

**Office of the Comptroller of the Currency**

**Guidelines for Subordinated Debt  
April 3, 2015**

**I. Introduction**

Subordinated debt (or subordinated debt note) is a financing tool that can be recognized in regulatory capital, if structured appropriately. The Office of the Comptroller of the Currency (OCC) has separate licensing rules for subordinated debt issued by national banks (12 CFR 5.47<sup>1</sup>) and federal savings associations (12 CFR 163.80 and 12 CFR 163.81<sup>2</sup>). When issuing subordinated debt, national banks and federal savings associations (collectively, bank or banks) typically do so to qualify the subordinated debt as regulatory capital. To qualify as tier 2 regulatory capital, the subordinated debt must satisfy the requirements in 12 CFR 3.20(d). These guidelines provide policy guidance and requirements for banks issuing subordinated debt.

All subordinated debt issued by banks must comply with applicable OCC rules and federal and state securities laws. In some instances, a bank may not be concerned whether the subordinated debt qualifies as regulatory capital. Instead, a bank may want to issue subordinated debt for funding and liquidity purposes, without regard to the subordinated debt's regulatory capital treatment. Both the rules and these guidelines reflect this difference. All subordinated debt issued by a national bank must satisfy the minimum requirements in the rules in 12 CFR 5.47. All subordinated debt issued by federal savings associations must satisfy the requirements in 12 CFR 163.80. To include the subordinated debt in regulatory capital, however, a bank also must satisfy the requirements in the capital rules in 12 CFR 3.20(d)(1). A federal savings association also must satisfy the requirements in 12 CFR 163.81 to include the subordinated debt in regulatory capital.

While the OCC believes that a bank should have broad discretion in exercising its business judgment to structure subordinated debt for non-capital purposes, the agency also believes that, as a matter of regulatory policy and safe and sound banking, issuance of subordinated debt should address the policy concerns in these guidelines, regardless of the subordinated debt's regulatory capital treatment.

In particular, these guidelines address concerns related to affirmative and negative covenants and the reasonableness of default provisions in a subordinated debt note and related documents (subordinated debt agreements). The guidelines also discuss specific requirements and issues related to subordinated debt that is intended to be included in tier 2 capital.

If banks have questions regarding subordinated debt, the OCC encourages them to contact the appropriate OCC supervisory office.

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<sup>1</sup> See 79 Fed. Reg. 75417 (December 18, 2014) for the most recent amendments to 12 CFR 5.47.

<sup>2</sup> The OCC notes that it has proposed moving 12 CFR 163.81 to the new 12 CFR 5.56. See 79 Fed. Reg. 33260 (June 10, 2014). In the future, the OCC will consider integrating 12 CFR 5.47 and 12 CFR 163.81.

## **II. Policies Applicable to All Subordinated Debt**

In addition to the requirements in 12 CFR 5.47 for national banks and in 12 CFR 163.80 for federal savings associations, the policies in these guidelines apply to all subordinated debt issued by a bank, unless otherwise noted. A bank generally may enter into any type of agreement, provided the agreement does not violate a law, regulation, or OCC policy or constitute an unsafe or unsound banking practice.

### **A. Representations and Warranties**

As a policy matter, the OCC is concerned that, in some circumstances, subordinated debt agreements may contain representations and warranties that unduly interfere with the management of a bank and could result in unsafe or unsound banking practices. For example, the OCC is concerned that some subordinated debt agreements contain warranties stating there has been no material change in the issuing bank's condition or that a bank is not in default on any agreement or in violation of its articles of association (national bank) or charter (federal savings association) or bylaws. Under such a broad provision, a technical violation of a contractual term could violate the representations or warranties and result in acceleration of the subordinated debt note, even if such violation was based on a reasonable legal dispute or was immaterial in nature. Any such representation or warranty that would require acceleration and repayment of the subordinated debt note because of a technical violation that does not reflect underlying credit issues could be contrary to safety and soundness.

Accordingly, any representation or warranty should be worded to avoid the undue or otherwise unreasonable operation of any default clause when the default clause is based on a change in the bank's status, the bank's default on any other agreement, or any violation of the national bank's articles of association or federal savings association's charter (as applicable) or bylaws.

### **B. Affirmative Covenants**

In an affirmative covenant, a bank promises to perform certain actions, and the bank's failure to do so may constitute an event of default. The OCC generally does not object to a covenant permitting the purchaser to inspect the books and correspondence of a bank, provided the covenant does not violate applicable laws and regulations. The OCC pays special attention, however, to any affirmative covenant that may unduly restrict a bank's operations or potentially require a bank to violate a law, regulation, or OCC policy. Two areas of specific concern are:

#### **1. Report of Examination and Non-Public OCC Information Generally**

Pursuant to 12 CFR 4, subpart C, a bank is prohibited from disseminating non-public OCC information if it has not complied with the procedures established to obtain OCC approval to release non-public information and has not obtained OCC approval. Non-public OCC information includes a bank's confidential correspondence with the OCC, reports of examination, or reports of supervisory activity. Thus, the subordinated debt note must not include any clause that would require a bank to violate the applicable regulations at 12 CFR 4, subpart C regarding non-public OCC information.

## 2. Financial Statements

A prospective purchaser of subordinated debt may require a bank to provide it with financial information. While such a request by a prospective purchaser is reasonable and the bank may provide such information, the OCC recommends that, in order to protect the confidentiality of such information, when appropriate, a bank execute a confidentiality agreement prior to providing such information.

### **C. Negative Covenants**

The OCC also pays special attention to negative covenants. In a negative covenant, a bank promises to refrain from performing certain actions or agrees that the occurrence of a certain event will give rise to default. Pursuant to 12 USC 1818, the OCC is concerned that a negative covenant that unduly interferes with the management of a bank could result in unsafe or unsound banking practices. Accordingly, a bank should not include in a subordinated debt note any negative covenant that unreasonably impairs the bank's flexibility in conducting its operations or interferes unduly with management. See 12 CFR 5.47 for examples of specific negative covenants that the OCC prohibits.

### **D. Events of Default**

A subordinated debt note generally includes a clause that specifies events of default. Because a subordinated debt note may make failure to abide by an affirmative or negative covenant an event of default, banks should be aware that there may be some overlap between affirmative and negative covenants and events of default. If an event of default occurs, the subordinated debt note may provide that the note holder, at its option, may declare the note to be due and payable (that is, payment of the principal and interest and premium, if any, due on the subordinated debt note is accelerated and becomes due and payable immediately).

Banks should be aware that, pursuant to 12 CFR 3.20(d), the holder of an instrument included in tier 2 capital must not have the ability to accelerate payment of principal or interest on the note, except in the event of a receivership, insolvency, liquidation, or similar proceeding of the bank.

The OCC is aware that default triggers can cover a variety of circumstances. As with general representations and warranties, however, any default triggers should not be based on minor, insignificant, or nonconsequential events. In particular, with respect to such events of default, a bank should have a reasonable opportunity to cure the default.

Below are examples of default triggers that the OCC has concluded to be reasonable:

- With respect to nonpayment of the interest and/or principal when due, a reasonable period to cure the default generally would be a minimum of the later of 30 days or the next due date.

- With respect to default in performance or observance of certain other covenants, the note generally should provide for a reasonable grace period of the later of 30 days or the next due date.
- With respect to a trigger based on the bank's having defaulted on other debts, the note generally should establish a threshold for the amount of defaulted debt. A reasonable threshold generally would be 3 percent of a bank's common equity tier 1 capital at the time of the default.
- With respect to a default trigger based on a bank's insolvency, a reasonable indication of that insolvency would be if (i) a bank admitted in writing it was unable to pay its debts, (ii) a bank filed a petition for voluntary liquidation under applicable statutes, or (iii) a bank consented to the appointment of a conservator or receiver.

#### **E. Contemporaneous Loan Agreements**

The OCC has found, on occasion, that a bank's parent holding company will fund the purchase of a subordinated debt note issued by its subsidiary bank by a contemporaneous loan agreement with a third-party lender. The terms and conditions of these loan agreements can place significant and unacceptable restrictions on the bank's parent holding company with respect to the operations of the bank issuing subordinated debt.<sup>3</sup> Accordingly, a bank should make all reasonable efforts to determine whether its parent holding company has executed such a third-party loan agreement and, if such an agreement exists, to review that agreement for compliance with the requirements and policies discussed in these guidelines.

#### **F. Novel, Untested, or Extraordinary Provisions**

If a subordinated debt note includes novel, untested, or extraordinary provisions, additional review by the OCC may be required, particularly for any provisions that raise policy or safety and soundness concerns. The OCC encourages banks to contact the appropriate OCC supervisory office if they have any questions regarding subordinated debt.

### **III. Subordinated Debt Included in Tier 2 Capital**

#### **A. Additional Requirements for Subordinated Debt Included in Tier 2 Capital**

In addition to the requirements and policies applicable to all subordinated debt described in these guidelines and outlined in 12 CFR 5.47 (national banks) and in 12 CFR 163.80 (federal savings associations), subordinated debt that is included in tier 2 capital must meet the requirements in 12 CFR 3.20(d) and, for federal savings associations, in 12 CFR 163.81. The OCC notes that the tier 2 capital requirements in 12 CFR 3.20(d) impose additional, more restrictive requirements than those requirements generally applicable to all subordinated debt. A national bank, therefore,

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<sup>3</sup> For example, if the parent holding company's ability to repay the loan is solely dependent on dividends upstreamed by the subsidiary bank, it may be asked to agree to restrict the operations of the subsidiary bank in a manner that is not consistent with these guidelines.

that intends to include subordinated debt in its tier 2 capital should carefully review all of the requirements.

## **B. OCC Policies and Areas of Concern**

### **1. Significant Incentive to Redeem Prior to Maturity**

Pursuant to 12 CFR 3.20(d)(1)(iv), a tier 2 capital instrument may not include terms or features that require, or create significant incentives for, a bank to redeem the instrument prior to maturity. The OCC believes that what constitutes a significant incentive to redeem can take any number of forms, and it would be impossible to list all the possibilities. The experience of the OCC, nonetheless, is that repricing clauses may create significant incentives to redeem the bank's subordinated debt. For this reason, a bank should pay particular attention to debt instruments that include periodic contractual increases in the interest rates that may create significant incentives to redeem (that is, a "step-up").

For this discussion, a "step-up" is a change in coupon rate that occurs at a specific time after issuance of subordinated debt when the new coupon rate is explicitly higher than the original coupon rate, or there is an implied increase in the original reference credit spread rate. An explicitly higher coupon rate would occur, for example, if the coupon rate increased from a fixed 4 percent for the first five years to a fixed 6 percent for years five through maturity. An implied increase in the original reference credit spread rate would occur in a subordinated debt instrument that has a fixed coupon for an initial period followed by a floating rate coupon when the credit spread over the second reference rate is greater than the initial coupon rate less the swap rate (that is, the fixed rate paid to the call date to receive the second reference rate). For example, if the initial reference rate is 0.9 percent, the credit spread over the initial reference rate is 2 percent (that is, the initial coupon rate is 2.9 percent), and the swap rate to the call date is 1.2 percent, a credit spread over the second reference rate greater than 1.7 percent (2.9 percent minus 1.2 percent) would be considered an incentive to redeem.

### **2. Credit-Sensitive Features**

Pursuant to 12 CFR 3.20(d)(1)(vii), the subordinated debt note must not have a credit-sensitive feature, such as an interest rate that is reset periodically based in whole or in part on a bank's credit standing. A bank should pay special attention to the mechanics for determining the interest rate of the subordinated debt note to ensure that it is not based directly or indirectly on the bank's credit standing, which is prohibited. The subordinated debt note, however, is permitted to include an interest rate that is adjusted periodically, independent of a bank's credit standing, in relation to general market interest rates or similar adjustments.

### **3. No Expectation That Call Option Will Be Exercised**

Pursuant to 12 CFR 3.20(d)(1)(v), a subordinated debt note, by its terms, generally may be called by the bank only after a minimum of five years following issuance. At the time a bank issues the subordinated debt, however, the bank must not create an expectation, whether through actions or communications, that the call option will be exercised. In this regard, a bank, consistent with all

applicable laws and regulations, should pay special attention to any communication made contemporaneously with the marketing or sale of subordinated debt, particularly with respect to the bank's future expectations regarding its regulatory capital and debt structure.<sup>4</sup>

#### 4. Funding Purchase of the Subordinated Debt

A bank should pay special attention to the purchaser's source of funds. Pursuant to 12 CFR 3.20(d)(1)(viii), a bank, or an entity that the bank controls, is prohibited from purchasing, or directly or indirectly funding the purchase of, the subordinated debt note. A bank should take reasonable efforts to ensure that the source of funds does not violate 12 CFR 3.20(d)(1)(viii).

#### 5. Entity Issuing Subordinated Debt

A bank should pay special attention to the entity it uses to issue the subordinated debt note. Pursuant to 12 CFR 3.20(d)(1)(ix), if the subordinated debt note is not issued directly by the bank or a subsidiary that is an operating entity, the only asset of the issuing entity must be its investment in the capital of the bank. In addition, the proceeds from sale of the subordinated debt note must be immediately available without any limitation to the bank or the bank's top-tier holding company in a form that satisfies all the other criteria in 12 CFR 3.20(d) for tier 2 capital instruments. Banks should be aware that, for purposes of the regulatory capital rules, an "operating entity" is not an "operating subsidiary." For regulatory capital purposes, an "operating entity" is defined as "a company established to conduct business with clients with the intention of earning a profit in its own right." See 12 CFR 3.2.

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<sup>4</sup> For example, bank management must ensure that any communication pursuant to the marketing or sale of the subordinated debt does not raise any concerns under the OCC's securities offering regulations (12 CFR 16 for national banks and 12 CFR 197 for federal savings associations).