SUBORDINATED DEBT: AN EFFECTIVE TOOL FOR FINANCING GROWTH

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Financial Services Alert

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COVID-19 and the resulting economic downturn are expected to strain the U.S. banking system at a time when banks are grappling with how to modernize their products and services and keep pace with technological innovation. Issuing subordinated debt can be an attractive option to replenish capital or finance growth.

Subordinated debt is an unsecured borrowing. If the issuing bank were liquidated, its subordinated debt would be paid only after its other debt obligations (including deposit obligations) are paid in full but before any payment to its stockholders.

Banks issue subordinated debt for various reasons, including shoring up capital, funding investments in technology, acquisitions or other opportunities, and replacing higher-cost capital. In the current low interest rate environment, subordinated debt can be relatively inexpensive capital. Publicly traded banks whose stock prices are depressed due to COVID-19 may find subordinated debt an especially efficient alternative to raising capital by issuing stock. Unlike equity, subordinated debt does not dilute existing stockholders or confer voting or control rights on investors. Unlike traditional debt, it does not contain onerous financial or operating covenants. Interest payments on subordinated debt are tax deductible by the issuer.

Subordinated debt offerings are generally streamlined. An investment banker for the issuing bank places the debt with investors, which may include other banks. The issuer may arrange for the debt to be rated by a rating agency to enhance its marketability. Investor due diligence is more limited than for an equity offering and focuses on the issuer's financial condition. A subordinated debt offering is usually conducted as a private placement exempt from federal and state securities registration requirements.

If certain regulatory requirements are met, subordinated debt is treated as Tier 2 capital of the issuer. These requirements include the debt having a minimum maturity of five years, the holder having no right to accelerate the debt prior to maturity except under certain limited circumstances, and the issuer having no right to redeem the debt within the first five years after issuance.[1] The debt may also not have any "credit-sensitive" features, including interest rate payments that are tied to the financial condition of the issuer.[2]

Banks with a parent holding company typically issue subordinated debt at the holding company level and then may downstream the proceeds to the bank. The proceeds are treated as Tier 2 capital of the holding company and, once contributed to the bank, as Tier 1 capital of the bank. Outside of a stock conversion, this is effectively the only way for a mutual bank to raise Tier 1 capital (other than, of course, over time through retained earnings). It is the reason that many mutual banks have reorganized into the mutual holding company structure. For qualifying bank holding companies with less than US$3 billion in consolidated assets, the flexibility regarding leverage afforded by the Federal Reserve's Small Bank Holding Company Policy Statement can make subordinated debt a particularly attractive option for financing acquisitions and other growth investments.[3]

The market for bank subordinated debt has been quite active over the last few years. The Federal Reserve's commitment to keep interest rates at historic lows for the foreseeable future signals that this trend is likely to continue. For banks in need of capital amidst the current economic uncertainty, subordinated debt may be an effective tool.

FOOTNOTES

[1] *See* 12 C.F.R. § 217.20(d).

[2] *See* id. §§ 217.20(d)(1)(vii); 250.166(b)(4).

[3] *See* Appendix C to 12 C.F.R. pt. 225.

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