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Sometimes equity, sometimes debt, always capital

Trust preferred stock, a new financing vehicle for community financial institutions

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Even in an era when the banking industry as a whole has adequate capital, many healthy community financial institutions continue to have a use for additional capital. Among these uses are (i) additional growth in assets and deposits, (ii) growth through various "wholesale" leveraging strategies, (iii) the repurchase of common or preferred shares for estate planning and other purposes, (iv) going private transactions, (v) the refinancing of existing holding company debt and (vi) the acquisition of other institutions or branches. Unfortunately, many community institutions have difficulty raising Tier One capital in the current environment because of the dilution that would be caused by the sale of common stock at prevailing market prices and the regulatory limitations on the utilization of subordinated debt as Tier One capital.

As described below, the trust preferred stock funding vehicle was created several years ago to provide Tier One capital for depository institutions for which a common stock offering was not desirable or practical. While the vast majority of trust preferred stock offerings in the past have been made by larger financial institutions, as a result of the recent (i) uncertainties in the stock market, (ii) decline in interest rates and (iii) investor confidence in community financial institutions, the trust preferred financing option is now available to community financial institutions.

Overview of trust preferred stock

In its simplest form, trust preferred stock represents preferred stock which is issued from a "special purpose vehicle" (normally a business trust) which then uses the cash raised to purchase subordinated debt in the issuing institution (or its holding company). The terms of the debenture and the preferred stock are generally identical. Each has a long term (generally 30 years); each is non-callable for a period of time and each carries the same yield to the investor (expressed as interest in the case of the debenture and dividends in the case of the trust preferred stock). The interest/dividend on these securities are generally cumulative but, under applicable regulations of the federal banking regulators, may be deferred for up to five years.

From the point of view of the issuing institution, trust preferred securities are essentially subordinated debentures. However, in contrast to subordinate debt which may not be included in the calculation of Tier One capital, under applicable federal banking regulations, up to 25 percent of an institution's Tier One capital may consist of trust preferred securities. (There is a possibility that this limit may be reduced to 15 percent based on a proposed provision of the Basel Accords, a draft international capital guideline. However, both the 15 percent limit and the Basel Accords have been subject to significant criticism and it is far from clear whether either limit will ever see the light of day.)

The capital treatment offered to trust preferred stock can be particularly helpful to holding companies, which are subject to the Federal Reserve Board's holding company capital requirements. (Such requirements are generally applicable to bank and financial holding companies with $150 million or more of assets.) Traditionally, many holding companies have raised capital through third party loans secured by the stock in their bank subsidiaries. While such loans can provide capital at the bank level (if the cash raised by a holding company is invested into its bank subsidiaries in the form of a common stock purchase), under applicable regulations of the Federal Reserve Board, they do not provide capital at the holding company level. As a result, holding companies, which raise capital through bank loans, may be subject to significant restrictions on their ability to grow. However, with the development of the trust preferred stock market for community financial institutions, such institutions now have a new financing tool, which can provide capital at both the bank and holding company level.

While the capital treatment of trust preferred stock is similar to that of many "permanent" forms of capital such as traditional common or preferred stock, the tax treatment is similar to debt securities. Thus, unlike other types of Tier One capital, the interest on the debentures issued in connection with the trust preferred offering is deductible to the issuing company. In this light, trust preferred stock may be considered a "win-win" security, which combines some of the best attributes of a number of different types of securities.

Key features

Of course, the key feature of any fixed income security is its credit quality. Since the cash flow of an issue of trust preferred stock depends upon the ability of the issuing institution to repay the underlying subordinated debenture, the investors in trust preferred securities will invariably pay very close attention to the earnings, capital, cash flow (including the debt coverage ratios), asset quality and balance sheet of the issuing institution. As a result, the issuing institution is often required to prepare a detailed disclosure document to provide material financial information regarding the issuing institution.

Other important features of an issue of trust preferred securities from an investor's standpoint are the dividend rate, the term (generally around 30 years) and the redemption provisions (see below.)

Capital markets considerations

Trust preferred securities are generally issued through three different distribution mechanisms in the current market environment.

Retail Distribution. Retail investors have increased their interest in trust preferred securities over the last eighteen months as they have searched for stability and yield in an unpredictable stock market. This has created a retail market for the trust preferred stock of community financial institutions. Trust preferred stock offerings aimed at retail investors are virtually always sold by investment bankers in underwritten public offerings. While trust preferred offerings aimed at institutional investors sometimes carry adjustable or floating interest rates, trust preferred offerings aimed at retail investors in the current market almost always have fixed rates (generally from 8.5-10.5 percent per annum). Current issuances of retail trust preferred securities generally permit the issuer to redeem the securities without penalty at any time after five years from the date of issue. Retail trust preferred securities are generally traded in the secondary market although the trading activity of small issues can be quite limited. To support such trading, the underwriters generally require that the issuing company file reports with the SEC for at least five years, regardless of whether such reporting is required under applicable regulations.

The advantages to the issuer of a retail distribution of trust preferred securities in the current market are relatively favorable economic terms, a measure of structural and underwriting flexibility and a level of issuer control over the issuance process. The primary disadvantages of a retail distribution are the relatively high issuance expenses and the SEC reporting requirements. In addition, most underwriters are reluctant to underwrite on a retail basis any trust preferred issuance of less than $10 - $15 million. Also, under current market conditions, many investment bankers may be reluctant to underwrite trust preferred stock issuances of institutions with less than $300 - $400 million in assets.

Private Placement of Trust Preferred Securities. From time to time, trust preferred securities have been issued directly to institutional investors (including depository institution holding companies) in a private placement. While the issuance costs can be significantly lower than in retail transactions, the institutional investors tend to drive significantly harder bargains on the other terms of the transaction, including the interest/dividends rates, convertibility, call flexibility, etc.

While many community financial institutions will find it difficult in the current market to obtain attractive terms for their trust preferred stock in a private placement to an institutional investor (whether through an investment banker or otherwise), they may be able to obtain reasonable terms through a private placement to a "friend of the bank" such as a director. While these transaction are not highly publicized, they are in fact the most common form of trust preferred stock issuances.

Pooled Transactions. Over the last several years, several major investment banking firms have created separate funding entities to aggregate large numbers of trust preferred issuances into a single "pool" to be placed with large institutional investors. To date, nearly 200 community institutions have issued trust preferred through pool transactions. The advantages of pool transactions are significantly lower issuance costs than a retail offering and, because the investors experience a diversification of risk, generally better economic terms than a private placement. In addition, pool transactions provide a vehicle for smaller institutions to issue trust preferred stock to persons other than "friends of the bank." The disadvantages of pool transactions include the loss of flexibility with respect to the timing and amount of the offering and an inability to negotiate most of the economic and other terms of the transaction.

Leveraging strategy; funding of subchapter S transaction

One of the most important uses of trust preferred stock is to fund growth through retail and wholesale leveraging. For instance, by issuing $10 million of preferred stock, most community financial institutions could easily support at least $75 million of asset and liability growth.

Of course, many institutions are not in a position because of market or other factors to grow rapidly on a retail basis. However, as a result of the recent changes in the yield curve, such institutions may now be in a position to implement "wholesale" leveraging strategies with spreads of 125 bps or more with minimal credit and interest rate risk. Using the example above, if an institution added $75 million in wholesale growth, even assuming that the weighted average spread on such growth is only 100 bps, it would receive $750,000 of additional interest income which of course would easily offset the net interest and other costs of the trust preferred.

Another attractive use of trust preferred securities is to fund a stock repurchase program, an issuer tender offer and/or a "squeeze-out" transaction to reduce the number of the issuer's shareholders. Such programs are often implemented to enable the issuing institution to make a "Subchapter S" election to eliminate double taxation. Needless to say, the economic benefits of the permanent elimination of corporate taxation can dwarf the costs of a trust preferred offering.

Conclusion

A trust preferred stock offering constitutes a very effective mechanism for community financial institutions to raise capital without the dilution and loss of control inherent in common stock offerings. These transactions can constitute a "win" for an institution seeking to expand its capital base, a "win" for the investors seeking a stable fixed income investment and a "win" for a board of directors seeking to guide a community financial institution through the difficult challenges presented by the current market environment.

Unfortunately, while investors have recently evidenced a strong appetite for community financial institutions' trust preferred, this appetite could change significantly in the event of a recovery in the stock market, a rise in interest rates or a decline in investor confidence in community financial institutions. Accordingly, if you think that an issuance of trust preferred stock might make sense for your institution, there is no better time than now to take a hard look at it. ●