Community Banks Discover Benefits of Trust Preferred Securities

By Wynne R. Comer

Large bank holding companies have issued trust preferred securities into the capital markets for years because of the benefits these securities provide: tax deductible payments and Tier 1 capital treatment without diluting returns to shareholders.

In the fall of 1996, the Federal Reserve authorized the use of trust preferred securities for banks. Trust preferred securities are debt-like instruments issued by trusts that are wholly owned subsidiaries of bank holding companies or banks.

Since then, national institutions have been economically issuing these securities in large amounts over which to spread the relatively fixed cost. At present, Citigroup is the No. 1 underwriter of trust preferred securities for large issuers.

Now a growing number of community banks are trying trust preferreds as well. Citigroup has a long tradition of providing services to small and mid-sized banks. Through a new partnership with ACB, Citigroup will extend that role to assisting ACB member banks in raising cost-effective Tier 1 and Tier 2 capital with the latest version of its Mini-TruPS® program.

Early on, Citigroup recognized that small and mid-size banks could benefit from this type of capitalization, but that it would not be economical due to the high fixed costs relative to the small sizes that such banks would issue. In addition, a significant premium would be required to compensate investors for the lack of liquidity, lack of ratings and limited information available about the institutions.

Unwilling to let a good idea die without a fight, Citigroup conducted an extensive study of the banking industry to try to establish a method of economically bringing this product to smaller issuers. As expected, research conducted by Citigroup over the course of more than a year revealed that, despite the absence of a rating by one of the national rating agencies, small and mid-sized banks are well managed and sound institutions to be envied by other industries for their safety.

From this research a portfolio structuring team developed the first pooled trust preferred transaction, which closed in March 2000. In a pooled transaction, many smaller banks issue their securities at the same time and under the same terms. As a result, significant economies of scale can be achieved by all of the issuers, as the fixed costs, although slightly higher, can be spread over a much larger issuance size.

The pool was designed to spread risk by the main location of the bank holding companies. By dividing banks into five different geographic regions, the research indicated to Moody's and Fitch, two of the national rating agencies (later to include S&P, a third national rating agency in subsequent transactions) that a pool of smaller size banks that is diversified in five geographically distinguished regions was similar in characteristics to a pool of investment grade securities of companies operating in five different and uncorrelated industries. The transaction was then structured in which a special purpose company issued debt and equity securities to finance the purchase of the pool of trust preferred securities.

This first transaction, named Regional Diversified Fund Ltd., changed the capital-raising landscape forever for smaller banks and was hailed in several industries as a pioneering transaction. It was the spark that initiated a booming market for trust preferred securities.

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Since 2000, the cost to smaller issues of these securities has declined because spreads have narrowed in response to the growth in demand for the product. This, in addition to the current historically low interest rate environment, has provided added economic incentives to issuers to issue trust preferred securities, as issuers seek to lock in low interest rates for long term financing.

Since its first transaction in 2000, Citigroup has participated in raising over $3 billion for small and mid-sized banks, and the market has continued to grow. With its new program, Citigroup is taking a lesson from smaller banks. Many smaller banks originate mortgages and after a significant amount of accumulation, the mortgages are sold to raise cash to fund new originations within the local community. Citigroup is taking the same approach with trust preferred securities.

Instead of tying the trust preferred issuance directly to a pooled transaction, Citigroup funds the securities immediately and accumulates them on its balance sheet for a pooled transaction. Issuers are therefore indifferent to timing or the terms of the pooled transaction and can fund their capital needs when it is most convenient for them.

Another benefit to issuers is the streamlined documentation process. Rather than having to craft new documents for each transaction, Citigroup provides standardized documents that require little work by issuers. Finally, the trustee fees that would normally be an ongoing cost to issuers are paid for by the pooled transaction.

Members of ACB will receive significant benefits in issuing securities through Citigroup including competitive pricing for members, certainty of execution, and timely funding unrelated to a pooled transaction.

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