BLOG

NCUA regulation on subordinated debt issuance– brewing a storm for US banks?

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The US National Credit Union Administration (NCUA) proposed a new rule on 23 January 2020 stating that “new credit unions” and existing “complex credit unions” (those with a minimum of USD500m of assets) can issue subordinated debt to maintain their regulatory capital requirement. At present, only low-income nominated credit unions (where more than 50% of all members are in the low-income category, according to NCUA regulations) are authorised to offer subordinated debt for the purpose of maintaining the regulatory capital requirement.

There are approximately 122m members in more than 5,100 credit unions under the NCUA. Credit unions with fewer members will likely benefit the most from this new regulation, as they could grow their monetary bases despite having fewer members. After the new rule is implemented, credit unions will have access to institutional investors – for example, corporate debt markets such as hedge funds, mutual funds and pension funds – and would be able to accept investments from them.

Credit unions (low-income nominated) had total secondary capital of just USD290m on their books as of 30 September 2019, against USD1.54tn of assets, indicating credit unions’ low appetite for secondary capital. The new rule authorises another 285 credit unions (which are “complex” in nature and hold USD730bn of assets, almost half of the total assets of all credit unions) to issue subordinated debt. However, it is uncertain whether these credit unions will be keen about this new type of lending, as most of them are already well funded. After the new rule is implemented, credit unions will be able to offer subordinated debt with maturity periods of 5-20 years.

The American Bankers Association (ABA) has argued that the proposed regulation is not based on proper rationale and has demanded that the regulation be revoked, as almost all credit unions (more than 95% of them) comply with the NCUA’s obligation of net worth. Even most of the complex credit unions (more than 95% of them) adhere to the guidelines governing risk-based capital requirements. The ABA also highlighted that the proposed new regulation does not follow the Federal Credit Union Act properly; the Act prohibits debt offering for the purpose of capital raising. In addition, the ABA stated that credit unions have no logical limitations on subordinated debt raising, and that this could create risk in the financial system.

One of the growth tactics of credit unions is to purchase underperforming banks, although the number of current acquisitions is low. Banks are concerned; as the bigger credit unions could acquire more underperforming banks once they have access to subordinated debt funding.

Although credit unions have yet to start raising capital through subordinated debt instruments, the ABA has expressed serious concern, as credit unions could reduce banks' lending opportunities. Banks could also witness pressure on their margins, as credit unions will have the benefit of tax exemption, resulting in incremental operating profit at the expense of bank profit. Amid the current economic conditions, the US is expected to experience a protracted slowdown and a low-interest-rate regime over the coming few years, when yields on subordinated debt could attract a large number of institutional investors (to the credit unions), eroding banks' share in the subordinated debt market.

Institutional investors need funds to invest in credit unions, and banks can arrange that.

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Sources

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