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Legal Updates & News

Legal Updates

Recent Development in Tier 1 Hybrids

January 2008

Related Practices:

- Capital Markets

Last week we were informed by the staff at the Board of Governors of the Federal Reserve System (the "Fed") that they had recently approved a new variation on the WITS structure for Tier 1 bank holding company capital. WITS typically involve the issuance of securities by a trust that evidence a beneficial interest in: (i) a forward stock purchase contract by a trust to purchase noncumulative perpetual preferred stock of the bank holding company issuer; and the (ii) purchase by the trust of long dated junior subordinated notes of the issuer. The trust would remarket the junior subordinated notes at the forward stock purchase date for the perpetual preferred stock in order to obtain funds to fulfill the forward purchase agreement. If the junior subordinated notes could not be remarketed, they would be delivered to the issuer to satisfy the requirement to purchase the noncumulative perpetual preferred stock. Once issued, subject to Fed approval, the noncumulative perpetual preferred stock could be redeemed and replaced with another comparable capital instrument.

To date, the Fed has required the maturity of the forward purchase agreement to be not less than five years, consistent with the 1998 Sidney Agreement of the Basel Committee on Bank Supervision. Last week the Fed staff approved a transaction with a forward three-year stock purchase date. The Fed staff appears to view this shorter maturity of the forward purchase agreement, and the potential accompanying redemption, as enabling bank holding companies to take advantage of potential nearer term reductions in the cost of capital. In other words, if the cost of replacement capital has fallen, why should a bank holding company have to wait five years to replace the capital? Any risk to the bank holding company can be limited by the requirement that any redemption of the noncummulative perpetual preferred stock be subject to Fed approval. It remains to be seen whether this development foreshadows a willingness to consider redemption of noncumulative perpetual preferred stock generally within three years of its issuance.