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The Impact of the Dodd-Frank Wall Street Reform Act on Trust Preferred Securities

Background

In 1996, the Federal Reserve Board approved the use of trust preferred securities as part of Tier 1 capital for bank holding companies. Trust preferred securities (TPS) are akin to cumulative senior preferred stock and feature a fixed dividend payment, in most cases. However, the structure of TPS differs from that of traditional preferred stock.

TPS are issued through a special purpose vehicle (SPV) of the bank holding company. The funds raised by the SPV are then lent to the bank holding company in exchange for subordinated notes which typically feature near-identical terms as the TPS with regard to coupon, maturity, and deferral provisions. The bank then makes interest payments on the subordinated debt and the trust company, in turn, passes the interest payment on to the trust preferred shareholders in the form of a dividend payment.

Because the bank is able to deduct these interest payments, the TPS structure provided banks with a means to raise regulatory capital more cheaply than traditional preferred stock and without the dilution of issuing common stock. This vehicle became very popular with banks of all sizes. Through 2008, banks issued approximately $150 billion of trust preferred securities.

New issuance of TPS virtually ceased in 2008-09 as the financial crisis made it extremely difficult for financial institutions to raise capital. A number of small community banks were forced to defer payments on their trust preferred securities, most of which had been privately-placed and were not publicly-traded. However, large bank trust preferred securities faired much better. None of the top 50 bank holding companies, by asset size, deferred dividend payments on the trust preferred securities during the financial crisis.

The Dodd-Frank Wall Street Reform Act: Impact on Trust Preferred Securities

The Dodd-Frank Act was signed into law on July 21, 2010. The Act includes a provision known as the Collins Amendment, which requires bank holding companies to phase out trust preferred securities as part of Tier 1 capital by January 1, 2016. Specifically:

- Banks will receive full Tier 1 capital credit for trust preferred securities until January 1, 2013 when the phase-out period begins.
- Beginning January 1, 2013 trust preferred inclusion in Tier 1 capital will decline equally by one third per year through 2015.
- Trust preferreds will be fully eliminated from Tier 1 capital on January 1, 2016.
- Bank holding companies with less than $15 billion in assets as of December 31, 2009 are excluded from this provision and will continue to receive full Tier 1 capital credit for trust preferred securities.
- New trust preferred issuance will not be included as part of Tier 1 capital.

Analysis

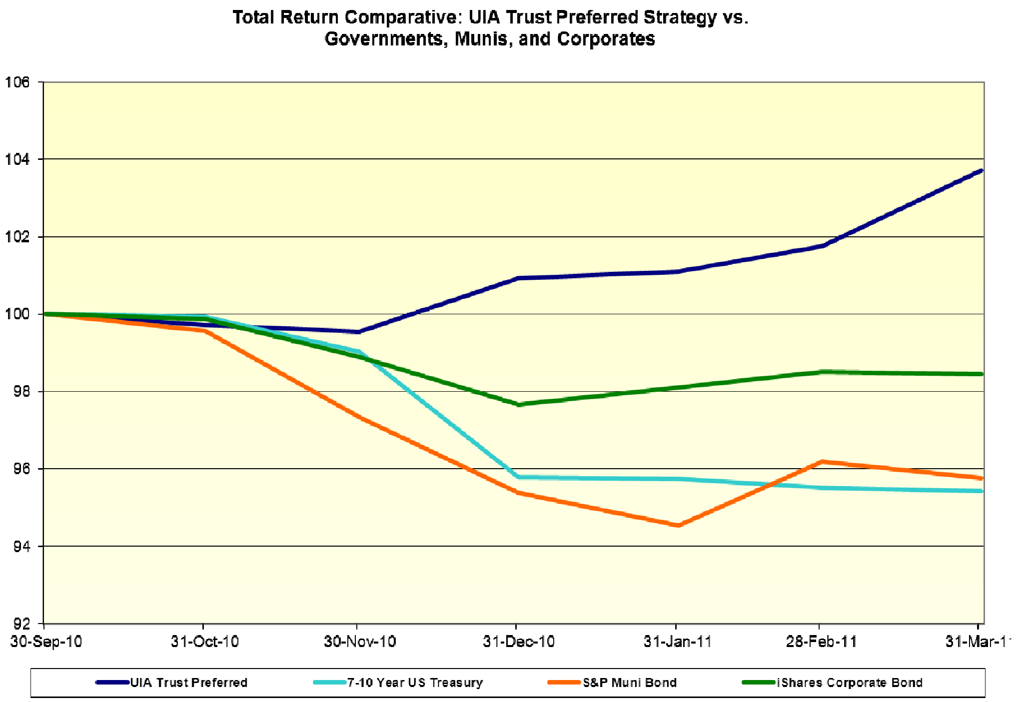
Future Trust Preferred Issuance - Trust preferreds provided banks with a cheap form of regulatory capital when compared to common or traditional preferred stock. However, the Dodd-Frank Act effectively ends future issuance of trust preferred securities, since any new trust preferred issues will not count as Tier 1 capital.

Existing Trust Preferreds - The banks will be reticent to continue to pay the relatively high coupon of trust preferreds once the securities are no longer included in Tier 1 capital. As such, we believe banks will redeem, at par value, existing trust preferreds when the phase out period begins in 2013. We expect banks to call their trust preferreds gradually until the full phase-out of trust preferreds in 2016 with higher coupon trust preferreds likely to be called first.

Interest Rate Sensitivity – Historically, trust preferreds have been sensitive to rising interest rates because of the long-dated maturity of the securities. However, the Dodd-Frank Reform Act, in essence, converted the trust preferred shares from long-term securities to intermediate-term ones by creating an economic incentive for the banks to redeem the shares over the next five years.

We believe this development put a floor under trust preferred prices, even in the event of rising rates.

In fact, the fourth quarter of 2010 provided an interest rate stress test for trust preferreds as rates moved higher. Trust preferreds performed better than fixed income alternatives in a rising interest rate environment, as we predicted. See chart below:



Strategy

Upon the passage of the Dodd-Frank Act in July 2010, trust preferred share prices were bid up reflecting investor anticipation of future redemptions. Even though many trust preferreds now trade at or near par, we continue to advocate buying trust preferreds for stable income generation over the next several years. Most banks will not call their trust preferreds until the phase-out period begins in two years and even then banks will likely elect to call trust preferreds gradually over the three year phase-out period. Therefore, investors can expect to receive annual dividend yields of over 7 percent (based on current market rates), depending on the credit quality of the issuer.

Summary

- The phase-out of trust preferred securities begins January 1, 2013, declining by an equal amount each year over a three year period for bank holding companies with assets greater than $15 billion.

- Trust preferreds will be fully eliminated from inclusion in Tier 1 capital on January 1, 2016, for bank holding companies with assets greater than $15 billion.

- Small banks with assets less than $15 billion are not affected by the legislation.

- Banks have an incentive to call, or redeem, their trust preferreds when the phase out begins in 2013, essentially converting the security from a long-term instrument to a short-term one.

- The Dodd-Frank Act does not require banks to redeem their trust preferred securities; however, the economics of the situation suggest this is a very likely outcome.

- The expected redemption of trust preferreds by the large banks, in conjunction with the above-market dividend yield, should provide protection from rising interest rates.

- Investors looking for stable fixed income investments will find trust preferred securities compelling over the next several years as the securities represent the highest investment grade yield in the market.

Please contact Keith Wolter at 612-312-1407 for additional information.