Capital Raising in 2016: Subordinated Debt on the Rise

Banks turn to different sources in search of greater ROE

Wisconsin banks seeking additional capital may initially be discouraged by the cost and potential regulatory scrutiny. However, with improving loan growth and elevated merger and acquisition activity, raising capital is an important part of many institutions' strategic plans. The solution? **Karl J. Ostby**, managing director of investment banking at Ambassador Financial Group, says more banks are turning to subordinated debt offerings at the bank holding company level, fueled by three main catalysts.

First, community bank earnings and credit quality have dramatically improved since the 2008 crisis, providing greater access to debt markets. "Banks today are in much better shape than they were five or eight years ago, so investors are much more willing to invest," Ostby explained. So, more banks are financially attractive and can take advantage of the current market than in recent history. The second catalyst behind the steady rise in popularity of subordinated debt offerings are changes implemented by the Federal Reserve in May 2015 to allow significantly higher leverage for bank and thrift holding companies (BHC) with assets under $1 billion.

Finally, subordinated debt offerings have experienced a jump in popularity due to cost. "What used to be popular is preferred debt, but the dividend is not tax-deductible, so it's inherently more expensive," Ostby explained. While many of Wisconsin's community banks are in a financial position to raise common equity, that option is more expensive and often dilutive to existing shareholders. Generally, common equity is 9-10 percent cost per capital, compared to subordinated debt which is closer to 4 percent (after-tax). Another reason BHC subordinated debt has become more popular is because of its favorable regulatory treatment. "Regulators also prefer to see sub debt, compared to senior debt," said Ostby. "You can treat it as Tier 2 capital at the BHC level, and Tier 1 at the bank level."

These and other factors have combined to reshape bank preferences when it comes to capital raising. In fact, issuance of subordinated debt, both in number and amount, has increased for banks below $20 billion since 2011, rising from 14 issuances in 2011 to 68 in 2015 (through September), climbing from $26.3 million to over $1 billion. Despite this growth in popularity, diversity is still the key when raising capital. "We also encourage diversity in capital structure," Ostby advised. "It's appropriate to have 10-25% of capital in sub debt."

There is another diverse option for capital raising that is just beginning to emerge: crowdfunding. The Wisconsin legislature passed a WBA-supported crowdfunding law in 2014 that is more favorable than federal law. Ostby expects crowdfunding will be used – initially – more by banks' business customers, but that eventually it could become a capital raising tool for banks themselves. "It could give bank clients better access to capital, which in turn makes them better clients for the bank," he said. "It's more likely in the early stage to be geared toward bank clients, but there is potential for banks to use it to raise capital."

The current rise of subordinated debt and the potential waiting to be tapped in crowdfunding are just two examples of how the banking industry adapts to new conditions in order to thrive.

Ambassador Financial Group offers financial institutions a comprehensive solution that includes balance sheet management, investment banking and capital markets. Their broad range of services combined with personal service and professional advice can help you improve your institution's financial performance and achieve your strategic objectives. They built their process from the ground up to deliver Wall Street Execution with Main Street Customer Service.™

WBA Comments on Securities, FFIEC Cybersecurity Assessment Tool Information Collection

Summary of recent comment letters below

On January 8, WBA filed a comment letter with the Securities and Exchange Commission regarding amendments to Rule 147 under the Securities Act of 1933. WBA expressed concern over the proposed $5,000,000 cap on the aggregate offering amount and requirement of individual investment limits, particularly with respect to accredited investors. WBA also expressed concern over how the proposal's limit requirements would impact Wisconsin's current state exemptions.

On January 14, WBA submitted a comment letter to the OCC regarding the renewal of the FFIEC Cybersecurity Assessment Tool information collection notice. In the letter, WBA expressed appreciation that the federal banking agencies will: (1) consider developing an FAQ document to address questions and requests for clarifications that the agencies have received since the publication of the Assessment; (2) develop a process to update the Assessment on a periodic basis; (3) refine their burden estimates to be based on financial institution asset size; and (4) further educate examiners on the voluntary nature of the Assessment – including statements about its voluntary nature in examiner training materials. WBA also indicated that Wisconsin financial institutions will continue to be diligent in their efforts to review, update and protect against cyberattacks.

The WBA Legal Department advocates for the industry by writing comment letters to federal and state regulators on proposals affecting the industry and by filing friend-of-the-court briefs at the request of WBA members and per approval by the WBA Board of Directors.

For copies of this or other WBA comment letters, please contact the WBA Legal Department at 608/441-1200 or visit www.wisbank.com/CommentLetters.