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What Does the New Subordinated Debt Rule Mean to My Credit Union?

Subordinated debt is an unsecured loan issued by a depository institution that is treated as regulatory capital due to its subordination to all other creditors. Recent changes to the NCUA's subordinated debt regulations, issued late 2021 and effective January 1 of this year, have expanded and modernized the rule.

Low-income designated credit unions (LICUs)[1] were given the ability to issue subordinated debt in 1996 with the finalization of CFR 701.34, allowing LICUs to raise secondary capital from foundations and philanthropic-minded organizations. In 1998, the Federal Credit Union Act was amended to include a prompt corrective action framework for federally insured credit unions based on their level of net worth, which specifically included subordinated debt issued by LICUs in its calculation. Some restrictions were implemented in 2006, which required LICUs to first seek regulatory approval prior to issuing secondary capital.

The recently effective rule incorporates additions and amendments reflecting a balance between flexibility and responsibility to protect credit union safety and soundness. Notably, complex credit unions[2] and new credit unions[3] are now permitted to issue subordinated debt and include these balances in regulatory risk-based capital (RBC). However, only LICUs can include subordinated debt in statutory Net Worth, as defined by the Federal Credit Union Act. Therefore, LICU ability to issue subordinated debt, include it in Net Worth and apply it toward the Net Worth Ratio calculation is unaltered. Keep in mind, changes to the Federal Credit Union Act require congressional action.

Invest or Issue?

[1] LICU definition outlined in part 701.34 of the NCUA's rules and regulations
[2] Complex credit union is defined as a credit union with total assets greater than $500 million outlined in part 702.103
[3] New credit unions are defined as those that have been in operation for less than 10 years and have total assets of not more than $10 million

In effect, credit unions are not able to both issue and invest in credit union sub-debt. Part 702.403 of NCUA regulations outlines eligibility requirements, one of which being the CU cannot have direct or indirect investments in other credit union sub-debt. For complex credit unions that issue subordinated debt, those not considered a LICU are limited to issuing debt amounts that do not exceed 100 percent of net worth. For credit unions that elect to invest in subordinated debt, investments are limited to the lessor of 25 percent of net worth, or the portion of net worth totaling more than 7 percent of the institution's assets. In addition, investments in sub-debt from a single credit union cannot exceed 15 percent of net worth.

How to Issue

Subordinated debt can be an effective tool for raising the necessary capital for strategic growth initiatives. Ultimately, however, the best use case is still with LICUs. Even though non-LICUs can issue sub-debt, it only counts for RBC calculations and not net worth. Issuing sub-debt generally requires four categories of functions to be completed: regulatory, legal, financial and placement.

Sections 702.408 and 702.409 of the NCUA's rules and regulations detail a list of requirements for issuing subordinated debt. The regulatory approval process consists of two stages of approvals and a post issuance notification. More specifically, the credit union must submit an initial application to issue, followed by the offering document submission, which must receive an "approved for use" declaration before issuance can proceed. Once the subordinated debt is formally issued, the credit union is required to notify the NCUA within 10 days of the successful issuance. NCUA approvals are valid for 2 years.

The amount of legal work required will depend on whether the issuance is rated by a rating agency and the nature of placement. Smaller transactions that occur directly between a lender and a credit union will require less legal work than an issue offered through an investment bank. Legal work will be required on the debt note structure itself and may be required for state-chartered credit unions as state approval is required in addition to NCUA approval.

Financial planning functions are required in the initial application submitted to the NCUA. Financial projections and strategic plans must detail how the credit union plans to use the funds raised along with proforma financial statements covering at least 24 months forward. In addition, the analysis must be provided for how the credit union will repay the subordinated debt upon maturity.

Placement costs are the fees paid to the investment bank placing the debt, and can be significant, as they may amount to 1.5 percent to 2.0 percent of the total amount of debt raised. These issuance costs are paid directly out of the amount raised and then amortized over the life of the debt as interest expense. Subordinated debt is generally structured in a fixed-to-floating manner, most commonly with a 10-year maturity – the first 5 years at a fixed rate of interest, followed by a 5-year floating rate period, with par call at the fixed-to-floating transition date.

Conclusion

Issuance of subordinated debt can provide resources for expansion into new territories, acquisitions, or growth initiatives while managing regulatory capital levels. Issuing requires a sizeable amount of planning, and it is required that the institution have a decisive plan in place regarding the use of funds. The funds typically come with a high interest rate relative to market, given its unsecured nature. As an investor, subordinated debt investments can offer returns that will bolster the financial strength of the organization and provide for greater member benefit. Keep in mind, while a CU cannot both invest and issue *credit union* sub-debt, owning bank sub-debt does not prohibit issuance.

As with any strategic decision, a credit union's decision to issue or invest in subordinated debt should be considered alongside the overall strategic priorities of the intuition with the well-being of members in mind. Partnering with a knowledgeable advisor can help credit unions navigate the difficult regulatory and financial modeling hurdles as well as provide strategic advice around both investing and issuing.

Contact us today to learn how ALM First may assist your institution.
