

Implications of Proposed Bank Capital Regulations for Investors in Preferred Securities

Summary

On June 7, 2012, the Federal Reserve released its long-awaited Notice of Proposed Rulemaking (NPR) on bank capital requirements, along with two related NPRs on rules for calculating risk weighted assets (RWA). Although these rules are not yet final – that will happen after a public comment period and final vote by regulators – they answer many questions investors in preferred securities have been asking since the passage of the Dodd-Frank Act nearly two years ago. If adopted as proposed:

- Traditional DRD/QDI-eligible Preferred stock would be eligible Tier 1 Capital;
- Trust preferred securities (TruPS) would not be eligible;
- Banks would maintain higher levels of common equity to support preferred and debt holders; and
- Banks have begun and will continue to refinance their outstanding TruPS with traditional tax-advantaged preferred stock.

Preferred stock would be eligible Tier 1 Capital

If the rule is passed as proposed, banks would be allowed to count non-cumulative perpetual preferred stock, eligible for the inter-corporate dividends received deduction (the DRD), as Tier 1 capital. Among other requirements, Tier-1-eligible issues would have to be perpetual, subordinated, pay non-cumulative dividends, could be callable no less than five years from the issue date (with no coupon step-up or other incentive to call), and require either replacement or regulatory approval prior to redemption or repurchase by the issuer. Tier 1 preferred securities would be subject to conversion to common equity or write-down (i.e., bail-in) under prospective resolution authority; this would be part of standard disclosure for new issues beginning in January 2013. Government-issued TARP preferred and Tier 1 capital instruments issued under the Small Business Jobs Act of 2008 would be exempt from the above requirements.

TruPS would no longer qualify as Tier 1 Capital

Under the proposal, most trust preferred securities (TruPS) would begin losing Tier 1 capital treatment in 2013. They would receive 75% Tier 1 credit in 2013, 50% in 2014, and 25% in 2015, with full phase-out in 2016.¹ TruPS that no longer qualify as Tier 1 capital generally would continue to count as Tier 2 capital without limit. These preferred securities would also be subject to “bail-in” similar to Tier 1 capital instruments.

Because most, though not all, TruPS have features that allow the issuer to call the security upon a regulatory event – and publication of the NPR qualifies – we expect that many TruPS will be called between now and early 2013. Some TruPS with relatively low coupons may continue to represent attractive Tier 2 capital for their issuers, so not all issues that can be called will be called. Still other issues do not have regulatory calls or have “make-whole” calls that are economically unattractive for issuers; in those cases, issuers will wait until their regular call

¹ TruPS issued by banks with assets of less than \$15 billion as of 12/31/2009 will phase out Tier 1 eligibility over a 10-year period (10% per year) starting in 2013.

dates before redeeming them. As usual in the preferred market, we have to assess the likelihood and timing of issuer calls on a case-by-case basis.

Banks would hold substantially more common equity below preferreds and debt

Banks would be required to hold substantially more capital under the proposals, which closely follow the Basel 3 framework we have discussed in the past. Most importantly from the perspective of investors in preferred securities, the bulk of the additional capital must be in the form of common equity, which supports the credit standing of preferred securities. There are four components of the common equity Tier 1 (CET1) requirement: (i) minimum common equity of 4.5%, (ii) a 2.5% capital conservation buffer, (iii) a countercyclical capital buffer² of 0-2.5% (initially set at 0%), and (iv) a systemically important financial institution (SIFI) buffer³ of 1-2.5%. There are varying phase-in schedules for these new standards, which are summarized in the table below.

Phase-In Schedule of Proposed U.S. Bank Capital Requirements

Capital Requirement (percent of RWA)	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity (CET1)	3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital Conservation Buffer (CET1)	-	-	-	0.625	1.125	1.875	2.5
Countercyclical Capital Buffer (CET1)	-	-	-	0-0.625	0-1.125	0-1.875	0-2.5
SIFI Buffer (CET1)	-	-	-	0.25-0.625	0.45-1.125	0.75-1.875	1.0-2.5
Minimum Tier 1 (including T1 preferred)	4.5	5.5	6.0	6.0+buffers	6.0+buffers	6.0+buffers	6.0+buffers
Minimum Total Capital	8.0	8.0	8.0	8.0+buffers	8.0+buffers	8.0+buffers	8.0+buffers

Note: Buffers are not strict minimum regulatory requirements, but they are required for a bank to avoid restrictions on payments of dividends on common equity and on bonus payments to executives. If a bank is above minimum requirements but below a "minimum + buffers" amount, dividend and bonus payments will be limited according to prescribed schedules in the regulations.

When fully phased-in, the new rules will require that large banks hold at least 9.5% common equity (4.5% minimum equity + 2.5% capital conservation buffer + 2.5% SIFI buffer + countercyclical capital buffer of 0-2.5%) to RWA to avoid restrictions on dividend and bonus payments. This compares to the current regulatory minimum of just 2.5% common equity (although common equity capital at most banks is well above that minimum requirement). Because minimum Tier 1 would be 11% for large banks, we would expect banks to utilize about 1.5% of traditional preferred stock to fulfill the rest of their Tier 1 requirements. In addition, there are more deductions from the regulatory definition of common equity for certain forms of capital under the proposed rules, which would further increase the amount of common equity capital that banks would need to hold.

² The countercyclical capital buffer applies to banks using the "Advanced Approaches" RWA methodology.

³ The SIFI buffer applies to SIFI banks as determined by the Financial Stability Council.

Finally, although the proposed rules on RWA are quite complex, they generally increase the risk weights applied to assets on banks' balance sheets. This means that both the numerator (capital requirement) and denominator (RWA) for bank capital calculations will increase. When the dust settles, we expect that large banks will carry roughly double the amount of common equity capital than they did prior to the financial crisis for a given set of risky assets, adding substantially to the capital cushion beneath preferred securities.

Impact on the Preferred Securities Market

Over time, we expect that banks will replace most outstanding TruPS with DRD-eligible preferred stock. However, the substitution of preferred stock for TruPS will be neither dollar-for-dollar nor simultaneous.

Initially, we expect that many banks will redeem TruPS at par between now and early 2013 by taking advantage of regulatory calls that were triggered by release of the NPR. Some banks may replace called TruPS quickly. As reflected in Exhibit 1, there has been more than \$24 billion in redemptions since the NPR was published.

We also have seen increased issuance of traditional preferred stock this year. However, many banks are shrinking their balance sheets and have plenty of common equity capital. Those banks may take their time to issue new preferred stock.

Greater Tax Advantages?

Another potential impact on investors of the shift from TruPS to preferred stock by banks is that the character of income will change. TruPS pay interest, which is taxable at ordinary income tax rates in the United States. Preferred stocks pay dividends, which (usually) are eligible for the DRD for corporate entities and qualified dividend income (QDI) tax rates for individuals.

Looking only at federal income taxes, this means that an 8% TruPS coupon currently generates the same after-tax income as a QDI-eligible preferred stock dividend of 6.12% for an individual investor in the 35% tax bracket for interest income and the 15% tax bracket for QDI.

This may blunt the after-tax impact of reinvesting proceeds from called TruPS into preferred stock for taxable investors. To make matters more complicated, however, lower tax rates for individuals on QDI will expire at the end of 2012.⁴ While there appears to be general support for lower tax rates on QDI, the political outlook is uncertain and negotiations on taxes are likely to be difficult. We cannot say with any certainty whether or not current tax advantages for QDI will be extended. As always, clients should consult their own tax advisors for more complete information and for application to their particular situations.

⁴ The dividends received deduction (DRD) for corporations is not set to expire and is currently in effect for 2013 and future tax years.

These changes may create some dislocations in the preferred market, and it certainly will make reinvesting proceeds from called securities challenging. From a credit standpoint, however, the new rules are good news for investors in preferred securities and ensure that present healthy levels of bank capital only get healthier.

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Exhibit 1

Called Trust Preferred Securities (June 7 – July 5, 2012)

Issuer/Security	Coupon	Effective Date	Total \$ amount Redeemed
JPMorgan Chase Cap XV	5.875	7/12/2012	92,939,000
JPMorgan Chase Cap XVII	5.85	7/12/2012	500,000,000
JPMorgan Chase Cap XXV	6.8	7/12/2012	1,500,000,000
JPMorgan Chase Cap XVIII	6.95	7/12/2012	750,000,000
JPMorgan Chase Cap XX	6.55	7/12/2012	909,576,000
JPMorgan Chase Cap XXII	6.45	7/12/2012	913,773,000
JPMorgan Chase Cap XXVI	8	7/12/2012	1,815,000,000
JPMorgan Chase Cap XXVIII	7.2	7/12/2012	1,500,000,000
JPMorgan Chase Cap XXVII	7	7/12/2012	1,000,000,000
Citigroup Capital XXI	8.3	7/18/2012	2,345,801,000
Citigroup Capital XII	8.5	7/18/2012	2,300,000,000
Suntrust Capital IX	7.875	7/11/2012	685,000,000
Suntrust Capital VIII	6.1	7/11/2012	607,872,000
Keycorp Capital X	8	7/12/2012	568,083,325
Keycorp Capital VII	5.7	7/12/2012	139,108,000
BB&T Capital Trust I	5.85	7/18/2012	500,000,000
BB&T Capital Trust II	6.75	7/18/2012	600,000,000
BB&T Capital Trust V	8.95	7/18/2012	450,000,000
BB&T Capital Trust VI	9.6	7/18/2012	575,000,000
BB&T Capital Trust VII	8.1	7/18/2012	350,000,000
BB&T Capital Trust IV	6.82	7/20/2012	600,000,000
Webster Capital Trust IV	7.65	7/18/2012	136,070,000
BAC Capital Trust X	6.25	7/25/2012	891,150,000
BankAmerica Capital II	8	7/25/2012	450,000,000
BankAmerica Instit-A	8.07	7/25/2012	450,000,000
Fleet Capital Trust II	7.92	7/25/2012	203,280,000
Fleet Capital Trust VIII	7.2	7/25/2012	534,000,000
Fleet Capital Trust IX	6	7/25/2012	175,000,000
MBNA Capital	8.278	7/25/2012	250,000,000
MBNA Capital D	8.125	7/25/2012	300,000,000
MBNA Capital E	8.1	7/25/2012	200,000,000
NB Capital Trust IV	8.25	7/25/2012	476,406,000
USB Capital XIII	6.625	7/28/2012	500,000,000
TCF Capital I	10.75	7/30/2012	115,000,000
National City Capital Trust IV	8	7/30/2012	517,500,000
PNC Capital Trust E	7.75	7/30/2012	450,000,000
Fifth Third Cap Trust V	7.25	8/15/2012	575,000,000