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What is subordinated debt?

This type of debt is secondary to primary debts like mortgages

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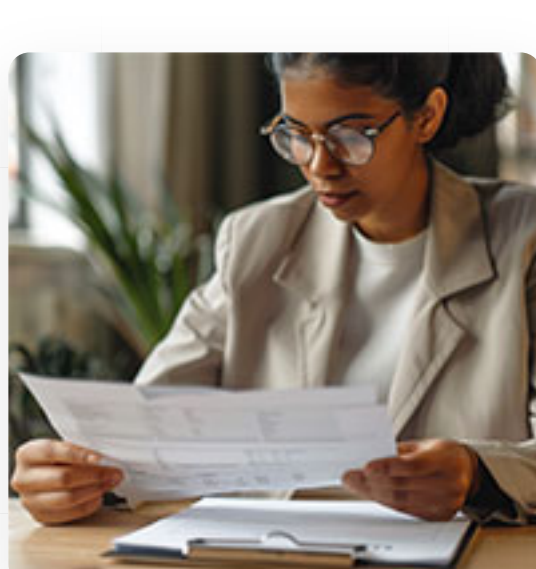
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Fact Checked

While the term “subordinated debt” may sound straight out of a business school textbook, it’s quite common among homeowners and businesses alike. It simply means debt that is in a position behind other primary debts.



If a homeowner has subordinated debt and is in a situation where there’s a default on their primary mortgage, then it will be helpful to understand where this type of debt falls in line among creditors. This term can also come up if you ever try to refinance a primary mortgage while you have a home equity line of credit or home equity loan in place.

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KEY INSIGHTS

Subordinated debt, or sub-debt, refers to debt that is in a secondary position behind primary or senior debt.

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Homeowners may take on subordinated debt in the form of a home equity loan or line of credit; businesses can also take on this type of debt.

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Senior and primary debts get paid first in the event of a loan default or bankruptcy before the subordinated debt.

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Subordinated debt defined

Subordinated debt is a secondary debt, which means it won’t get paid until all other primary [liens](#) have been paid in case of [bankruptcy](#) or [default](#). Since this debt is not the first in line for payment, it’s considered riskier and typically comes with higher interest rates. Subordinated debt can come in the form of a secured or unsecured loan, so it may or may not [need collateral](#) for approval.



Subordinated debt is debt that’s funded behind another lender that holds a senior or first position.”

— JOE CAMBERATO, CEO AND FOUNDER, NATIONAL BUSINESS CAPITAL

“Subordinated debt is debt that’s funded behind another lender that holds a senior or first position,” explained Joe Camberato, the CEO and founder of National Business Capital. “The subordinated lender is in second position behind the senior lender. Essentially, the senior lender has the first claim to the collateral if the loan defaults.”

Camberato explained that if there’s any money left over after the senior lender is repaid, it goes to the subordinated lender.

Subordinated debt example

An easier way of understanding how subordinated debt works is by considering a more common example with a mortgage borrower. Let’s say a homeowner has a primary mortgage, plus a home equity line of credit, or HELOC. These are two different loans and the lenders are assigned a lien position for each debt.

In this scenario, the mortgage is the first lien, or senior debt, while the HELOC is the second lien, or subordinated debt. In the event of a [foreclosure](#), the mortgage lender receives payment first and the financial institution holding the HELOC, or subordinated debt, then gets paid if there’s any money left.

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Subordinated debt vs. senior debt

Another way of understanding how subordinated debt works is by comparing it to senior debt, such as a mortgage. Senior debt is another way to describe primary debt. In the case of a foreclosure or [bankruptcy](#), senior debt has the priority for repayment, so it must be paid first. Typically it’s secured with collateral, such as in the case of a mortgage where the home is the collateral, but you’ll find unsecured options too.

The main differences between senior debt and subordinated debt are:

- **Senior debt:** It’s considered the primary debt, paid first in case of bankruptcy or default. It typically requires collateral, so it is viewed as less risky for a lender.
- **Subordinated debt:** Referred to as the secondary debt, it’s paid second in the case of a bankruptcy or default. Secondary debt can be an unsecured loan and often is considered riskier for the lender, which is why it usually has a higher interest rate.

How subordinated debt impacts refinancing

Refinancing a mortgage means applying for a new mortgage with different terms and replacing the original mortgage. If you have both a mortgage and [home equity loan](#) or [HELOC](#), then you’ll have to go through the process of subordination when refinancing, otherwise the HELOC or home equity loan will move up to the senior debt position.

To keep the HELOC or loan from moving into the senior debt position, the lender will have to put a subordination agreement in place. This allows the mortgage to get the assignment as the senior, or primary, debt.

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Types of subordinated debt

Whether you’re a homeowner or business owner, taking on subordinated debt needs careful consideration because of the higher interest rates that are often involved. Below are the common types of subordinated debt besides home equity loans and HELOCs.

Personal loans

A [personal loan](#) is one type of consumer loan, usually in an amount ranging anywhere from \$1,000 to \$100,000. You can take out personal loans for a variety of reasons, including home improvements or [debt consolidation](#). Most personal loans are unsecured, and you can find them with a variety of repayment terms, ranging from a few months to a few years.

Personal line of credit

Like a personal loan, a [personal line of credit](#) can be used for a variety of reasons, and you can borrow from it as needed. Unlike a loan, a line of credit offers the flexibility of only borrowing the exact amount you need at a time. Repaying the balance restores your credit line so you can continue using it as needed.

0% APR credit

Credit cards can provide smaller loan amounts for homeowners or business owners, but borrowers may avoid using credit cards due to the [high interest rates](#) they typically have (compared with other loan options).

However, you can find credit cards offering a 0% introductory offer for balance transfers for a specified period of time, such as six months to 21 months, which can allow for a period of interest-free payments, after which interest rates generally return to high levels.

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FAQ

Who funds subordinated debt? +

What advantages does subordinated debt offer? +

Why is subordinated debt risky? +

Bottom line

Whether you’re a homeowner or business owner, taking on subordinated debt means other debts will have the priority of getting paid first. Banks often charge higher interest rates for subordinated debt because it’s lower in priority for payback in case of bankruptcy or default.

While different types of subordinated debt, such as HELOCs and home equity loans, are common, they do carry risk and higher interest rates.

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