Over the last three years, community banks have embraced trust preferred security issuance with a vengeance. This cost-effective form of regulatory capital found its place in bankers’ hearts via its tax deductible interest expense. Issuance costs and ongoing expenses have decreased markedly over time as the investor community has welcomed the pooled issues of trust preferred. Now the decrease in overall costs is leading many early issuers to execute refinancing transactions.

Opportunity Arrives
Most trust preferred issues are structured with a five-year call provision with the issuing bank holding the option. Issuers in the 2001 and earlier era are taking advantage of their first five year call date, and calling in issues on which they paid very high fixed rates or floating rates in the area of three-month LIBOR, plus 300 basis points. Current floating rates are in the area of LIBOR plus 135 basis points to LIBOR plus 150 basis points, depending on individual circumstances and structure. Another recent development in trust preferred rate structure is the use of hybrids. One example might be an issue in which the interest rate is fixed for the first five years at

Growth in Pooled Bank TPS Issuance
$12.8 billion of TruPS issuances from small to mid-sized banks and thrifts will be callable from 2006 through 2010

the five year swap curve rate plus 135 basis points to plus 150 basis points, and then converts to a quarterly floating rate of LIBOR plus a similar margin for the remainder of the term to maturity, assuming the issue is not subsequently called.

Early issuers who missed their first call date should check their issuance documentation, as most allow the issue to be called at any interest payment date after the first call date. It is also worth noting that trust preferreds, unlike traditional preferred stock, have a 30-year maturity date with call options after five years.

**Time to Cash In?**

It is estimated that as much as $6 billion of trust preferred stock was issued in 2001. The refinancing activity for these issues is beginning in earnest. ICBA Securities, ICBA’s portfolio management services corporation, is active in assisting in this process and has facilitated refinancing transactions by helping banks enter into pooling agreements.

Further abetting the re-issuance process is the fact that underwriting, trustee and legal fees are being absorbed by the underwriter. When trust preferred issuance was in its infancy, these fees were borne by the issuing holding company and were significant (frequently accounting for three percent of the issuance amount). Any unamortized fees paid on the original issuance date (typically written off over periods much longer than five years) should be considered in determining the cost/benefit or break-even date for the refinancing.

ICBA Securities has developed a spreadsheet analysis to help determine the economic benefit derived from refinancing to a lower rate and immediately expensing unamortized fees from the original issue. Our analysis to date has generally indicated that refinancing provides a breakeven point slightly beyond one year (when incorporating the expensing of unamortized fees), with very significant cost savings over the first five years (the new call date) of the new issue. For a $5 million issue, refinancing from LIBOR plus 300 basis points to LIBOR plus 140 basis points provides a cost savings of $80,000 annually or $400,000 over the first five years in interest costs alone.

Further, some early issues waived trustee fees for the first five years, beyond which point the issuing holding company bears responsibility for paying these fees. Refinancing could help the issuer to avoid these costs.

**Low Costs, High Benefits**

When compared to earlier issuers, the holding companies today are issuing trust preferreds in a lower interest rate environment and at lesser spreads to LIBOR or the swap curve. Motivations for issuing trust preferreds vary but could include:

- Funding a stock buyback while maintaining regulatory capital levels;
- Buying back stock to convert to “S Corp” status;
- Buying back ESOP stock in a “going private” or “S Corp” conversion;
- Increasing regulatory capital to support core growth; and
- Increasing regulatory capital for leverage and ROE improvement.

Determining the need for additional regulatory capital can be aided by a planning model. Such a model can also serve as the presentation tool for the board of directors. Once need is determined, the issuance process is simple and typically involves completing a due diligence questionnaire and having a due diligence telephone review with the collateral manager for the pool. Assuming approval from the underwriter, the remainder of the process—which entails receiving and approving a term sheet and securing funding—typically takes 10 business days or less. Since this is not a transaction that many community banks have entered into before, it is essential that the analyses to determine the need, and the presentation to the board of directors, are thorough and well documented.

If you would like to have your bank analyzed by ICBA Securities’ investment strategies department to determine the benefits for trust preferred issuance, or to calculate the economic viability of exercising a call option on an existing issue, call (800) 422-6442.

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