September 10, 2024

Hon. Todd Harper
Chairman
National Credit Union Administration
1775 Duke St #4206,
Alexandria, VA 22314

RE: CREDIT UNIONS ARE TURNING TO WALL STREET TO FUND THE ACQUISITION OF MAIN STREET COMMUNITY BANKS USING LEGALLY QUESTIONABLE SUBORDINATED DEBT

Dear Mr. Harper,

In 2021, the National Credit Union Administration (NCUA) issued its subordinated debt rule which significantly expanded the number of credit unions permitted to issue subordinated debt and in 2023 the agency furthered relaxed its rules, allowing credit unions to issue long duration, equity like subordinated notes.[1] Since that time, we have seen a spree of credit union subordinated debt offerings that have been used to fund the acquisitions of taxpaying community banks. Each of these transactions represents two distinct harms: (1) the taxpayer and the community are harmed by the loss of a bank which is subject to federal corporate tax and the Community Reinvestment Act (CRA) and (2) the acquiring credit union's members are harmed by the increased debt loan borne by their credit union which results in less funds available to pay interest and offer services to its member owners.

When the Federal Credit Union Act was enacted in 1934, Congress intended for credit unions to operate as small, cooperative financial institutions to serve people of modest means. It certainly did not envision today's modern billion-dollar regional credit unions – with membership no longer restricted by any ascertainable "common bonds" – that utilize sophisticated Wall Street debt offerings to fund bank acquisitions. The average member of these credit unions is ill-equipped to understand the legal and financial complexities of nine-figure subordinated debt offering or whether they serve the long-term interests of his or her credit union. Instead, these debt offerings, and the acquisitions they fund, are driven by management who are primarily incentivized by revenue growth and excessive compensation.

The Independent Community Bankers of America (ICBA)[2] calls on the NCUA Board to curb this abuse of credit union powers by prohibiting credit unions from using the proceeds of subordinated debt offerings

[1] *See* NCUA, 21-CU-13, available at: https://ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/subordinated-debt-final-rule-effective-january-1-2022; Board Action Bulletin, "NCUA Board Approves Final Subordinated Debt Rule to Support ECIP Participation" (March 2023), available at: https://ncua.gov/newsroom/press-release/2023/ncua-board-approves-final-subordinated-debt-rule-support-ecip-participation.

[2] The Independent Community Bankers of America® has one mission: to create and promote an environment where community banks flourish. We power the potential of the nation's community banks through effective advocacy, education, and innovation. As local and trusted sources of credit, America's community banks leverage their relationship-based business model and innovative offerings to channel deposits into the neighborhoods they

to purchase taxpaying banks. In doing so, the NCUA has several reasonable options for doing do, such as **prohibiting any credit union that issues subordinated debt from participating in a merger or purchase and assumption transaction for the five succeeding years following the offering; or from issuing subordinated debt for five years after completing the acquisition of a community bank.** Credit union acquisitions of community banks are contrary to the public interest and the NCUA should not enable credit unions to leverage Wall Street dollars to fund Main Street deals.

Credit Union Issuance of Subordinated Debt

On January 1, 2022, the NCUA's final subordinated debt rule became effective.[3] This rule expanded the ability to issue subordinated debt to low-income credit unions, complex credit unions, and new credit unions for purposes of regulatory capital treatment. The finalization of this rule led to an explosion of subordinated debt issuance by credit unions, with total credit union subordinated debt outstanding rising from $540 million in Q2 of 2021 to $3.65 billion in Q2 of 2023.[4]

The issuance of subordinated debt by credit unions – particularly subordinated debt with long maturities – has effectively blurred the line between debt and equity financing. As non-profit cooperatives, credit unions are not permitted to sell equity interests to investors. Long duration notes that are subordinated to the interests of other creditors could reasonably be considered equity securities in legal proceedings, regardless of the stated intention of the issuer. In other words, credit union issuers of subordinated debt may be inadvertently selling impermissible ownership interests in their credit unions to non-member investors, to the detriment of their member owners. This is doubly troubling when the proceeds from these offerings are used for acquisitions of community banks that enrich the credit union's officers.

There is no bright line that determines whether a security constitutes debt or equity. 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, etc.[5] When courts apply these tests, no one factor is dispositive and factors need not be weighted equally. In every case, the decision whether an instrument constitutes debt or equity is determined by a totality of the circumstances analysis.

In *United States v. Snyder Brothers Company*, the United States Court of Appeals for 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.[6] 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

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serve, creating jobs, fostering economic prosperity, and fueling their customers' financial goals and dreams. For more information, visit ICBA's website at www.icba.org.

[3] 86 Fed. Reg. 72807, available at: https://www.regulations.gov/document/NCUA-2022-0040-0001.

[4] Lauren Seay and Zuhaib Gull, *S&P Global Market Intelligence*, "Credit union subordinated debt levels stall after years of rapid growth" (September 26, 2023), available at: https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/credit-union-subordinated-debt-levels-stall-after-years-of-rapid-growth-77541326.

[5] See *Est. of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972).

[6] *United States v. Snyder Bros. Co*., 367 F.2d 980 (5th Cir. 1966).

any difference between the holders of these debentures and preferred stockholders than any case that has been called to our attention."[7]

Under the current rules, there is nothing to prohibit a credit union from issuing a security identical to the note in the *Snyder Brothers* case – a security which was held to be an equity investment. NCUA regulations explicitly state that credit union subordinated notes must be subordinate to all other claims in liquidation,[8] be unsecured, including, without limitation, prohibiting the establishment of a sinking fund or reserve,[9] and may have maturities longer than 20 years, subject to certain conditions.[10] These rules, in fact, would permit the issuance of notes even more equity-like than the debentures that the Snyder Brothers court found to be an equity interest because they may have maturities longer than 20 years and because the outstanding balance would be treated as regulatory capital for purposes of calculating credit union net worth.

NCUA regulations should not permit credit unions to push the bounds of what is legally permissible but should instead air on the side of caution. Credit union issuance of subordinated debt should be limited to relatively short duration notes that fund operating expenses. Long duration notes that risk making creditors into de facto equity investors and whose proceeds are used to fund acquisitions should not be permitted.

<u>The Use of Subordinated Debt to Fund Acquisitions</u>

The top five credit union issuers of subordinated debt are Self-Help Credit Union, VyStar Credit Union, Suncoast Credit Union, ELGA Credit Union, and GreenState Credit Union. All five of these credit unions have announced, completed, or attempted an acquisition of a taxpaying community bank in the last ten years.[11]

The NCUA's subordinated debt rule allows eligible credit unions to treat subordinated debt as regulatory capital. This capital treatment was designed to allow credit unions to raise secondary capital to fortify their balance sheets and decrease the likelihood of NCUA intervention in times of financial stress. However, it did not take investment bankers long to realize that this new rule dramatically expands the pool of credit unions able to raise outside capital to fund risky M&A transactions. A cottage industry of boutique investment banks and consultants has since taken root to enable credit unions to offer nine-figure debt placements and pursue community bank acquisitions, often with both advisory services under the same roof.

As an illustration of this strategy at work, GreenState Credit Union issued $20 million in subordinated debt in October of 2020 and $40 million in subordinated debt in November 2021, both through its placement agent, Olden Lane.[12] GreenState would later issue an additional $100 million in subordinated debt in 2023. In 2021, GreenState Credit Union purchased three separate community banks, with a

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[7] *Id.* at 984.
[8] 12 CFR 702.404(a)(3).
[9] 12 CFR 702.404(a)(5).
[10] 12 CFR 702.404(a)(2); 12 CFR 702.408(b)(14).
[11] *Supra* note 4.
[12] Olden Lane, "Significant Transactions," (accessed August 20, 2024), available at: https://oldenlane.com/.

combined total of $1.509 billion in assets.[13] On a podcast interview, Todd Fanning, the CFO of GreenState, explained how he thinks about the cost of capital to fund growth by raising capital externally (i.e. through the issuance of subordinated debt) versus the cost of capital internal to a credit union (i.e. through retained earnings), saying:

> [T]here's a couple of ways you can go about that, if it's, if it's simply a cushion that you're looking to build up, then the metrics are a little bit different. But if it's an acquisition, for instance, like if you're merging with a credit union, you're going to combine the capital of the two entities. If you're buying a bank, you're on your own. So, you're going to immediately have a lower capital ratio, because you're adding a lot of assets to your balance sheet. So, the way you think about that is in terms of your leverage, you know, if you're adding so much in capital, and you want to maintain, say, a 9% capital ratio, then you just lever up to that number. And that tells you how much you can add in terms of total assets generally speaking.[14]

In the same interview, Michael Macchiarola, the CEO of Olden Lane, follows up by saying:

> Well, this is really the hottest topic if you would, today, around sub debt … folks that want to see growth, for one reason or another, are going to have to look to non-traditional or non-organic sources for that growth. Enter the acquisition, or the merger. The merger in many cases is easier, because it's less capital intensive, you'll suffer less dilution, as Todd alluded to it average of the capital level, when you get a net worth, the bank deal is going to require you to pay the bank shareholders typically, at a multiple, let's call it one and a half to two times, depending on where in the country, you're trying to buy that bank. And if it's in Florida, it may be north of two, God bless Florida. But it's very capital intensive, your capital ratio, your net worth ratio is going to suffer. And that's why today we're seeing sub debt used to push that capital ratio back up either prior to a merger or an acquisition or contemporaneous with or right after acquisition. That's what you've seen.[15]

GreenState is not the only credit union to utilize risky Wall Street fundraising to acquire community banks, but this conversation illustrates the extent that these transactions have gone beyond their traditional member-driven mission. Increasingly, credit unions are looking for alternatives to growing their member base organically – through common bonds - and instead, turning to capital markets to finance exponential growth.

A Wall Street model of expansive growth at any cost fails to serve credit union members or further a cooperative business model. As the excerpt above demonstrates, in some cases the multiples that credit unions pay for community banks can be eye-watering. One driver of these outsized multiples is that credit unions possess unfair regulatory and tax advantages over banks. Therefore, when a credit union purchases a bank, it makes that bank's earnings, which were subject to taxation the day before, immediately exempt from federal tax. In addition, credit unions that acquire community banks are often

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[13] S&P Global Market Intelligence, "GreenState CU scoops up 3 banks in 5 months on quest for scale" (October 28, 2021, available at: https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/greenstate-cu-scoops-up-3-banks-in-5-months-on-quest-for-scale-67264615.

[14] Doug England (Host), *C.U. on the Show*, "How Credit Unions Can Leverage Subordinate Debt for Growth and Impact" (April 16, 2024), transcript and audio available at: https://act-advisors.com/how-technology-can-humanize-culture-transforming-credit-union-workplaces/.

[15] *Ibid.*

able to save on regulatory compliance costs due to their less frequent fair lending exam schedule and exemption from the federal CRA.

However, as large credit unions become increasingly focused on high-cost growth, it is worth noting the correlation between credit union size and executive pay. For example, the 2023 compensation survey by CU management concluded that "Like past surveys, this year's report found that a credit union's asset size is the leading influencer of compensation levels."[16] Because credit union executives cannot be paid in their company's stock, they may be more likely to engage in debt-fueled deals that grow the absolute size of the credit union but burden it with long term debt in the hopes of higher compensation in the short term.

Conclusion

For the reasons stated above, ICBA respectfully requests that the NCUA investigate the practices described above and ensuing consequences for Main Street. By allowing credit unions to issue long duration subordinated debt, the NCUA has enabled credit unions to offer impermissible equity financing to the detriment of their members in favor of Wall Street. Further, credit unions' use of subordinated debt offerings to fund the acquisitions of taxpaying community banks harms taxpayers and Main Street, while solely enriching credit union management.

Accordingly, we urge the NCUA to take steps to address the concerns noted above. At a minimum, the NCUA should take action to immediately prohibit credit unions from acquiring community banks for a minimum of five years after the issuance of subordinated debt. In addition, we urge the NCUA to prohibit credit unions from issuing subordinated debt for five years after any subject acquisition. Further, the NCUA must limit the maturity of subordinated debt issued by credit unions to its previous limit of 20 years.

Please feel free to contact me at Mickey.Marshall@icba.org if you have any questions about the positions stated in this letter.

Sincerely,

M. Marshall

Mickey Marshall
AVP and Regulatory Counsel

[16] Diane Franklin, CU Management magazine, "Solid Gains Continue to Boost Executive Pay Levels" (October 1, 2023), available at: https://www.cumanagement.com/articles/2023/10/solid-gains-continue-boost-executive-pay-levels.