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Sub Debt Can Provide Bank Liquidity

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By now, we have all heard about the Bank Term Funding Program initiated by the Federal Reserve and the FDIC to provide liquidity to financial institutions. Under the program, banks can borrow from the applicable Federal Reserve Bank with any collateral eligible for purchase by the Federal Reserve Bank so long as the collateral was owned by the bank on March 12, 2023. The collateral would be valued at 100 percent of par. The advances would have a term of one year with an interest rate equal to the one-year overnight index swap rate plus 10 basis points. This seems to be the most widely discussed avenue for increasing bank liquidity, but there is another option available to provide liquidity for banks that is often overlooked.

Subordinated debt can be treated as Tier 2 capital up to 100 percent of Tier 1 if it meets certain requirements. First, the debt instrument must be subordinated to depositors and general creditors. The debt instrument cannot be secured by a guarantee of the bank or of an affiliate, and there cannot be any other arrangements that enhance the seniority of the subordinated debt compared to more senior obligations. Finally, the subordinated debt instrument must have a maturity of at least five years. The subordinated debt may have a dividend rate that is adjusted periodically based on general market interest rates or similar adjustments.

There are some quirks to this Tier 2 capital instrument. The amount that is eligible to be included in Tier 2 capital is reduced by 20 percent of the original amount of the debt. This occurs at the beginning of each of the last five years of the life of the sub debt. The subordinated debt is therefore excluded from regulatory capital altogether when the remaining maturity is less than one year. In addition, the debt instrument must not have any terms or features that require or create significant incentives to redeem the debt prior to maturity.

The subordinated debt can be called after five years with prior regulatory approval.

Care must be taken that there is no hint or suggestion to the holder of the debt that they should expect the call option to be exercised. If the call option is triggered, the subordinated debt must either be replaced with an equivalent instrument that meets the Tier 2 criteria, or the regulatory body must be satisfied that following redemption, the bank would continue to meet its capital needs.

Similarly, the holder of the subordinated debt cannot have any right to accelerate payment of principal or interest, except in the event of a receivership, insolvency, liquidation, or the like.

If you are looking for a liquidity fix that goes beyond the one year of the Bank Term Funding Program yet can still be temporary, albeit of an intermediate range, subordinated debt may be your ticket.