Back in the Spotlight: Subordinated Debt

Over the past several months, we’ve seen a few bank holding companies in the Fifth District raise subordinated debt, and have seen that others are in the planning phase. It seems most, if not all, of the debt proceeds is down-streamed to the bank subsidiary as tier 1 capital.

We’ve also seen new subordinated debt issuances, due to the low rate environment, to refinance higher cost debt or preferred shares issued initially by the U.S. Treasury. While issuing subordinated debt often benefits the subsidiary banks, BHCs should ensure that their subsidiary banks aren’t harmed by excessive parent debt that could require significant bank dividends to service those obligations.

BHCs source of strength

Keep in mind that BHCs are required to serve as a source of strength for their banking subsidiaries. Also BHCs should factor the debt usage and appropriate limits in their capital plans. Here are some issues to consider when incurring this type of debt:

- **Parent liquidity and the level of debt** — Parent liquidity is assessed by looking at the contractual maturity of the BHC’s assets and liabilities to determine whether any funding gaps exist. We also focus on the debt-to-equity ratio and the double-leverage ratio, especially when the proceeds are down-streamed to the bank. The double-leverage ratio is calculated by dividing the parent’s equity investment in the subsidiary by its total equity, and a BHC is considered to have double leverage when this ratio exceeds 100 percent. There’s no specific limit for this ratio, but generally speaking, a double leverage ratio above 120 percent is considered high and will get added scrutiny by the supervision team. The key factors we consider are how the ratios compare with the averages of peer institutions and the BHC’s ability to service and repay debt.

- **Ability to service debt** — Examiners will check to ensure that there’s adequate cash flow to make interest payments. When BHCs downstream proceeds to the bank, they typically hold back a year or two of interest payments or downstream all funds and rely entirely on dividends from the subsidiary to make future payments.

  To the extent that the BHC relies on dividends from the bank, we’ll analyze the bank’s existing and projected earnings and capital positions. Overreliance on bank dividends may become a concern when the subsidiary’s capital position is weakened or its earnings power declines to the
point where dividends are restricted by bank regulators. For additional information on parent-only liquidity and cash flow, see section 4010.0 of the Bank Holding Company Supervision Manual.

• **Tier 2 treatment** — For BHCs not subject to the Small Bank Holding Company Policy Statement (generally those over $1 billion in assets), regulators look at capital on a consolidated basis. For these BHCs, subordinated debt may count as tier 2 capital if certain criteria are met. For example, the instrument must be subordinated to depositors, unsecured and have an original maturity of at least five years. If you desire tier 2 treatment for the debt, please see section 217.20(d) of Regulation Q for a full description of the requirements.

For smaller companies subject to the Small BHC Policy Statement, consolidated capital is not applicable and tier 2 treatment isn’t formally analyzed from a supervisory standpoint. Nonetheless, examiners would still analyze the impact of the debt on the BHC. Also, bankers may want to ensure that newly incurred debt qualifies as tier 2 capital in case BHC growth took it above the $1 billion asset threshold in the future.

• **Reciprocal holdings** — Bank holding companies that issue subordinated debt should ensure that they don’t have reciprocal holdings with other subordinated debt issuers. Reciprocal debt holding would typically result in a deduction of those holdings from regulatory capital under section 217.22(c) of Regulation Q.

• **Enforcement actions** — If a BHC is under an enforcement action, it will likely be required to obtain the prior written approval of both the Reserve Bank and applicable state regulator before incurring debt. You’ll also typically need prior regulatory approval for making interest payments on and redeeming debt. We’ll closely scrutinize these requests, so we should receive them at least 30 days in advance.

If you have any questions about subordinated debt, or whether a new issuance qualifies as tier 2 capital, feel free to reach out to your supervision contact at the Richmond Fed.

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**BSA Coalition Conference Covers Due Diligence, Communication across Business Lines**

The BSA Coalition, which is comprised of bankers, credit union employees, auditors, law enforcement officials and regulators, held its annual Anti-Money Laundering conference this past June. The Richmond Fed hosts the conference for the coalition, a group independent of the Fed.

The coalition’s primary objective is to provide a forum in which anti-money laundering professionals can discuss, debate and resolve questions about regulatory guidance and day-to-day issues facing the development and implementation of effective BSA/AML and OFAC programs. The Richmond Fed also shares regulatory expectations on BSA/AML and OFAC through this forum.

**Panama Papers**
At the conference, keynote speaker John J. Byrne, executive vice president of the Association of Certified Anti-Money Laundering Specialists kicked off the conference with a discussion of the Panama Papers.

“What the Panama Papers are showing us is nothing new,” John shared. “Using shell companies to evade taxes has been happening for years.”

John went onto explain that until tax evasion becomes a precursor offense for money laundering, and until stronger controls are required for U.S. corporate formations, shell companies will continue to be used for illicit purposes.

Banks should perform appropriate due diligence to understand the ownership structure and BSA/AML risk profiles of companies that they do business with. This insight will help banks to more effectively analyze the entities’ transactions and suspicious activity monitoring results, which leads to a greater understanding of the entity, its purpose and expected activity.

**Seeing full customer relationship**

“Communication between BSA/AML functions and key business lines is important to a successful BSA program” noted panel moderator Chris Noack, a senior portfolio analyst in Supervision, Regulation and Credit at the Richmond Fed.

His panel explored the idea that to most effectively identify suspicious activity, BSA officers need to understand the entirety of the customer’s relationships within the bank, both on the deposit and loan sides of the house, and across all business lines. Loan officers in turn should understand what customer due diligence items AML professionals need from them to identify suspicious activity.

The event’s regulatory speakers reinforced the importance of due diligence in creating and maintaining an effective BSA/AML compliance program. The speakers also highlighted FinCEN’s new beneficial ownership rule. The rule requires covered financial institutions to obtain, verify and record the identities of the beneficial owners of legal-entity customers. Examples of legal-entity customers include corporations, limited liability companies and general partnerships.

**Mergers and acquisitions**

Speakers also discussed due diligence related to mergers and acquisitions. Panelists stressed the importance of BSA officers getting a seat at the table early in the process. It’s also important to have a clean BSA record in garnering regulatory approval for a merger.

The BSA Coalition’s Board of Directors and a diverse team across Supervision, Regulation and Credit at the Richmond Fed develop the agenda and plan the conference. Managing Examiner Elaine Yancey, who is responsible for the Richmond Fed’s anti-money laundering and fiduciary risk examination team in Supervision, Regulation and Credit, leads the effort. Additional information about BSA Coalition training events can be found at bsacoalition.org.
Upcoming Banking Events at the Richmond Fed

**Community Bankers Forum**
November 14-15
This forum brings together community bank leaders representing every state in our District to hear a variety of risk-focused topics and emerging issues as well as to share insights with Fed experts and one another. Contact Sean O’Hara for more information.

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**Recap of Recent Supervision and Regulation Guidance**
Supervision and Regulation Letters, commonly known as SR Letters, address significant policy and procedural matters related to the Federal Reserve System’s supervisory responsibilities. Consumer Affairs letters address significant policy and procedural matters related to the Federal Reserve System’s consumer compliance supervisory responsibilities. Active SR and CA letters are listed in reverse chronological order.

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