Trust Originated Preferred Securities

Background

On October 21, 1996, the Federal Reserve Board announced that bank holding companies could treat certain kinds of tax-deductible preferred securities as equity capital, or Tier 1 capital. As such, these securities can now be treated as equity on the balance sheet and interest payments made on these securities are therefore tax deductible. This allows companies to receive cheap equity financing by issuing Trust Originated Preferred securities.

Structural Features

Trust Structures

In a typical trust structure, the ultimate obligor creates a legal, wholly-owned subsidiary known as a statutory business trust (the "issues"). The obligor, at the holding company level, issues junior subordinate debt to the issuer. In turn, the issuer sells trust participation certificates to the investor. Interest on the junior subordinate debt is paid by the obligor to the subsidiary. The issuer then uses the interest payments received from the obligor to make interest payments on the trust participation certificates held by the investor. Interest on the participation certificates accrues daily and typically pays semi-annually. The certificates trade with price plus accrued interest, which is an important debt-like characteristic.

Interest Deferrals

Interest payments on bank originated preferred securities may be delayed for up to five years without the issuer being considered in default. However, the suspended payments are cumulative, and must be paid at the end of five years. In the case a payment is delayed, the bank is not allowed to make dividend payments on other preferred and common stock.

Trust Originated Preferred Securities

Liquidation Preference

In the event the trust must be liquidated, most structures convert to junior subordinate debt at the bank holding company level.

Tax-Call Structure

In the typical structure, trust originated securities have a final maturity of 30 years and are non-callable for the first 10 years. In addition, most trust securities can be called immediately at a make whole premium or par if the securities' tax-advantage status is eliminated by Congress.

Summary of Structural Features

	Typical Features	Alternative Features
Maturity	30 year	40 year / 49 year
Call feature	Callable in 10 years	NC5/NC Life
Tax-Call Structure	Make whole to call date UST + 125 in year 1 UST + 50 thereafter	Par Call
Form of Offering	144A	Public
Registration Rights	Yes/no	Public
Subordination	Junior to subordinate debt senior to preferred stock	Same
Coupon Frequency	semi annually	monthly/quarterly
Coupon Delay	5 years-cumulative	same

Trust Originated Preferred Securities

Relative Value

Trust originated preferred securities trade at a yield premium to 30-year bank subordinate debt because they are junior to bank subordinate debt and senior to bank preferred stock. TOPR's are also callable and carry the 5-year interest contingency, which adds to the premium. Taking into account these factors, we arrive at a fair value of +140.

Bank 30 year single – A subordinate debt	+95
Subordination premium	5
5 year interest deferral	5
spread volatility premium	5
credit curve premium	5
call premium	25
"Fair Value"	+140

Recent Events Affecting Trust Securities

In August, 1996, President Clinton initiated several major policies which he planned to fund through the decrease of the dividend received deduction (DRD) for corporations, as well as prohibiting issuers from deducting the interest on bonds with long dated maturities. This loophole was expected to close when Congress reconvened in February 1997. Although it remains open, it is expected that the interest deduction on trust preferred securities will be eventually eliminated and that the outstanding issues will be grandfathered.

If these two events take place, the value of the 10-year call option on trust securities will be come worthless to the issuer. Since the value of the call option is approximately 25 basis points, in theory trust securities would tighten by this amount when the legislation is adopted.

Trust Originated Preferred Securities

Conclusion

We believe there is a high probability the Government will eliminate the current loophole existing with Trust Preferred Securities, and grandfather the previously issued securities. If this occurs, the value of the call option will decline to zero and investors would receive a rapid capital appreciation on a long duration security. Therefore, we feel that there is an excellent relative value opportunity for investors.

If the Government were to close the loophole, and not grandfather existing issues, outstanding bonds would be subject to a par call, which would still be of value to the investor.