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With Apologies to Jan Brady: Capital, Capital, Capital

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In the '70s sitcom *The Brady Bunch,* Jan Brady had a preoccupation with her older sister, Marcia. Oftentimes she would exclaim in exasperation: "Marcia, Marcia, Marcia." In this environment, bankers can be excused for a similar type of fixation; only in this case it is with capital.

Even banks that by all reasonable prior metrics were not leveraging their capital enough (as recently as 2007, they were called "overcapitalized") are now focused on building up their capital base. Capital provides many benefits in the current environment.

Capital needs to be sufficient to:

- address asset problems,
- provide a margin of error to take risk on loan originations and securities purchases,
- expect the unexpected,
- provide a halo for tougher regulatory examinations,
- fund stock repurchases at low price levels, and
- serve as opportunity capital for growth.

Today's question is not does a banker need more capital, but what capital is available? This article discusses the alternatives for capital and the pros and cons of the respective types of securities.

Real Estate Gains

For Subchapter S holding companies, we have developed a structure that avoids many of the drawbacks associated with sale/leasebacks of bank premises. In particular, this structure enables a bank to capture most of the gain in the value of such real estate immediately, rather than over the term of the lease. We have a patent pending for this business process and one of our clients has already engaged in such a transaction.

Bank Stock Loan

Bank holding companies of more than $500 million in total assets are required to maintain a leverage ratio of at least 4% (and generally 5% for growing organizations), a Tier 1 to risk-weighted assets ratio of 6% and a total capital to risk-weighted assets ratio of 10%, all on a

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consolidated basis. Below this threshold, bank holding companies are subject to a leverage limitation (essentially 100% debt to holding company equity) and a requirement that a subsidiary bank remains well capitalized. In contrast, thrift holding companies do not have quantitative holding company capital or leverage requirements.

Smaller organizations, which represent the vast majority of bank holding companies, can borrow funds at the parent level and contribute such funds into the subsidiary financial institution as capital. The loans are secured by the stock of the subsidiary. Obviously, interest on bank stock debt is tax deductible. The traditional sources of such loans — correspondent banks and bankers banks — are still the best bet, but a bank or thrift holding company ("HC") can borrow from anyone, often with fewer representations and covenants.

Debentures – Overview

The Federal Reserve provides that subordinated debentures that have an average weighted maturity of at least five years count as Tier 2 capital subject to a limitation equal to 50% of Tier 1 capital. Subordinated debentures must be unsecured and pari passu (of an equal preference) with other subordinated debt. There are also other technical requirements for indebtedness to count as Tier 2 capital.

The interest on the subordinated debentures is tax deductible as would be the case with distributions on the trust preferred securities discussed below. Subordinated debentures typically have maturities between seven and twelve years. If the investor has "an option to put" the securities back to the company, the term is based on the timing of such right. Debentures are typically interest-only and can be floating or fixed rate.

Alternatives

Correspondent Banks. The investor market for subordinated debentures includes some large correspondent banking institutions. Certainly the market for such indebtedness from traditional bank stock and other lenders is less robust than it was a year ago at this time. Nonetheless, the possibility of obtaining such funding still exists. We have helped correspondent lenders to design secured facilities that would still qualify as subordinated indebtedness for Federal Reserve capital purposes. Such facilities would provide greater availability for HCs to borrow debt structured as Tier 2 capital.

Other Issuances. Alternatively, a HC could consider a public offering or an exempt offering, such as a Rule 144A offering or a private placement on a retail or institutional basis to raise the requisite funding. These options are discussed below under "Trust Preferred Securities."

Trust Preferred Securities – Overview

Trust preferred securities are securities that are treated as debt for tax purposes, but which count as Tier 1 capital, within limits, for regulatory purposes. A trust preferred securities issuance would not reduce an existing shareholder's ownership interest. In essence, an issuance of trust preferred securities is a borrowing. The payment of interest on trust preferred securities is generally deductible for tax purposes, yet such securities, within limits, count as capital as discussed below.

The debentures and the preferred securities would have identical terms. In general, trust preferred securities are long-term (30+ years) instruments. Typically, trust preferred securities will have a floating or a fixed interest rate, with interest payable quarterly. The entire principal will be due at maturity. Such securities are typically "noncallable" by the issuer of such securities, for a minimum of five years after issuance (this is an investor preference). The issuer of such securities must retain the right to defer the payment of interest for five years. Distributions on such securities, however, are typically cumulative. Accordingly, the obligation to pay the distributions does not go away; it simply is deferred.

Terms (Other Than Financial Terms) of Trust Preferred Issuance. To reiterate, the terms of trust preferred securities are as follows:

- *No Financial Covenants*. The HC will not be subject to any financial covenants, such as debt/equity, classified assets to gross capital funds, past due, capital adequacy or any other such ratios or limitations.
- *No Amortization*. The trust preferred securities are nonamortizing. Instead, the HC pays interest only for 30 years.
- *Deferral Right*. The HC would have the right to defer making even the interest payments for five years or 20 consecutive quarters. It is true that the interest payments would continue to accumulate, but if the HC had cash-flow difficulties, it could go without making any payments for quite a number of years without being in default under

the instrument. Many HCs have deferred such payments in the past year.

- *No Guarantees*. There are no personal guarantees required regardless of the amount of the trust preferred issuance.
- *No Holder-Mandated Redemption*. The holder of the security cannot require that the HC redeem the securities.

Capital Treatment

Trust preferred securities, when coupled with all other preferred-type instruments issued by a HC, that can count toward Tier 1 capital are 25% of pro forma capital. In other words, the securities can represent 25% of Tier 1 capital (net of goodwill unless grandfathered) elements after the securities issuance. Any additional amounts count as Tier 2 capital.

Comparison

Private Offering. There are a number of alternatives for a HC to consider in issuing trust preferred securities or debentures. A HC can engage in a nonpublic offering either to "accredited investors," or an offering that is otherwise exempt from registration. Accredited investors are: (i) investors with a net worth of one million dollars, (ii) investors with earnings each of the last two years in excess of $200,000 ($300,000 if joint earnings) and expected earnings in excess of $200,000 the coming year or (iii) certain types of entities. The HC can alternatively engage in an exempt offering under Rule 144A to qualified institutional buyers ("QIBs").

In a Rule 144A transaction, the issuer relies on the same exemption from registration as described above. The difference is that Rule 144A exempts subsequent resales of the securities when resold to QIBs. This can enhance the attractiveness of the securities by mitigating the embedded marketability discount on securities sold in private placements. In most cases, our clients have either found their own investors or hired an investment banking firm to assist them.

What we are seeing in this environment is investors are again in search of yield. As a result, a private debenture, trust preferred or preferred stock (discussed below) offering may be attractive if the company could find its own investors. We are working with a number of issuers on such transactions. These transactions tend to be priced at the prime rate with a floor of 5%. We have had clients who have been successful in marketing such securities with ceilings as well.

Public Offering. To the extent that the HC is public and it anticipates making frequent public offerings of its securities, it may decide to file a shelf registration under Rule 415 (assuming that it meets the standards for a shelf registration). A shelf registration covers securities that are not necessarily sold in a single discrete offering immediately upon effectiveness, but rather are proposed to be sold in a number of tranches over time or on a continuous basis. A universal shelf can register debt, equity and other securities on a single shelf registration statement, without having to specify the amount of each class of securities to be offered. With a shelf registration in place, the HC has increased flexibility to raise money without the need of further SEC clearance. There is also a considerable saving in paperwork, since only a prospectus supplement need be filed with the SEC.

Rights Offering. A HC may consider a rights offering to existing shareholders as a means to raise additional capital. The rights offering could either be registered with the SEC or, if an exemption from registration were available, as a private offering. In a rights offering, the HC allows existing shareholders to purchase their pro rata share of the securities offered. For more information about rights offerings, see our Hunton & Williams Client Alert from Fall 2008.

PIPEs. In a PIPE offering, which stands for "private investment in public equity," a public company issues securities in a private placement to selected accredited investors, normally QIBS or other institutional accredited investors. As a part of the securities purchase, the issuer agrees to file a resale registration statement covering the resale of the securities within a period of time following the closing. This allows the holders of the securities to gain liquidity while allowing the issuer to receive the capital without the delay of an SEC registration process.

Exchange Offers. A version of a Rule 144A transaction, described above under "Private Offering," is the Exxon Capital Exchange Offer transaction (the "Exchange Offer"), named after the first company to do it. The Exchange Offer is a financing technique in which an issuer offers securities in a private placement, and agrees to exchange the privately issued securities for registered securities within a certain period after the closing of the private placement. The registered securities have terms identical to the privately securities, except that the registered securities

are not subject to resale restrictions of the type applicable to the privately issued securities. Prior to the filing of a registration statement, the initial purchasers (typically investment banks) can resell the privately issued securities, without a SEC registration, to QIBs, to institutional accredited investors and, in many instances, to non-U.S. persons.

The Exchange Offer transaction would allow the HC to bring a transaction to market quicker than a registered offering because it avoids the SEC registration process, which can be lengthy. In addition, the Exchange Offer permits the HC to obtain similar pricing to those of a registered public offering because this type of private placement is more attractive to institutional bond purchasers that may be reluctant to be subject to the resale restrictions of traditional private placements and may prefer the liquidity of a freely transferable security.

Advantage of Debentures Over Trust Preferred Securities. Trust preferred securities count as Tier 1 capital (within limits) and Tier 2 capital (beyond those limits), which is an advantage of such securities over subordinated debentures (which are only Tier 2 capital). Now that the trust preferred pools are essentially "dead," there are few issuances of trust preferred securities. Such issuances are typically on a stand-alone basis. Still, the 30-year duration of such instruments and the deferral features are not attractive to investors. Accordingly, it is more realistic to seek to raise funds in the form of subordinated debentures or even senior debt.

Preferred Stock

Preferred Stock. As evidenced by the Capital Purchase Program under TARP and numerous news reports, many investors prefer to make investments of preferred stock in financial institutions. Preferred stock gives the holder a preference over common stock for dividends and in the event of liquidation. Many large financial institutions have issued preferred stock convertible into common stock at the option of the holder. The preferred stock may be cumulative, allowing the HC not to pay dividends, but requiring all dividends due to the holder to be paid before common stock holders receive any dividends. Investors in preferred stock are usually private equity or other sophisticated investors who may require additional features such as redemption rights, board rights and antidilution protection.

Unlike interest on debt securities, dividends paid by an HC on preferred stock are not tax deductible. Coupons on recent preferred stock for public companies have ranged from 5% to over 10% of the par value of the preferred stock. In addition conversion premiums can be heavily negotiated by investors and often result in conversions below market price. Preferred stock must be noncumulative to qualify as Tier 1 capital at the HC. As such, a HC may be able to justify the higher cost as compared to debt if necessary to improve the HC's leverage or Tier 1 risk-based capital ratios.

Other Securities. Institutions have been issuing debentures with payment in kind features in the form of shares of common or preferred stock in the event an issuer cannot pay interest with cash.

Summary

Our expectation is that the most likely source of funding for a debenture offering would be correspondent banks. For trust preferred securities and preferred stock offerings, the opportunity is probably a retail offering either with or without an investment banker. Nonetheless, some of our clients have had success with exempt offerings of debentures, trust preferred securities and preferred stock, on a retail basis. Such issuances provide the HC with flexibility on terms and structure. Lastly, for Subchapter S banks, a real estate spinoff may fit their circumstances.

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