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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Two Alternatives For Capital

Trust preferred securities and non-cumulative perpetual preferred stock are two alternatives for financial institutions needing to raise additional capital.

The Federal Reserve Board ("FRB") adopted a final rule during 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.

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. 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.

Noncumulative perpetual preferred stock ("Perpetual Preferred") is another alternative to bank holding companies that need tier 1 capital but are beyond the 25 percent trust preferred limitation. Although common stock should generally be the dominate form of tier 1 capital for a bank holding company, Perpetual Preferred qualifies as tier 1 capital. The issuance of Perpetual Preferred also increases the amount of trust preferred qualifying as tier 1 capital, in that for each $1 million of Perpetual Preferred issued, $333,333 of trust preferred securities in tier 2 become eligible for tier 1 capital.

Perpetual Preferred may be issued at both the bank holding company level and the bank level in order to increase tier 1 capital. Because Perpetual Preferred is considered a separate class of stock, Subchapter S corporations are not eligible since they can only have one class of stock.

A coupon payment on Perpetual Preferred is similar to trust preferred, and the issuer has the option to call the securities after five (5) years. Any redemption of Perpetual Preferred is subject to regulatory approval. Perpetual Preferred has no voting rights and is perpetual, meaning that it has no final maturity date. Quarterly dividends are subject to board approval and are noncumulative if not paid. Unlike dividends paid on trust preferred securities, dividends paid on Perpetual Preferred are not a tax deductible interest expense.

Both trust preferred securities and Perpetual Preferred are excellent vehicles for increasing tier 1 capital, maintaining share-holder ownership, funding acquisitions, stock repurchases and providing funds for internal growth. Our firm is available to answer questions on the benefits of issuing both trust preferred and Perpetual Preferred and the placement of these securities with third parties.

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