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LEGAL UPDATES AND NEWS

NCUA Approves an Amendment to its Current Rule on Subordinated Debt

The NCUA recently amended its current rule on subordinated debt, which was finalized in December 2020 with an effective date of January 1, 2022 (the "Amendment"). As described in more detail below, this Amendment makes two material changes to the current rule. First, there is no longer a maximum maturity for subordinated debt notes, provided that a credit union seeking to issue subordinated debt notes with maturities longer than 20 years demonstrates how such instruments would be considered debt. In addition, the regulatory capital treatment of grandfathered secondary capital was extended to the later of 30 years from the date of issuance or January 1, 2052. This extension aligns the regulatory capital treatment of grandfathered secondary capital with the 30-year maximum permissible maturity for any secondary capital issued by a credit union under the U.S Department of the Treasury's Emergency Capital Investment Program (ECIP) or other programs administered by the U.S. Government.

Based on the foregoing, eligible credit unions should strongly consider getting NCUA pre-approval to issue subordinated debt for liquidity and capital planning purposes even if eligible credit unions have no immediate plans to issue subordinated debt. The current rule provides eligible credit unions with a two-year window to issue the subordinated debt without any further approvals from the NCUA.

More information about subordinated debt can be found here: White Paper - NCUA Subordinated Debt Final Rule.

Background

The current rule on subordinated debt (or the "current rule") permits low-income designated credit unions, credit unions without a low-income designation and with assets greater than $500 million and new credit unions (collectively, "eligible credit unions") to issue subordinated debt for purposes of being included as regulatory capital if certain requirements are satisfied. "Subordinated debt" is an unsecured borrowing issued by an eligible credit union to certain qualifying investors (such as other credit unions). Relevant to the Amendment, the current rule provided that any secondary capital issued by low-income designated credit unions prior to January 1, 2022 would be considered "grandfathered secondary capital" that is exempt from the requirements of the current rule. Any secondary capital issued by a low-income designated credit union on or after January 1, 2022 is considered "subordinated debt" and subject to the requirements of the current rule.

Maximum Maturity of Promissory Notes

The current rule requires that any subordinated debt issuance must be evidenced by certain legal documents, including a promissory note. The current rule also contained a provision requiring that promissory notes for subordinated debt must have a minimum maturity of five years and a maximum maturity of 20 years. The Amendment removes the maximum maturity limit of 20 years. Instead, when

an eligible credit union applies for NCUA preapproval to issue promissory notes with maturities longer than 20 years from the date of issuance, the eligible credit union must demonstrate that the issuance is debt pursuant to either: (1) a written legal opinion from qualified legal counsel; (2) a written opinion from a licensed certified public accountant; and/or (3) an analysis conducted by the eligible credit union or independent third-party.

This revision to the current rule is to help ensure the promissory note for subordinated debt is considered debt. The NCUA does not anticipate that a legal or accounting opinion would be necessary for issuances that have fixed stated maturities that are not significantly longer than 20 years and do not contain any other features or terms that could be viewed as akin to an equity issuance. However, the NCUA recognizes that each issuance is unique, and while unlikely, a legal or accounting opinion may be necessary to fully ensure that the promissory note for the subordinated debt issuance would be considered debt.

Extension of Regulatory Capital treatment for Grandfathered Secondary Capital

Relevant to the Amendment, the ECIP was established in 2021 and enables the U.S. Department of the Treasury to make investments in "eligible institutions" (which includes federally insured credit unions that are minority depository institutions or community development financial institutions). Investments in eligible credit unions through the ECIP are in the form of "secondary capital." Treasury offered either 15- or 30-year maturity options for the secondary capital investments. In December 2021, the NCUA amended its regulatory capital rules permitting secondary capital issued by a low-income designated credit union to Treasury through the ECIP to be designated as grandfathered secondary capital for regulatory capital purposes regardless of the issuance date, provided certain conditions were satisfied.

The Amendment permits grandfathered secondary capital to receive regulatory capital treatment for a 30-year period from the later of the date of issuance or January 1, 2022. Previously, regulatory capital treatment for grandfathered secondary capital was 20 years. This extension to 30 years aligns the regulatory capital treatment of grandfathered secondary capital with the maximum permissible maturity for any secondary capital issued under the ECIP. Consequently, participating low-income designated credit unions will be able to receive the maximum benefit of the ECIP from a regulatory capital standpoint. Moreover, capital with longer maturities helps credit unions make more loans to underserved communities and improve such area's economic well-being.

Next Steps – Consider Getting Preapproved to Issue Subordinated Debt Immediately

The issues that contributed to the recent failures of Silicon Valley Bank and Signature Bank – underwater securities portfolios, deposit outflow and pricing pressures due to adverse market conditions – are ones that may impact several credit unions. In a rising interest rate environment, liquidity and capital are significant risks to the safety and soundness of credit unions. As discussed above, eligible credit unions should consider getting preapproved by the NCUA to issue subordinated debt, which would be a prudent step to maximize their ability to increase liquidity and strengthen regulatory capital levels.

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