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The Next Financial Crisis: Coming to Your Neighborhood Soon?
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One of the fiercest debates during the Wall Street Reform conference negotiations has been over Sen. Susan Collins (R-ME)’s amendment to improve the quality of capital used by America’s banks. The amendment would accomplish this by eliminating the designation of “trust-preferred securities” as Tier 1 capital.

Trust preferred securities - also known as TruPS - are not new but their use expanded dramatically before the financial crisis and their role in exacerbating the crisis has belatedly become apparent. On June 8, a Bloomberg Businessweek article by Yalman Onaran and Jody Shenn reported on the background that led to the problem these instruments have created. The critical timeframe for its initiation is a 1996 ruling by the Fed. As the regulator of bank holding companies, it ruled that debt sold by a bank holding company (BHC) to an off-balance sheet trust it created could then be sold to investors and counted as Tier 1 capital. Early on, only the largest financial institutions had access to this market for their notes which were seen as a hybrid between common stock and preferred debt. But by 2002, investment banks had bundled issues by smaller institutions into CDOs that were given AAA ratings by the agencies and the expansion began. The Philadelphia Fed reports that 1,400 U.S. lenders had issued $149 billion of trust preferred securities by the end of 2008.

TruPS were marketed as a cheap and very attractive form of capital. They were defined as debt for tax purposes even though issuers could defer interest payments on the securities for up to five years. It was assumed that they would be sold to institutional investors and that the profits from increased lending supported by additional capital would continue indefinitely. But, over time, these CDOs were also sold to banks and the cross-ownership of other banks’ capital intensified the downward spiral as the crisis mounted. Capital charges by one bank experiencing losses triggered charges by others that held its debt.

The fact that these notes were part of a bundle of notes of many banks made it difficult to convert this form of hybrid debt into stock. But even if that had been possible, it would have sharply raised the capital charge for a bank whose holding of debt had been transformed into equity. As for the issuers, they were between a rock and a hard place. Not paying the interest on the notes meant they would be downgraded by the rating firms. That, too, would have meant much higher capital charges for the banks that held their TruPS as well as virtually ending their ability to raise new capital.
The Bloomberg article quotes George French, deputy director for policy in the division of supervision and regulation at the FDIC as saying the use of TruPS contributes to a downward spiral. It quotes Joshua Rosner, an analyst with Graham Fisher and Company as saying that selling TruPS back to banks was a Ponzi scheme. By April of 2010, losses were mounting. About 400 banks had suspended interest payments on 17 percent of outstanding TruPS and defaults accounted for another 13 percent of outstandings. As Joseph Mason, professor of finance at Louisiana State University, told the Bloomberg reporters, the fact that self-capitalization was taking place in a portion of the banking sector meant that losses fed on each other.

That is the nature of the problem the Collins amendment seeks to address. The response from the American Banking Association is that fixing the problem would be worse - that banning TruPS as tier 1 capital would require banks to raise about $130 billion of new capital or (the usual threat) curtail lending. In other words, they want banks to continue issuing TruPS as Tier 1 capital. Even Senator Collins agrees that the existing TruPS will need to be grandfathered or that the ban will need to be implemented over time.

The Senate conferees accepted an amendment by Sen. Corker (R-TN) late last Thursday to have the GAO and bank regulators conduct a study about capital quality. With the FDIC as a consultant, there will at least be one vote for caution. That agency did not implement the authority to allow hybrid capital to count as Tier 1 capital and Chairman Bair wrote a letter of support for the Collins amendment on May 7, the day the Senator introduced it.

Meanwhile, if the Collins amendment were lost, section 610 of the Senate bill could act to reduce sales of hybrid capital to other banks if it is adopted by the conference. That section addresses the overall problem of interconnectedness by limiting a bank's credit exposure to another bank or financial institution as a percentage of its capital. This is another critical structural provision because it constrains borrowing within the financial sector as well as concentrations among derivatives dealers and counterparties. But it would not necessarily stop self-capitalization if trust preferred securities or other hybrid capital instruments are bundled into CDOs and sold without the transparency needed to identify the underlying debt they hold.

Even with the possibility of a future ban, the prospect of a delay in dealing with this problem is frightening. Those who want to continue the use of trust preferred securities as Tier 1 capital assume that bank holding companies can continue to sell them. Is it possible to believe that investment banks will be able to convince investors to buy CDOs that bundle such securities? What ratings will the agencies give them now that losses have begun to proliferate? While selling bank capital to other banks greatly facilitated the marketing of TruPS, surely no one wants to perpetuate such dangerously incestuous relationships.

The fact is that the days when trust preferred securities were a cheap way for bank holding companies to raise capital are over. Meanwhile, the downward spiral they set in motion is likely to continue. Capital will continue to leak out of the system at what could become an accelerated rate for small and medium-sized institutions. The next financial crisis may already be underway.