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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Trust Preferred Securities

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. The Federal Reserve Board ("FRB") adopted a final rule in 2005 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. 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. Because of the higher interest rate spreads with institutional purchasers, bank holding companies may want to consider the placement of trust preferred securities with local investors such as board members and later rolling the securities into a pool when interest rates decline and paying off the local investors with the proceeds. 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 local investors and third parties.

Quarterly Banking Profile

The Federal Deposit Insurance Corporation ("FDIC") has issued its *Quarterly Banking Profile* reflecting the financial results for the third quarter of this year. Loan-loss provisions total $16.6 billion, which was more than double the amount set aside for credit losses by insured institutions in the third quarter of 2006 and was the third largest quarterly loss provision since the second quarter of 1987. Loans to commercial and industrial borrowers had record growth for the second consecutive quarter, increasing by 6.9% during the third quarter. Problem institutions (defined as those with financial, operational or managerial weaknesses that threaten their continued viability) increased for the fourth quarter in a row from 61 to 65, but the assets of problem institutions declined during the third quarter from $23.8 billion to $18.5 billion. In comparison, it is interesting to note that, in reviewing historical trends, there were 1,426 problem institutions having assets of $819 billion at the end of 1991. The report is available on the website of the FDIC at *www.fdic.gov*.

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