WHAT ARE SUBORDINATED BONDS?

A subordinated bond is only repaid once all other creditors have been repaid if the issuer goes bankrupt. Holders of a subordinated bond are repaid before shareholders.

Features

A subordinated bond has the same basic features as a standard bond.

- The **issuer** is the entity issuing the bond. This entity (usually a financial institution) borrows money from investors and will pay interest (the **coupon**) to those investors in return. Interest is usually paid annually.
- Subordinated bonds are often **rated**. This rating gives an indication of the creditworthiness of the issuer when it is awarded. It is awarded by specialised, independent firms (mainly Moody's and Standard & Poor's).
- Most subordinated bonds also have a fixed **term**. Once the term has expired (on maturity), the issuer repays the borrowed capital, provided, of course, that the issuer has not gone bankrupt.

A subordinated bond differs from a standard bond in the following ways:

- If the issuer goes **bankrupt**, the holder of a subordinated bond is not repaid until the other bondholders have been repaid. Holders of subordinated bonds are repaid before shareholders.
- Subordinated bonds pay more **interest** precisely because the risk inherent in subordinated bonds is greater than that of standard bonds.

Risks

Currency risk: if you invest in bonds in foreign currency, there is a currency risk against the euro. The amount in euro that you receive in the event of sale or at maturity can be more or less than the amount that you originally invested owing to the exchange rate.

Liquidity risk: a bond's liquidity reflects whether it is easy or difficult to sell the bond on the market. Liquid bonds are easy to buy and sell. Illiquid bonds are more difficult to buy and sell. Subordinated bonds are usually less liquid than ordinary bonds.

Interest rate risk: the value of a bond is considerably dependent on the market interest rate. The example below shows how this works.

For example: you have a bond bearing interest at 4%. Now let's suppose that the market interest rate rises to 5%. Your bond then becomes immediately less appealing because investors seeking an attractive bond can in any case find bonds in the market bearing interest at 5%. The value (price) of your bond will then fall until an equilibrium is reached. Of course, the reverse is also true: if the market interest rate falls to 3%, your bond will be in high demand in the market; the value (price) of your bond will then rise.

Credit risk: if the issuer of a bond gets into financial difficulties, it is possible that you will recoup only part of your investment or even not recoup it at all.

Please note: an issuer's creditworthiness is sometimes expressed as a 'rating'. It is best to check this before buying a bond. Note that there will not always be a rating; check all the details, therefore, before buying subordinated bonds.

Please note: note that the credit risk for subordinated bonds is greater than for 'ordinary' bonds. If the issuer goes bankrupt, you will not be repaid until all ordinary bondholders have been repaid.

Specific risk: subordinated paper issued by financial institutions contains an additional risk. This is because these bonds can be written off, either wholly or in part, or converted to shares at the request of the regulator if the institution is no longer viable (to prevent bankruptcy) or is involved in a bankruptcy. This means that anyone buying bonds ultimately runs the risk of receiving shares. This is why you should only buy subordinated bank bonds issued by banks with the highest credit rating.

Costs and taxes

When you buy bonds, it is in your best interest to take the costs and taxes that you will have to pay into account. This is because they will affect the return on your bonds.

COSTS

Brokerage: banks charge fees to execute your orders on the secondary market.

Custody fee: most banks charge fees for keeping your bonds in a custody account.

Sale and placing commission: when buying bonds on the primary market, you pay placing commission. Together with the par value, this forms the issue price.

TAXES

Stamp tax on share deals: if you buy or sell existing bonds on the secondary market, you have to pay stock exchange tax. If you buy new bonds on the primary market, you don't have to pay this tax.

Withholding tax on interest: you have to pay withholding tax on the interest earned on Belgian corporate and government bonds. The interest earned on non-Belgian corporate and government bonds is taxed first in the country of origin and then it is subject to withholding tax in Belgium.

Capital gains tax if you sell bonds before maturity for more than the price you paid at the time of purchase, you make a capital gain. You don't have to pay any tax on this capital gain.

Note: you do have to pay withholding tax on the difference between the purchase price and redemption price of a zero-coupon bond.

Do you want to find out more about subordinated bonds?

Read our *Financial instruments information sheet* on our website at www.bnpparibasfortis.be.

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