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Trust Preferred Securities (TruPS)

Overview

Regulatory implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA, P.L. 111-203) has brought trust preferred securities (TruPS) to congressional attention. The Volcker Rule (section 619 of the DFA), as issued in December 2013, may force banks to divest certain TruPS that they already participate in. Banks have asked Congress to address the treatment of TruPS under the Dodd-Frank Act, and have challenged agency rulemaking in court. This note describes TruPS and discusses related policy issues, including bank leverage and the relationship between banks and risky investment firms.

What is a TruPS?

A trust preferred security is a hybrid investment instrument (combining features of equity and debt) issued by a trust. To create a TruPS, a firm establishes a trust, puts debt in it, then has the trust issue preferred securities. The preferred securities issued by the new trust are the TruPS, not the debt deposited in the trust, although TruPS themselves can be held in a trust which then issues new securities. TruPS typically pay a quarterly dividend, are redeemable by the issuer, and have long terms to maturity. Although taxed as debt, TruPS also constitute part of the capital of bank holding companies (BHCs), including for small banks.

Although any firm can create a trust that issues TruPS, BHCs are particularly attracted to the investment instrument because of tax and regulatory capital treatment. Two policy issues associated with bank-related TruPS are (1) BHC issuance and use of TruPS to increase bank leverage and (2) bank ownership of TruPS that might form an impermissible relationship with risky investment firms.

TruPS, Bank Leverage, and the Collins Amendment

The Collins Amendment (section 171(b)(2) of the DFA) attempts to address bank leverage. This issue relates to a banking organization issuing TruPS to fund itself, as opposed to holding TruPS issued by other organizations. One measure of leverage is the ratio of a bank's debt to its capital. Prior to 2010, the regulator of BHCs (the Federal Reserve) gave more favorable capital treatment for TruPS than the regulator of depository bank subsidiaries (the FDIC). Banks could take advantage of this differential regulatory treatment to increase leverage.

The potential for increased debt by the banking organization can be illustrated with an example. A BHC could issue TruPS at the holding company level and use the proceeds to buy common stock issued by its depository subsidiary. In this example, the common stock issued by the depository subsidiary would receive tier 1 status from the FDIC and the TruPS issued by the holding company would receive tier 1 status (up to a limit) by the Federal Reserve, even though the FDIC would not have given the TruPS as favorable capital treatment if they had been issued by the depository itself. From the FDIC's perspective, the banking organization would become more leveraged (because the FDIC is emphasizing the debt-like characteristics of the TruPS hybrid security), yet the capital standing at the holding company and depository levels would not fully reflect the higher risk of the institution.

Figure 1. TruPS used as Capital by Bank Size (2010)

Bank Size by Assets Held	% of TruPS in Tier 1 Capital
$100 Billion +	11.80%
$15 - $100 Billion	7.00%
$1 - $15 Billion	11.30%
$500 Million - $1 Billion	10.10%
Less than $500 Million	13.00%
All Reporting BHCs	11.20%

Source: Created by CRS using data from FDIC *Supervisory Insights*, winter 2010 available at http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/SI_Wtr10.pdf

There is evidence that TruPS were a common method of funding banks. A 2010 study of TruPS by the FDIC found that banks of all sizes included TruPS in their capital, and that TruPS constituted 13% of the tier 1 capital of BHCs for the smallest class of banks. (See Figure 1).

The Collins Amendment sets the more strict depository subsidiary regulatory treatment of hybrid securities at the time of passage of Dodd-Frank as the floor for capital treatment by the holding company regulator. Thus, the Dodd-Frank Act reduces the potential for a BHC to use TruPS for a more favorable treatment than would be received if the depository subsidiary were to raise the same funds from TruPS itself, although the Collins Amendment has some exemptions for smaller banks.

TruPS and the Volcker Rule

In addition to prohibiting proprietary trading, the Volcker Rule limits the relationships that banks can have with risky investment institutions. Are trusts that issue TruPS covered

firms within the meaning of the Volcker Rule? If so, do the equity-like features of hybrid securities such as TruPS constitute an impermissible relationship between a bank and the trust that issued the TruPS? For CDO-TruPS (described below), the December rule answered both of these questions in the affirmative. As a result, banks that own CDO-TruPS have to divest themselves and reclassify CDO-TruPS as being available for sale. Rapid divestiture could trigger losses through fire sales, and reclassification may force immediate recognition of losses under accounting standards. Banks have responded by challenging the rule in court and by asking Congress to address bank ownership of TruPS.

(The Collins Amendment) "...(2) MINIMUM RISK-BASED CAPITAL REQUIREMENTS.—The appropriate Federal banking agencies shall establish minimum risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Board of Governors. The minimum risk-based capital requirements established under this paragraph shall not be less than the generally applicable risk-based capital requirements, which shall serve as a floor for any capital requirements that the agency may require, nor quantitatively lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions as of the date of enactment of this Act. DFA, section 171(b)(2)

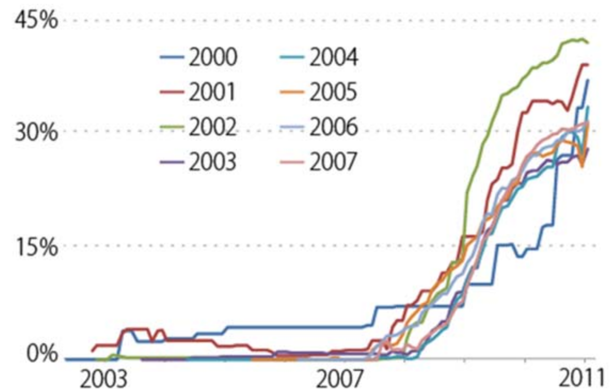
CDO-TruPS

As mentioned above, not only can a trust be formed to issue TruPS, but a trust can be formed to acquire and hold TruPS themselves, and then issue new securities. One example is a collateralized debt obligation (CDO) that results from pooling TruPS issued by small and mid-sized banks. Small and mid-sized banks argue that these CDO-TruPS allow them to access capital markets on more favorable terms than if securities investors had to evaluate each bank individually. Some banks own CDO-TruPS.

The holder of a CDO-TruPS is indirectly exposed to the market for the class of assets held by the trust. In the case of bank CDO-TruPS, many small and midsized banks have relatively high concentrations of commercial real estate. Therefore, holders of these CDO-TruPS are likely to experience losses if legacy problems in commercial real estate markets cause regional bank losses.

Researchers at the Federal Reserve Bank of Philadelphia did a study of bank CDO-TruPS in 2011. They found that the legacy problems in commercial real estate have already caused unrealized losses in bank CDO-TruPS. "Using data and valuation software from the leading provider of such information, we estimate that large numbers of the subordinated bonds and some senior bonds will be either fully or partially written down, even if no further defaults occur going forward." Figure 2 shows their estimation of cumulative defaults by year of origination for CDO-TruPS.

Figure 2. TruPS CDO Cumulative Default as % of Balance



Source: Edited by CRS from http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-22.pdf

Issues Before Congress

Banks argue that they will experience significant losses if they are forced to divest themselves of CDO-TruPS by the summer 2014 conformance deadline and reclassify CDO-TruPS in their accounting statements. Congress could amend section 619 to exempt CDO-TruPS originated or acquired before a particular date. Extending the conformance period could address fire sales, but not accounting reclassification. On the other hand, commercial real estate losses might mean that a date-based exemption might merely delay the recognition of existing losses.

Community banks argue that TruPS in general, and CDO-TruPS in particular, are a useful means to raise capital, and that the December 2013 Volcker Rule puts them at a competitive disadvantage compared to larger institutions. It could also be argued that fears that banks might misuse TruPS to increase leverage are addressed by the Collins Amendment, although small banks have some exceptions. Congress could provide an exception based on bank size. Some who advocate for such an approach argue that small banks did not cause the recent financial crisis. On the other hand, smaller financial institutions were a significant part of the Savings and Loan Crisis.

Congress could wait until regulators and the courts have dealt with the issue, although the accounting issue is immediate. Regulators announced they would reconsider the treatment of TruPS under the Volcker Rule. The courts have not as yet ruled on the challenge to the December rulemaking.

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