

## **BANK HOLDING COMPANY TRUST PREFERRED SECURITIES: RECENT DEVELOPMENTS**

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### **I. INTRODUCTION**

On October 21, 1996, the Board of Governors of the Federal Reserve System (Federal Reserve) explicitly approved the inclusion of trust preferred securities in tier 1 capital by bank holding companies.<sup>3</sup> Within a year, nearly 100 bank holding companies had issued trust preferred securities,<sup>4</sup> and by December 31, 1999, there were approximately \$31 billion dollars in bank holding company-issued trust preferred securities outstanding.<sup>5</sup> According to the Federal Reserve, as of 2005, over 800 bank holding companies had issued and outstanding trust preferred securities totaling over \$85 billion dollars.<sup>6</sup>

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3. Press Release, Fed. Reserve Bd., Approval of the Use of Certain Cumulative Preferred Stock Instruments (Oct. 21, 1996), *available at* <http://www.federalreserve.gov/boarddocs/press/bcreg/1996/19961021/default.htm>.

4. Vincent J. Poppa, *Trust Preferred Securities*, SRC INSIGHTS (Fed. Reserve Bank of Phila./Supervision, Regulation & Credit Dep't, Phila., Pa.), 4th Quarter 1997, at 5, *available at* <http://www.phil.frb.org/src/srcinsights/srcinsights/fourth97.pdf>.

5. See George Benston, Paul Irvine, Jim Rosenfield & Joseph F. Sinkey, Jr., *Bank Capital Structure, Regulatory Capital and Securities Innovations* 1, 15 (Fed. Reserve Bank of Atlanta, Working Paper No. 18, Oct. 2000).

6. Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital, 70 Fed. Reg. 11,827, 11,829 (Mar. 10, 2005) [hereinafter Federal Reserve Final Rule] (to be codified at 12 C.F.R. pt. 208 & 225).

The steady increase in bank holding company issuance of trust preferred securities during the last ten years is primarily a result of the favorable tax, financial reporting, and capital treatment accorded these securities.<sup>7</sup> Trust preferred securities achieve favorable tax and financial reporting characteristics because they are “hybrid”<sup>8</sup> securities, possessing certain advantageous features of debt securities, namely deductibility of interest/dividend payments,<sup>9</sup> nondilution of existing shareholders, and, if properly deployed, a positive effect on earnings per share and return on equity, while maintaining sufficient characteristics of equity to count as tier 1 capital.<sup>10</sup> The “hybrid” nature of trust preferred securities derives from the fact that their issuance actually involves two offerings: first, the issuance of subordinated debt with strict interest deferral features and an overall maturity of at least thirty years to a special purpose subsidiary of the issuer,<sup>11</sup>

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7. While the favorable tax, financial reporting, and capital treatment characteristics of trust preferred securities have spurred the trend, it is also a result of management teams’ increased familiarity with trust preferred securities and the advent of pooled issuance of these securities by bank holding companies. Pooled transactions have greatly reduced the costs associated with issuing trust preferred securities, making it by far the most cost-effective means for holding companies to form new capital. Pooled transactions have also made the capital markets far more accessible for community bank holding companies wishing to issue trust preferred securities. *See id.* at 11,828; *see also infra* notes 73-87 and accompanying text (discussing pooled issuance of trust preferred securities). Although the capital regulations of the Office of Thrift Supervision do not mirror those of the Federal Reserve in terms of inclusion of trust preferred securities in tier 1 capital, thrift holding companies have also been active issuers of trust preferred securities.

8. Traditional preferred stock is also sometimes referred to as a “hybrid” security due to its debt-like traits relative to common stock. *See* JAMES D. COX, THOMAS L. HAZEN & F. HODGE O’NEAL, CORPORATIONS § 18.1, at 494-95 (1997).

9. *See* 26 U.S.C. § 163(a) (2000); *see also* VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 373 (3d ed. 1987).

10. *See* Todd H. Eveson, *Financial and Bank Holding Company Issuance of Trust Preferred Securities*, 6 N.C. BANKING INST. 315 (2002) (providing an overview of the hybrid characteristics of trust preferred securities and the structure of their issuance by bank holding companies).

11. Business trusts, particularly statutory trusts organized under the laws of Delaware or Connecticut, are the special purpose vehicles most frequently utilized in the issuance of trust preferred securities, thus the name “trust preferred.” *See id.* at 323-26. The special purpose vehicle must possess certain characteristics in order for the transaction to function properly. Specifically, it must: (i) be an association not taxable as a corporation for U.S. federal income tax purposes; (ii) be authorized to hold subordinated debentures of the type employed in the issuance of trust preferred securities; (iii) be authorized to issue securities; and (iv) provide limited liability for the holders of its issued and outstanding securities. *Id.*

and second, the issuance by that subsidiary of preferred stock to investors and common stock to the parent bank holding company.<sup>12</sup>

The capital treatment of trust preferred securities, which was first confirmed by the Federal Reserve over a decade ago, permits bank holding companies to include trust preferred securities in tier 1 capital, up to applicable quantitative limits, so long as the terms of such securities, and the subordinated debentures underlying them, meet certain mandated criteria.<sup>13</sup> The Federal Reserve revised these quantitative limits and the overall qualitative requirements for inclusion of trust preferred securities in tier 1 capital in a final rule adopted on March 1, 2005.<sup>14</sup>

Part II of this Article will analyze the Federal Reserve's March 1, 2005, final rule permitting the continued inclusion of trust preferred securities in tier 1 capital subject to revised limitations, including a transition period for compliance with new quantitative limitations ending on March 31, 2009.<sup>15</sup> Part III reviews considerations to be assessed in refinancing trust preferred securities,<sup>16</sup> and Part IV highlights certain recent developments pertaining to trust preferred securities.<sup>17</sup>

## II. FEDERAL RESERVE BOARD FINAL RULE RISK-BASED CAPITAL STANDARDS: TRUST PREFERRED SECURITIES AND THE DEFINITION OF CAPITAL

On March 1, 2005, the Federal Reserve adopted a final rule addressing the capital treatment of trust preferred securities for bank holding companies. The rule provides for the continued

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12. *See id.* at 327-28.

13. 12 C.F.R. pt. 225, app. A, § II.A.1.c.iv.(2) (2006).

14. Press Release, Fed. Reserve Bd., Board Approves Final Rule on Trust Preferred Securities (Mar. 1, 2005), *available at* <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/default.htm>.

15. *See infra* notes 18-70 and accompanying text.

16. *See infra* notes 71-87 and accompanying text. Refinancing activity is expected to increase the number of trust preferred securities offerings during the next several years as securities originally issued through pooled transactions beginning in 2002 begin to reach the expiration of contractual five-year "no call" provisions.

17. *See infra* notes 88-111 and accompanying text.

inclusion of trust preferred securities in tier 1 capital subject to compliance with new quantitative and qualitative standards. The effective date of the rule was April 11, 2005, however, it grandfathers trust preferred securities outstanding prior to this effective date which meet certain criteria.<sup>18</sup> It also provides for a transition period ending on March 31, 2009, for compliance with the new quantitative standards.<sup>19</sup> Despite the transition period, bank holding companies are required to “consult with the Federal Reserve on a plan for ensuring that the banking organization is not unduly relying on [restricted core capital] elements in its capital base and, where appropriate, for reducing such reliance to ensure that the organization complies with these limits as of March 31, 2009.”<sup>20</sup>

#### A. *Quantitative Limits*

The new rule continues to allow bank holding companies to include trust preferred securities in tier 1 capital, but it imposes new quantitative limitations with respect to the maximum amount of trust preferred securities that may be included in tier 1 capital.<sup>21</sup> Specifically, bank holding companies may include restricted core capital elements, including trust preferred securities,<sup>22</sup> in tier 1 capital up to 25% of the sum of all core capital elements. Goodwill less any associated deferred tax liability, however, must be deducted in calculating the core capital element base.<sup>23</sup>

After expiration of the transition period on March 31, 2009, bank holding companies will be required to deduct goodwill and other intangibles, less any associated deferred tax liability, from

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18. 12 C.F.R. pt. 225, app. A, § II.A.1.c.iv.(2) & n.12 (2006).

19. *Id.* The extended transition period was intended to give bank holding companies sufficient lead time to allow the five-year “no call” provisions that are typically included in pooled issuances of trust preferred securities to expire in the event that outstanding trust preferred securities would not meet all criteria for inclusion in tier 1 capital. *See infra* notes 67-72 and accompanying text (discussing call features in trust preferred securities).

20. pt. 225, app. A, § II.A.1.b.ii.(1).

21. *Id.*

22. Federal Reserve regulations now explicitly include trust preferred securities within the definition of “restricted core capital elements.” pt. 225, app. A, § II.A.1.a.iv.(4).

23. pt. 225, app. A, § II.A.1.b.i.(1).

core capital elements in calculating the amount of trust preferred securities that may be included in tier 1 capital.<sup>24</sup> This change will materially impact any bank holding company that has effected a business combination transaction accounted for under the purchase method and which, as a result, has recorded goodwill on its balance sheet.<sup>25</sup> Similarly, bank holding companies planning to finance a merger or acquisition transaction by issuing trust preferred securities must ensure that the effect of the deduction for goodwill is taken into account when analyzing the pro forma capitalization of the company following the proposed transaction.

The Federal Reserve rule also broadened the scope of what is defined as a “restricted core capital element.”<sup>26</sup> As a result, the aggregate amount of trust preferred securities that an issuer may include in tier 1 capital may be reduced depending on whether, aside from trust preferred securities, any of the company’s other outstanding components of tier 1 capital now come within the definition of restricted core capital elements.

The rule continues to allow the inclusion in tier 2 capital of trust preferred securities which are not eligible for inclusion in tier 1 capital due to the quantitative limits of Regulation Y.<sup>27</sup> The inclusion of trust preferred securities in tier 2 capital, however,

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24. pt. 225, app. A, § II.A.1.b.ii.(1)-(2).

25. The adoption of Statement of Financial Accounting Standards No. 141 (FAS 141) in 2001 eliminated pooling of interests accounting in business combination transactions and mandated that such transactions be accounted for using the purchase method of accounting. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 141, BUSINESS COMBINATIONS 6 (2001), <http://www.fasb.org/pdf/fas141.pdf>. Under the purchase method, any premium over the book value of the acquired company is recorded as goodwill on the balance sheet of the acquirer. With the release of FAS 141, any bank holding company that has effected a merger or acquisition transaction accounting for using the purchase method must assess the effect of the deduction of goodwill on its capital structure.

26. Appendix A to Federal Reserve Board Regulation Y defines “restricted core capital elements” to include: (1) qualifying cumulative perpetual preferred stock (including related surplus); (2) minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class B minority interest); (3) minority interest related to qualifying common shareholders’ equity or perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank (Class C minority interest); and (4) qualifying trust preferred securities. pt. 225, app. A, § II.A.1.a.iv.

27. pt. 225, app. A, § II.A.1.b.i.(3).

remains subject to the overall quantitative limitations on tier 2 capital.<sup>28</sup>

*B. Special Rule for Internationally Active Bank Holding Companies*

Another significant quantitative limitation included in the Federal Reserve rule is a 15% limit on inclusion of restricted core capital elements in tier 1 capital by “internationally active” bank holding companies.<sup>29</sup> Regulation Y defines an “internationally active” bank holding company as a banking organization that, as of its most recent year-end FR Y-9C, either reports total consolidated assets equal to \$250 billion or more or reports, on a consolidated basis, total on-balance-sheet foreign exposure of \$10 billion or more in its filings of the most recent year-end Federal Financial Institutions Examination Council 009 Country Exposure Report.<sup>30</sup> Given these parameters, the 15% limitation will affect only the largest bank holding companies in the United States, although any bank holding company with total consolidated assets of over \$250 billion is defined as “internationally active” for purposes of this regulation even if its operations are entirely domestic.

The rationale behind the 15% limitation for internationally active bank holding companies is twofold. First, the 15% standard

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28. pt. 225, app. A, § II.A.2.d.iv. Following expiration of the transition period on March 31, 2009, the amount of trust preferred securities that may be included in tier 2 capital will be limited to 50% of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with Federal Reserve regulations). *Id.* Additional trust preferred securities exceeding this limit may not be counted as tier 2 capital, although Regulation Y states that excess trust preferred securities which are not eligible for classification as tier 2 capital will be “taken into account by the Federal Reserve in its overall assessment of a banking organization’s funding and financial condition.” *Id.*

29. pt. 225, app. A, § II.A.1.b.i.(3).

30. pt. 225, app. A, § II.A.1.b.i.(2) & n.6. Though the final rule did not extend the definition of “internationally active” to include bank holding companies that are candidates for the Advanced International Ratings-Based (AIRB) approach under the revised Basel Accord, International Convergence of Capital Measurement and Capital Standards as was originally proposed, the definition of the final rule “closely proxies the definition proposed for mandatory advanced AIRB banking organizations in the Advance Notice of Proposed Rulemaking to implement” the Basel Accord, International Convergence of Capital Measurement and Capital Standards. Federal Reserve Final Rule, *supra* note 6, at 11,831.

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aligns with the 15% limitation on “innovative securities,” including trust preferred securities, agreed upon by the Basel Committee on Banking Supervision in the 1998 Sydney Agreement, thus promoting consistency for multinational banking organizations operating in the world economy.<sup>31</sup> Second, the Federal Reserve believes that the lower limit is necessary to “ensure the strength” of the capital bases of the “largest and most complex” U.S. bank holding companies.<sup>32</sup> Qualifying mandatory convertible preferred securities are not counted towards the 15% limitation for purposes of the 15% rule for internationally active bank holding companies.<sup>33</sup>

C. *Qualitative Limits*

The Federal Reserve rule also imposed new qualitative requirements for the qualification of trust preferred securities as tier 1 capital.<sup>34</sup> Of paramount importance for the hundreds of bank holding companies with outstanding trust preferred securities, the rule grandfathers previously issued trust preferred securities despite the fact that they do not meet all of the new qualitative requirements provided that they satisfy certain minimum requirements.<sup>35</sup> Under the grandfathering rule, trust preferred securities issued prior to April 15, 2005, may generally be included in tier 1 capital

provided the noncomplying terms of the instrument  
(i) have been commonly used by banking  
organizations, (ii) do not provide an unreasonably  
high degree of protection to the holder in

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31. Federal Reserve Final Rule, *supra* note 6, at 11,831.

32. *Id.*

33. pt. 225, app. A, § II.A.1.b.i.(2). Footnote 5 to Appendix A of Regulation Y explains that “[q]ualifying mandatory convertible preferred securities generally consist of the joint issuance by a bank holding company to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralize with the securities . . .” *Id.* The forward purchase contract “obligates the investors to purchase a fixed amount of the bank holding company’s common stock, generally in three years.” *Id.*

34. See Federal Reserve Final Rule, *supra* note 6, at 11,833.

35. pt. 225, app. A., § II.A.1.c.iv.(2) & n.12.

circumstances other than bankruptcy of the banking organization,<sup>36</sup> and (iii) do not effectively allow a holder in due course of the note to stand ahead of senior or subordinated debt holders in the event of bankruptcy of the banking organization.<sup>37</sup>

The new qualitative requirements for trust preferred securities and the subordinated debentures that underlie them are discussed below.<sup>38</sup>

### 1. Required Terms for Junior Subordinated Debentures

The terms of junior subordinated debentures issued by bank holding companies in connection with the issuance of trust preferred securities must meet all criteria for inclusion as tier 2 capital articulated in Appendix A of Federal Reserve Regulation Y and the Federal Reserve's subordinated debt policy statement.<sup>39</sup> These requirements specify that the junior subordinated debentures must be unsecured<sup>40</sup> and that any certificate representing the debentures must state on its face that it is not a deposit and is not insured by any federal agency.<sup>41</sup> In addition, the

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36. § 250.166(b)(3)(ii)(A)-(F) (providing a non-exhaustive list of permissible terms that provide reasonable protection to the creditor).

37. pt. 225, app. A., § II.A.1.c.iv.(2) & n.12.

38. Practitioners involved in drafting or reviewing the operative documents for an issuance of trust preferred securities must ensure that all qualitative requirements specified by Regulation Y and associated Federal Reserve guidance are satisfied. In practice, counsel for trust preferred pools should be well versed on these qualitative requirements, and it is unlikely that revisions to the indenture or amended and restated trust agreement will be necessary in order to ensure full compliance with the Federal Reserve's requirements. That said, it is nevertheless incumbent upon issuer's counsel to confirm that all required terms are included. After all, it is ultimately the issuing bank holding company's problem if tier 1 capital treatment cannot be obtained.

39. pt. 225, app. A., § II.A.1.c.iv.(2); §250.166. Ensuring that the junior subordinated debentures associated with the issuance of trust preferred securities meet the requirements for inclusion in tier 2 capital also has a very real practical benefit. In the event that the debentures are ever passed through to the holders of the trust preferred securities (as is typically provided upon the occurrence of certain triggering events), satisfaction of the requirements for inclusion in tier 2 capital will ensure that the issuing bank holding company can still count the proceeds of the debentures as regulatory capital.

40. pt. 225, app. A., § II.A.2.d.ii.(1).

41. pt. 225, app. A., § II.A.2.d.ii.(2).

debentures must not include any “credit sensitive features”<sup>42</sup> “or other provisions that are inconsistent with safe and sound banking practices.”<sup>43</sup>

Qualifying subordinated debt must permit acceleration of principal and interest only in the event of bankruptcy, reorganization under Chapter 7<sup>44</sup> or 11<sup>45</sup> of the Bankruptcy Code, insolvency, termination of the special purpose vehicle without redemption of the trust preferred securities, distribution of the debentures to investors, or assumption of the obligation represented by the debentures by a successor to the banking organization.<sup>46</sup> Acceleration is also permissible where nonpayment of interest has exceeded the permitted deferral period of twenty consecutive quarters.<sup>47</sup>

With regard to the deferral of payments, the Federal Reserve regulations now clarify that the advance notification period for notice of deferral must be “reasonably short” and in no event more than fifteen days.<sup>48</sup> Accordingly, the indenture and amended and restated trust agreement must be crafted to comply with this requirement. Furthermore, the final rule clarifies that an indenture provision that prohibits deferral due to a failure to follow the proper deferral procedure or due to any other event of default not explicitly permitted to trigger acceleration of the

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42. § 250.166(b)(4). Credit-sensitive features include provisions that increase the interest rate on debt based on deterioration in the financial condition of the borrower. *Id.*

43. pt. 225, app. A, § II.A.2.d.ii.(3). Provisions deemed inconsistent with safe and sound banking practices include terms that “affect liquidity or unduly restrict management’s flexibility to run the organization, particularly in times of financial difficulty, or that could limit the regulator’s ability to resolve problem bank situations.” § 250.166(b)(3)(i). Specific examples include covenants that prohibit the company from making additional secured or senior borrowings or that would block a change in control of the company or a subsidiary. *Id.*

44. 11 U.S.C. § 727 (2000), *amended by* Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in various sections of 11 U.S.C.A.).

45. 11 U.S.C. § 1121 (2000), *amended by* Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in various sections of 11 U.S.C.).

46. § 250.166(b)(2); pt. 225, app. A, § II.A.1.c.iv.(2).

47. pt. 225, app. A, § II.A.1.c.iv.(2).

48. pt. 225, app. A, § II.A.1.c.iv.(1).

indebtedness is impermissible for qualifying junior subordinated debt.<sup>49</sup>

The Federal Reserve final rule also confirms that while qualifying junior subordinated debt must be subordinated in right of payment to the claims of general creditors as well as to senior debt and subordinated debt of the holding company, it may be *pari passu* with trade accounts payable and other accrued liabilities.<sup>50</sup> It may also rank *pari passu* with junior subordinated debt underlying another issuance of trust preferred securities.<sup>51</sup>

Junior subordinated debentures issued by a bank holding company in connection with the issuance of trust preferred securities must still specify a minimum maturity<sup>52</sup> of thirty years.<sup>53</sup> However, because qualifying subordinated debt is required to have a minimum maturity of five years,<sup>54</sup> the junior subordinated debentures underlying trust preferred securities entering the five-year period immediately preceding their maturity date are deemed to “take on characteristics of a short-term obligation”<sup>55</sup> and, as a result, the associated trust preferred securities are excluded from tier 1 capital and included in tier 2 capital.<sup>56</sup>

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49. See Federal Reserve Final Rule, *supra* note 6, at 11,833.

50. *Id.* This interpretation is consistent with the Federal Reserve’s subordinated debt policy. § 250.166. The final rule goes on to clarify that qualifying junior subordinated debt underlying trust preferred securities must be subordinate to senior debt and other subordinated debt not only in liquidation but also in priority of interest payments while the company remains a going concern. Federal Reserve Final Rule, *supra* note 6, at 11,833.

51. See Federal Reserve Final Rule, *supra* note 6, at 11,833. *But see infra* notes 99-106 and accompanying text (discussing enhanced trust preferred securities, which may be subordinate to standard trust preferred securities).

52. The Federal Reserve regulations define “maturity” as “original weighted average maturity.” See, e.g., Federal Reserve Final Rule, *supra* note 6, at 11,837.

53. pt. 225, app. A, § II.A.1.c.iv.(2) (stating that the junior subordinated debenture underlying trust preferred securities must have a minimum maturity of thirty years for the proceeds of the trust preferred securities to be eligible for inclusion in tier 1 capital).

54. pt. 225, app. A, § II.A.2.d.i.

55. pt. 225, app. A, § II.A.2.d.iii.

56. pt. 225, app. A, § II.A.1.c.iv.(3). Furthermore, trust preferred securities are included in tier 2 capital only where they are subject to the amortization provisions and quantitative restrictions set forth in sections II.A.2.d.iii and iv of Appendix A of 12 C.F.R. pt 225. *Id.*

## 2. Required Terms for Trust Preferred Securities

The basic structure of bank holding company-issued trust preferred securities was largely unaltered by the Federal Reserve's final rule.<sup>57</sup> In order to be eligible for inclusion in tier 1 capital, such securities must still be undated preferred securities issued by a business trust or other suitable special purpose vehicle,<sup>58</sup> the common equity of which is wholly owned by the holding company.<sup>59</sup> In addition, such securities must still permit the deferral of dividends for up to twenty consecutive quarters without triggering a default.<sup>60</sup>

The final rule also now explicitly states that in order to be included in tier 1 capital,<sup>61</sup> trust preferred securities must comply with all restrictions on terms and features applicable to qualifying perpetual preferred stock.<sup>62</sup> These restrictions are: (1) the securities cannot allow for redemption at the option of the holder;<sup>63</sup> (2) redemption at the option of the issuer is permissible only if it is with the prior approval of the Federal Reserve;<sup>64</sup> (3) dividend step-up provisions or other provisions that require or create significant incentives for the issuer to redeem the securities for cash or cash equivalents are prohibited;<sup>65</sup> and (4) market value conversion features are generally prohibited.<sup>66</sup>

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57. See Eveson, *supra* note 10, at 322-29 (providing an overview of the basic structure of trust preferred securities).

58. It is not an absolute requirement that the special purpose vehicle employed in connection with an issuance of trust preferred securities be a business trust, although a business trust has all of the required characteristics and is far and away the entity of choice for such transactions. See *id.* at 323-26.

59. pt. 225, app. A, § II.A.1.c.iv.(1).

60. *Id.*

61. Such inclusion, of course, remains subject to the quantitative limits applicable to the inclusion of trust preferred securities in tier 1 capital. See *supra* notes 21-26, 29-33 and accompanying text.

62. pt. 225, app. A, § II.A.1.c.iv.(1).

63. pt. 225, app. A, § II.A.1.c.ii.(1).

64. pt. 225, app. A, § II.A.1.c.ii.(2).

65. *Id.* The Federal Reserve gives an example of such a provision as follows: "a credit-sensitive dividend feature – that is, a dividend rate that is reset periodically based, in whole or in part, on the banking organization's current credit standing – generally does not qualify for inclusion in tier 1 capital." *Id.* While certain dividend step-up mechanisms are permitted under the 1998 Sydney Agreement of the Basel Committee on Banking Supervision, the Federal Reserve declined to permit the inclusion of such provisions in qualifying trust preferred securities. See Federal

Another significant change is the elimination of the requirement that a call option be included in the terms of qualifying trust preferred securities.<sup>67</sup> The Federal Reserve's final rule explains that call option provisions were originally required for tier 1-eligible trust preferred securities because they were a prevailing "market standard" during the mid 1990s.<sup>68</sup> However, because call options are not required in qualifying perpetual preferred stock and because the market for bank holding company-issued trust preferred securities has shifted from one oriented to retail investors to one which now includes institutional investors, call options are no longer mandatory.<sup>69</sup> While no longer an absolute requirement, call options nevertheless afford enhanced flexibility to issuers, albeit presumably at additional cost priced into the dividend yield, and the Federal Reserve has stated that call features are "beneficial from both a financial and a supervisory perspective."<sup>70</sup>

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Reserve Final Rule, *supra* note 6, at 11,832. The Federal Reserve's reasoning on this point was that dividend step-up provisions incent the issuer to redeem securities prior to their stated maturity, thereby shortening the maturity and stability of instruments that include them. *Id.* The prohibition on credit-sensitive dividend features does not affect floating rate trust preferred securities. Trust preferred securities with a floating interest rate tied to the three-month London Interbank Offered Rate (LIBOR) curve are very common, especially in pooled issuance transactions. Such securities remain eligible for inclusion in tier 1 capital because the interest rate is adjusted as a result of market fluctuations rather than changes in the credit rating of the issuer.

66. pt. 225, app. A, § II.A.1.c.ii.(2). The Federal Reserve clarifies in footnote 8 to section II.A.2.d. that "[t]raditional convertible perpetual preferred stock, which the holder must or can convert into a fixed number of common shares at a preset price" will generally be eligible for inclusion in tier 1 capital. pt. 225, app. A, § II.A.1.c.ii.(2) n.8. This confirms that trust preferred securities that are convertible into common stock or qualifying perpetual preferred stock can be included in tier 1 capital, so long as the conversion ratio is set at the time of issuance and remains fixed for the life of the security and assuming the inclusion of all other required terms for tier 1 capital treatment. Adjustment for stock splits or stock dividends would, presumably, be permissible with the prior approval of the Federal Reserve.

67. See Federal Reserve Final Rule, *supra* note 6, at 11,833.

68. See *id.* at 11,832-33.

69. See *id.* at 11,833.

70. *Id.*

### III. REFINANCING TRUST PREFERRED SECURITIES

When trust preferred securities first appeared, a ten-year no-call period was standard.<sup>71</sup> Consequently, there was very little refinance activity for trust preferred securities until 2005 and 2006. Refinancing activity is expected to increase dramatically beginning in 2007 as the wave of trust preferred securities issued in late 2002 and early 2003 with five-year no-call provisions become callable. For most bank holding companies with older, callable trust preferred securities, the economic advantages of refinancing are compelling. In addition, there are few disincentives to refinancing older trust preferred securities with new, less expensive<sup>72</sup> trust preferred securities.

#### A. *Market Acceptance*

The market for trust preferred securities greatly expanded with the advent of pooled trust preferred offerings.<sup>73</sup> Pooled transactions involve the securitization of trust preferred securities issued by a “pool” of anywhere from 50 to over 100 bank holding companies.<sup>74</sup> Pooled offerings enable smaller community bank

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71. *See generally id.* at 11,832-33. The Federal Reserve Final Rule states that the no-call provisions typically included in trust preferred securities were based on the market standard prevailing at the time trust preferred securities were originally approved for inclusion in tier 1 capital. The market for trust preferred securities at that time was strictly retail but has since expanded to include institutional investors. Unlike retail investors, who tend to focus on yield, non-retail investors charge for call options because they give the issuer flexibility to call the instrument should interest rates decline or the institution’s condition improve, allowing refinancing at a cheaper rate. *Id.*

72. Federal Reserve Final Rule, *supra* note 6, at 11,833 (stating that bank holding companies that issued trust preferred securities in the late 1990s have been able to realize “substantial rate reductions” in recent periods by exercising built-in call options and refinancing their outstanding trust preferred securities with new issuances at lower rates).

73. *See infra* notes 74-76, 79-84 and accompanying text.

74. In a pooled transaction, trust preferred securities are issued to a pooling vehicle which, in turn, issues securities to the eventual investors. *See* PAUL JORDAN, FEDERAL RESERVE BANK EMERGING ISSUES SERIES, POOLED TRUST PREFERRED STOCK – A NEW TWIST ON AN OLDER PRODUCT 4 (2000), <http://www.chicagofed.org/publications/publicpolicystudies/emergingissues/pdf/S&R-2000-2.pdf>. Subordinated debt issued by banks not in the holding company form of organization is also often included in the pool. *See generally* TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES § 8.1 (1991) (providing general background on pooled transactions and securitization).

holding companies to participate in the trust preferred market in a cost-efficient way.<sup>75</sup> In addition to cost, there are two other significant advantages to smaller institutions participating in a pooled trust preferred offering. First, because the investor is buying into a diversified pool of bank issuers, the investor is not relying on the credit quality of any one institution. Therefore, minimal due diligence is required, and there is virtually no disclosure for the issuer. Second, the transaction documentation is all standardized. As a result, the whole process can often be completed in three weeks or less. It is estimated that approximately \$33 billion in trust preferred securities has been issued by financial institutions through pooled transactions.<sup>76</sup>

Market acceptance of trust preferred securities can be attributed to several factors. Initially investors were attracted to the yield.<sup>77</sup> This was especially true when short-term interest rates were at a forty-year low during the period from 2001 to 2004.<sup>78</sup> Investors have also been attracted to the relative safety of trust preferred securities. Although trust preferred securities are unsecured, there have been very few defaults. There have been few instances in which issuers had to defer interest payments, and in most cases these issuers have ultimately repaid the principal and the deferred interest without defaulting.

Another factor contributing to the acceptance of trust preferred securities is the collateralized debt obligation (CDO) structure.<sup>79</sup> Most pooled trust preferred securities have been structured as CDOs. In the CDO structure, the securities sold to

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75. JORDAN, *supra* note 74, at 2; *see also* BRUCE MILLER, RYAN BECK & CO., FINANCIAL INSTITUTIONS GROUP, TRUST PREFERRED SECURITIES – FLAT YIELD CURVE OPPORTUNITIES (2006), <http://rbcoweb.ryanbeck.com/rbeck/emails/fireview/606trustpreferred.htm> (stating that “more attractive pricing is available from the various trust preferred pools”). Many pools are able to accommodate issuances as small as \$2 million, which also makes the capital markets far more accessible to community bank holding companies desiring to issue trust preferred securities.

76. Statistics courtesy of FTN Financial Capital Markets, Memphis, Tennessee.

77. Federal Reserve Final Rule, *supra* note 6, at 11,833.

78. *See, e.g.*, Richard W. Stevenson, *Fed Holds the Line on Interest Uncertainty About Recovery's Strength Keeps Rates at 40-year Low*, S.F. CHRON., May 8, 2002, at B3.

79. *See generally* SECURITIZATION OF FINANCIAL ASSETS § 7.02[G][4] (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 2005-2) (providing an overview of collateralized debt obligations).

investors are issued in tranches.<sup>80</sup> Cash flows from the debt collateral issued by the pool participants are distributed to the tranches based on maturity. The shorter-maturity tranches, which are typically of a one- two- or three-year duration, receive cash flows first and are repaid sooner than the longer-maturity tranches, which can last for five years or longer. Therefore, because they are more likely to be repaid, the shorter-maturity tranches are perceived to be less risky and require a lower yield than longer-maturity tranches. The use of the CDO structure is important for two reasons. Tranching the securities appeals to a broader universe of potential investors.<sup>81</sup> Some investors may be willing to purchase a two-year trust preferred investment but not a ten-year investment. Also, tranching the securities sold to investors results in a lower overall funding cost.<sup>82</sup> Ultimately, this lower funding cost has resulted in lower costs to the issuers participating in pooled trust preferred offerings.

#### *B. Declining Costs*

For bank holding companies, the cost of participating in a pooled trust preferred offering has been reduced significantly since 2002. Institutions issuing trust preferred securities in pooled transactions in 2002 typically contracted to pay interest on the underlying debt at a spread of 3.25% to 3.75% over the ninety-day LIBOR. In addition, pool participants paid a placement fee and certain out-of-pocket expenses, such as trustee fees and legal fees. At the time, placement fees were customarily 3% of the amount issued. Trustee and legal fees could easily add \$20,000 to \$30,000 or more to the cost of the transaction, depending upon the amount issued.<sup>83</sup> Placement fees and other out-of-pocket expenses were capitalized and amortized over the expected life of the trust preferred securities, thereby increasing the overall funding cost to the issuer.

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80. *See id.*

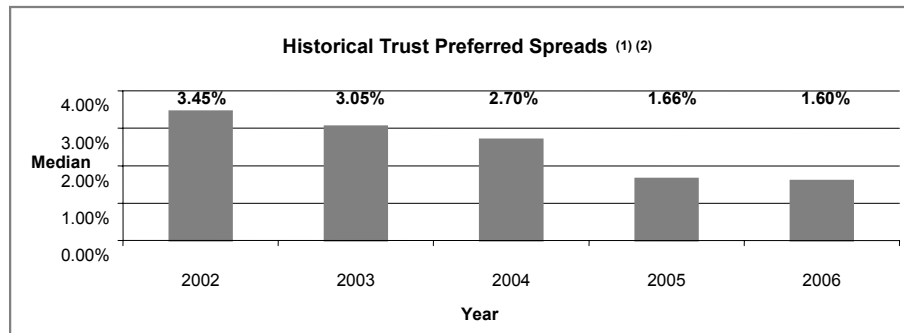
81. *Id.*

82. *Id.*

83. Moreover, trustee's fees often represented an ongoing annual expense for bank holding companies with outstanding trust preferred securities.

By comparison, holding companies issuing trust preferred securities in pooled transactions in the second half of 2006, typically contracted to pay interest on the underlying debt at a spread of 1.50% to 1.80% over the ninety-day LIBOR. Placement fees and other upfront costs have been largely eliminated. None of the organizations currently active in the pooled trust preferred market charges a placement fee to issuers for participating in a pooled trust preferred transaction.<sup>84</sup> Trustee fees have been absorbed by the trust preferred pools, with funds set aside by the pooled structure to cover all upfront and ongoing trustee expenses. Furthermore, most trust preferred pools provide the issuer with an allowance of \$10,000 or more for the issuer's legal expenses related to the offering.

Trust Preferred Spreads to 3 Month LIBOR <sup>(1)</sup>					
	2002	2003	2004	2005	2006
# of Transactions <sup>(2)</sup>	151	178	162	86	96
Minimum	3.25%	2.70%	1.55%	1.33%	1.31%
<b>Median</b>	<b>3.45%</b>	<b>3.05%</b>	<b>2.70%</b>	<b>1.66%</b>	<b>1.60%</b>
Maximum	3.75%	3.65%	3.65%	3.60%	3.10%



(1) Source: SNL Financial LC

(2) Based solely on transactions where data is available

84. Placement fees were effectively eliminated in early 2005.

C. *The Decision to Refinance*

For most bank holding companies with callable trust preferred securities, the decision to refinance should be a relatively easy one. In most cases the organization should be able to reduce the cost of funds by 1.50% to 2.00% with little or no out-of-pocket cost.<sup>85</sup> For a bank holding company with \$10 million of trust preferred securities outstanding, this could represent annual pre-tax savings of \$150,000 to \$200,000 per year. However, before electing to refinance callable trust preferred securities, the institution should consider several other potential issues.

If the issuer capitalized a placement fee and other issuance costs when the original trust preferred securities were issued, then the remaining unamortized issuance costs must be expensed when the trust preferred securities are refinanced. This should not be an issue if the capitalized expenses were amortized over five years. If so, such expenses should be fully amortized by the call date. If, on the other hand, the issuer elected to amortize the capitalized issuance expenses over thirty years, then as much as 83% of the capitalized expense may remain unamortized. The cost of accelerating this expense could be considerable. For example, if a bank holding company issued \$10 million of trust preferred securities five years ago and paid a 3% placement fee and amortized the placement fee over thirty years, the remaining unamortized placement fee would be \$250,000. Clearly, the benefit of saving \$150,000 to \$200,000 per year outweighs the one-time cost of expensing \$250,000 of capitalized issuance expenses in this example. Nonetheless, the issuer should be aware of all of the costs and benefits of refinancing trust preferred securities before making a decision.

Some pooled trust preferred offerings require the issuer to pay a prepayment penalty if the trust preferred securities are called earlier than ten years. This prepayment penalty usually takes the form of a redemption price above par that declines over time. A significant redemption premium might make it

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85. See Federal Reserve Final Rule, *supra* note 6, at 11,833.

uneconomical to refinance for the first few years that the trust preferred securities are callable.

Refinancing existing trust preferred securities is also contingent on the financial condition of the banking organization. If the organization is to refinance through a pooled trust preferred transaction, it must meet the pool's eligibility requirements. If the organization's financial condition has deteriorated or it is too highly leveraged or has unacceptable concentrations on its balance sheet, refinancing through a pool may not be possible. In that case, the best decision may be to retain the existing trust preferred securities.

#### *D. Mechanics of Refinancing*

Refinancing trust preferred securities is a relatively straightforward process. The pooled trust preferred business is highly competitive. Organizations offering pooled trust preferred securities are well aware of the coming wave of trust preferred refinance activity and are prepared to make it as "turnkey" as possible. In particular, the trust preferred pools will permit bank holding companies to lock-in a spread as far as one year prior to the call date, although ninety days prior to the call date is more common. The earlier a bank attempts to lock in the spread, the higher the premium will typically be. Locking in the spread enables the bank to reduce the risk of market fluctuations after making the commitment to refinance.

Trust preferred pools will also set the funding date to coincide with the call date, so there is no overlap or gap in the organization's funding needs. In the past, the funding date was dictated by the cycle (usually quarterly) in which the pools sold securities to investors. Now, all of the active trust preferred pools utilize a warehouse line for liquidity, and the funding date is completely flexible. Moreover, the funds can be delivered directly to the trustee to retire the existing trust preferred securities.

Trust preferred securities that are callable after five years generally provide for the securities to be called on the fifth anniversary or any quarter thereafter. Proper notice, which is generally thirty to sixty days, must be given to the trustee in order

to call the securities in a given quarter. This requires the bank to have commitments to refinance in place at least sixty to ninety days prior to the call date. Bank holding companies desiring to refinance outstanding trust preferred securities must also secure the approval of the Federal Reserve before redeeming such securities.<sup>86</sup>

Finally, if the bank holding company has capacity to issue more than the existing trust preferred securities and has the need for additional capital, it can issue more trust preferred securities than the amount required to refinance the existing trust preferred securities and use the additional capital to support growth.<sup>87</sup>

#### IV. RECENT DEVELOPMENTS

The rise of pooled issuance of trust preferred securities is probably the most significant recent development affecting bank holding company issuance of trust preferred securities in recent years; however, there have also been other noteworthy developments.

##### A. *Federal Reserve Policy Statement for Small Bank Holding Companies*

On February 27, 2006, the Federal Reserve announced the approval of a final rule expanding the definition of a “small bank holding company” under its Small Bank Holding Company Policy Statement and the bank holding company risk-based and leverage capital guidelines.<sup>88</sup> The Small Bank Holding Company Policy Statement provides an exemption from the Federal Reserve’s capital guidelines, allowing bank holding companies meeting

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86. See 12 C.F.R. pt. 225, app. A, § II.A.1.c.iv.(1) (2006); pt. 225, app. A, § II.A.1.c.ii.(2).

87. pt. 225, app. A, § II.A.1.b.i.(2). *But see infra* notes 88-98 and accompanying text (discussing the Small Bank Holding Company Policy Statement and the possible ramifications of small bank holding companies issuing additional trust preferred securities in a refinancing transaction prior to December 31, 2010).

88. Press Release, Fed. Reserve Bd., Approval of Final Rule Expanding the Definition of a Small Bank Holding Company (Feb. 27, 2006) [hereinafter Press Release Expanding Small Bank Holding Company Definition], available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060227/default.htm>.

certain quantitative and qualitative requirements to incur heightened levels of debt in connection with bank or nonbank acquisitions.<sup>89</sup>

The revised rule raised the asset size limitation for qualification as a “small bank holding company” from \$150 million to \$500 million.<sup>90</sup> Bank holding companies with consolidated assets of less than \$500 million and which (1) are not engaged in any nonbanking activities involving significant leverage, (2) are not engaged in any significant off-balance sheet activities, and (3) do not have a significant amount of outstanding debt or equity that is held by the general public<sup>91</sup> now qualify as “small bank holding companies” under the Federal Reserve policy statement and, as such, may use debt to finance up to 75% of the purchase price of an acquisition.<sup>92</sup> This heightened level of debt is permissible only where the small bank holding company can meet certain ongoing requirements, principal among which are that the company: (1) reduce its parent company debt in such a manner that all debt is retired within twenty-five years of the debt being incurred; (2) reduce its debt-to-equity ratio to 0.30:1 or less within twelve years of the debt being incurred; (3) ensure that each of its subsidiary insured depository institutions is well capitalized; and (4) refrain from paying dividends until its debt-to-equity ratio is 1.0:1 or less.<sup>93</sup>

Subordinated debt issued by a small bank holding company in connection with the issuance of trust preferred securities is generally counted as debt for purposes of the Small Bank Holding

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89. *Id.* While the Federal Reserve generally discourages the use of debt by bank holding companies to finance acquisitions, the agency has recognized that acquisition debt gives small bank holding companies added flexibility in structuring acquisitions, facilitating the transfer of small community banks. *See* pt. 225, app. C.

90. Press Release Expanding Small Bank Holding Company Definition, Fed. Reserve Bd., *supra* note 88. The Federal Reserve has indicated that it expects to re-evaluate the \$500 million ceiling at least once every five years to determine whether a further increase would be warranted.

91. Such debt or equity would be debt or equity securities registered under the Securities Act of 1933. *See* 15 U.S.C. § 77c (2000); *see also* pt. 225, app. C.

92. 12 C.F.R. pt. 225, app. C (2006). The \$500 million ceiling on consolidated asset size applies to the pro forma assets of the combined post-acquisition company. *Id.*

93. *Id.* A small bank holding company availing itself of the heightened leverage limitations permitted by the Small Bank Holding Company Policy Statement is not eligible for expedited application processing procedures or waivers of the stock redemption filing requirements under Regulation Y. *Id.*

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Company Policy Statement.<sup>94</sup> However, a small bank holding company may exclude such subordinated debt in an amount up to 25% of its equity, less goodwill.<sup>95</sup> In addition, until expiration of a five-year transition period on December 31, 2010, any small bank holding company which has not issued trust preferred securities after December 31, 2005, may, for purposes of the Small Bank Holding Company Policy Statement, exclude from debt *all* subordinated debt issued in connection with the issuance of trust preferred securities.<sup>96</sup> Subordinated debt incurred in connection with the issuance of trust preferred securities after December 31, 2005, may also be excluded through December 31, 2010, as long as such trust preferred securities were issued to refinance other trust preferred securities that were issued on or before December 31, 2005, and the refinancing does not increase the holding company's overall level of subordinated debt.<sup>97</sup> Subordinated debt issued in connection with the issuance of trust preferred securities is not counted towards the 12- and 25-year debt-to-equity ratio reduction requirements discussed above.<sup>98</sup>

*B. Enhanced Trust Preferred Securities*

The emergence of so-called “enhanced trust preferred securities” has been another recent development in the field of trust preferred securities. While standard trust preferred securities achieve desirable tax, financial reporting, and regulatory capital treatment results, they have been viewed by some ratings agencies and investment analysts as a weaker form of capital.<sup>99</sup> As a result, the credit rating of a bank holding company with outstanding trust preferred securities may be negatively impacted vis-à-vis a similarly situated institution capitalized exclusively with common stock.<sup>100</sup> Enhanced trust preferred securities are designed to

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94. pt. 225, app. C, § 2.A. & n.3.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. See Kathy R. Kalser, *Chicago Regional Outlook*, REGIONAL OUTLOOK (Fed. Deposit Ins. Corp./Div. of Ins., D.C.), 4th Quarter 1997, at 19.

100. *Id.* at 22.

maintain the favorable tax and regulatory treatment of trust preferred securities while adding the additional benefit of partial to full capital treatment by the ratings agencies.<sup>101</sup> For larger bank holding companies that have rated securities, this additional feature can result in heightened capital adequacy calculations for rating purposes.<sup>102</sup>

Enhanced trust preferred securities are structured in a manner similar to standard trust preferred securities.<sup>103</sup> A key difference is that generally, the underlying junior subordinated debentures rank junior to the debentures issued in connection with standard trust preferred securities and have a longer maturity term, typically ranging from forty to sixty years.<sup>104</sup> Other distinctions may include the inclusion of “replacement capital covenants,”<sup>105</sup> and “alternative payment mechanisms.”<sup>106</sup> Since enhanced trust preferred securities are a variation on standard trust preferred securities, it is especially important that any bank holding company that is considering issuing enhanced trust preferred securities consult with the appropriate Federal Reserve Bank to determine whether the terms of such securities will qualify them for the capital treatment that is sought.

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101. See Christopher Gastelu, *New Hybrid Capital Securities Provide Banks with Additional Tier 1 Capital Alternatives*, FIN. INSTITUTIONS REV. (Ryan Beck & Co. Financial Institutions Group, Florham Park, N.J.), June 2006, <http://rbcoweb.ryanbeck.com/rbeck/emails/fireview/606newhybrid.htm>. An additional advantage to rated enhanced trust preferred securities is that such securities are more likely to come within the definition of “investment securities” set forth by the Office of the Comptroller of the Currency. See 12 C.F.R. § 1.2(e); see also Eveson, *supra* note 10, at 316 (describing the favorable tax, accounting, and regulatory treatment of trust preferred securities).

102. See Gastelu, *supra* note 101.

103. *Id.*

104. *Id.*

105. A replacement capital covenant “requires that the issuer covenant to holders of an existing series of its debt that it will not redeem or repurchase the [enhanced trust preferred securities], except with the proceeds of ‘qualified replacement capital securities,’ such as another series of [enhanced trust preferred securities].” *Id.*

106. An alternative payment mechanism “requires that, in the event of an extended interest deferral period, deferred interest can only be paid from the proceeds of qualified replacement capital securities.” *Id.*

C. *Accounting and Tax Issues*

1. Revision of Financial Accounting Standards Board  
Interpretation No. 46 Consolidation of Variable Interest Entities

The revision of Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46R) in December 2003, required the deconsolidation of the special purpose vehicle that is formed in connection with the issuance of trust preferred securities from the consolidated financial statements of the issuing bank holding company.<sup>107</sup> The business trust is deemed a variable interest entity under FIN 46R, and, because the issuing bank holding company is not the primary beneficiary of the trust, the financial statements of the special purpose vehicle are not consolidated.<sup>108</sup>

There was some concern as to whether FIN 46R would affect the tax or capital treatment of trust preferred securities. The revision has altered the manner in which bank holding companies report their ownership of the common securities of the special purpose vehicle and their issuance of the junior subordinated debentures, but it does not impact the viability of trust preferred securities as a core capital element. As the Federal Reserve states in its final rule, “[a] change in the GAAP accounting for a capital instrument does not necessarily change the regulatory capital treatment of that instrument.”<sup>109</sup>

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107. See FIN. ACCOUNTING STANDARDS BD., INTERPRETATION NO. 46, CONSOLIDATION OF VARIABLE INTEREST ENTITIES 5 (2003), <http://www.fasb.org/pdf/fin%2046R.pdf>.

108. *Id.*

109. Federal Reserve Final Rule, *supra* note 6, at 11,828. The Federal Reserve final rule goes on to state, however, that “GAAP informs the definition of regulatory capital” but that the Federal Reserve

is not bound to use GAAP accounting concepts in its definition of tier 1 or tier 2 capital because regulatory capital requirements are regulatory constructs designed to ensure the safety and soundness of banking organizations. . . . Nevertheless, consistent with longstanding [Federal Reserve] direction, Bank Holding Companies are required to follow GAAP for regulatory reporting purposes.

*Id.* Interestingly, the Federal Deposit Insurance Corporation submitted a comment letter in opposition to the continued inclusion of trust preferred securities in tier 1 capital based on the argument that securities accounted for as a liability under GAAP should not be included in tier 1 capital. See *id.* at 11,829.

## 2. Grantor Trust Taxpayer Identification Number

The special purpose vehicle formed in connection with an issuance of trust preferred securities is typically a business trust, which is structured to qualify as a grantor trust under applicable tax law.<sup>110</sup> A grantor trust is disregarded as a separate entity under the Internal Revenue Code.<sup>111</sup> Thus, despite the fact that the business trust is not included in the consolidated financial statements of the issuing bank holding company under GAAP, it is nevertheless viewed as part of the bank holding company for tax law purposes, allowing trust preferred securities to achieve their debt/equity hybrid character.

Because the grantor trust is disregarded for tax purposes, there is often uncertainty as to whether the issuer should apply for a tax identification number for the trust. The more conservative approach has been to obtain a taxpayer identification number for the trust and to file grantor trust returns. The question of whether or not to obtain a taxpayer identification number for the trust should be answered in consultation with the issuer's tax preparer and should take into consideration whether the preparer intends to file a grantor trust return for the trust.

## V. CONCLUSION

The Federal Reserve's final rule allows trust preferred securities to remain a very viable and cost-effective source of tier 1 capital for bank holding companies. The compelling business reasons for refinancing trust preferred securities and the accessibility of trust preferred "pools" to issuers of all sizes are only expected to increase the utilization of trust preferred securities by bank holding companies through the end of the decade.

Issuing bank holding companies must be mindful of the new qualitative requirements for trust preferred securities and their underlying junior subordinated debentures as well as the new quantitative limitations on inclusion of trust preferred securities in

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110. See Eveson, *supra* note 10, at 323 & n.49.

111. See 26 U.S.C.A. §§ 671-679 (2006).

tier 1 capital. While it has always been advisable for bank holding companies that intend to issue trust preferred securities to consult with the appropriate Federal Reserve Bank prior to issuance in order to ensure that the securities' terms are consistent with all requirements for inclusion in tier 1 capital, the Federal Reserve's new rule now makes consultation prior to issuance a requirement.<sup>112</sup> Furthermore, bank holding companies with outstanding trust preferred securities should consult with their Federal Reserve Bank now to ensure that they will be in full compliance with the new quantitative limitations after expiration of the March 31, 2009, transition deadline. Holding companies which are "internationally active" or which have recorded goodwill as a result of one or more business combination transactions must be especially mindful of the new quantitative limitations.

Finally, it is important to note that while there is clear authority for the inclusion of qualifying trust preferred securities in tier 1 capital, the Federal Reserve has also long held that voting equity should be the dominant component of tier 1 capital.<sup>113</sup> In fact, the Federal Reserve's final rule on trust preferred securities states that the agency will "as a general matter, heighten its supervisory scrutiny of the corporate governance and financial strategies" of bank holding companies for which voting common equity is not the predominant component of tier 1 capital.<sup>114</sup> With this in mind, banking organizations should strive to avoid over-reliance on restricted core capital elements.

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112. 12 C.F.R. pt. 225, app. A, § II.A.1.c.iv.(1) (2006) ("[A] banking organization that wishes to issue trust preferred securities and include them in tier 1 capital must first consult with the Federal Reserve.").

113. Federal Reserve Final Rule, *supra* note 6, at 11,832; *see also* pt. 225, app. A, § II.A.1.c.i.(3) (stating that common stockholders' equity is preferred to other forms of tier 1 capital); FED. RESERVE BD., BANK HOLDING COMPANY SUPERVISION MANUAL § 4060.3.2.1.1.3 (2006) ("[V]oting common stockholders' equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within tier 1 capital").

114. Federal Reserve Final Rule, *supra* note 6, at 11,832.

