

GAO Downplays Key Issues in Hybrid Capital Report:

Profitability and Capital Access for Small Banks; International Competitiveness for Big Banks

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During the recent financial downturn, regulators concluded that hybrid capital did not provide adequate support for financial institutions to withstand financial stress as well as common stock. For this reason, Section 171 of the Dodd-Frank Act (“DFA”) mandated that bank holding companies generally be subject to the same capital rules as banks, eliminating Tier 1 capital treatment for trust preferred securities (“TPS”) except for TPS issued before May 19, 2010 by bank holding companies (“BHCs”) smaller than \$15 billion in assets at December 31, 2009. Congress feared that excluding all outstanding hybrid capital from Tier 1 capital would make domestic credit less available and more costly and reduce international competitiveness of U.S. financial institutions. As a result, Section 174 of the DFA directed the U.S. Government Accountability Office (“GAO”) to study the use and benefits of hybrid capital instruments, the risks to banking institutions and the economy of excluding hybrid capital from Tier 1 capital, and alternative means for small banks (those with less than \$10 billion in assets) to access capital.

Issued on January 18, 2012, the GAO’s 80–page report¹ provides a comprehensive window into capital raising by U.S. banks, with a focus on smaller banks. The report contains many generally expected conclusions but also some key unresolved issues, including the following:

GAO’s Conclusions

- Hybrid capital is an important source of Tier 1 capital
- Hybrid capital does not absorb losses as well as common stock
- Limited impact on credit availability and pricing expected from excluding hybrid capital
- Small BHCs have limited options but limited capital needs

Key Unresolved Issues

- Impact on small BHC profitability if they cannot adjust pricing and availability of credit in response to higher capital requirements
- Potential understatement of small bank capital needs because GAO’s assessment is not forward looking
- Potential negative impact on international competitiveness for large banks if no tax efficient hybrid capital and shorter amortization period for TPS

¹ GAO, Report to Congressional Committees, *Dodd-Frank Act: Hybrid Capital Instruments and Small Institution Access to Capital*, January 2012.

GAO's Conclusions

Hybrid Capital Is An Important Source of Tier 1 Capital for US Banks: Two-thirds of all top-tier U.S. banking companies with greater than \$500 million in assets, 85% of bank holding companies with greater than \$10 billion in assets, and 100% of all BHCs over \$100 billion in assets include hybrid capital in their Tier 1 capital, aggregating \$157 billion. Overall, TPS accounted for 82% of total hybrid capital issued, and, among BHCs less than \$10 billion in assets, TPS accounted for almost 97% of all hybrid capital issued. TPS is popular among issuing BHCs because it has a lower after-tax cost of capital, does not dilute equity ownership, has no ownership concentration limitations, and permits deferral of dividend payments for five years. Among BHCs that issued hybrid capital between 2000 and 2010, BHCs with less than \$10 billion in assets relied more on hybrid capital, with an average of about 21% of Tier 1 capital compared to about 14% for BHCs with greater than \$10 billion in assets.

Hybrid Capital Does Not Absorb Losses as Well as Common Stock: TPS are the primary form of hybrid capital, and because they are accounted for as liabilities, they do not absorb losses outside of bankruptcy of the BHC. Issuance proceeds that are invested in a subsidiary bank provide loss-absorbing equity at the bank level. But on a consolidated basis, the BHC would become insolvent if losses exceed GAAP equity. Moreover, investors in TPS or collateralized debt obligations backed by pools of TPS have creditor rights that may limit their willingness to approve debt-for-equity exchanges that would otherwise make financial sense.

Excluding Hybrid Capital from Tier 1 Capital Will Have Limited Negative Impact on Credit Availability and Pricing: Of the 969 top-level BHCs filing consolidated financial reports for year-end 2010,² roughly two-thirds had hybrid capital instruments that the DFA would exclude from Tier 1 capital. For BHCs greater than \$15 billion in assets, exclusion would cause the Tier 1 capital and leverage ratios to decline about 11%; for banks between \$500 million and \$15 billion in assets, the decline would be about 17%; and for banks with less than \$500 million in assets, the decline would be about 21%. While these declines in capital ratios are significant, the GAO's study indicates that only eight BHCs would fall below current minimum required regulatory capital ratios, and DFA specifically grandfathers banks less than \$15 billion from the exclusion of hybrid capital from Tier 1 capital treatment.

However, there are several caveats. It is unclear how these results would vary if a larger number of BHCs were included, as there are currently 4,157 top-tier bank holding companies, thrift holding companies and savings bank holding companies. Information on savings banks and savings

² The GAO defines top-level bank holding companies as institutions that are not owned or controlled by other bank holding companies. Based on SNL Financial data, as of July 11, 2011 the GAO determined that there were 973 top-level bank holding companies that filed FR Y-9C, "Consolidated Financial Statements for Bank Holding Companies," four of which were not included because they were domestic subsidiaries of foreign banks not required to meet capital requirements.

institutions whose parent holding companies have issued TPS is not included in the GAO study.³ Similarly, it is unclear how these ratios would differ if the repayment of TARP or compliance with Basel III capital ratios were considered. Nor is it clear how many more BHCs would fall below the enhanced minimum capital requirements being implemented pursuant to DFA and Basel III.

The GAO study acknowledges that small banks have limited access to capital markets, but its authors do not believe that this lack of access will negatively impact the availability or pricing of credit. To make this point, the GAO utilized various econometric models to estimate the likely reduction in lending volume and increase in loan pricing as a result of a decline in Tier 1 capital caused by Tier 1 hybrid exclusion. Initially, a negative capital shock could cause banks to reduce lending volumes, tighten lending standards, and increase lending spreads, with commercial and industrial loans the most impacted. While the GAO acknowledges that customers of smaller banks could experience large increases in loan rates, it suggests that such increases would be mitigated by competitive pressures that would make it difficult to pass along higher costs to borrowers without losing market share. The GAO does not acknowledge that such competition would of necessity constrain earnings and capital retention at smaller banks.

Small BHCs Have Limited Capital Raising Options But Report Limited Unmet Needs: As noted above, the exclusion of hybrid capital from Tier 1 capital would reduce Tier 1 capital ratios from 11% to 21% depending upon the size of bank, with the smallest banks the most negatively impacted. Roughly 76% of the smaller banking institutions cited the current capital-raising environment as challenging due to the economic climate, market conditions, and laws and regulations. But the GAO reports that small banks have limited unmet capital needs based on results of a questionnaire mailed to a sample of approximately 800 banks with less than \$10 billion in assets. In this survey, 65% of smaller banks had not raised capital since 2008, and 88% of those did not need or want to raise capital. Of the 35% of smaller banks that did raise capital during this period, 28% raised capital through a Federal government capital program such as the Capital Purchase Program (“CPP”) under the Troubled Asset Relief Program (“TARP”) and the Community Development Capital Initiative. In 2008 and 2009, over half of small institution capital offerings were preferred stock, with TARP accounting for about 82% of the amount issued. Recognizing the difficulties that small banks have raising capital, Congress approved the Small Business Lending Fund (SBLF) in 2010 and appropriated \$30 billion for investment in small banks with \$10 billion or less in assets. Overall, 932 banks applied for \$11.8 billion of funds, but only 332 were approved with \$4.0 billion funded, representing only about 13% of the original \$30 billion commitment. Ultimately, small banks had \$7.8 billion of unmet capital needs in

³ As of January 31, 2012, SNL Financial reported 4,157 top-tier bank holding companies, thrift holding companies, and savings bank holding companies. Thrift holding companies and savings bank holding companies can issue TPS at the holding company but many are not required to file FR Y9-C reports.

the SBLF program.⁴ With TARP and SBLF no longer available, common equity placement with Board members or the local community is now the most common form of capital available to the smallest of institutions.

Unresolved Issues

Impact on Small BHC Profitability if They Cannot Adjust Pricing and Availability of Credit In Response to Higher Capital Requirements: The GAO states that the exclusion of Tier 1 hybrid capital will not meaningfully affect the cost or availability of credit to borrowers. It supports this conclusion with econometric models using a variety of methodologies to show an equilibrium response to this change in capital structure. The GAO acknowledges that given the large number of banks with less than \$15 billion in assets, it would be difficult for any one institution to raise loan pricing in response to the exclusion of Tier 1 hybrid capital. In other words, smaller banks would likely bear the brunt of more expensive capital because they will not be able to pass along higher costs to borrowers without losing market share. This would likely hasten further consolidation among smaller banks as returns on invested capital decline. Mitigating this impact somewhat is the grandfathering of the Tier 1 capital treatment of TPS issued before May 19, 2010 by BHCs smaller than \$15 billion at December 31, 2009, which will buffer the capital shock that might otherwise have been experienced by smaller banks.

Potential Understatement of Small BHC Capital Needs Because GAO Study is Not Forward Looking: The GAO study notes that a majority of small banks found the capital-raising environment challenging, but had limited unmet capital needs. This observation of limited unmet capital needs was based on a questionnaire addressed to bank management teams and represented their self-assessment. It did not factor in other views, including those of investors or lenders who may be reluctant to invest without further loan loss reserves and/or enhanced capital cushions. In addition, the GAO study was not forward looking and did not consider the impact of repaying TARP or compliance with Basel III capital ratios when considering capital raising needs. Of the \$17.6 billion of TARP still outstanding, approximately \$8 billion remains outstanding to about 400 banking companies with less than \$10 billion in assets.⁵ If the repayment of TARP or compliance with Basel III capital ratios had been considered in this assessment of unmet capital needs, the conclusion might have been substantially different. This additional analysis should be considered before a final conclusion is reached about the limited unmet capital needs for small banks. Alternatively, the Treasury Department may view the \$8 billion of TARP invested in small banks as unlikely to be repaid by such banks and focus its exit strategy instead on selling the Treasury's interests to other buyers.

⁴ Small Business Lending Fund, Report to Congress submitted pursuant to Section 4106(3) of the Small Business Jobs Act of 2010, Fourth Quarter 2011.

⁵ U.S. Treasury, Troubled Asset Relief Program ("TARP"), Monthly 105(a) Report – December 2011, submitted to Congress pursuant to Section 105(a) of the Emergency Economic Stabilization Act of 2008, January 12, 2012.

Potential Negative Impact On International Competitiveness for Large Banks If No Tax Efficient Form of Hybrid Tier 1 Capital Along With Shorter Amortization Period of TPS:

One of the primary reasons that TPS was approved for inclusion in consolidated Tier 1 capital in 1996 was the Fed's concern about international competitiveness and the cost-of-capital disadvantage faced by U.S. banks issuing perpetual preferred stock. In many European countries, including France, Germany, Spain and the United Kingdom, dividend payments on some types of noncumulative, perpetual preferred instruments that qualify for Tier 1 capital treatment are tax deductible, whereas these payments are not tax deductible under the U.S. tax code. This concern is noted in the GAO report, but the study observes that Basel III limits the inclusion of hybrid capital in Tier 1 capital from a potential of 49% to less than 20%, which would reduce the after-tax cost-of-capital advantage for the European banks.

However, this difference in tax treatment of hybrid capital may be the least of the competitive concerns for U.S. banks given the comprehensive changes in regulation of systemic risk, trading and investment activities of banking institutions, use and trading of derivatives, securities regulation, and the structure of bank supervision imposed by the DFA regulations relative to the Basel III guidelines applied to the other G20 banks. Another competitive concern is the three-year phase-out for Tier 1 capital treatment of TPS issued by banks with greater than \$15 billion in assets mandated by Section 171 of the DFA versus the 10-year phase-out of TPS mandated by Basel III. These competitive differences should be closely monitored in the event that U.S. regulators need to provide greater flexibility to issue Tier 1 qualifying REIT preferred stock and other forms of loss absorbing, tax-deductible preferred stock to level the competitive landscape.

In conclusion, while the GAO report provides abundant information about the uses of hybrid capital instruments as well as their benefits, it downplays the key risks of limiting the future inclusion of hybrid capital instruments in regulatory capital to big and small banks alike. These risks include smaller banks' profitability and access to capital and large banks' international competitiveness. As a result, the report does not fully respond to the Congressional mandate.

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