Trust Preferred Securities
A new capital source for enterprising community banks

by C.J. Pickering and Jim Taylor

Community banks were effectively barred from issuing Trust Preferred Securities, (or TruPs in trader lingo) in the mid and late 1990s because the fixed costs were too expensive for issues of less than $20 million. Since that time, pooled issues have allowed institutions to economically issue TruPs in amounts as small as $2.5 million.

Some of the more common reasons for issuing TruPs are:
- **To grow capital.** Limited Tier 1 capital can restrict asset growth plans such as acquisitions, new branch openings or projected internal growth rates. Issuing TruPs allows wholesale leveraging strategies to dramatically improve ROE.
- **To enhance earnings per share.** Issuing TruPs allows banks to buy back a sufficient measure of outstanding stock, resulting in fewer outstanding shares. TruPs are a “non-dilutive” form of new capital. Capital adequacy and earnings per share are both improved since TruPs are included in Tier 1 capital.
- **To convert to Subchapter S Corporation status.** Institutions wishing to convert to Subchapter S Corporation status can use TruPs as a funding vehicle to buy back stock and reduce the number of shareholders to a qualifying level. Again, Tier 1 capital adequacy and earnings per share are both improved.

Issuer Viewpoint
TruPs are usually the least expensive, immediately obtainable form of new regulatory capital. From a GAAP viewpoint, TruPs look like long-term debt with tax-deductible interest expense. There is no other form of Tier capital that offers these benefits.

Banks as small as $75 million in assets may be able to issue cost-effective pooled issues in the foreseeable future.

Shorter-term debt issuance might seem like a less expensive form of funding, but it cannot be included in Tier 1 capital. Like all things that seem too good to be true, TruPs’ inclusion in Tier 1 capital is restricted and can make up no more than 25 percent of Tier 1 capital.

Very recently, as investors have become more comfortable with TruPs, banks with smaller and smaller investment portfolios have been able to join pooled issuances. Pooled issuance helps to:
- Reduce the issuance cost per share;
- Improve the marketability of the shares issued; and
- Reduce the cost of obtaining adequate credit ratings.

Today, institutions with as little as $100 million in deposits are being invited into upcoming pools. Potentially, banks as small as $75 million in assets may be able to issue cost-effective pooled issues in the foreseeable future.

Underwriting fees for issuing TruPs are typically in the 3 percent range. The issuing bank also pays internal expenses, such as legal counsel and tax opinion. The underwriter usually pays annual trust maintenance fees for the first five years of the issue’s life. No single issuer will typically represent more than 5 percent of the total pool.

Additionally, the *pro-forma* Tier 1 risk-based capital ratio for issuing institutions must be at least 10 percent, and the institution should have an operating history of at least five years.

TruPs are not for everyone. However, their benefits make them one of the most popular and inexpensive methods for raising community bank capital.

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To Learn More

ICBA Securities’ Strategies Department has developed investment models that can assess the feasibility of TruPs’ issuance for any given community bank. These models include the following analyses and management assistance:
- Leveraging;
- Growth and capital planning;
- Asset-liability analyses (earnings at risk);
- In-house board of director presentations; and
- An experienced strategist to help manage the process.

As an “introducing broker,” ICBA Securities is compensated for these services by the underwriter. No additional fees are charged to the issuer.