**2022 | INVESTING IN SUB DEBT WEBCAST**

# INVESTING IN SUBORDINATED DEBT:

## WHAT SHOULD YOU LOOK FOR?

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Credit unions are issuing subordinated debt more readily than they have in years past. Your credit union may have already seen some of these deals. What should you look for when deciding whether to invest in subordinated debt? Let's take a closer look.

## What is subordinated debt?

Subordinated debt is an *unsecured, subordinated* borrowing of the issuing credit union. While the issuance is classified as a borrowing or "note" by the issuing credit union, it is classified as a security for the investors in subordinated debt notes, per SEC and NCUA rules.

This classification requires every issuance to conform to standard security issuance guidelines. The issuances are typically offered through a private placement memorandum and are eligible for exemption from Securities and Exchange Commission registration under Rule 506. Rule 506 permits the issuing entity (a credit union in this case) an exemption, given the issuer satisfies certain requirements, which include:

- The issuer may not use general solicitation or advertising to market the securities
- The issuer may sell the securities to an unlimited number of "accredited investors" and up to 35 non-accredited investors
- The issuer must determine what information to provide to accredited investors, so long as it does not violate federal securities laws or antifraud prohibitions by including inaccurate or misleading statements, or excluding information that results in inaccurate or misleading information
- The issuer must be available to answer questions provided by potential or prospective investors

The securities, when purchased, will be classified as "restricted" securities, which means that an investor cannot sell the securities for six months.

While the issuer is not required to register the securities with the SEC, they must file a Form D, which informs the SEC when the securities were first offered for sale, provides a description of the issuer, identifies executives and gives general details of the securities.

## Why do credit unions issue subordinated debt?

The greatest benefit to a credit union issuing subordinated debt is that the issuance may be counted toward regulatory net worth if the issuing credit union: 1) is low income designated, and 2) has obtained prior regulatory approval to count the issuance towards net worth.

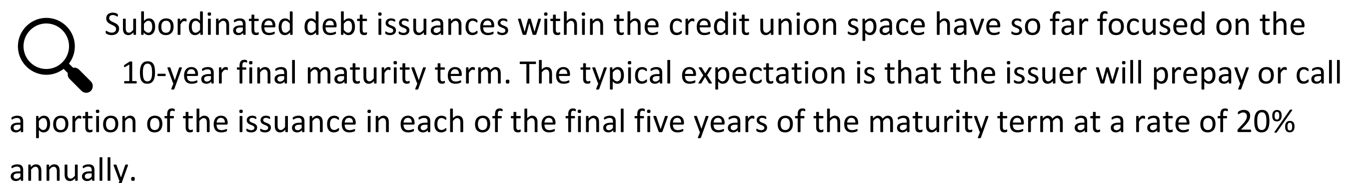
Regulatory approval must be obtained in advance of the issuance from the National Credit Union Administration for federally chartered credit unions, and from the issuer's state examiners and the NCUA for state-chartered federally insured credit unions.

While the issuance is technically a borrowing, the ability to count the amount of the issuance towards net worth enables the issuer to "leverage" the borrowing in the same capacity as organic net worth.

This allows issuing credit unions to achieve a higher level of balance sheet growth than possible through organic net worth creation. It can also help restore net worth to a desired or optimal level, fund expansion into new territories, build new or renovate existing branches, invest in new technologies, fuel restrained organic loan and deposit growth, or support future mergers and acquisitions.

***"Subordinated debt issuance can support many initiatives and strategies for issuers and investors. As a potential investor, you should fully understand the issuing credit union's initiatives, because if the issuer is unable to successfully execute those strategies, it could negatively impact ability to repay."***

## What do the issuances look like?



Subordinated debt issuances within the credit union space have so far focused on the 10-year final maturity term. The typical expectation is that the issuer will prepay or call a portion of the issuance in each of the final five years of the maturity term at a rate of 20% annually.

The reason for this prepayment or call is due to the regulatory net worth treatment rules. In the final five years of the maturity term, by rule, the issuing credit union must reduce the amount counted toward net worth by 20% annually, down to zero at the maturity date. However, it is worth noting that the issuer's ability to prepay/call, or even repay the notes, is subject to prior written regulatory approval.

## What do the issuance rates look like?

Subordinated debt notes represent an unsecured, uninsured and subordinated claim against the issuing credit union. In fact, these notes represent the first loss position after undivided earnings and reserves and will absorb losses before deposit insurance.

As a result, there is no collateral pledged to support the security of these notes. Think of them like a credit card loan (but with a maturity date) that you offer to your members. In this case, the issuer is a large financial institution with a variety of earning assets on the balance sheet, access to liquidity and borrowing capacity, and member deposits. Still, none of this guarantees future financial performance to ensure repayment of the notes upon maturity.

As a result of the lack of collateral and the first loss position, the issuance rates are typically offered with a relatively high spread over a similar duration U.S. Treasury bond. The spread will vary based upon the credit quality and potential default risk of the issuer; there is no singular spread applied against all issuers. You can expect credit spreads to generally range, depending on the strength of the issuer, between 200 to 400+ basis points over a similar duration U.S. Treasury.

## Considering an investment in subordinated debt?

There's more to take into account than just the rate. All credit unions should consider five key areas when evaluating the strength of potential opportunities: growth trends, loan quality, earnings capacity, liquidity and planned use of funds all impact the strength of an issuer.

### 1 Growth trends

First, it's important to assess the credit union's probability of growing safely in the future. Will the credit union be able to grow loans at a rate that maintains positive net income, expands services to members and increases their market footprint?

Net worth that has declined over the past few years may warrant deeper analysis to determine the cause. For example, is net worth under pressure due to deposit inflows associated with COVID stimulus money, or is it due to weak operating performance? If deposit inflows were due to COVID, review the credit union's historical and expected loan growth, deposit growth and earnings levels to determine the issuer's overall strength and soundness.

### 2 Loan quality

Loan quality can present operating challenges for credit unions. Pay close attention to loan quality after a period of accelerated loan growth. Has the issuer lowered underwriting standards to attract the growth? If so, determine how that may affect long-term earnings trends.

### 3 Earnings capacity

Long-term earnings capacity is a critical element in determining the safety of a subordinated debt note investment. Most issuers prepay subordinated debt notes with earnings as they become due. Therefore, it's beneficial to consider the rate of loan growth relative to broader asset and deposit growth. Credit union net income levels expand when loans grow and represent a larger portion of the balance sheet, as these typically contribute to a widening of net interest margin. However, as noted above, you should review whether loans grew because of lower underwriting standards.

An ideal profile to seek is a credit union with loan growth greater than asset growth and a loan-to-asset ratio that is rising without deterioration in loan quality.

## 4 Liquidity

The overall liquidity position of the issuing credit union is also critical. Is the issuer prudent in their liquidity management practices? Historically, the use of borrowings should not, in isolation, be viewed as a deterrent to investment. When evaluating past or current borrowing activity, look for the justification.

Were borrowings used to support funding of additional loan growth, elevate the loan-to-share ratio and reduce liquidity? In this situation, what are the issuer's plans to restore the credit union's liquidity position? Another possibility would be using borrowings as a strategic hedging strategy to lock in a yield against other earning assets.

***"Reviewing liquidity helps evaluate whether the issuer can prudently manage and maintain a healthy liquidity position and can justify any borrowings."***

## 5 Use of funds

How does the issuer plan to use the funds to support their mission, strategy and vision? An investor should ensure the issuer has a strong business reason for issuing subordinated debt and that the planned use of the funds aligns with the issuer's business strategy. Review any strategy deviation to ensure the expected outcomes are probable and that failure to execute the proposed strategy will not have a severe negative impact on the issuer's overall operating performance.

Deposit inflows during the pandemic caused many credit unions to experience above-trend growth, placing significant downward pressure on net worth. This trend may be part of a larger overall justification for issuing subordinated debt, such as declining net worth due to core operations.

When exploring subordinated debt issuance, search for a credit union that is experiencing growth, has stable loan quality, strong liquidity management, reasonable risk parameters and healthy net worth.

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## Think investing in subordinated debt is in your future?

Issuing subordinated debt is not for every credit union, but you may be able to benefit from others' issuances. If you need resources to put your plans into action, subordinated debt can turn your ideas into reality, and Catalyst Corporate, its partners, and subsidiaries can help.

## For more information, contact us today:

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