FINANCIAL INSTITUTIONS DEVELOPMENTS

Potential Opportunities for Issuers of
Trust Preferred Securities Under the Collins Amendment

The Collins amendment contained in the proposed Dodd-Frank Wall Street Reform and Consumer Protection Act has been well publicized as a result of the provisions that would, effective after a three year phase-in beginning on January 1, 2013, eliminate trust preferred securities as Tier 1 capital for bank holding companies that had $15 billion or more in assets as of December 31, 2009. Less widely recognized is the potential opportunity, in connection with the enactment of the Act, for bank holding companies to redeem their TruPS on an accelerated basis and to mitigate – at least in part – the potential resulting capital structure inefficiencies.

TruPS, with both Tier 1 equity credit and tax deductible distributions, grew very popular following the Federal Reserve’s determination in 1996 to permit Tier 1 treatment for bank holding companies. However, with the prospective loss of Tier 1 equity credit, TruPS – which typically bear a relatively high coupon – will become an expensive form of capital relative to other Tier 2 securities. Because TruPS were intended to serve as quasi-permanent capital, they have maturities of 30 years or more and limited redemption rights. However, for these very reasons, many TruPS indentures and trust agreements provide a window of time for special redemption rights in certain circumstances, including in the case of “regulatory capital events.” These are typically defined to include a change in law or proposed change in law giving rise to a “more than insubstantial risk” of impairment of the issuer’s ability to treat the TruPS as Tier 1 capital. Thus, while the Collins amendment may result in bank holding companies with significant levels of TruPS having to raise additional Tier 1 capital, the TruPS documentation will in many cases provide a route to early redemption.

While a careful analysis of the documents and circumstances should be conducted prior to reaching any conclusions as to the impact of the Collins amendment on the redeemability of a particular series of TruPS, the capital treatment redemption right may arguably be triggered on at least three separate occasions: the passage of the Act; the adoption by the Federal Reserve of the rules implementing the Act; and the actual loss of Tier 1 treatment. Thus, well capitalized institutions should have the opportunity to move quickly if they so desire, while other institutions should also able to redeem their securities at a later date when capital may be less of a challenge. Because of the TruPS’ relatively high yield, holders may seek to legally challenge redemption efforts.

Under current Federal Reserve guidelines, any redemption of TruPS securities will require prior regulatory approval. Moreover, a number of issuers entered into “replacement capital covenants” in connection with some TruPS issuances in order to obtain better rating agency treatment for the securities. Under these covenants, which vary to some degree among securities, redemption (notwithstanding any accelerated
redemption rights) is subject to raising specified levels of common stock or other securities having sufficient equity-like characteristics to satisfy the covenant terms within the six months prior to redemption (e.g., a sale of common stock for proceeds equal to 75% of the proposed aggregate redemption price within the six months preceding redemption). While the replacement capital covenants are often designed to prevent “double counting” any single replacement equity raise in connection with the redemption of any particular series of TruPS, they generally would not prevent an equity raise undertaken for purposes of repaying Treasury TARP preferred securities from counting towards a replacement capital obligation. Of course, all redemption plans would need to be discussed with the regulators as part of the approval process.

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