



DCU BULLETIN

Division of Credit Unions

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Guidance on NCUA's Final Subordinated Debt Rule

Introduction.

The final subordinated debt rule now permits complex credit unions¹ and newly chartered credit unions to issue subordinated debt to comply with risk-based capital requirements. The rule permits low-income credit unions to issue debt instruments to qualifying natural persons, but does not change the ability of a LICU to include Subordinated Debt in its net worth in the same manner in which it currently includes secondary capital in its net worth.

Background.

In March of 2020, the National Credit Union Administration (NCUA) issued a Proposed Rule on Subordinated Debt, 85 Fed. Reg. 13982 (March 10, 2020). The NCUA Board issued a final Subordinated Debt rule on December 17, 2020, published at 86 Fed. Reg. 11060 (February 23, 2021.) The rule has an effective date of January 1, 2022. The final Subordinated Debt rule creates a new subpart in the NCUA's final risk-based capital rule (RBC Rule), which also takes effect on January 1, 2022. It allows low-income credit unions (LICUs), complex credit unions and newly chartered credit unions to issue subordinated debt for regulatory capital treatment.² The final rule also amends other sections of NCUA regulations. This significant change in NCUA regulations will allow credit unions an additional source of capital outside of retained earnings.

¹ On November 6, 2018, the NCUA published a supplemental final rule that raised the threshold level for a complex credit union under 12 CFR 702.103 to \$500 million for purposes of the risk-based capital rule. 2018 Risk-Based Capital Final Rule, 83 FR 55467 (Nov. 6, 2018). The effective date of that rule is January 1, 2022. 84 FR 68781 (Dec. 17, 2019).

² RCW 31.12.005 (4) defines "capital" as "a credit union's reserves, undivided earnings, and allowance for loan and lease losses, and other items that may be included under RCW 31.12.413 or by rule or order of the director."

This Bulletin provides guidance for Washington state-chartered credit unions related to the new Final Rule on Subordinated Debt³.

Application and Regulatory Approval Process.

Newly codified rules, 12 CFR 702.408 and 702.409, set forth procedures for federally-insured, state chartered credit unions to apply for approval of subordinated debt plans. Applications must be submitted to the NCUA Appropriate Supervision Office and the credit union's state supervisory authority (SSA) and must include all information required by 12 CFR 702.408. The Appropriate Supervision Office will issue decisions approving a federally insured, state-chartered credit union's application only after obtaining the concurrence of the credit union's state supervisory authority. Approval decisions or conditional approval decisions will be made within 60 calendar days of application, unless the date is extended by the NCUA. Following receipt of written approval of its initial application, an Issuing Credit Union must prepare an Offering Document for each issuance of Subordinated Debt Notes. 12 CFR 702.408(d).

Low Income Credit Unions (LICUs).⁴ The Credit Union Membership Access Act (CUMAA)⁵ defines "net worth" to include secondary capital (*i.e.* subordinated debt) issued by a LICU, so long as the secondary capital is uninsured and subordinated to all other claims including those of creditors, shareholders, and the National Credit Union Share Insurance Fund (NCUSIF). Secondary capital accounts must comply with all regulatory requirements stated in 12 CFR 701.34 and must be reported in the Liability section of the 5300 Call Report. For the first time, the Subordinated Debt rule permits LICUs to also issue instruments to qualifying natural persons.

Subordinated debt issued by a LICU after the effective date of the final Subordinated Debt rule will be included in that credit union's Net Worth and Net Worth Ratio. The Final Rule does not change the ability of a LICU to include Subordinated Debt in its net worth in the same manner in which it currently includes secondary capital in its net worth.

Grandfathered Secondary Capital. Secondary capital issued before the effective date of the final Subordinated Debt rule is considered *Grandfathered Secondary Capital*. This preserves the regulatory capital treatment of *Grandfathered Secondary Capital* for 20 years after the effective date of the final Subordinated Debt rule. See recodification of § 701.34(b), (c), and (d) as § 702.414.

³ The NCUA previously used the term "alternative capital" to refer to supplemental capital and secondary capital. In the March 10, 2020 Proposed Rule, footnote 16, the Board notes that it is more appropriate to use the umbrella term "Subordinated Debt" to refer to both secondary capital and what was once referred to as supplemental capital. The NCUA's December 2018 Regulatory Reform Agenda also uses the term "subordinated debt".

⁴ Low income credit unions are those with a majority of members who are low-income, as defined at 12 CFR 701.34 (a). The term also includes students. In May 2020, the NCUA added active-duty military members to the definition.

⁵ *Credit Union Membership Access Act of 1998*, Public Law 105-219, 301, 112 Stat. 913, 929 (codified at 12 U.S.C. 1790d (o)(2)(C) (1998)).

Emergency Capital Investment Program (ECIP). LICUs may receive subordinated debt investments from the U.S. Treasury's ECIP. A LICU may also treat this ECIP funding as secondary capital in accordance with the NCUA's regulations, provided that it has an NCUA-approved secondary capital plan by December 31, 2021. The NCUA Board approved on December 16, 2021 a revised definition of *Grandfathered Secondary Capital* to include secondary capital issued to the United States Government or one of its subdivisions under an application approved before January 1, 2022. The revised final rule also provides that the expiration of capital treatment for these issuances is the later of 20 years from the date of issuance or January 1, 2042.

Complex Credit Unions. Complex credit unions that are not LICUs may not include subordinated debt in Net Worth. However, they may include Subordinated Debt in their Risk Based Capital ratio.

Investor Disclosure and Reporting Requirements.

The final rule requires any issuance of a subordinated debt note by an Issuing Credit Union be done in accordance with applicable federal and state securities laws. Credit unions contemplating an offer and sale of subordinated debt notes need to engage *qualified counsel* to ensure compliance with securities laws. §702.402 defines *qualified counsel* as “an attorney licensed to practice law in the relevant jurisdiction(s) who has expertise in the areas of federal and state securities laws and debt transactions similar to those described in this subpart.”

Credit unions must have procedures in place to address all requirements related to the offer, sale and issuance of subordinated debt instruments. This includes initial and ongoing disclosure requirements, anti-fraud provisions, and reports to investors. An initial application to issue subordinated debt must include a draft written policy which addresses compliance with federal and state securities laws, communications with investors, credit union employees who act as broker-dealers, and use of outside agents to assist with marketing and issuing subordinated debt. §702.408(b)(10).

Exemptions from registration requirements. The rule permits credit unions to offer and sell subordinated debt notes without registering the offerings under the Securities Act, based on either of two exemptions from registration: Rule 506 under Regulation D promulgated under Section 4(a)(5) (private placement/ accredited investors exemption) or Section 3(a)(5) of the Securities Act (savings and loan associations and similar institutions that are examined and supervised by State or Federal authority).⁶ The latter exemption is broader. Such offerings would be exempt from registration under Washington law (RCW 21.20.310(6) or RCW 21.20.320(1) and the accompanying rules).

Specific disclosures in Offering Documents to investors. Paragraph (e) of § 702.408 specifies the minimum scope and coverage of disclosures a credit union must include in its Offering Documents after it has completed the application and approval process.

⁶ See 15 U.S.C. 77c and 77d.

Broker-dealers and securities salespersons. Persons selling exempt securities may still need to register as broker-dealers/securities salespersons, depending on the type of exemption. See RCW 21.20.040 registration requirements for securities offered under RCW 21.20.310. Credit unions should consult with experienced securities counsel as to these requirements.

If you have any questions about this Bulletin, please contact Myriam Powers, Financial Examiner Supervisor, at (360) 556-0706 or Myriam.Powers@dfi.wa.gov or Margaret Esola, Financial Legal Examiner at (360) 970-0349 or Margaret.Esola@dfi.wa.gov