BANK CREDIT AND TRUST PREFERREDS

by Steve Brown

One thing that has been lost on the public is the general improvement of bank credit. As you can see by our picture, this makes many people very happy. Today we look at recent trust preferred performance as a proxy for a quantitative view on the status of overall bank credit. The analysis is timely, as more than $7B of trust preferred issuance has been upgraded in the last month, an event that hasn't happened in a long period of time. Trust preferreds, of course, are subordinated debt issued by banks that count for Tier 1 capital. Historically, close to 2,000 institutions issued trust preferreds on a cumulative basis, for a total of almost $40B. A tight spread of 144bp was reached back in 2007, but issuance now is virtually non-existent - largely due to liquidity issues and changes to regulatory treatment. Secondary issues trade at spreads from 600bp to 2,000+. For the most part, the average community bank with decent performance has been averaging a credit spread of about 825bp (yielding around 9.3%).

From a payment standpoint, roughly 204 banks have defaulted (approx. 11% of issuance) and 368 banks (approx. 20%) have chosen (or been forced to) defer payment. Of those 368 banks, we estimate about 50% now have sufficient earnings to resume making payments when the regulators feel the operating company demonstrates sustained earnings. Of interesting note, since 2007 626 banks have deferred payments. Of that group, 62 (about 10%) are now current, while the rest failed. Historically, banks that cure 1x have a 15% probability of deferring again. All told, we would put the probability of default for performing trust preferreds (given history and bank earnings projections at around 15bp, which is equal to about a "BBB" rated corporate. This is about where the 20Y mean is and a far cry from the 3.5% default rate seen back in 2008 (the equivalent of a "B" rated company). The question is how do you use this information? Banks can use such data in a number of ways. For banks that are investors in trust preferreds, the bounce back will help in valuation. While it really depends on the specific trust preferred issuance held (most are pools of different banks), the market is moving in a positive direction. This is good when you consider that more large banks continue to redeem their issues, thanks to Dodd-Frank (no longer gives full Tier 1 capital treatment for banks larger than $15B). On top of that, more bank consolidation should also help improve credit of pools in the future. If you are an issuer, then the analysis indicates that while credit is slowly coming back, issued trust preferreds are still more valuable to the issuing bank than to the market and should not be redeemed (there are other, more expensive forms of capital to repay first). That said, we point out that there is a valuation mismatch here that largely stems from a difference of opinion in liquidity. Issuing banks can capitalize on this arbitrage by attempting to repurchase their issues at a discount and accreting the difference between the purchase price and the issuance price into earnings. Unfortunately, this is easier said than done, as most community banks have issued into pools, so the stars have to align perfectly to convince the collateral manager to redeem your issue (as it may leave the current investors with an adversely selected pool), or substitute in other issue of similar or better credit quality (hard to find). For those looking to benchmark bank credit and operational risk to other banks (such as for participated loans), the trust preferred market is one place to track potential counterparty risk. The good news is that as the trust preferred market heals, all parties will have more options. As problem banks cure their credit problems, existing issues will become more valuable, liquidity will return and a 6% or 7% coupon will look attractive (for a 10bp default probability). That should prompt more investor buying. While we won't see capital as cheap as it was back at the height of issuance, better bank credit could make many people happier.

BANK NEWS

M&A

BNC Bancorp ($2.4B, NC) will buy First Trust Bank ($437mm, NC) for $35mm in cash (30%) and stock (70%).

M&A

Guaranty Bancorp ($1.7B, CO) will buy wealth management firm Private Capital Management for an undisclosed sum.

Less Lending

A study by research firm PayNet finds small business lending fell 2% in April and 3% in March, as uncertainty reduced owner interest in borrowing.

Coordination

Regulators have issued guidance saying they will coordinate supervision activities on banks and credit unions above $10B in size on such topics as scheduling exams and the sharing draft reports.

European Risk

Portugal announced it will pump $8.3B into 3 of its largest banks to strengthen them amid increasing loan losses. Meanwhile, Spain called for the European Union to do more, saying it has effectively lost access to capital markets because of high risk premiums demanded by investors.

Holding Cos

Under Dodd-Frank, the Fed approved a final rule that outlines the requirements for non-bank companies that own a securities broker or a dealer to register under Fed supervision (vs. the SEC). Dodd Frank eliminated the SEC's holding company supervisory framework and moved such companies to Fed supervision. The rule should create more of a level playing field between broker-dealer and bank products/operations.