Subordinated Debt - Effective Alternative for Capital

Article By:

Michael D. Waters

Banks and bank holding companies always need capital, and capital is crucial if a bank wants to undertake an acquisition, or improve its ratios for CRE concentration limits (something the regulators are looking at with greater frequency), or for other purposes. Of course, a sale of common stock is the typical way in which banks and bank holding companies raise capital, but the issuance of unsecured, subordinated debt may also be an advantageous way to raise needed capital.

Subordinated debt is most suitable for issuance by the bank holding company. Issued at the holding company, it is tier 2 capital (if certain requirements are met), but the proceeds may be downstreamed to the bank as tier 1 capital. Subordinated debt does not dilute common stockholders, and it can be issued at interest rates that are relatively low. Two significant advantages to this method of funding is that the interest paid is tax deductible, and a subordinated debt agreement generally does not contain the strict financial covenants that a typical holding company loan carries.

If tier 2 capital treatment at the holding company level is desired, the bank holding company must issue the debt in compliance with Federal Reserve regulations. This means the debt must (i) be unsecured, (ii) have a minimum maturity of five years, (iii) provide that principal and interest cannot be accelerated upon default except in limited circumstances, (iv) not allow the purchaser to require redemption, (v) not permit the holding company to redeem the debt within the first five years, and (vi) not contain limiting financial covenants that trigger a default (such as minimum capital ratios, minimum non-performing asset ratios, or minimum returns on assets or ROE).

Generally, no shareholder or regulatory approval is required, and the debt, while a security under state and federal securities law, can typically be issued pursuant to exemptions from registration. Depending upon the number and nature of investors, an offering memorandum may be required.

While subordinated debt is not for everyone because regular interest payments must be made, unlike common or preferred stock dividends, which may be skipped if financial circumstances require it, nevertheless, it can be a useful and practical alternative to increasing capital at the bank level.

National Law Review, Volume VI, Number 231