

UPDATE

News of Developments in the Financial Sector and Related Areas

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Trust Preferred Securities

During 2005, the Federal Reserve Board ("FRB") adopted a final rule that allowed the continued limited inclusion of trust preferred securities in the tier 1 capital of bank holding companies. Under the FRB's final rule, bank holding companies may include trust preferred securities in tier 1 capital in an amount equal to 25 percent of all core capital elements (including trust preferred securities). The final rule provides a five-year transition period until March 31, 2009, at which time bank holding companies will be required to net goodwill, less any associated deferred tax liability, from this calculation. Amounts of restricted core capital elements in excess of these limits generally will be included in tier 2 capital. The final rule also eliminates the requirement for trust preferred securities to include a call option. In adopting the final rule, the FRB noted that a key advantage of trust preferred securities to bank holding companies is that for tax purposes the dividends paid on trust preferred securities, unlike those paid on directly issued preferred stock, are a tax deductible interest expense. Under the final rule, the issuance of trust preferred securities must still be approved by the Federal Reserve Bank in the district in which the bank

holding company is located. A number of bank holding companies have issued trust preferred securities and continue to utilize trust preferred securities for a number of reasons. Trust preferred securities are advantageous to bank holding companies because they are treated as equity for bank regulatory purposes and as debt for tax purposes. Trust preferred securities are typically issued as non-perpetual cumulative preferred stock by a wholly-owned trust subsidiary of a bank holding company. The bank holding company owns all of the common stock of the trust subsidiary. Revenue from the sale of the trust preferred securities by the trust subsidiary is exchanged for junior subordinated debentures issued by the bank holding company. The debentures feature a coupon payment and term to maturity, which are identical to those of the trust preferred securities. The guidelines of the Federal Reserve provide that the subordinated debt and the trust preferred securities must have a maturity of not less than thirty (30) years and the subordinated debt must be subordinate to all other debt of the bank holding company. The bank holding company has the option to call the subordinated debt and the trust preferred securities after the expiration of five (5) years (bank holding companies who have had trust preferred securities outstanding for five (5) years may want to consider refinancing at lower interest rates). Both the subordinated debt and the trust preferred securities must allow for a consecutive five (5) year deferral on interest and dividends, respectively. The bank holding company must guarantee the distribution, liquidation, and redemption rights of the trust preferred securities. Any

redemption of the trust preferred securities must be approved by the Federal Reserve. Payments on the subordinated debt and the trust preferred securities are "interest only" until maturity. In accordance with the Financial Accounting Standards Board Interpretation Number 46 Revised, the subordinated debt is shown on the consolidated balance sheet of the bank holding company as long term debt and the securities issued by the trust are not consolidated. Trust preferred securities are useful for bank holding companies that are Subchapter S corporations. Although a Subchapter S corporation cannot have more than one class of stock, trust preferred securities are not considered a separate class of stock and purchasers of trust preferred securities will not be counted as additional shareholders. In Interpretive Letter No. 908, the Office of the Comptroller of Currency ("OCC") held that trust preferred securities may be purchased and treated as loans by national banks. The OCC noted that trust preferred securities are instruments that possess characteristics particularly associated with debt securities. Like debt holders, the holders of the trust preferred securities do not have voting rights in the management or the ordinary course of business of the trust. In addition, holders of the trust preferred securities do not share in any appreciation in the value of the trust and are protected from changes in the value of the principal of the instruments except for credit risk. Since the trust's only source of revenue for the dividends on the trust preferred securities is the interest on the underlying subordinated debt, the trust preferred securities must be redeemed upon redemption of the subordinated debt. Before purchasing trust preferred securities as loans, the OCC noted that a national bank should conduct a complete review of relevant credit information and loan administration practices, and determine that the purchase meets the bank's own internal loan underwriting standards. The interpretive ruling by the OCC provides a vehicle

for a bank holding company to convert debt to equity while allowing a bank purchaser of the trust preferred securities to treat the purchases as loans. Trust preferred securities provide an excellent vehicle for increasing tier 1 capital, maintaining shareholder ownership, funding acquisitions, stock repurchases and providing funds for internal growth. Our firm is available to answer questions on the benefits of issuing trust preferred securities and the placement with third parties.

Securities Activities of Banks

The Securities and Exchange Commission ("SEC") and the Board of Governors of the Federal Reserve System ("FRB") have issued joint proposed rules for public comment dealing with the securities activities that banks may engage in without registering as brokers. The original proposal by the SEC was known as Regulation B and was opposed by federal banking regulatory agencies. The new proposal, known as Regulation R, permits banks to continue to conduct securities transactions, subject to certain conditions, for their customers as part of a bank's trust and fiduciary, custodial and deposit "sweep" functions, and to refer customers to a securities broker-dealer pursuant to networking arrangements with broker-dealers without having to register. Regulation R will also allow banks to pay more than "nominal" fees to bank employees who refer institutional and high net worth customers to a broker-dealer. A bank will have until the first day of its first fiscal year commencing after June 30, 2008, to comply with Regulation R. Proposed Regulation R is available on the web site of the FRB at www.federalreserve.gov.

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