Subordination – Briefing Pack

Bankers without Boundaries (BwB)

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Fit4Finance

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What is subordination?

Definition

Subordination is a legal and financial mechanism that changes the order of repayment priority among creditors. It establishes that one creditor (the 'junior' or 'subordinated' creditor) agrees to be paid only after another creditor (the 'senior' creditor) has been paid in full.

Why it matters for Local Authorities

Subordination allows Local Authorities (LAs) to structure capital stacks that blend different types of funding. By using junior or subordinated capital to absorb first losses, LAs can 'crowd-in' senior creditors on more attractive payment terms, making complex projects more viable.

Key Terms

Senior Debt: Debt that holds higher priority claims on assets and cash flows. Because it is safer, it typically carries a lower interest rate.

Junior Debt / Subordinated Debt: Debt that ranks lower in priority. It carries a higher risk (paid after senior creditors) and therefore demands a higher return (higher interest rate).

Intercreditor Agreement / Subordination Deed: This is the most critical document in a subordination deal. It is a contract between the creditors (and often the borrower) that legally establishes the ranking of claims, standstill periods, turnover of funds, and enforcement rights between creditor classes.

Structural versus Contractual Subordination: Subordination achieved either by corporate structure (lending to parent versus subsidiary) or by specific contract terms.

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How subordination works: Payment Waterfall Mechanism

1. Senior Fees and Expenses
2. Senior Interest Payments
3. Senior Principal Repayment
4. Junior Interest
5. Junior Principal Repayment
6. Residual Cash (Equity/Reserve)

Risk Allocation and Protection

Loss Absorption
Junior debt acts as a 'risk buffer' relative to senior debt. In a default scenario, losses eat into the equity/first loss reserve first, followed by juniour debt, protecting the senior creditors' principal up to the value of the junior tranche

Standstill Provisions
If the borrower defaults, junior creditors are typically blocked from enforcing their security or demanding payment ('standstill') for a set period (e.g., 90-180 days) to allow senior creditors to lead enforcement and restructuring actions.

Senior Debt (Protected)
Junior Debt (Risk Buffer)
Equity / First Loss
Losses Absorb Upwards

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Understanding subordination

Subordination IS:

A Priority-Setting Mechanism
It is a contractual or structural way to establish payment priority between different creditors, ensuring clarity on who gets paid first.

A Tool to Crowd-In Senior Creditors
By providing loss-absorbing junior capital, it enhances credit quality for senior creditors, making senior debt more attractive.

A Financing Gap Filler
It is often used when senior lenders cannot provide the full level of debt required. Junior debt fills the gap between senior debt capacity and the total funding requirement, reducing the equity contribution needed.

Subordination IS NOT:

A Guarantee of Payment
It does not guarantee payment to junior creditors; they accept higher risk in exchange for potentially higher returns.

A Method to Avoid Insolvency Rules
It is not a mechanism to bypass insolvency regulations or misrepresent the true risk profile of the investment.

Always Unsecured
Junior debt can still have security (e.g., a mortgage), but it is a 'second ranking' mortgage behind the senior lender.

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Fit screening

1 Objective
Does the senior debt capacity fall short of required capital?
- Yes → 2
- No → **Consider Single-Tranche:** If senior lenders are comfortable alone, adding complexity adds cost.

2 Structure
Is contractual or structural subordination feasible?
- Yes → 3
- No → **Reconsider Design:** If legal or corporate structure forbids subordination, simplify deal.

3 Governance
Can LA manage intercreditor communication and consent?
- Yes → 4
- No → **Simplify or Outsource:** Engage an agent to manage complex creditor relationships.

4 Investor Base
Is there appetite for junior risk (pricing/tenor)?
- Yes → 5
- No → **Reassess Market:** Without junior lenders, the structure fails. Check market depth.

5 Legal
Is there clear powers, subsidy control, and insolvency enforceability?
- No → **Seek Legal Advice:** Subordination must hold up in insolvency. Confirm validity first.

✅ **Good Fit: Proceed with Structure**
All criteria met. Draft term sheet reflecting subordination terms

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Different subordination structures

Contractual Subordination

Description
Junior creditor contractually agrees that its debt ranks behind senior debt. Can be 'simple' (junior paid only after senior fully repaid) or 'contingent' (junior paid unless default occurs).

Key Mechanism
'Payment Blockage' notices prevent junior payments during senior default.

1

Turnover Subordination

Description
Junior creditor agrees to 'turn over' any payments received in breach of the subordination terms directly to the senior creditor.

Key Mechanism
Protects senior lender if junior accidentally gets paid or enforces security early.

Structural Subordination

Description
Achieved via corporate structure rather than contract. Senior lends to operating subsidiary (closer to assets); Junior lends to the subsidiary's holding company.

Key Mechanism
Subsidiary creditors (senior lender) must be paid in full before dividends flow up to the holding company to pay junior debt.

2

Trust Subordination

Description
Similar to turnover, but junior creditor holds any wrongly received funds on trust for the senior creditor. Creates a proprietary claim.

Key Mechanism
Stronger protection in junior creditor insolvency (funds are ring-fenced).

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Who is involved? (RACI)

R **Responsible:** Doing the work
A **Accountable:** Ultimate decision /approval
C **Consulted:** Provided input/expertise
I **Informed:** Kept up to date

	Role / Party	Business Case & Structure	Funding Strategy	Legal & Financial Close	Implementation	Monitoring
LA / Internal	Project Sponsor	R	C	C	A	A
LA / Internal	CFO / Section 151 Officer	A	A	A	I	A
LA / Internal	Treasury Team	C	R	R	R	R
LA / Internal	Internal Legal Counsel	C	C	R	I	C
LA / Internal	Cabinet / Members	C	I	A	I	I
External	Financial Advisor	R	R	C	I	I
External	External Legal Advisor	C	C	R	I	I
External	Lead Arranger / Bank	I	C	R	I	I

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Documentation and key considerations

Key Transaction Documents

Intercreditor Agreement / Subordination Deed
Primary document defining ranking, standstill periods, turnover mechanics, and enforcement voting rights among creditor classes.

Security Trust Deed
Governs the security package (if secured), establishing the payment waterfall and application of recoveries post-enforcement.

Facility Agreements
Separate loan agreements for senior and junior debt, each referencing the subordination deed for priority terms.

Fee Letters
Side letters detailing arrangement, agency, and monitoring fees specific to each tranche of debt.

The Intercreditor Agreement

Payment Blockage: If the project has an unforceen mishap (e.g., cash reserves dip slightly below a target), the senior lender can issue a 'Stop Notice.' This legally forbids the project from making any payments to the junior lender, even if there is cash in the bank. The junior lender must wait.

Standstill: If the project fails to pay the junior lender, normally, the junior lender would sue or seize assets. In a subordinated deal, they cannot. The 'Standstill Clause' forces them to wait (often for 180 days or more) while the senior lender decides what to do. The junior lender is effectively handcuffed to prevent them from tipping the project into bankruptcy.

Turnover: This is a 'clawback' clause. If the project administrator accidentally pays the junior lender when they should not have (e.g., during a Payment Blockage), the junior lender must legally turn over that cash immediately to the senior lender.

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Best Practices for Governance

Tax Considerations

- **Higher Interest Rates:** Junior interest typically higher to reflect risk; ensure rates are justifiable under 'arm's-length' principles.
- **VAT Exemption:** Interest on subordinated loans generally outside VAT scope (financial services); arrangement fees may attract VAT.
- **Deductibility:** For tax-paying entities, interest deductibility may be limited by Corporate Interest Restriction rules.

Accounting (CIPFA)

- **Classification (IFRS 9):** Assess if the instrument is a liability or equity-like. Most subordinated debt remains a financial liability.
- **Fair Value:** Initial recognition at fair value; subsequent measurement typically amortised cost unless designated otherwise.
- **Impairment:** Junior status affects Expected credit loss (ECL) calculation – higher probability of loss in default scenarios.

Regulatory Compliance

- **Recharacterisation Risk:** Ensure documentation clearly distinguishes debt from equity to avoid recharacterisation in insolvency.
- **Subsidy Control Act 2022:** Public support providing junior capital on non-market terms must be assessed for subsidy compliance.
- **AML / KYC:** Strict due diligence on junior investors required; verify source of funds for private placements.

Communication Governance

- **Centralised Notices:** Agent/Trustee serves as the single point of contact, distributing notices to all creditor classes simultaneously.
- **Reporting Obligations:** Borrower must provide financial reports to both senior and junior lenders to ensure transparency.
- **Trigger Alerts:** Clear protocols for notifying all parties immediately upon any breach of financial covenants.

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Subordination case study 1: Wave Community Bank

Project Overview and Structure

Instrument

Subordinated loan (junior debt)

Key Partners

Lewes and Eastbourne Councils + Wave Community Bank

Ranking

Junior to all depositors and senior creditors

Purpose

Strengthen capital base and financial inclusion

Context: The Local Authorities provided a subordinated loan to a community bank. This capital sits below senior debt and deposits in the payment waterfall, acting as a buffer that allows the bank to lend more to local residents who might otherwise be excluded from mainstream finance.

Relevance for Local Authorities (LAs)

This case demonstrates the policy rationale for using subordinated debt: accepting higher risk (junior position) to achieve social outcomes (financial inclusion). It highlights how public capital can 'crowd-in' or support other funding by absorbing first losses.

Key Characterstics

Risk-Return Balance

The higher risk of being a junior creditor is compensated by a higher interest rate compared to senior loans or deposits.

Capital Treatment

Subordinated loans can count towards the borrower's regulatory capital, strengthening their balance sheet and lending capacity.

Legal Ranking

Documentation must clearly establish the subordination – junior lenders cannot claim assets until senior creditors are fully paid.

Social Impact

The financial risk is justified by the tangible social benefit of providing affordable credit to vulnerable residents.

Source: Lewes & Eastbourne Councils – Wave Community Bank Subordinated Loan report (published council paper)

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Subordination case study 1: Wave Community Bank

Loan Structure

Instrument
Subordinated Loan
(Junior Capital)

Amount	Up to £100,000
Lender	Lewes and Eastbourne Council
Approval Date	June 2025
Tenor	5 years (initial) + 5 years extension option
Interest	Interest-free (public policy investment)

The 'Crowding In' Effect

By providing junior capital, the council strengthens the bank's regulatory capital position. This allows the credit union to attract additional deposits and safely increase lending volumes to local residents.

Key Lessons

The investment was designed to support financial inclusion and community wealth building, targeting residents excluded from mainstream banking.

Affordable Credit

Small-value loans as alternatives to high-cost payday lenders.

Inclusive Savings

Accessible savings products for low-income households.

Financial Resilience

Building credit history for those with poor records.

Education and Advice

Budgeting support and debt advice for members.

Source: Lewes & Eastbourne Councils – Wave Community Bank Subordinated Loan report (published council paper)

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Subordination case study 1: Wave Community Bank

Capital Structure

Wave Community Bank's funding base primarily consists of three key layers, with the subordinated loan playing a catalytic role.

Member Deposits
Primary funding source from community members

Retail Savings
Used to fund lending to members

Subordinated Capital (Council Loan)
Regulatory capital buffer that strengthens the balance sheet

Governance and Risk Management

- Full due diligence before loan approval
- Legal documentation by specialist external lawyers
- Oversight by Council's Section 151 Officer
- Performance monitoring against agreed outcomes

If the credit union were unable to repay the loan, the council would absorb losses after member deposits were repaid, reflecting the junior ranking of the investment.

Strategic Value

This approach is often used as a 'first-loss' or catalytic capital layer to unlock additional lending capacity.

Source: Lewes & Eastbourne Councils – Wave Community Bank Subordinated Loan report (published council paper)

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Subordination case study 2: Homes England – Home Building Fund

Project Overview and Structure

Instrument
Mezzanine development finance

Key Partners
Homes England (Public), private developers and senior lenders

Role of Funding
Unlock stalled sites / SME builder support

Risk Position
Subordinated to senior debt / priority over equity

Context: Homes England's Home Building Fund provides development finance to unlock housing sites that traditional lenders view as too risky. The fund often provides mezzanine finance, sitting between senior bank debt and developer equity in the capital stack.

Relevance to Local Authorities (LAs)

Illustrates public junior capital crowding-in senior debt, with applicable logic for LA-led regeneration joint ventures where subordinated public funding de-risks private senior lenders. Shows how to structure capital stacks with clear priority waterfalls.

Key Lessons

First Loss Absorption

By accepting a second-ranking charge, the public fund acts as a buffer. In a default, the public sector takes losses before the senior bank, making the deal bankable.

Leverage Effect

Subordinated debt enables higher loan-to-value ratios for projects (e.g., up to 80-90% total leverage) than senior banks alone would permit (typically 60-65%).

Pricing Risk

Subordinated loans must be priced to reflect risk (higher interest rates than senior debt) to comply with Subsidy Control rules, unless an exemption applies.

Intercreditor Agreement

A robust intercreditor deed is essential to define 'standstill' periods, preventing the junior lender (a public body) from enforcing security while senior lenders work on a solution.

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Subordination case study 2: Homes England – Home Building Fund

Transaction 1: Keepmoat Homes

Developer	Keepmoat Homes
Project	Northstowe Phase 2 housing development (Cambridgeshire)

Total Development
~3,500 homes

Financing Structure

Senior Lender	Barclays
Mezzanine	Homes England Home Building Fund
Equity	Keepmoat Homes (Developer Equity)

Purpose of Public Funding

To unlock infrastructure and early construction phases. The Homes England capital allowed the project to proceed at higher leverage than senior lenders alone would permit.

Transaction 2: Urban Splash

Developer	Urban Splash
Location	Wirral Waters regeneration project (Liverpool City Region)

Funding Facility
~£30 million

Financing Structure

Senior Lender	HSBC
Mezzanine	Homes England (Development Finance)
Equity	Urban Splash (Developer Equity)

Project Output

Modular housing units and large-scale waterfront regeneration. The public loan enabled the developer to begin construction while additional private capital was mobilised.

Source: Homes England – Home Building Fund guidance and case materials

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Subordination case study 2: Homes England – Home Building Fund

Transaction 3: Citu Climate Innovation District

Developer:	Citu (SME Developer)
Project Type:	Low-carbon housing development including energy-efficient homes and sustainable construction techniques.
Investment:	**~£10 million development loan**
Challenge:	Innovative project that traditional lenders considered higher risk due to modern methods of construction.
Impact:	Homes England funding helped unlock the site, proving the viability of sustainable housing models.

Deal Structure:

- ✓ Senior Debt: Commercial bank financing
- ✓ Mezzanine: Homes England development finance
- ✓ Equity: Developer contribution

Typical Capital Structure Stack

Standard leverage structure for Home Building Fund deals (~75–85% total leverage).

Senior Development Loan
Commercial Bank (e.g., Barclays, HSBC)
60–65% Loan-to-Cost (LTC)

Mezzanine / Subordinated Loan
Homes England (HBF)
10–20% LTC

Developer Equity
SME Developer Capital
15–25% LTC

Document Version Control

Version	Date	Purpose / Change	Produced by	Approved by	Date
0.1	DD-MMM-YY	Draft	Name surname	Name surname	DD-MMM-YY
0.2	DD-MMM-YY	Draft	Name surname	Name surname	DD-MMM-YY
0.3	DD-MMM-YY	Draft	Name surname	Name surname	DD-MMM-YY
0.4	DD-MMM-YY	Draft	Name surname	Name surname	DD-MMM-YY
1.0	DD-MMM-YY	Draft	Name surname	Name surname	DD-MMM-YY

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