

Preferred Securities—Still The Preferred Capital Alternative After All These Years

By Tim Graham

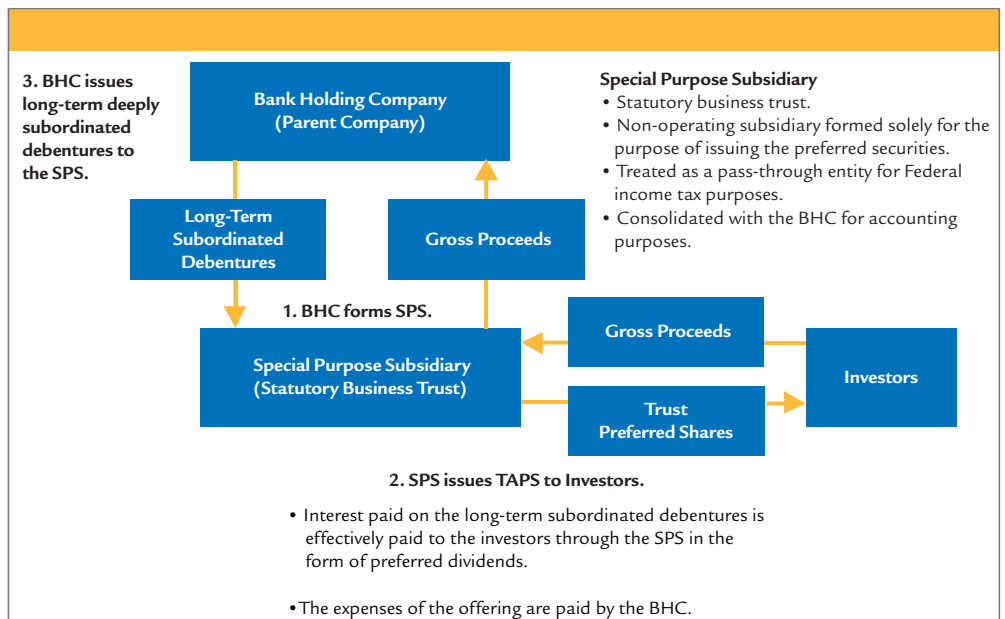
Preferred securities remain an effective financing tool for community banks to optimize shareholder value. While trust preferred securities have undergone accounting, regulatory and significant underwriting changes since their inception in 1996, they remain one of the most popular forms of capital. It is estimated that roughly \$46.3 billion of trust preferred collateral was outstanding in pooled CDOs at the end of 2006 and that approximately “\$12.5 billion in trust preferred collateral spread out across 26 CDOs will have become eligible for prepayment within the next two years,” according to a 2006 report by Derivative Fitch, a unit of Fitch Ratings Ltd. Over the past couple of years, non-cumulative perpetual preferred securities are finding a place in the capital structure on a selective basis but continue to lag due to their higher cost compared with trust preferred securities and a possible lack of understanding. The following is meant to provide a synthesis of preferred securities from trust preferred’s origins to where the market is today.

1996—Introduction to Trust Preferred Securities: In 1996, the Federal Reserve Board announced that a bank holding company may include certain tax-advantaged preferred securities (i.e., interest expense is tax deductible) in the calculation of tier 1 capital. The combination of tax deductible interest payments and tier 1 capital treatment (up to 25 percent of core capital) allowed trust preferred securities to effectively replace traditional preferred stock as a source for supporting organic growth with minimal shareholder dilution, acquisition funding, share repurchases, and refinancing of existing higher rate debt.

2005—New Rules for Tier 1 Capital Treatment: In March of 2005, the Board of Governors of the Federal Reserve System released a final ruling allowing for the “continued inclusion of outstanding and prospective issuances of trust preferred securities in the tier 1 capital of bank holding companies, subject to stricter quantitative limits and qualitative standards” (Board of Governors of the Federal Reserve System. Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital; May 6, 2004). Primary changes from this ruling include limiting trust preferred securities and other “restricted core capital elements” to 25 percent of core capital, net of goodwill. Because of the capital planning required and amount of trust preferred securities outstanding, the Board will not implement the new rules until March 31, 2009. The Board generally believes that trust preferred securities have

proven to be a successful instrument in securing the safety and soundness of banking institutions. However, in some instances, companies have become overly reliant on trust preferred in their capital structure. By subtracting goodwill from unrestricted core capital prior to calculating allowable limits of restricted core capital in tier 1, the Board hopes to lessen reliance on trust preferred securities.

2006—Small Bank Holding Companies: On February 22, 2006, the Federal Reserve Board released a final ruling increasing the asset size for small bank holding company designation to \$500 million from \$150 million. Because small bank holding companies are regulated at the subsidiary level rather than at the holding company level on a consolidated basis, small bank holding companies have greater flexibility to utilize debt and downstream the holding company debt



Tier 1 Calculation Example

	Current Rules	New Rules
Unrestricted Core Capital Elements	\$ 90.0	\$ 90.0
Less Goodwill	NA	(7.5)
Adjusted Unrestricted Core Capital Elements	\$ 90.0	\$ 82.5
Maximum Allowable TAPS (25%)	30.0	27.5
Total Core Capital	\$ 120.0	\$ 117.5
Less Total Intangibles		
Goodwill	\$ (7.5)	\$ (7.5)
Other Intangibles	(2.5)	(2.5)
Total Tier 1 Capital	\$ 110.0	\$ 107.5

as equity to the bank subsidiary to maintain a well capitalized status. Specific to trust preferred securities, the subordinated debt associated with trust preferred securities will be treated as debt for the small bank holding company with the following exceptions:

- May exclude from debt an amount of subordinated debt associated with trust preferred securities up to 25 percent of a small BHC's stockholders' equity less parent company goodwill; and
- Will not be included as debt in determining compliance with the 12-year debt reduction and 25-year debt retirement requirements of the policy statement.

Qualitatively, a small BHC that is approaching \$500 million in assets will probably want to manage their capital structure as though they are already a large BHC, and in that case, trust preferred securities may provide a more attractive capital alternative than other debt forms at the holding company.

Non-Cumulative Perpetual Preferred Securities: The acceptance and accessibility of trust preferred securities over the past six years has resulted in some institutions becoming leveraged to the extent that the trust preferred market is no longer available to them or any new trust preferred securities would not be eligible as tier 1, but only as tier 2 capital. Many of these institutions are private companies that have growth prospects beyond what their capital and retained earnings are able to support; however, they prefer not to dilute their existing shareholder base.

For these institutions non-cumulative perpetual preferred securities may provide a solution for the following reasons:

- Considered a core capital element, allowing 100 percent of the securities to count as tier 1 capital; and
- Allows additional trust preferred securities to be included in tier 1 capital.

The hesitancy to issue non-cumulative perpetual preferred securities may stem from dividend payments not being tax deductible, issuance fees of approximately 3 to 3.5 percent as compared to 0 percent for trust preferred securities, and an additional spread of approximately 175 to 225 basis points wider than where trust preferred securities may be issued today. However, when compared to the cost of issuing common equity, non-cumulative perpetual preferred securities may have a place in the capital structure. A combined issuance of non-cumulative perpetual preferred stock and trust preferred securities (as long as the common stock represents at least 51 percentage of the core capital) can sometimes be utilized to lower the overall expense of issuing strictly non-cumulative perpetual preferred stock.

Issuance Process: Whether interested in trust preferred securities or non-cumulative perpetual preferred, a market exists today that significantly reduces issuance time and expense and provides access to those banks that traditionally would not have access to the public markets.

Trust preferred pools and closed-end

funds for non-cumulative perpetual preferred securities have supplanted the public markets for providing capital markets access to community banks. Prior to 2000, issuances of preferred securities were generally the domain of the public markets. Issuers could expect underwriting fees of 3 to 4 percent, miscellaneous fees of roughly \$200,000, on-site due diligence and marketing that could occupy management for a week or more, printing of a prospectus, and minimum issuance sizes of \$10 million.

From start to finish, issuing trust preferred securities in the public market was generally a six- to eight-week process. Today, trust preferred may be issued into a pool within two weeks of signing a letter of intent, and generally carry no fees to the issuer aside from the rate on the securities. In addition, pooled rate spreads have generally declined from approximately 350 basis points five years ago to roughly 170 basis points today, making it virtually a "no brainer" decision to refinance issuances that are approaching or have passed their non-call period. More recently, closed-end funds have emerged for non-cumulative perpetual preferred securities. Non-cumulative perpetual preferred issuances can generally close within two to five weeks, but will include origination fees of 3 to 3.5 percent, and the issuer will be responsible for their own legal and miscellaneous costs, which may run approximately \$20,000.

Summary: Despite increased scrutiny in recent years from accountants and regulators, preferred securities remain a viable component of a community bank's capital structure and have never been more accessible. Whether supporting organic growth, funding an acquisition, repurchasing shares, or refinancing higher rate debt, trust preferred securities and non-cumulative perpetual preferred securities continue to assist with optimizing shareholder value through prudent financial leverage. **16**

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