day operations of the Bank and was in no way connected to any acquisition of capital assets" to be evidence of genuine indebtedness.[23] By contrast, when a credit union issues subordinated debt to fund the acquisition of a taxpaying community bank – or, for that matter, another credit union, it indicates that the instrument is more likely to be characterized as equity. This demonstrates the need for specific regulations that provide that funds raised from the issuance of subordinated debt can only be used as working capital – not to fund major acquisitions. Failure to promulgate such regulations –

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[17] *Id.* at 887.
[18] *United States v. Snyder Bros. Co*., 367 F.2d 980 (5th Cir. 1966).
[19] *Id*. at 984.
[20] 12 CFR 702.404(a)(3).
[21] 12 CFR 702.404(a)(5).
[22] 12 CFR 702.404(a)(2).
[23] *Est. of Mixon v. United States*, 464 F.2d 394, 410 (5th Cir. 1972).

coupled with this proposal, which would conceivably allow credit unions to issue notes of extremely long maturity – would result in courts routinely classifying credit union subordinated notes as equity.

Conclusion

In conclusion, if the Board desires only to allow credit unions to participate in 30 year investments through ECIP, it could have issued a much more narrowly tailored proposal. Instead, this proposal allows credit unions to issue long duration subordinated debt to any creditor and appears to be yet another expansion of credit union powers. Not only will this change enable credit unions to impermissibly blur the lines between debt and equity financing, but it will also stimulate further credit union acquisitions of community banks. Therefore, we urge the NCUA Board not to finalize these changes as proposed and to promulgate additional regulation limiting the use of subordinated debt to fund bank acquisitions.

Thank you again for the opportunity to provide feedback in response to the Board's proposed amendments to the Subordinated Debt rule. Please feel free to contact me at (202) 821-4411 or Mickey.Marshall@icba.org if you have any questions about the positions stated in this letter.

Sincerely,

Mickey Marshall
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