THE COST OF WAITING

by Steve Brown

The tricky thing about trying to make a traffic light that is about to change is that it is all about timing. Wait too long and one is likely to get broadsided in the intersection, accelerate too soon and risk the possibility of a speeding ticket for nothing. These days, banks issuing trust preferred securities ("TRUPs") may face a similar conundrum. Recall that TRUPs are popular because they are the least expensive capital option for independent banks, dividend payments are deductible, do not dilute existing shareholders and no longer carry upfront fees. Over 2,000 banks have issued TRUPs to date, clearly demonstrating the value of this effective and efficient capital raising tool. Because 700 banks are nearing their 5Y call periods on older TRUPs, spreads are widening. This group of banks, which were among the first to ever issue TRUPs, have been paying an average spread of about 350bp over Libor. Given that spreads have collapsed since then to about half those levels, most of this group will be looking to refinance. Widening is occurring primarily because investor interest is reducing (due to lower refinancing spreads) at the same time credit concerns are increasing (insurance sector has taken some hits and banks are carrying high exposures to real estate at a projected turning point in the cycle). The result is that spreads have widened 25bp since the lows reached last year and are expected to shift out another 25bp by year-end. In all, nearly $7B in TRUPs is expected to be refinanced through 2007, so the pressure is clearly on. Even larger banks with strong credit ratings are not immune from this spread widening. While large banks don't raise capital through pools like independent banks, some have recently issued directly at spreads as wide as Libor+180bp. While banks are probably not eager to double up on TRUPs dividend/interest payments for the next 6M to 18M (until their refinancing date is reached), some nonetheless have already begun doing so with en eye toward reducing future costs. For banks considering refinancing (or issuing for the first time), let's run a quick analysis. Assume a $10mm issuance size, 3M Libor at 5.24% and an issuance spread of 160bp (note that spreads vary based on individual bank credit, geographic location and other factors). Assuming Libor did not move over the next 12M, this bank would pay about $694k in annual cost (pre-tax). Now, assume the same bank waited to issue and spreads widened out another 20bp. Over a 5Y period (to the next call date), this spread widening costs the bank about $100k in additional interest. By going one level deeper and incorporating the forward curve, we find the cost increases to $125k. While banks shouldn't take capital they don't need, if you expect to be in the market in the next year, it pays to consider a variety of strategies. One often used strategy is to do a short-term leveraged defeasance to offset costs until the refinancing occurs. For banks trying to decide whether to issue now, wait it out, or just aren't sure - give us a call and we would be happy to assist in the analysis for you. As a direct result of our co-op-like ownership structure, banks can issue through BIG at some of the lowest costs around. We'll help you get through the issuance intersection while the light remains green.

BANK NEWS

Acquisition

Mercantile Bancorp ($1.1B, IL) will acquire Royal Palm Bancorp ($148mm, FL) in a transaction valued at nearly $44mm or 2.9x book.

Hedge

The credit default swap market, which allows banks and hedge funds to protect themselves against borrowers that file for bankruptcy, has reached $17T in size. At that level, this sector is larger than the world's outstanding corporate debt. Interestingly, the interest rate swap market is 10x that size.

IT

Reflecting the importance of technology in banking, a new study finds 77% of CFOs feel IT is a strategic function and not a utility. In addition, 65% of executives said they plan to spend more money on IT in 2006 than they did in 2005.

More IT

: A new study finds 60% of executives say IT does not meet performance expectations, slightly worse than in 2004. It is also interesting to note that only 6% of executives say their bank requires a formal ROI analysis for IT investments, while 30% say they conduct no analysis whatsoever.

GSE Earnings

FHLMC reported that its net income fell 27% last year to $2.1B, primarily as a result of losses related to Hurricane Katrina.

Student Debt

The WSJ reported that nearly 66% of students owe an average of $19k upon college graduation, according to a recent study by the Education Department.