CATALYST
Corporate Federal Credit Union

2023 | SUBORDINATED DEBT GROWTH CONTINUES

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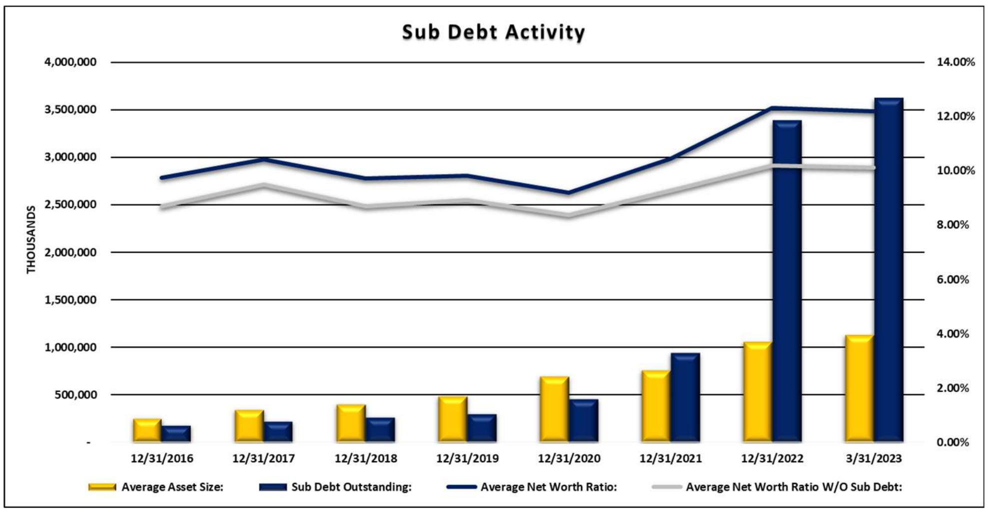
USAGE EXPANDS AS A STRATEGIC TOOL

Subordinated Debt Growth Continues:
Usage Expands as a Strategic Tool

Subordinated debt usage has exploded over recent years. Since the end of 2017, total outstanding subordinated debt has increased from a mere $223.5 million to over $3.6 billion.

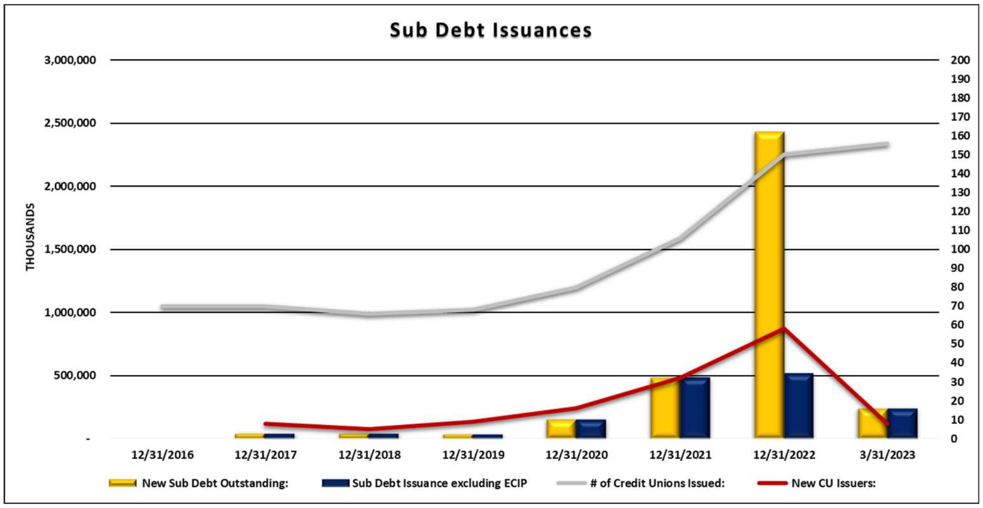


Admittedly, the U.S. Treasury Emergency Capital Investment Program (ECIP) helped spur the growth, adding $1.9 billion in subordinated debt during 2022. Excluding the ECIP program contributions, subordinated debt amounts still show a significant $1.7 billion increase as of March 31, up approximately $1.5 billion since year-end 2017.

Also noteworthy is the asset sizes of credit unions turning to subordinated debt as a strategic tool. At the end of 2016, the average asset size of credit unions issuing subordinated debt was $250 million. In the first quarter of 2023, the average asset size exceeded $1.1 billion. The overall strength of issuing credit unions has also increased. The adjusted net worth ratios (net worth less subordinated debt) have increased from 8.69% at the end of 2016 to over 10%, as of March 31, 2023.

Considering the changes in the overall asset size of credit union issuers, as well as the adjusted net worth ratios, a key observation is worth noting. In the past, subordinated debt was issued by smaller credit unions with lower net worth positions to help them sustain operations. Now, larger credit unions are turning to subordinated debt, not to sustain operations, but rather as a means of increasing net worth to fuel growth and expansion opportunities.

In 2022, the overall U.S. economy experienced some wild swings with rising inflation and rapidly increasing interest rates. Even so, there was no significant drop in overall subordinated debt issuances in 2022. In fact, new subordinated debt issuances, excluding ECIP funds, were $521.9 million, an increase from $487.9 million in 2021. Through the first quarter of 2023, new issuances totaled $240.9 million. If this pace continues, 2023 issuances will likely surpass 2022 issuances.



Why Has Activity Increased?

For starters, subordinated debt is eligible for net worth treatment if the issuing credit union is low-income-designated or expects to both achieve a low-income-designation within two years and obtain prior written approval from the NCUA and their state examiners (if state chartered).

"The potential to count subordinated debt toward net worth is the single most appealing factor driving issuance."

With that in mind, Catalyst has found that the drivers behind credit union subordinated debt issuances are generally strategic in nature. At a high level, most credit unions are seeking to expand their footprint, and subordinated debt can provide the necessary capital to fuel that expansion. This expansion can be organic through additional branches or accomplished through mergers and acquisitions. Many credit unions have additional strategic purposes, such as growing within their existing footprint, supporting information technology investments and even returning to a higher net worth level.

How Much Should a Credit Union Issue?

Over the last few years, the average amount of subordinated debt outstanding per issuer increased from less than $2.5 million in 2016 to over $20 million as of March 31, 2023. In addition, the percentage of subordinated debt relative to organic net worth has risen. This ratio, which reflects the percentage of subordinated debt in proportion to net worth without subordinated debt, helps estimate issuance amounts per credit union. Prior to 2022, subordinated debt issuances hovered at roughly 10-13% of net worth. Since 2022, this amount has jumped to over 20%. The graph highlights the broad industry averages and, looking at the individual credit union issuers, significant disparities exist among issuance amounts.

Credit unions seeking to determine how much they should request have additional elements to consider, most notably the level of subordinated debt investors/lenders are comfortable with.

Catalyst generally guides credit unions to issue no more than 25-30% of their organic net worth, but this can be increased if the business strategy justifies a larger amount through financial forecasting that can be supported without causing harm to the credit union.

Isn't Subordinated Debt Issuance Expensive?

Subordinated debt notes carry a relatively high cost when compared to other traditional borrowing sources, but key differences in the overall structure of the borrowings justify the higher cost. The fact that subordinated debt notes are unsecured and uninsured indicate that these notes have no collateral backing, which exposes the investors (lenders) to a higher degree of credit risk than a collateralized borrowing from Catalyst or the FHLB, for example. In addition, investors in these notes cannot use the notes as collateral, which further adds to the limitations. These reasons result in the higher cost of issuing.

However, while the cost of the borrowings is indeed higher, credit unions should look at the cost of the debt on a relative, rather than an absolute, basis. While a borrowing cost of 9.00%-9.50% (subject to specific issuer profile and risks) may seem high in absolute terms, consider the rate in terms of the loans that can be produced with the funds. With auto loan rates hovering in the 6.75%-7.50% range, the added cost of this debt is manageable. Further, if you are a low-income-designated credit union (or expect to be within two years), you would want to count these funds toward net worth. The fact that these funds could be treated as capital (i.e., net worth) makes them far more valuable than a traditional borrowing.

Why Is the Capital Treatment Important?

Net worth allows a credit union to grow deposits and loans upon acceptance. If you raise $100 million in subordinated debt and target a 10% net worth ratio for these funds, your credit union can support a total asset growth of $1 billion, but this does not mean you necessarily need to add $1 billion in loans. Catalyst generally advises credit unions to add loans in the amount of twice the subordinated debt issuance the first year to ensure the strategy is value additive.

To illustrate this point, below are two tables that demonstrate how loan production of roughly twice the subordinated debt issuance amount will lead to profitability of the issuing credit union. The table on the left considers $100 million subordinated debt issuance at a market rate of 9.50%, an additional increase in non-maturity shares at a cost of 0.50%, and $200 million in new auto loan production with a net yield of 6.00%. Assuming your credit union can generate the production in auto loans, this strategy produces a positive bottom-line impact of $1.5 million, which is a 1.50% positive strategic return to the credit union.

Subordinated Debt Strategy Profitability (Current Rates)		
	Amount	Interest Expense
Subordinated Debt @ 9.50%	$ 1,000,000,000	$ (95,000,000)
Additional Deposits @ 1.00%	$ 1,000,000,000	$ (10,000,000)
Auto Loans @ 6.00%	$ 2,000,000,000	$ 120,000,000
Income Contribution		$ 15,000,000
ROI		1.50%

Subordinated Debt Strategy Profitability (Current Rates)		
	Amount	Interest Expense
Subordinated Debt @ 5.50%	$ 1,000,000,000	$ (55,000,000)
Additional Deposits @ 0.15%	$ 1,000,000,000	$ (1,500,000)
Auto Loans @ 3.50%	$ 2,000,000,000	$ 70,000,000
Income Contribution		$ 13,500,000
ROI		1.35%

Further, to demonstrate that the issuance rate levels should not be a driving factor in the decision, the table on the right (above) considers a lower interest rate environment. Yes, the issuance rate on the subordinated debt is much lower at 5.50%, but the yield on the auto loans is also much lower at 3.50%.

Key Points for Credit Unions

1. **Subordinated debt is gaining popularity as a strategic growth tool for larger credit unions. It is no longer just a mechanism to help smaller credit unions maintain their operations.**

2. **Issuance levels have been rising, and 2023 is on pace to be the largest issuance year on record for credit unions.**

3. **The absolute cost of subordinated debt issuance should not be the driving force when considering subordinated debt as a strategic tool. Instead, credit unions should focus on:**
   - **Their ability to produce sufficient growth to ensure the strategy is profitable**
   - **The spread differential between their loan yields (net of costs) and the subordinated debt notes**

Can Subordinated Debt Help You?

Of course, subordinated debt is not a cure-all and should be pursued with caution. Managers must have confidence in their ability to grow and expand to make the strategy valuable to their membership.

Catalyst has been working with mid to large-sized credit unions in their subordinated debt initiatives. Subordinated debt is as an excellent tool for credit unions with growth potential and capabilities that are restricted by their capital levels. Adding net worth through subordinated debt can ease growth limitations and enable credit unions to grow and bring value to more members within their existing or surrounding communities.

For more information, contact us today:

[Request a Consultation]

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