

# Subordinated Debt: Issuance and Investment Considerations

Many banking organizations, including smaller bank holding companies (BHCs) and insured depository institutions (IDIs), issue subordinated debt to achieve their regulatory capital and funding objectives. In addition, a number of IDIs invest in the subordinated debt of other institutions. The issuance of subordinated debt can have a variety of benefits for banking organizations, and financial institutions should remain aware of capital rules related to subordinated debt. In addition, there are a variety of benefits and risks associated with an IDI's investment in the subordinated debt of other financial institutions. Of particular importance, the capital rules include deductions from regulatory capital for certain investments in subordinated debt instruments issued by financial institutions. Institutions that invest in subordinated debt should consider the credit quality and repayment capacity of the issuer, and how such investments may affect the institution's risk profile.

The purpose of this article is to help support FDIC-supervised institutions' understanding of the applicable capital, investment, and regulatory reporting requirements that may apply when such institutions issue or invest in a subordinated debt instrument. It also describes the treatment of subordinated debt for purposes of an institution's Federal deposit insurance assessment.

The article aims to highlight certain requirements under the FDIC's regulations and should not be viewed as supervisory guidance or a directive.

## What is Subordinated Debt?

Subordinated debt, a junior fixed income instrument, is an unsecured loan or bond that ranks below more senior loans or debt securities with respect to claims on assets and earnings. Its payment priority rights fall between senior debt and equity in the capital priority "stack." For example, if an obligor defaults, subordinated debt holders will be paid after depositors, general creditors, and secured bond holders are repaid and before equity shareholders. Consequently, subordinated debt is generally viewed as riskier than senior secured or unsecured debt in a default scenario.

## Subordinated Debt Issuance from a Capital Perspective<sup>1</sup>

BHCs and IDIs issue subordinated debt as an efficient way to raise regulatory capital and long-term funding without diluting equity shareholders. From a regulatory capital perspective, subordinated debt can qualify as tier 2 capital of the issuer provided that the instrument satisfies the requirements of the FDIC's capital rule.<sup>2</sup> Institutions with BHCs often issue subordinated debt at the parent level and contribute the proceeds from the offering to subsidiary IDIs as additional paid-in capital in order to help the IDI meet its tier 1 capital requirements.

The down-streamed proceeds must meet all of the requirements in Part 324 of the FDIC's capital rule to

<sup>1</sup> This section does not cover additional requirements for the issuance of subordinated debt applicable to advanced approaches banking organizations. In addition, it does not cover the capital treatment of pre-Dodd-Frank instruments such as trust preferred instruments. The section refers to holding companies but does not attempt to describe the Federal Reserve's holding company requirements.

<sup>2</sup> See 12 CFR § 324.20(d)(1).

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qualify for the applicable tier of regulatory capital.<sup>3</sup>

Several criteria are required for subordinated debt to be eligible as tier 2 capital.<sup>4</sup> Among other things, subordinated debt:

- must be subordinated to depositors and general creditors of the banking organization;
- must not be covered by a guarantee or subject to other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;
- must have a minimum original maturity of at least five years; and
- must not have any terms or features that create significant incentives for the banking organization to redeem the instrument prior to maturity.

The capital rule further requires that during the last five years of the instrument, the amount eligible for tier 2 capital must be reduced by 20 percent of the original amount annually (net of redemptions) and that no amount of the instrument is eligible for inclusion in tier 2 capital when the remaining maturity of the instrument is less than one year.<sup>7</sup> These requirements are designed to allow the subordinated debt issuance to support a stable capital structure and to be available to absorb losses on a gone-concern basis and support the sale or resolution of a failed IDI.

Because tier 2 capital is not recognized in the community bank leverage ratio (CBLR) framework,<sup>8</sup> CBLR institutions are less likely to issue subordinated debt directly as there is no immediate regulatory capital benefit. However, if a CBLR institution has a BHC, it could benefit from down-streamed capital that the parent generates through the issuance of subordinated debt at the BHC.

Please note that FDIC-supervised institutions must seek prior approval to reduce or retire subordinated debt issued at the IDI level.

## Down-streaming Capital from a BHC

Institutions with BHCs often issue subordinated debt at the BHC-level and contribute the proceeds of the offering to the subsidiary IDI as additional paid-in capital to help support IDI-level tier 1 capital requirements.

### Regulatory Notice and Prior Approval Requirements for Retiring Subordinated Debt

- FDIC-supervised institutions should be aware of several regulatory notice and prior approval requirements for reducing or retiring subordinated debt, as well as restrictions on subordinated debt interest and principal payments by critically undercapitalized institutions.
- Specifically, FDIC-supervised institutions seeking to reduce, retire, call, or otherwise pay down principal on a subordinated debt capital instrument must apply for prior approval.<sup>5</sup>
- Further, all critically undercapitalized FDIC-supervised institutions must seek prior approval before paying interest or principal on subordinated debt instruments.<sup>6</sup>
- Questions about these requirements should be directed to the appropriate FDIC regional office.

<sup>3</sup> See 12 CFR § 324.20.

<sup>4</sup> See 12 CFR § 324.20(d)(1).

<sup>5</sup> See 12 U.S.C. §1828(i); 12 CFR §303.241.

<sup>6</sup> See 12 U.S.C. § 1831o; 12 CFR § 303.206. See also 12 CFR § 324.405.

<sup>7</sup> See 12 CFR §324.20(d)(1)(iv).

<sup>8</sup> See 12 CFR § 324.12.

The subordinated debt and the down-streamed proceeds must meet *all* of the requirements under the capital rule to qualify for the applicable tier of regulatory capital.<sup>9</sup>

In most cases, the BHC passes the down-streamed capital directly to the IDI as common equity through a credit to paid-in capital. Thus, funds from issuing subordinated debt that may count as tier 2 at the holding company level may be down-streamed as a common equity or additional tier 1 capital investment at the IDI level.

Subordinated debt may also be issued as convertible debt, which requires or permits the issuer to exchange the debt instrument for qualifying common or perpetual preferred stock by a certain date or before maturity. Convertible debt may qualify as tier 2 capital, without limitation, if it meets all of the requirements described in the FDIC's capital rule. The conversion feature does not present a barrier to qualification as tier 2 capital if the instrument converts to a tier 1 capital instrument.

In addition, minority interest<sup>10</sup> generated by a subordinated debt issuance by a subsidiary of an IDI may be included as tier 2 capital by the IDI if the instrument terms meet the capital rule's requirements. However, under the regulatory capital rule, the total amount of minority interests that a non-advanced approaches FDIC-supervised institution may include in total capital must be no greater than 10 percent of the sum of all total capital elements (not including the total capital minority interest itself), less any total

capital regulatory adjustments and deductions.<sup>11</sup>

### Subordinated Debt Issuance: Key Takeaways

- Subordinated debt can be included in tier 2 capital if the requirements of Part 324 are met.
- Proceeds from subordinated debt issued at the holding company can be down-streamed to the IDI as tier 1 capital.
- Institutions must seek approval from their primary federal regulator to reduce or retire subordinated debt.

### Call Report Instructions for Subordinated Debt Issuances

On the Consolidated Report of Condition and Income (Call Report), issuers report subordinated debt in Schedule RC, in the liabilities section on line item 19, subordinated notes and debentures. However, when issued by a subsidiary, subordinated debt may or may not be explicitly subordinated to the deposits of the parent bank that may report subordinated debt in Schedule RC, item 16, "Other borrowed money," or item 19, "Subordinated notes and debentures," as appropriate.

### Cost of Servicing Subordinated Debt

As part of the business decision and capital planning efforts, IDIs evaluate the annual cost of servicing subordinated debt obligations as well as the impact it could have on earnings performance. Issuing subordinated debt may be attractive because of its relatively low cost, but capital deployment options that generate adequate returns to investors may be constrained by factors such as a low interest rate environment. Additionally, if subordinated debt is issued by a holding company and injected into an IDI subsidiary, the IDI may need to pay higher

<sup>9</sup> See 12 CFR § 324.20.

<sup>10</sup> The term "minority interest" refers to an interest in the capital of a consolidated subsidiary that is not owned by the parent FDIC-supervised institution.

<sup>11</sup> See 12 CFR § 324.21(a)(4).

dividends to the holding company to service the obligation unless the parent has other sources of capital or funding. Also, subordinated debt is often issued at a fixed rate for the first five years before converting to a variable coupon rate. Therefore, if interest rates rise over the instrument's life, servicing costs may increase.

subordinated debt instrument that is not permissible for a national bank or Federal savings association; however, to make such an investment the institution must receive prior FDIC approval and the investment must be permissible under the laws of the State (for aggregated investment and lending limits) where the FDIC-supervised institution is chartered.

## Subordinated Debt from an Investment Perspective

FDIC-supervised institutions and their subsidiaries may purchase subordinated debt instruments of BHCs and IDIs<sup>12</sup> as set forth in supervisory due diligence standards.<sup>13</sup> In certain circumstances, an FDIC-supervised institution may invest in a

To meet supervisory due diligence standards for subordinated debt investments, institutions may consider internal analyses; external research and analytics (including credit ratings, internal risk ratings, default statistics of external credit rating agencies); and other sources of information, as appropriate. As part of prudent risk management, an institution is expected

### Subordinated Debt Investments: Key Takeaways

- Institutions may generally only purchase investment grade subordinated debt securities that are permissible investments for national banks.
- Investments in subordinated debt are assigned a risk-weight and may also be subject to capital deduction.
- Investments in subordinated debt that are deemed reciprocal cross-holdings are immediately deducted from capital.
- Aggregated investments in subordinated debt may be subject to prudential credit concentration considerations, as well as State investment and lending limits.

<sup>12</sup> Section 24 of the FDI Act prohibits an insured State bank from engaging as principal in any type of activity that is not permissible for a national bank. 12 U.S.C. § 1831a. National banks may invest in subordinated debt if the debt is both marketable and investment grade. See 12 CFR § 1.2(f) and 1.2(d). Part 362 of the FDIC's Rules and Regulations allow State banks to apply to the FDIC to make investments that are not permissible for national banks provided applicable state law allows the investment. See 12 CFR Part 362, Subpart A. State savings associations have similar, but not identical requirements, under section 28 of the FDI Act. 12 U.S.C. § 1831e. Additionally, State savings associations have a specific prohibition against acquiring or retaining any corporate debt security that does not meet FDIC's standards of creditworthiness unless it is retained by a qualified affiliate. 12 U.S.C. § 1831e(d). State savings associations may apply to the FDIC to make investments not permissible for a Federal savings association if allowed by state law. See 12 CFR Part 362, Subpart C. All State bank and State savings association investments are subject to FDIC safety and soundness determinations.

<sup>13</sup> Financial institutions can refer to the Revised Standards of Creditworthiness for Investment Securities, and the Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment when contemplating subordinated debt investments.

to maintain documentation of its due diligence efforts.<sup>14</sup>

The analysis of a potential subordinated debt investment would be similar to the evaluation of bonds that do not carry explicit or implied support from the U.S. government. Therefore, IDIs consider the credit, market, concentration, and other risks that arise from investing in subordinated debt. In the normal course of examinations, FDIC examiners evaluate institutions' pre-purchase analyses, ongoing monitoring, and concentration risk for investment securities. Please note that subordinated debt instruments not meeting investment grade standards may be subject to adverse classification as described in the *Uniform Agreement on the Classification and Appraisal of Securities Held by Financial Institutions*.

In addition to each issuer's idiosyncratic risk, IDIs may consider the risk caused by regional or national economic turbulence. Macroeconomic stress episodes frequently have amplifying or correlation effects that can weaken the debt-servicing capacity of issuers while simultaneously subjecting the investor bank to financial difficulties.

### Due Diligence for Subordinated Debt Investment by CBLR Institutions

Although subordinated debt investments are not subject to a deduction or risk-based capital calculation for CBLR institutions, they still merit prudent due diligence efforts, monitoring, and diversification. Consistent with non-CBLR institutions, subordinated debt investments by

#### **Call Report Instructions for Subordinated Debt Investments**

Subordinated debt investments are generally accounted for as debt securities on Call Report Schedule RC-B, and categorized as trading, available-for-sale, or held-to-maturity consistent with ASC Topic 320, Investments—Debt Securities. Management should periodically reassess its security categorization decisions to ensure that the designations remain appropriate. If accounted for as a security, the subordinated debt instrument would be reported on Schedule RC-B Item 6.a, as “Other domestic debt securities” if the issuer were an U.S. entity. It would be reported in Item 6.b, as “Other foreign debt securities” if the issuer were a non-U.S. entity. If the security were accounted for as held for trading or under the fair value option, the investment would be reported on Schedule RC Item 5, “Trading Assets” and for the FFIEC 031 or FFIEC 041 Call Reports, as applicable, on Schedule RC-D, Item 5.b. for, “All other debt securities.”

In cases where the criteria for a security are not met, institutions may instead classify and report subordinated debt as a loan rather than a security depending on the instrument's facts and circumstances. This sometimes occurs when one institution acquires the entire subordinated debt issuance of another institution. If accounted for as a loan, the subordinated debt instrument would be reported in Schedule RC-C according to borrower type (such as a depository institution) and accounted for as held for investment or held for sale based on the institution's designation, unless the fair value option were elected. If the loan is held for trading, the instrument would be reported on Schedule RC Item 5, “Trading Assets” and for the FFIEC 031 or FFIEC 041 Call Reports, as applicable, in the appropriate category in Schedule RC-D Item 6, “Loans.”

<sup>14</sup> See FIL-54-2014, Filing and Documentation Procedures for State Banks Engaging, Directly or Indirectly, in Activities or Investments that are Permissible for National Banks, November 19, 2014, <https://www.fdic.gov/news/financial-institution-letters/2014/fil14054.html>

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CBLR institutions should adhere to regulatory standards for investment quality, loan underwriting, and risk management.

## Regulatory Capital Deductions and Risk-Weights for Subordinated Debt Exposures

FDIC-supervised institutions should be aware of the regulatory requirements affecting investments in the subordinated debt of another unconsolidated financial institution

(IDI or BHC). There are two aspects to the treatment of investments in the capital instruments of unconsolidated financial institutions, including investments in another financial institution's subordinated debt. The first aspect is a potential deduction from capital for reciprocal cross holdings or when a FDIC-supervised institution has reached the applicable deduction threshold(s) in Part 324. The second aspect is regulatory capital risk-weighting. A detailed description of these considerations is presented below.

### **Required Capital Deductions**

The first step is to determine whether there are any applicable capital deductions associated with holding subordinated debt of other financial institutions (not consolidated). Banks following the generally applicable capital rule are reminded that reciprocal cross holdings (See 12 CFR § 324.22(c)(3)) of capital instruments with another bank, including subordinated debt, are deducted from capital. That is, FDIC-supervised institutions must deduct investments in the capital of other financial institutions they hold reciprocally, where such reciprocal cross holdings result from a formal or informal arrangement to swap, exchange, or otherwise indicate intention to hold each other's capital instruments. The purpose of this deduction is to prevent banking organizations from artificially inflating each other's regulatory capital levels such that stress in one institution directly causes loss and deterioration in the capital of another financial institution.

If such reciprocal cross holdings exist, the institution's management team would apply the corresponding deduction approach outlined in the rule. Bankers and examiners should refer to the Call Report instructions for complete details on the mechanics of the deductions. In general, the full amount of cross holdings would first be deducted from the applicable tier of capital in order to determine the starting amount of regulatory capital to calculate the applicable threshold for the remaining investments in other financial institutions.

In most cases, a reciprocal cross holding would not exist. In this case, the institution's management team would determine whether its investment in the capital instruments of unconsolidated financial institutions exceeds the 25 percent of common equity tier 1 capital threshold limit (see the description and deduction requirement in 12 CFR § 324.22(c)(4)). Investments in the capital of unconsolidated financial institutions include investments in common equity, additional tier 1 capital instruments such as preferred shares, and investments in tier 2 capital instruments such as subordinated debt. These items are summed and compared against the 25 percent limit. Amounts over the limit are deducted. Institutions have the flexibility of deciding which of the investments in the capital of unconsolidated financial institutions that they choose to risk weight and which they choose to deduct (see the instructions for line item 13a in Schedule RC-R Part I in the FFIEC 031 and 041 forms).

For CBLR institutions, there is no deduction for investment in another financial institution's subordinated debt under the CBLR framework as electing institutions do not calculate tier 2 capital. CBLR institutions are required to report all investments in the tier 2 capital instruments of nonconsolidated financial institutions – an important disclosure mechanism that was included in the CBLR framework.

## Risk-Weights for Subordinated Debt Exposures

After an FDIC-supervised institution determines whether a capital deduction is appropriate, the next step is risk-weighting the subordinated debt investment, whether in the form of a security or loan instrument. Please note that FDIC-supervised institutions are not required to risk weight the amounts of any investments in the capital of unconsolidated financial institutions that have been deducted from capital (see 12 CFR § 324.22(g)).

The portion of subordinated debt that is not deducted is generally subject to a minimum 100 percent risk-weight. If in the rare case the IDI that owns the subordinated debt obtains a guarantee or other credit risk mitigant recognized under the capital rule, the IDI may be allowed to apply a risk-weight of less than 100 percent (see § 324.36 and § 324.37(b)). On the other hand, in the event the subordinated debt is past due the IDI must apply a risk-weight of 150 percent (see § 324.32(k)). While CBLR institutions do not report risk-weighted assets, management teams should be aware of the requirements under the generally applicable capital rule regarding deductions and risk-weighting in case the FDIC-supervised institution were to revert to the generally applicable capital rule at a future date.

## Treatment of Subordinated Debt for Deposit Insurance Assessments

IDIs that issue or invest in subordinated debt may also experience adjustments to their deposit insurance assessments. All other things equal, greater amounts of long-term unsecured debt can reduce the FDIC's loss in the event of a failure. In recognition of this, the assessment system includes an unsecured debt adjustment that lowers a financial institution's initial base assessment rate (determined by the

## Call Report Instructions for Subordinated Debt Capital Deductions, Risk-Weights, and CBLR Disclosure Information on Investments on Schedule RC-R

### Capital Deductions

- For the FFIEC 041 or FFIEC 051 Call Reports, the deduction for amounts over the 25 percent limit are recorded on RC-R Part I, Items 13 and/or 17, 24, and 45. The deduction for the portion of subordinated debt that qualifies for tier 2 capital occurs in Item 45.
- For the FFIEC 031 Call Reports, the deduction for amounts over the 25 percent limit are recorded on RC-R Part I, Items 13a and/or 17, 24, and 45. The deduction for the portion of subordinated debt that qualifies for tier 2 capital occurs in Item 45.
- CLBR institutions are not subject to the corresponding deduction approach. Aggregated investments in subordinated debt may be subject to prudential credit concentration considerations, as well as State investment and lending limits.

### Regulatory Capital Risk-Weights

- Investments in subordinated debt of unconsolidated financial institutions are assigned a 100 percent risk-weight. Subordinated debt of other banking organizations is generally risk weighted in Item 2 Securities in Schedule RC-R Part II. If the asset is held for trading, it would be reported in Item 7.
- CBLR institutions do not calculate risk-weighted assets, but they have disclosure requirements that other institutions are not required to make.

### CBLR Disclosure of Subordinated Debt and Other Tier 2 Instruments Held for Investment Capital Risk-Weights

- CBLR institutions report their investments in the tier 2 capital of unconsolidated financial institutions on line item 36 of Schedule RC-R, Part I.

ratio of the financial institution's long-term unsecured debt to its assessment base). The unsecured debt adjustment cannot exceed the lesser of 5 basis points or 50 percent of an institution's initial base assessment rate. It also does not apply to new (de novo) financial institutions or insured branches.

However, when unsecured debt, such as subordinated debt, issued by a financial institution is held by other IDIs, the Deposit Insurance Fund remains exposed to risk of loss. Therefore, the depository institution debt adjustment increases the

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assessment rate when an IDI holds long-term, unsecured debt issued by another financial institution. An IDI pays a 50-basis point adjustment on the amount of unsecured debt it holds that was issued by another IDI to the extent that such debt exceeds three percent of the institution's tier 1 capital.<sup>15</sup>

debt can offer. Management of FDIC-supervised institutions is encouraged to seek technical assistance from their regional office contacts when needed.

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## Summary

Banking organizations have successfully issued, serviced, and retired subordinated debt instruments for decades. Although regulatory capital requirements and eligibility criteria for subordinated debt issuance can be complex, over the years these instruments have helped banking organizations achieve their long-term capital planning and funding objectives. In addition, institutions may be able to prudently diversify their investment portfolios with subordinated debt securities and loans issued by other financial institutions, while complying with permissibility, diversification, and investment quality standards. Investing in subordinated debt must be done in compliance with the capital rule, which requires capital deductions for reciprocal cross holdings and/or exceeding threshold limits in the rule. Even questions as to how to report subordinated-debt investment holdings on quarterly Call Reports sometimes can be less than straightforward and require an analysis of the instrument documentation.

FDIC-supervised institutions that issue subordinated debt, take downstreamed capital injections, or invest in the capital of an unconsolidated financial institution should review the applicable rules to ensure the institution can enjoy the capital and investment benefits that subordinated

<sup>15</sup> Long-term unsecured debt issued by other IDIs is reported in Call Report Schedule RC-O, item 6.