Asset Liability Management: An Ideal Time to Issue Debt

“The most important single central fact about a free market is that no exchange takes place unless both parties benefit.” – Milton Friedman. The market for community bank debt (senior and subordinated) will likely command more attention as both issuers and buyers find pricing more attractive in the current environment. The new issuance market is near-perfect due to a supply/demand imbalance, low Treasury yields, and relatively tight credit spreads.

Reasons to issue debt include enhancing capital, funding acquisitions, refinancing higher cost debt, and repurchasing stock.

Senior debt is not as prevalent as subordinated debt (“sub debt”) among community banks but there are occasional new issue deals. Senior debt does not get the Tier 2 treatment at the holding company which isn’t necessarily a problem for banks below $3 billion. In theory, senior debt should price more favorably given the higher ranking in the capital structure, but the limitations around capital treatment at the holding company make this a less common source of capital in the current environment. In any case, the environment is conducive to issuing both senior debt and subordinated debt, depending on your institution’s needs.

Due to its position within the capital hierarchy, sub debt may be preferable to equity given that common shareholders will not be diluted and there are no voting rights attached to these debt instruments. Due in part to its tax-deductibility, the cost of capital on sub-debt is often lower than that of equity capital for community banks.

- Senior and subordinated debt are effective forms of financing for banks that seek capital to support growth.
- Sub debt is included as Tier 2 capital for bank holding companies (“BHCs”). Regulations permit BHCs to “push down” proceeds to the subsidiary bank where they are included as Tier 1 capital. This often helps banking organizations meet or exceed total risk-based capital requirements, which are 10.5% under Basel III regulations.
- The ability to issue debt facilitates the use of cash to fund acquisitions, which is significant as common equity raises can be more difficult for smaller institutions. Non-stock deals appeal to sellers seeking to “cash out”.
- Regulators and bank investors appreciate proactive asset/liability management, which use funding that more or less matches the expected duration or maturities of assets.
- Sub-debt remains one of the more attractive investments on a risk/reward basis, which has fueled an almost insatiable demand among investors in today’s market.

The historically low interest rate environment was a key factor for the pick-up in sub debt issuance from 2014-2017. Other reasons for the more widespread use of sub debt financing was the prevalence of Troubled Asset Relief Program (“TARP”) and Small Business Lending Fund (“SBLF”) financing that needed to be redeemed before these instruments reset to 9.0% coupon rates. Other factors that contributed to more sub debt issuances included the
realization that investors and regulators demanded higher total capital ratios; the Federal Reserve change to the Small Bank Holding Company Policy Statement that allowed for significantly higher leverage for BHCS under $1 billion in assets (subsequently amended to $3 billion); and last, but not least, a more receptive market for debt issuances.

The pricing on new deals is both a function of Treasury rates and credit spreads. Treasury yields are moving in a favorable direction for issuers. Over the past seven months, the 10-year Treasury has dropped 125 bps. With the 10-year Treasury below 2.00%, we are at the lowest yield since 2016. The other side of the equation is corporate spreads. If we use the Bloomberg US Financials BBB 10-year yield curve as a baseline, the spread to Treasuries is currently +158 bps. Credit spreads have widened a little over the last couple months but not drastically. In November 2018, when the 10-year Treasury was yielding 3.238%, the spread on this BBB index was +159 bps. So while rates have been moving significantly lower, credit spreads have remained fairly stable. Obviously Kroll rated and non-rated issues will trade wider than the BBB composite curve, but this gives an idea of the general health of the credit market. Issuers should be aware that even though the yields on Treasuries continue to face downward pressure, risk happens fast, and credit spreads could widen significantly, particularly if the economy sours.

**Figure 1**

A sub debt issuance qualifies as capital as long as the maturity date is five years or more. At the five year point, the percentage that is includable as capital at the holding company declines by 20% each year. Companies, therefore, that issued sub debt in 2014 should be incentivized to issue new debt and use the proceeds to repay the earlier debt issuance.
There are three major categories of community bank debt investors. The first group is comprised of other banks that find the yields to be a compelling loan surrogate while offering the opportunity to “invest in what you know”. Demand from other banks has been steadily increasing as the yields on this asset class are much greater than alternatives and can help fight net interest margin compression. The second group of investors is insurance companies, which continue to have appetite given their higher risk profile and elevated yield bogey. The last group is asset managers. With recent community bank debt securitizations and capital that continues to flow into the space to capture higher yields, demand has been increasing from asset managers. Although insurance companies typically only have appetite for rated issuances, many community banks and asset managers are looking to invest in both rated and non-rated deals.

Institutional investors strongly prefer to invest at least $5 million in a debt deal as it is harder to justify smaller investments when the same amount of due diligence is required. Thus, a $15-$20 million debt offering can be absorbed by just a handful of buyers.

Institutional investors take a hard look at bank profitability, interest coverage and double leverage ratios. These investors generally prefer that proceeds are used to support organic growth, prudent mergers and acquisitions, and -arguably best of all – to refinance existing debt with higher coupons.

Depending upon the issuer, size of the issuance, and other circumstances, community bank debt can be rated or unrated. In recent times, given the demand referenced above and the increasing depth of the market, we have seen a compression in the yield differential between rated and non-rated deals. The rating can be costly with the combination of the upfront fee and annual surveillance fees. On smaller deals, the rating is cost prohibitive and a non-rated deal is often the cheaper option after accounting for the rating in the net interest cost. On larger deals, the rating still make senses as it will broaden the distribution channels and because the fixed rating expense will be spread over a larger issuance amount.

Sub debt is generally issued with 10-year maturities and a five year call option. Coupons are usually fixed for the first five years and float after the call date. On the contrary senior debt is often non-callable with a fixed rate coupon structure and a maturity of 5 to 7 years. The spread on the standard sub-debt structure for the floating rate is the difference between the fixed coupon and the five year swap rate on the pricing date. This spread was often priced in the 300 to 500 basis point range in previous years. For example, a May 2015 sub-debt issuance was priced at 6.50% with a five year swap rate of approximately 1.50%. Thus, the floating coupon after the May 2020 call date is Libor + 500bps. Assuming that the three month LIBOR is currently yielding 2.40%, the floating coupon would be 7.40% if resetting today. Rated deals are currently pricing around 5.25% depending on the issuer’s performance, issuance size, debt outstanding, etc. Thus, there is considerable interest expense savings comparing the floating coupon vs. the rate where a new issuance would price, so refinancing activity is expected to pick up considerably as we approach the call date on deals issued in 2014-2016.

Banks that seek steady returns should be encouraged to consider senior or sub debt as an alternative form of capital. As a supplement to equity, debt (arguably under-utilized) can help
banks achieve a higher earnings per share and return on equity. The marketing and pricing of senior and sub debt issuances by community banks are not “cookie cutter” and therefore, should be carefully planned on an individualized basis. Please feel free to contact a member of the PNC FIG Advisory team to discuss if issuing now makes sense for your institution.
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