DBRS Criteria: Bank and Bank Holding Company Trust Preferred Securities

MAY 2006

Insight beyond the rating.

Policies & Procedures

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Overview:

Trust Preferred Securities ("TP Securities") essentially represent a vehicle where long-dated junior subordinated debentures are wrapped with covenants that allow payment deferral under certain circumstances. U.S. banks and bank holding companies ("BHC") have found that TP Securities provide an important part of their capital structure by satisfying the following objectives:

(1) Subject to certain limits, TP Securities are treated as Tier 1 capital by U.S. banking regulators, thereby increasing regulatory capital without any earnings per share dilution related to the issuance of common stock;
(2) The interest payments on the deeply subordinated debentures used in the Trust structure are a tax-deductible expense; and
(3) The scale and extent of issuance by U.S. BHCs reflects the combination of equity capital treatment by the regulators and the tax-advantaged nature of these instruments that lowers their cost in the capital markets.

This policy outlines the structure and key features of TP Securities, how DBRS assesses their equity value, and the approach used by DBRS in assigning ratings to the TP Securities, all from the perspective of the issuer being a banking entity.

<u>Base Structure:</u>
● TP Securities are issued out of a Trust, typically wholly owned by a BHC, although issuance from other industries has occurred.
● The assets in the Trust typically consist of junior subordinated debentures of the BHC.
● The Trust is formed for the sole purpose of holding the debentures and issuing TP Securities, which have identical terms to the subordinated debentures in maturity and payment requirements.
● The BHC guarantees that payments made on the debentures to the Trust will be flowed through in payments to the TP Securities.
● While not perpetual, the TP Securities have a long maturity, typically in the 30-year range, and are non-amortizing over that period to make the securities more equity-like from the regulators' perspective.
● Eligibility for tax deductibility constrains the maturity of the debt. Very long-dated debt or perpetual debts are treated as equity for tax purposes.

<u>Deferral Ability:</u>
● So long as the BHC is not in default on the debentures, it may elect to defer interest payments on the debentures for up to five years on one or more occasions (but not beyond the maturity of the debentures), without triggering a default.
● Deferring debt payments would trigger payments on the TP Securities to also be deferred.
● During any such period of deferred payments, the BHC may not pay dividends or repurchase securities ranking at or below the junior subordinated debentures.
● Payments missed on the TP Securities and the junior subordinated debentures are cumulative.

<u>Other Noteworthy Features:</u>
● After a period that is typically five to ten years, the BHC may call the debentures, which would cause a similar call on the TP Securities, but any such prepayment action must be approved by regulators.
● TP Securities typically have no voting rights.
● Subject to certain limits, TP Securities are treated as Tier 1 capital from a regulatory perspective.

DBRS View of Equity Value:

In general, the way in which DBRS views TP Securities for banks is consistent our treatment of non-cumulative perpetual preferred shares. Specifically, DBRS takes the view of effectively agreeing with the treatment provided by U.S. regulators, although we also track the banks' overall mix of capital relative to common equity. We view lower dependence on TP Securities and other "hybrid instruments" as positive for an issuer.

It is important to note that, in the view of DBRS, non-cumulative qualifying perpetual preferred shares are clearly a stronger form of equity than is the case with TP Securities. The differences between the perpetual preferred and the TP Securities include the key areas of permanence (perpetual status versus 30-year term), subordination (preferred equity versus junior subordinated debentures), and loss absorption (non-cumulative versus cumulative).

DBRS does acknowledge these realities, and, in general, banks with higher mixes of TP Securities would be viewed less favourably than banks with more common equity or non-cumulative preferred securities. However, in most cases, the difference is not viewed as a major rating consideration and, in reality, it is rare that different mixes of securities within Tier 1 capital would cause a difference in the ultimate ratings of the bank or its BHC, as the major stress for DBRS in weighing the value of these instruments is the regulatory treatment. In combination with the long-dated nature of the instrument, the regulator has the power to pressure banks to use deferrals when needed and can prevent early redemption actions. These realities mean that DBRS attributes a much higher equity weight to TP Securities used by banks and BHCs than would be the case when similar securities are issued by companies outside of the regulated financial services area.

Rating the Instrument:

Based on the structure and terms, DBRS views the credit strength of TP Securities to be equivalent to the rating strength of the junior subordinate debentures that a trust holds. Ratings on the junior subordinate debentures would incorporate both the strength of the overall BHC (with recognition for the fact that this issuer is a holding company) and the ranking of the junior subordinated debentures in the capital structure.

For TP Securities issued by U.S. banks, the rating that DBRS assigns to the junior subordinate debentures (and, hence, the TP Security) is the same rating that DBRS would assign to the subordinated debt of the issuing bank or BHC. Notwithstanding the reality that the junior subordinated debt is ranked lower, this is DBRS policy for the following reasons:

(1) DBRS analysis of default and recovery rates supports the opinion that the differences between subordinated debt and junior subordinated debt do not warrant a rating notch difference, particularly when consideration is given for the fact that subordinated debt is already rated one notch below senior debt and that any preferred equity ranking below the junior subordinated debt would be notched down by one level.
(2) Regulatory rules restrict the amount of TP Securities that count as Tier 1 capital for banks in the United States.
(3) Notwithstanding different ranking, covenants, and terms, there is some comparability between TP Securities and subordinated debt in that both are viewed as elements of capital from a regulatory perspective.
(4) DBRS does not view the ability to defer payments as a credit risk, but rather, a risk that holders of the TP Securities have agreed to as per the covenant structure. DBRS would thus not consider "deferral" as being equal to "default" and ratings on TP Securities in a deferral situation would not automatically be assigned a D rating [(1)]. This view means that the ability to defer payments has not resulted in a lower rating for TP Securities.
(5) This approach is consistent with DBRS policy on the equity consideration for hybrids, particularly when account is taken of the role of the regulators and the power they hold. DBRS views on both equity consideration and rating rationale could be meaningfully different for non-regulated, non-bank financial institutions.

[(1)] A security rated D implies the issuer has either not met a scheduled payment or the issuer has made it clear that it will be missing such a payment in the near future. In some cases, DBRS may not assign a D rating under a bankruptcy announcement scenario, as allowances for grace periods may exist in the underlying legal documentation. Once assigned, the D rating will continue as long as the missed payment continues to be in arrears, and until such time as the rating is suspended, discontinued, or reinstated by DBRS.

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