BYBEL RUTLEDGE LLP

LEGAL ALERT

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LOW FED RATES FAVOR ISSUANCE OF SUBORDINATED DEBT BY FINANCIAL INSTITUTIONS

In response to the impact government COVID-19 stay-at-home orders have had on the economy, the Federal Reserve has cut the federal funds rate to 0.00-0.25%. Nevertheless, the financial press reports that there has been no shortage of investor interest in 10-year US Treasury debt obligations at 1% which it argues, if held to maturity, results in a negative interest rate.

This low interest rate environment may be an opportune time for financial institutions to revisit their capital plans. Capital planning should be one of the most important components of a financial institution's overall strategic plan and one that should be opportunistic as well as methodical. Capital is the raw material of financial institutions and, like industrial companies, financial institutions need to ensure that they have sufficient raw materials necessary to secure their future (defensively, with respect to credit quality in connection with loan portfolios) and expand their business (offensively, with respect to M&A opportunities under circumstances where cash consideration may be more attractive than shares).

In these uncertain times when shares of financial institutions are under market pressure, issuance of subordinated debt may be an attractive capital instrument because subordinated debt is not dilutive to existing equity and interest rates on subordinated debt exceed most dividend yields on common stock. In addition, payment of interest on subordinated debt is tax-deductible to the issuer as a business expense, thereby making the effective cost very attractive in today's environment.

Furthermore, properly structured subordinated debt can qualify as Tier 2 regulatory capital and be downstreamed to depository subsidiaries as equity capital. This generally requires that the subordinated debt have a minimum maturity of five (5) years with a five (5) year no call provision. The debt must be subordinated to depositors and general creditors and there generally is no right to acceleration. It is good practice to have proposed subordinated debt "precleared" for inclusion as Tier 2 regulatory capital by a financial institution's Federal Reserve Bank prior to issuance. Financial institutions should seek to obtain such "preclearance" at least 30 days prior to the anticipated subordinated debt issuance. The subordinated debt cannot have an interest rate step-up based on credit quality and cannot be secured or guaranteed in a manner that enhances the security's seniority.

Generally, financial institutions issuing subordinated debt usually offer a fixed interest rate for a five (5) year period which then coverts to a floating rate usually based on LIBOR plus a stated number of basis points. However, the LIBOR benchmark is being phased out in 2021 and issuers of subordinated debt must select a new benchmark on which to determine a floating interest rate (eg SOFR). In addition, issuers should take steps to protect themselves in the event that interest rates of the selected benchmark would go negative in the future.

Bybel Rutledge LLP maintains a proprietary database of important terms of subordinated debt offerings made by Pennsylvania financial institutions over the past several years. This,

Bybel Rutledge LLP
1017 Mumma Road, Lemoyne, PA 17043
Phone: 717-731-1700
Fax: 717-731-8205
Website: www.bybelrutledge.com

along with our many knowledgeable and experienced advisers, provides our clients with valuable insight into shaping a subordinated debt offering with features that address the unique concerns and circumstances of each client.

The foregoing information applies to subordinated debt issued by bank holding companies. If a bank is considering issuing subordinated debt and the bank desires the subordinated debt to be deemed a "capital security" under the Pennsylvania Banking Code of 1965, it will need to follow the provisions outlined in Section 1105 of the Banking Code.

Need More Information?

If you would like additional information, please contact any of the following members of Bybel Rutledge LLP at (717) 731-1700 or at their respective email address:

Nicholas Bybel, Jr., Esq.
(bybel@bybelrutledge.com)

Erik Gerhard, Esq.
(gerhard@bybelrutledge.com)

G. Philip Rutledge, Esq.
(rutledge@bybelrutledge.com)

Carter D. Frantz, Esq.
(frantz@bybelrutledge.com)