A Discussion of Community Bank Subordinated Debt

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

As the country continues to enter the reopening phase, we're beginning to see indicators like non-farm payrolls and retail sales move in a positive direction. Investor optimism hit recent peaks, as stocks retraced the majority of losses from late February. However, Fed Chair Jerome Powell painted a grim picture of economic and financial conditions in the event of a second wave of COVID-19, and investors heeded the warning as a selloff in risk assets and flattening of the yield curve ensued. Whether or not these budding economic indicators will be transitory remains to be seen.

On Tuesday, the Fed entered into new territory as it began buying individual corporate bonds under the $250B Secondary Market Corporate Credit Facility (SMCCF). Until now, the U.S. had been able to avoid purchasing risk assets as part of monetary policy actions similar to those in Europe and Japan. The need to quickly set a floor for asset prices and further stabilize credit markets forced their hand. Since the program was announced, the Fed has purchased ~$5.5B of ETFs tied to U.S. investment grade credit. Powell urged Congress during his recent testimony to the Senate Banking Committee that more fiscal stimulus would be needed and Fed policy action won't be enough to fully stabilize the economy.

Observations on Survey Results

Thanks to everyone who responded to last week's survey. Over the next few weeks we will interpret results, and as is our usual approach, recommend strategies to address concerns and exposures. Let's take a look at what's on your mind:

The yield curve and its effect on your balance sheet: Generally as a group, you expect rates to stay the same or fall. Approximately 98% of you believe the Fed when they say they'll stay in this range. Further, approximately 54% of respondents said 5-year treasuries will remain within 10 bps of their current level. With respect to negative rates, you are split 54%/46% on whether it is possible or likely to happen vs. not a possibility.

But as we always say, we are risk managers here to balance our exposures, not to predict rates. As far as positioning, 60% of respondents said they are asset sensitive. Additionally, 52% are exposed to the short end of curve, and another 42% to the 2-5 year part. So as a whole, the group can certainly use some duration on the asset side of the balance sheet.

Loan growth and credit are on your mind: Approximately 91% of respondents expect negative or less than 5% loan growth, excluding PPP. Every respondent chose credit as the biggest concern for both themselves (52% of responses) and regulators (76% of responses). Finally, most institutions feel most constrained by the leverage ratio, not the risk based ratio.

So where does this all lead? As a group, respondents are looking to move away from credit in loan books, expect loan demand to slow, and are likely able to take some duration risk on the asset side. As an alternative to loan growth, many institutions are turning to the community bank subordinated debt market as a loan surrogate. And since most of you are constrained by the leverage ratio, not risk-based capital, many can take advantage of the sector vs. agency products.

Why Subordinated Debt? And Why Now?

As we often advise our clients on new tools available to them: explore them, educate yourselves and your board, then make an informed decision on whether they are appropriate for your institution. Let's take a look at the reasons to consider a purchase of community bank subordinated debt:

Market Opportunity:

- **Relative value has shifted:** The Fed has implemented QE$ and is directly impacting asset and liability pricing. Many market yields are suppressed due to Fed MBS purchases, corporate credit facilities giving investors in risk assets more confidence, and inflows of liquidity creating demand for the highest quality municipal paper due to COVID-19 and oil & gas issues. The market for bank subordinated notes does not have an invisible hand and overzealous investor base distorting value, creating one of the more attractive risk/reward profiles in fixed income markets, in our view.
- **Active primary AND secondary market:** Bank subordinated notes are a security, they have a CUSIP, and are tradable in the secondary market. Liquidity is better relative to certain whole loans held on balance sheet, but less attractive relative to agency bonds. As a credit instrument, liquidity is pro-cyclical. In times of market stress, subordinated notes may have difficulty to solicit a bid, but in bullish markets, bids can be very competitive. 49% of deals are SEC-registered deals from publicly-traded banks or bank holding companies that settle and trade via DTC, and 51% of deals are issued by privately-held companies where financial information is made available for a full credit review under an NDA process
- **Loan surrogate:** It's no secret that loan pipelines are drying up, and we will undoubtedly see loan/deposit ratios move lower across the industry. Treat bank subordinated notes akin to a loan. Get your credit team involved and underwrite it as such. There is a dearth of credit exposure today, but with the capital markets open there is opportunity to be selective, find the right name to underwrite, and help combat earnings pressure.

Regulatory Improvements:

- **Increased regulatory focus** on the subordinated debt market has led to institutions, somewhat conter-intutitively, feeling more comfort with the sector. The market has been incredibly active since 2014 many banks who own the product have gone through exams, and best practices have been established and can now be followed.
- **Increasing limits**: Regulatory guidance allows institutions to buy subordinated debt up to 25% of their Tier 1 Capital, an increase from 10% under previous guidelines. We believe this signals that bank regulators are comfortable with the asset class.
- **Additional regulatory clarity** from Dodd-Frank 939A established a pre-purchase requirement for the consideration of information from sources other than the issuer in rating decisions. We view this as a positive, as there is a more established roadmap for community banks to follow.

Industry Liquidity and Asset / Liability Sensitivity:

- **Subordinated debt can fill a balance sheet need.** Recent increases in on-balance sheet liquidity, securities/assets, cash/assets, and a reduction in non-PPP lending have made room for credit risk in the bond portfolio. Excess liquidity can be deployed into subordinated1 debt securities that take the place of loans.
- **Get duration when needed**: With 60% of banks surveying as asset sensitive and over 90% exposed to the short end of the curve (<5 years), subordinated debt with a 5 year fixed term with a callable 5 year floating tail (10 year final) will help those sensitivities in a lower-for-longer environment. If you fall into the minority and have a liability sensitive bank or need more floating exposure, the fixed term of the subordinated debt instrument is easily changed to floating with an interest rate swap that offers a competitive rate vs. other pure floating rate structures.

Adding Subordinated Debt to Your Repertoire

The language added to your investment policy should reflection a thorough educational process. Through our expanded advisory business, we have access to many investment policies. More than ever, we have helped people get comfortable with the sector, assess compatibility, and set up best practices and procedures. Investing in subordinated debt of other financial institutions requires a few extra steps when it comes to underwriting and establishing an investment policy. Work with a trusted partner to determine what items (e.g., establishing a standardized go/no-go credit, a non-specific process of credit underwriting requiring documentation that may not rely exclusively on credit ratings, establishing limits on percentage of securities portfolio and/or an equity measure, parameters on security features) to include in your underwriting process and investment policy to comply with best practices.

What about the risks?

Despite sitting in the investment portfolio, subordinated debt is akin to an unsecured loan to a non-customer (most likely), and should be evaluated as such. Risks include market risk (as interest rates and credit spreads fluctuate), liquidity risk (generally more liquid than a whole loan, less liquid than agency securities, particularly in times of stress), credit risk, concentration risk (banks can be viewed as doubling down on the sector), and regulatory risk (new types of investments will likely garner attention during an exam).

We encourage banks to establish holistic suitability (does a pool of these types of investments make sense from an overall balance sheet and risk management perspective?) and issuer suitability (does the investment provide an attractive risk/reward profile as well as strategic fit?). While Piper Sandler can certainly be helpful in providing market color and some guidance on policies and procedures and best practices, it is ultimately the investor's determination to allocate capital and resources to the sector.

If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

- **FinTech Introductions**: We provide financial services companies with introductions to leading financial technology providers. Introductions are predicated on an understanding of your needs, refined by our deep knowledge of the sector and filtered for solutions that are actionable, enterprise ready, and cost-effective.

- Recent conversations and introductions have encompassed a broad range of topics from improving customer acquisition, onboarding and experience to liquidity and balance sheet management.

- We invite you to contact FSG-Solutions@psc.com to discuss your FinTech needs and the ways in which Piper Sandler can be of assistance in providing solutions.

- **2 Minute FinTech Survey**: Please see below for a short, 10 question FinTech survey that is designed to gather our clients' perspective on the opportunities and challenges associated with financial technology. Your response is greatly appreciated and will help us to continue to provide our clients with best-in-class advice and solutions. Please click here to take the survey.

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