



NCUA
National Credit Union Administration

Office of Examination & Insurance
Office of General Counsel

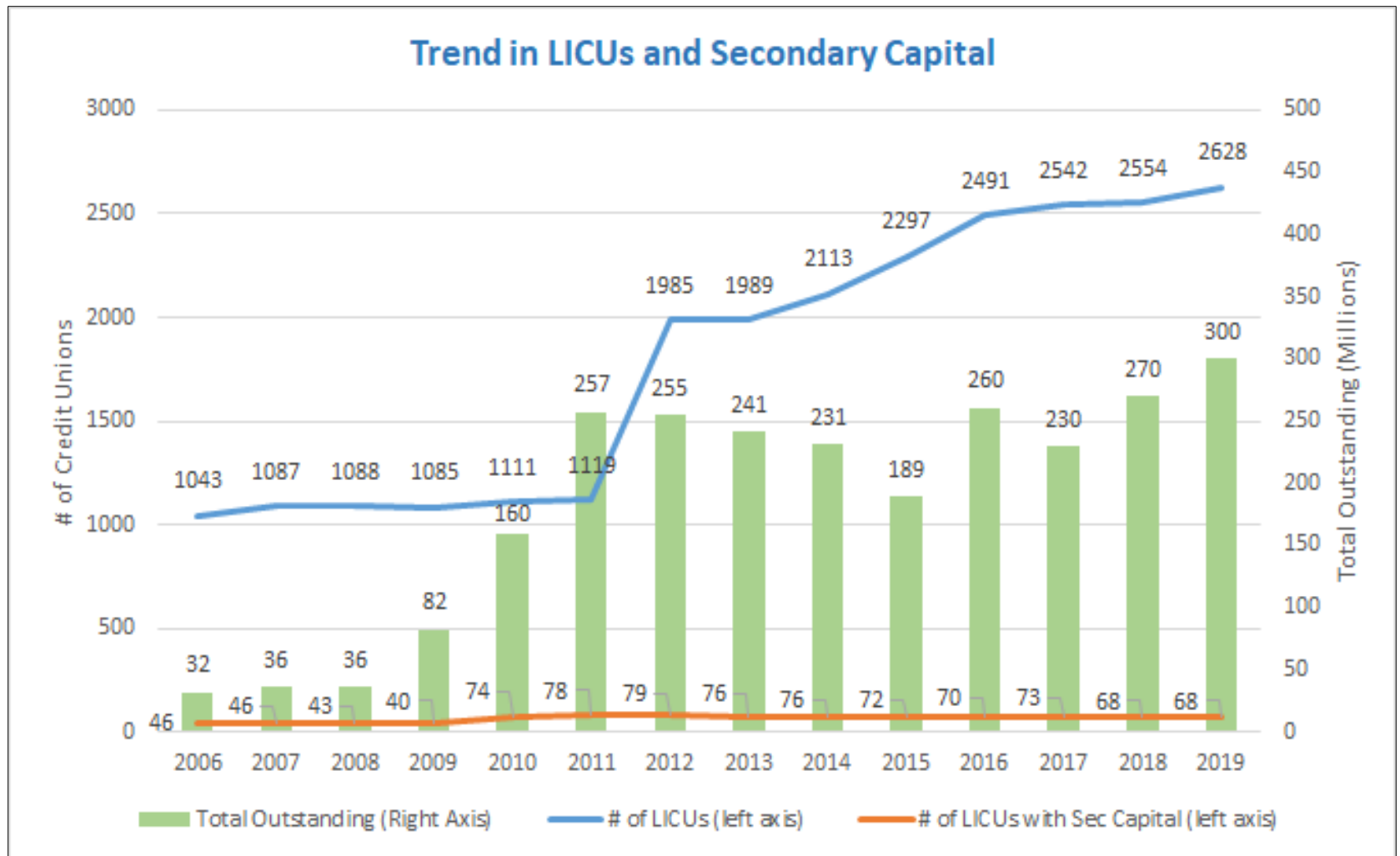
Subordinated Debt Notice of Proposed Rulemaking

NCUA Board Meeting
January 23, 2020

History

- **1996 - Final Rule for LICUs to accept Secondary Capital**
- **1998 - CUMAA Net Worth to include Secondary Capital for LICUs**
- **2006 - Board amends Secondary Capital rule to require prior approval before issuance**
- **2015 - Board finalizes RBC**
- **2016 - Public Board Briefing on Alternative Capital**
- **2017 - ANPR on Alternative Capital**
- **2018 - Subordinated Debt as Tier 1 Priority in Regulatory Reform Agenda**
- **2019 - Supervisory Letter on “Evaluating Secondary Capital Plans”**
- **2020 - Proposed Rule on Subordinated Debt**

Trends in LICUs and Secondary Capital (Data as of Sept 2019)



Project Research by Staff

1. Consultation with outside counsel
 - a) Securities law
 - b) Tax Implications
 - c) Debt Treatment
2. Reviewed OCC's subordinated debt rule and Comptrollers Licensing Manual
3. Review of current Secondary Capital contracts
 - a) Contract characteristics
 - b) Terms & Rates
4. Comprehensive review of various current NCUA regulations impacted by Subordinated Debt
5. Industry outreach

Top Subordinated Debt Considerations

1. Federal and State Securities Laws
2. Debt Treatment
3. Regulatory Capital Treatment
4. Investor Protection and Disclosures
5. Marketability
6. Challenges with current regulation and Application Reviews
7. Federal Charter and State Charter Federal Income Tax Exemption
8. NCUA Resources

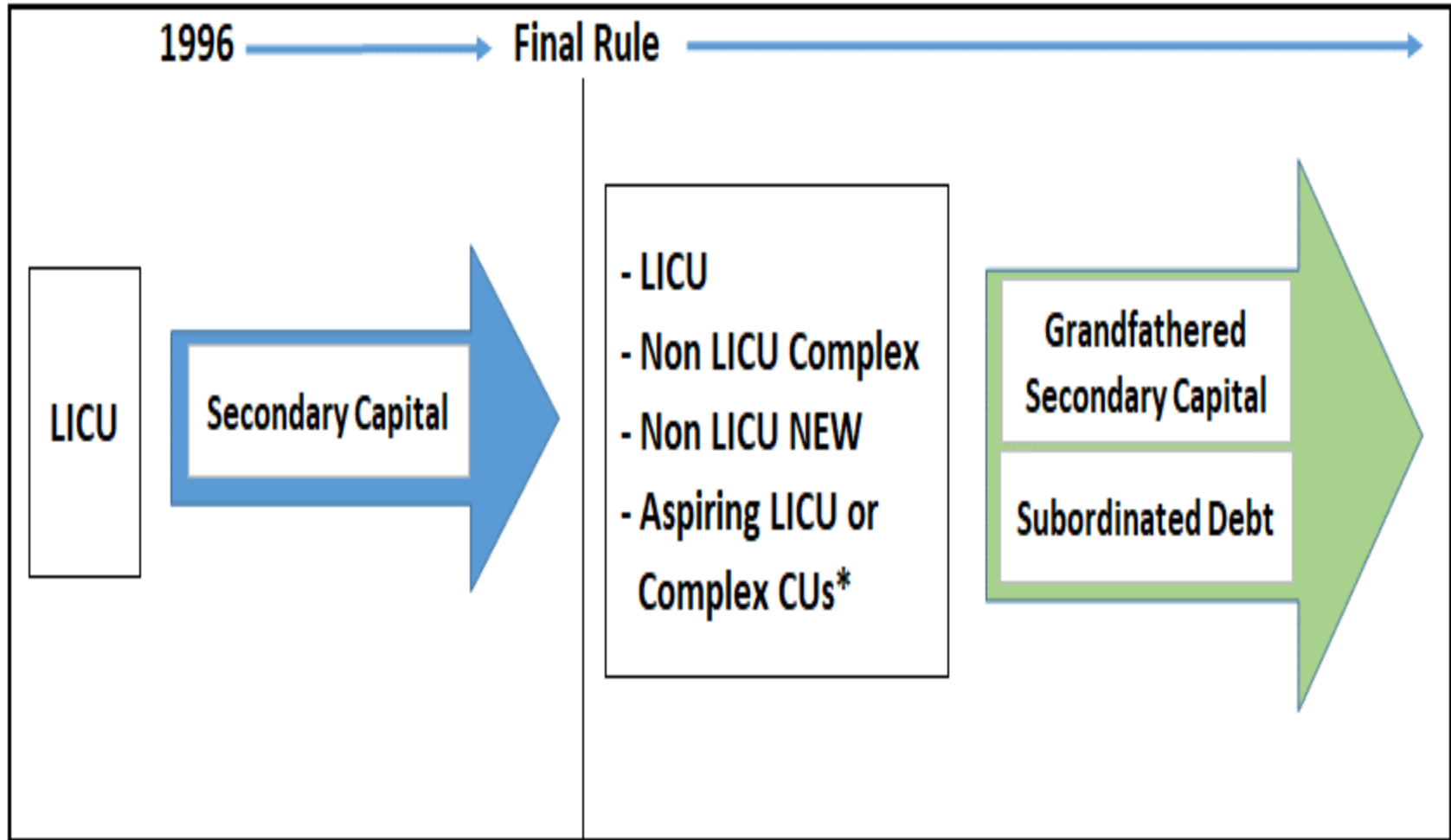
Securities Laws

1. **Subordinated Debt Notes are securities for purposes of federal and state securities laws**
2. **Credit unions can likely qualify for an exemption from federal registration requirements.**
3. **The marketing and sale of securities remain subject to the broad anti-fraud prohibitions of the Securities Exchange Act of 1934.**
 - a) **Generally prohibits the use of manipulative or deceptive devices or contrivances in connection with the purchase or sale of securities.**
 - b) **The type and amount of disclosure varies depending on a number of facts and circumstances.**
4. **Other Security Law considerations**
 - a) **Ongoing disclosures and communications with investors**
 - b) **Potential Broker-Dealer Registration issues**
 - c) **Director and Officer Liability Insurance Coverage for Issuing Credit Unions**

Key Objectives

- 1. Incorporate lessons learned from the current Secondary Capital rule, commenter feedback on the 2017 ANPR, and input from outside counsel**
- 2. Provide responsible regulatory relief by authorizing New and Complex Credit Unions to issue Subordinated Debt**
- 3. Make other improvements and provide additional flexibility for LICU use of Secondary Capital**
- 4. Reorganize applicable sections of the NCUA's regulations in a logical, clear and transparent manner**

Secondary Capital to Subordinated Debt



*Expected within 24 months

Proposed Subordinated Debt Eligibility and Regulatory Treatment

| | Proposed Eligible | # of CUs | Total Assets | NW | RBC* |
|------------------------------|---|----------|---------------|-----|------|
| Currently Eligible | LICU – Not Complex <i>Low Income Designation and Total Assets < \$500m</i> | 2,323 | \$159 billion | ✓ | N/A |
| | LICU – Complex <i>Low Income Designation and Total Assets > \$500m</i> | 295 | \$469 billion | ✓ | ✓ |
| | LICU – New Credit Unions <i>Low Income Designation and NEW (<\$10m assets)</i> | 10 | \$24 million | ✓ | N/A |
| New Eligible | Non-LICU Complex <i>Total Assets > \$500m and not a LICU</i> | 281 | \$730 billion | N/A | ✓ ** |
| | Non-LICU NEW Credit Unions <i>Assets <\$10m and chartered for < 10yrs and not LICU</i> | 4 | \$12 million | *** | N/A |
| | Credit Unions that anticipate becoming Complex or LICU within 24 months of Issuance | TBD | | TBD | |
| Proposed Not Eligible | | | | | |
| | Non-LICU Non-Complex <i>Not Eligible to issue Subordinated Debt</i> | 2,409 | \$162 billion | N/A | N/A |

Data as of June 30, 2019

*Based on current RBC Rule **Limited to 100% of NW at Issuance and can only issue at least “Undercapitalized”

*** Taken into consideration for the New Credit Union’s business plan/revised business plan

REGULATORY CHANGES TOWARDS CENTRALIZING CAPITAL RULES

1. **§ 701.25 – Loans to credit unions (New section)**
 - General authority
 - Approval and policies
 - Investment in Subordinated Debt
2. **§ 701.34 – Low-income designation (LID)**
 - Secondary capital (part B) moves to Subpart D in 702
 - Would only address how a credit union obtains a LID
3. **§ 701.38 - Borrowed Funds**
 - Expanded to cover all borrowings (currently only addresses borrowings from a natural person)
4. **Part 702 – Subpart D – Subordinated Debt**
 - Would house all regulations related to Subordinated Debt and Capital treatment, including grandfathered Secondary Capital.
5. **Part 709 – Payout Priorities**
 - Cohering changes.
6. **Part 741 – Subpart B – Regulations that apply to FISCUs**
 - Cross references back to Subpart D of part 702.

Notable Items of the Subordinated Debt NPR

- 1. Regulatory Relief or New Authority** **Slide 12**
- 2. Retained, Clarifications and Cohering Changes** **Slide 13**
- 3. Proposed New Requirements** **Slide 14**

Regulatory Relief or New Authority

| Item | Rule |
|--|--------------------|
| 1. Expands eligibility to issue Subordinated Debt to include Non-LICU Complex CUs, CUs that anticipate being a LICU or Complex in 24 months, and Non-LICU NEW CUs. | 702.403 |
| 2. Expands eligible investors for Subordinated Debt from Institutional investors to Accredited Investors | 702.406 |
| 3. Adds flexibility for multiple issuances without reapplying | 702.408 |
| 4. Adds flexibility on repayment amount | 702.411 |
| 5. Adds flexibility to retain Subordinated Debt through a merger or dissolution | 702.412 |
| 6. Provides new Safe Harbors for repudiation, interest payments | 702.410 702.413 |

Retained, Clarifications and Cohering Changes

| Item | Rule |
|---|--------------------|
| 1. Borrowed Funds rule revised to permit borrowing from “any source” to align with the FCU Act | 701.38 |
| 2. Preapproval Requirements including the Initial Application and Prepayment have been expanded for clarification | 702.408 702.411 |
| 3. Regulatory Capital Treatment | 702.407 |
| 4. Payout Priorities in involuntary liquidation | 709.5 |
| 5. Applicability to Federally Insured State Chartered CUs | 741.226 741.227 |

Proposed New Requirements

| Item | Rule |
|--|-------------------------------|
| 1. Defined maximum maturity of 20 years (current minimum maturity of 5 years is retained) | 702.404 |
| 2. Subordinated Debt Note requirements are largely retained with additions for restrictions, covenants, default and minimum denomination of \$100,000. | 702.404 |
| 3. Prohibition on being an issuer and investor, unless the credit union meets certain conditions related to mergers | 702.403 |
| 4. Expanded requirements for Disclosures and new requirements for Offering Documents | 702.405 702.406 702.408 |
| 5. New rules and limits for making loans to other credit unions including investing into Subordinated Debt | 701.25 741.227 |
| 6. Prohibition of Interest Payments on “Undercapitalized” credit unions to mandatory | 702.109 702.410 |

Subordinated Debt Resource Requirements

The complexity of the Securities Law component will require NCUA to augment and support legal staff.

Overall Resource Requirements:

- Business (Safety & Soundness)..... No supplemental Resources
- IT & Infrastructure..... No supplemental Resources
- Legal (Securities Law)..... ***New Resources***
 - ✓ Hire ***two*** Senior staff with Securities Law experience
 - ✓ Augment legal staff with outside counsel

Estimated Budget Impact.....\$1 million/year

Subordinated Debt NPR

Request approval of the Notice of Proposed Rulemaking attached to the Board Action Memorandum with a 120-day comment period.

Appendix

Summary of Current Statutory & Regulatory Framework

(Slide 18)

Summary of Proposed Subordinated Debt rule items by Rule Section

(Slides 19 – 28)

SUMMARY OF CURRENT STATUTORY & REGULATORY FRAMEWORK

Secondary Capital Rule - §701.34(b-d) *Acceptance of secondary capital accounts by LICUs. Also applicable to State-Chartered credit unions in §741.204(c).*

Statutory Net Worth - §1790d(o)(2)—With respect to a LICU, the term “net worth” includes secondary capital accounts that are uninsured and subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the NCUSIF.

Risk-based Net Worth - §1790d(d) Risk-based net worth requirement for complex credit unions.

FCU Borrowing Authority - §1757(9) – An FCU has the power to borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III of this chapter, *50 per centum of its paid-in and unimpaired capital and surplus.*

Subordinated Debt NPR

| Section | Change Summary |
|---------|--|
| 701.25 | <p>Establishes a new section for “Loans to Credit Unions”</p> <ul style="list-style-type: none">• Establishes aggregate limits consistent with FCU Act• Establishes single borrow limits of 15% of Net Worth• Creates approval and policy standards• Criteria and limits for investing in Subordinated Debt<ul style="list-style-type: none">• Investing FCU must be Well Capitalized• Investing FCU must not have outstanding Subordinated Debt where it was the Issuing Credit Union• Investing FCU is not currently eligible to issue Subordinated Debt• Aggregate limit to the lesser of 25% of Net Worth or any amount of Net Worth in excess of 7% of total assets |
| 701.34 | Relocated current Secondary Capital section to part 702 |

Subordinated Debt NPR

| Section | Change Summary |
|---------|---|
| 701.38 | <p>Expanded “Borrow Funds” from borrowing from natural persons to borrowing from any source.</p> <ul style="list-style-type: none">• Evidenced by “written contract”, replacing “promissory note”• Description of borrowings as “funds”• FCU borrowing authority to reference the FCU Act |
| 702.2 | <p>Capital Adequacy Definitions</p> <ul style="list-style-type: none">• Clarifies accounting terms not defined in part 702 should use GAAP definitions• Minor revisions to the definition of Net Worth to include Subordinated Debt for LICUs• Added a definition for Grandfathered Secondary Capital |

Subordinated Debt NPR

| Section | Change Summary |
|-----------------------|--|
| 702.104 | <p>Risk-Based Capital</p> <ul style="list-style-type: none">• Included the amount of Subordinated Debt and Grandfathered Secondary Capital treated as Regulatory Capital in the risk-based capital numerator• Assigned a 100% risk weighting to Subordinated Debt, Grandfathered Secondary Capital, and loans or obligations issued by privately insured credit unions that are subordinate to a private insurer. |
| 702.109, 702.205 - | <p>PCA</p> <ul style="list-style-type: none">• Minor revisions to PCA to incorporate the provisions in the NPR.• Mandatory supervisory action for Subordinated Debt when Critically Undercapitalized. |
| 702.207 | <ul style="list-style-type: none">• Include consideration of Subordinated Debt for New Credit Unions. |

Subordinated Debt NPR

| Section | Change Summary |
|---------|---|
| 702.401 | <p>Purpose and Scope</p> <ul style="list-style-type: none">• Current Secondary Capital Accounts are grandfathered for 20 years.• FISCUs may only issue Subordinated Debt if permitted by state law.• If state law may be more restrictive than Subpart D for FISCUs |
| 702.402 | <p>Added relevant definitions</p> |
| 702.403 | <p>Expanded eligibility to issue Subordinated Debt to include Non-LICU Complex CUs, CUs that anticipate being a LICU or Complex in 24 months, and Non-LICU NEW CUs.</p> <ul style="list-style-type: none">• Prohibits a CU from being an issuer and investor of Subordinated Debt |

Subordinated Debt NPR

| Section | Change Summary |
|---------|---|
| 702.404 | <p>Requirements of Subordinated Debt and Subordinated Debt Note.</p> <ul style="list-style-type: none">• Must be characterized as debt in accordance with GAAP• Fixed stated maturity of at least 5 years but no more than 20 years• Must be unsecured• Permissible investors: Natural Person Accredited Investors and Entity Accredited Investors• At the end of each fiscal year, must be applied to deficit in Retained Earnings of Issuing Credit Union on a pro rata basis• Must disclose prepayment penalties or restrictions on prepayment• Prohibitions on certain default conditions• Must not cause a credit union to exceed the borrowing limit• Must not provide an investor with management or voting rights• May have default covenants but must have reasonable cure period• Minimum denomination of \$100,000 requirements for the Note |

Subordinated Debt NPR

| Section | Change Summary |
|---------|---|
| 702.405 | <p>Revised disclosure requirements for the issuance of Subordinated Debt. Such disclosures include:</p> <ul style="list-style-type: none">• A statement indicating that the Note will not be registered in the Securities Act of 1933.• A general description of the NCUA's regulatory authority• The risk factors associated with the NCUA's or, if applicable, the state supervisory authority's, authority to conserve or liquidate a credit union under the Federal Credit Union Act (FCU Act) or applicable state law. |
| 702.406 | <p>Requirements for offering, sale and issuance of Subordinated Debt Note</p> <ul style="list-style-type: none">• Introduction of the requirement that Issuing Credit Unions use an Offering document• Accredited Investor Certification Form• Application Process for the issuance of Subordinated Debt at an office of the Issuing Credit Union. |

Subordinated Debt NPR

| Section | Change Summary |
|---------|--|
| 702.407 | <p>Discounting amount of Subordinated Debt treated as Regulatory Capital</p> <ul style="list-style-type: none">• Outstanding Subordinated Debt treated as Regulatory Capital declines by 20% annually starting once the remaining maturity is less than 5 years. |
| 702.408 | <p>Preapproval requirements</p> <ul style="list-style-type: none">• Initial application requirements<ul style="list-style-type: none">▪ Statement on Eligibility▪ Maximum Aggregate amount▪ Number and type of Investors▪ Strategic, Business and Budget plans▪ Liquidity plan to repay▪ Pro-forma Financial Statements▪ Intended use of Sub Debt Proceeds▪ Governing Law▪ Written policies governing the Issuance |

Subordinated Debt NPR

| Section | Change Summary |
|---------|---|
| 702.408 | <ul style="list-style-type: none">• Decision on initial application<ul style="list-style-type: none">▪ 60 Day Review of Initial application▪ Approval may contain certain conditions• Offering documents<ul style="list-style-type: none">▪ Approval for Natural Person Accredited Investor documents<ul style="list-style-type: none">• 60 Day Review of Offering documents▪ Filing only for Entity Accredited Investor documents• Filing requirements no later than 10 days after closing to NCUA |
| 702.409 | <p>FISCU Preapproval</p> <ul style="list-style-type: none">• Subject to 702.408 Preapproval requirements• Concurrence from State• Federal tax review |
| 702.410 | <p>Interest Payments on Subordinated Debt</p> <ul style="list-style-type: none">• Prohibitions and accruals• Safe harbor |

Subordinated Debt NPR

| Section | Change Summary |
|---------|---|
| 702.411 | <p>Approval to Prepay</p> <ul style="list-style-type: none">• Can prepay Subordinated Debt Note (Call Option) if disclosed in offering document• Expands authority to prepay any portion of the Subordinated Debt• Prior approval required<ul style="list-style-type: none">• Written decision within 45 days, no automatic approvals |
| 702.412 | <p>Effect of a merger or dissolution on the treatment of Subordinated Debt as Regulatory Capital.</p> <ul style="list-style-type: none">• If the resulting credit union is not an “eligible credit union” the Subordinated Debt may be repaid or held by the resulting credit union, but will not count as Regulatory Capital. |
| 702.413 | <p>Repudiation of Safe Harbor.</p> <ul style="list-style-type: none">• NCUA will not exercise its repudiation authority with respect to Subordinated Debt provided certain conditions are met. |

Subordinated Debt NPR

| Section | Change Summary |
|-------------------|---|
| 702.414 | <p>Grandfathered Secondary Capital</p> <ul style="list-style-type: none">• Secondary Capital Accounts issued under 701.34 before effective date of final Subordinated Debt Rule will be called as Grandfathered Secondary Capital.• Grandfathered Secondary Capital remains subject to the requirements of 701.34, which will be moved to this section, with minor changes, for ease of reference. |
| 709.5 | Subordinated Debt included in the payout priority at the same level as current Secondary Capital. |
| 741.204 | Change cross-reference to proposed rule 702.414 |
| 741.226 & 741.227 | FISCUs subject to Subpart D (Subordinated Debt rule) and 701.25 (Loans to Credit Unions) provided such FISCUs are permitted by state law to issue Subordinated Debt. |