Emerging Issues Series

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Pooled Trust Preferred Stock - A New Twist on an Older Product

Overview

Pooled Trust Preferred Stock (Pooled TPS) is a new twist on Trust Preferred Stock[1], a capital security for bank holding companies, which became popular in late 1996. Pooled TPS allows smaller bank holding companies to participate in the benefits of using Trust Preferred Stock to raise Tier 1 capital while gaining tax benefits. The market for Trust Preferred Stock generally tightens for issues of less than $15 million, and the issuance costs may be prohibitive. Pooled TPS would allow smaller issues to be pooled, alleviating both of those concerns while retaining the advantages found in the Trust Preferred Stock structure. Although this pooled product has been anticipated for a number of years, a limited number of offerings have been brought to market.

Preferred stock has always been a component of capital due to the issuer's legal right to defer or eliminate preferred stock dividends. Federal Reserve Capital Adequacy guidelines allow non-cumulative perpetual (that is, no maturity date) preferred stock to be counted as a core capital element, or Tier 1 capital. Trust Preferred Stock became popular primarily due to a Federal Reserve ruling that allowed this stock to comprise up to 25% of a bank holding company's Tier 1 capital. In addition, the possibility existed (at that time) that tax benefits related to Trust Preferred Stock would be eliminated under the 1997 federal budget. That threat caused many bank holding companies to take immediate advantage of existing tax benefits by issuing Trust Preferred Stock, the proceeds of which were used to retire more expensive preferred stock issues, finance acquisitions, and buy back common stock. Subsequently, the elimination of interest deductions in Trust Preferred Stock structures did not become part of the 1997 federal budget.

Understanding Trust Preferred Stock

Understanding Pooled TPS begins with an explanation of Trust Preferred Stock[2], which is preferred stock issued by a trust subsidiary of a bank holding company, the proceeds of which are used to purchase subordinated debt of the parent. The parent gains a tax benefit by being able to deduct the interest paid on the subordinated debt for tax purposes, while retaining a minority interest in subsidiaries (the trust) that qualify as Tier 1 capital, subject to the 25% limitation mentioned above. The structure of Trust Preferred Stock can be summarized as follows:

1. A wholly owned trust is formed by the bank holding company, which sells Trust Preferred Stock to investors.

[1] Also known as Trust Originated Preferred Shares, Quarterly Income Preferred Shares, and Monthly Income Preferred Shares.

[2] For a comprehensive article that discusses Trust Preferred Stock, please see: Kalser, Kathy R., Chicago Regional Outlook - Financial Markets, Federal Deposit Insurance Corporation, Fourth Quarter 1997, pp. 19-22. This article is also available in the FDIC's web site at www.fdic.gov.

2. Proceeds from the sale of the Trust Preferred Stock are then used by the trust to purchase a subordinated note from the bank holding company, the terms of which are identical to the terms of the Trust Preferred Stock. That subordinated note must be the sole asset of the trust and subordinated to all other debt of the bank holding company.
3. When the trust is consolidated with the bank holding company, the subordinated note is eliminated as inter-company debt. The Trust Preferred Stock is treated as "minority interest in equity accounts of consolidated subsidiaries"[3] on the financial statements of the bank holding company (parent).

Current tax laws allow Trust Preferred Stock dividends to be tax deductible at the bank holding company level, as long as the dividends are cumulative. Those dividends are funded through the receipt of interest payments from the bank holding company on the subordinated note.

Characteristics of Trust Preferred Stock

Any Trust Preferred Stock issue must receive clearance from the issuer's District Federal Reserve Bank. Although there is no official regulatory checklist, the Federal Reserve has usually cleared, for inclusion as Tier 1 capital, issues that have the following characteristics:

- The issuer must be a U.S. bank holding company. Bank subsidiaries are not permitted to count Trust Preferred Stock towards Tier 1 capital because of the cumulative feature of trust preferred dividends.
- The inter-company note must have a stated maturity of at least 30 years and must be subordinate to all subordinated debt. Any initial redemption may not occur prior to the expiration of five years.
- The issuer has the option to call the preferred stock at least after ten years, but not prior to the expiration of five years.
- Both the inter-company note and the preferred stock must allow for a consecutive five-year deferral period for interest and dividends, respectively.
- Maturity and redemption provisions are within the Federal Reserve's understanding of current Internal Revenue Service guidelines for debt treatment.
- Distribution, liquidation, and redemption payments have been fully guaranteed by the corporation issuing the subordinated debentures.
- The preferred stock has essentially no voting rights.

[3] Federal Reserve Capital Adequacy guidelines allow minority interest to be counted as Tier 1 capital. The guidelines state that "While not subject to an explicit sub-limit within Tier 1, banks are expected to avoid using minority interest as an avenue for introducing into their capital structures elements that might not otherwise qualify as Tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within Tier 1." An October 21, 1996 ruling by the Federal Reserve Board of Governors approved the use of certain cumulative preferred stock instruments in Tier 1 capital for bank holding companies, which cleared up many questions about the use of Trust Preferred Stock as Tier 1 capital.

- The preferred stock must be cumulative. The cumulative feature allows these instruments to be considered “debt” for income tax purposes.
- The preferred stock must contain a provision that any redemption of these securities requires approval of the Federal Reserve.
- The amount of Trust Preferred Stock, along with other cumulative preferred stock, may not exceed 25% of Tier 1 Capital.

Creating Pooled Trust Preferred Stock

In order to create Pooled TPS, another trust is added to the structure, referred to as the business trust. The business trust issues securities to investors and uses the proceeds to purchase all of the Trust Preferred Stock from each of the wholly owned trusts participating in the pool. The business trust simply becomes the sole investor for each of the wholly owned trusts, and in the consolidated financial statements of each bank holding company, the same minority interest will exist as if the Trust Preferred Stock had been issued to the general public.

Two main economic issues prevail regarding the ability of the business trust to market its securities. The business trust will normally guarantee principal and interest payments to the investors, and since its only assets are the Trust Preferred Stock from the wholly owned trusts, an insurance company will typically be used to obtain that guarantee. Likewise, in order to obtain that insurance, the securities of the business trust must be rated, and the rating agencies can be very demanding for these types of issues. Concerns associated with Pooled TPS are the same as with Trust Preferred Stock; some analysts view Trust Preferred stock as a weaker form of Tier 1 capital because it is not perpetual, which creates a potential for a ratings downgrade. In an economic downturn, an excessive reliance on debt-like capital instruments could result in increased financial fragility of the overall organization and would, most likely, attract the attention of bank regulators. Nevertheless, as the obstacles to marketing Pooled TPS are overcome, it is anticipated that the benefits of this type of capital will become available to an even broader cross-section of bank holding companies.

- Paul Jordan [4]

[4] The views expressed are the author's and do not necessarily reflect the views of management of the Federal Reserve Bank of Chicago or the Federal Reserve System.

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