EXHIBIT 7. DIFFERENCE BY YEAR BETWEEN LONGER AND IMMEDIATE ADJUSTING PRIME BASED LOANS

For loans with terms of 3 years

Calendar Year	Quarterly	Semi-annual	Annual
1982	0.59%	1.31%	2.31%
1983	0.09%	0.36%	1.53%
1984	-0.06%	-0.26%	-0.69%
1985	0.25%	0.63%	1.26%
1986	0.25%	0.49%	0.88%
1987	-0.16%	-0.30%	-0.29%
1988	-0.19%	-0.34%	-0.60%
1989	-0.03%	-0.10%	-0.52%
1990	0.06%	0.13%	0.37%
1991	0.32%	0.57%	0.94%
1992	0.18%	0.43%	1.00%
1993	0.00%	0.00%	0.06%
1994	-0.29%	-0.51%	-0.80%
1995	-0.05%	-0.17%	-0.60%
1996	0.06%	0.12%	0.27%
1997	-0.03%	-0.06%	-0.12%
1998	0.08%	0.11%	0.12%
1999	-0.07%	-0.07%	0.05%
2000	-0.13%	-0.29%	-0.64%
2001	0.57%	1.02%	1.62%
Entire Period			
loss times	9	9	8
average loss	-0.11%	-0.23%	-0.53%
1992-2001			
loss times	5	5	4
average loss	-0.12%	-0.22%	-0.54%

in slowly increasing rate environments. Given that some borrowers prefer the stability of fewer rate adjustments and are willing to pay a premium for this benefit, nearly everybody wins. For the bank or thrift anyway, by charging an adequate additional spread, the benefit is worthwhile 90 percent of the time, and that's not too bad.

JOEL ROSENBERG
US Banking Alliance

Looking at Trust Preferreds from Both Sides Now

The Capital Securities marketplace is of interest to banks from both issuer and investor perspectives. Capital Securities are known in the banking sector as trust preferred securities, a form of preferred stock possessing characteristics typically associated with debt obligations, including the ability to deduct interest for tax purposes and a structure with a longer maturity, but with a shorter call option. As is frequently the case, your overall perspective depends on which side of the balance sheet you are looking at life from. In this article we look at this structure from both sides (note that data is as of January 16, 2002).

Issuers Perspective. From a theoretical corporate finance perspective, the case for issuing capital securities is compelling. Based on an 8.50 percent cost, and a 40 percent tax rate, the after-tax cost of capital is 5.10 percent. This rate is quite low from an historical perspective and compares favorably, for most banks, to a targeted return on equity (ROE) and cost of capital of 15 to 20 percent.

Recent bank capital securities issuances have been concentrated in two structures:

- *Fixed rate, exchange-traded securities with a 30-year maturity and a 5-year call.* These are occasionally referred to as retail as much of the issuance is sold to individual and small institutional investors. Wide distribution, competitive pricing, increased analyst coverage, and seemingly transparent pricing are but a few of the advantages of this structure.
- *Fixed rate or floating rate pooled Trust Preferreds with a 30-year maturity and either a 5- or 10-year call.* In this structure, numerous banks pool their issuance in order to diversify the credit risk inherent in capital securities, especially in the first few years. Due to the relatively low level of floating rates (3 month LIBOR at 1.71 percent), the floating alternative has garnered a lot of interest. Spreads are around 375 basis points (bps) over LIBOR, resulting in a cost of around 5.46 percent. These are typically sold institutionally as 144A securities.

Bank Asset/Liability Management

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Pick Your Issuance Term—Swap from Floating to Fixed. Issuers eager to issue capital securities, but reluctant to allow their rate to float, may wish to consider issuing the floating rate alternative and swap into their target maturity, locking in a fixed rate for several years. For example:

- Issue the floating rate alternative at +3.75 over 3 month LIBOR.
- Enter into a pay-fixed 5-year swap at 4.75 percent + the 3.75 percent spread, or 8.50 percent, and receive 3 month LIBOR.
- Net impact is to pay 8.50 percent fixed for five years, with exposure to rates matched to a 5-year call date. The 3-month LIBOR exposure nets to zero as you pay floating on the security and receive floating on the swap. Consult your accounting advisor for the FAS 133 implications of this tactic.
- Compare this tactic to issuing a single issuer Trust Preferred at 8.50 percent—the rate for five years is the same with either alternative.
- There are many other differences between the structures, including issuance and administrative costs. It is prudent to consider the pros and cons of both structures.

A/L Modeling Considerations. At the bank level, Capital Securities count as equity (typically subject to a limitation of 25 percent of Tier 1 capital), so it is appealing, at least initially, to model this structure as equity. Upon further reflection, many banks realize that this may be their longest maturity fixed rate liability and one of the few that they have written the call option on and therefore serves as an on balance sheet hedge to certain fixed rate assets. A more rigorous, better practices approach is to model the issued capital security as long-term callable debt, with pro forma adjustments to capital ratios, as appropriate.

Investment Perspective. Fixed rate spreads are approximately where they were back in May 2001, after allowing for some spread drift due to name and event risk. Floating rate spreads remain slightly wider than those seen for much of last year. The wider margin and OAS of the floating rate product is appealing and suggests engineered alternatives based on the slope of the yield and credit curves. In Exhibit 8 we compare two issues of one of the larger banks: JPM/Chase.

Pick Your Investment Term—Swap from Floating to Fixed. Investors willing to accept the credit risk of JPM/Chase (A-rated), but unwilling to accept the interest rate risk of long-term fixed rate bonds, may wish to consider purchasing the floating rate alternative and swap into their target maturity, especially given the higher OAS. For example:

- Purchase the floating rate alternative at +138 over 3 month LIBOR.
- Enter into a receive-fixed five-year swap at 4.75 percent, paying 3 month LIBOR.

EXHIBIT 8. ISSUE COMPARISON OF JPM/CHASE

Issue	Maturity Date	Next Call Date	Next Call Price	$ Price	Yield
Chase Cap III L+55	2/2027	N/a	N/a	89.88	3.09
JPM 7.95 2/2027	2/2027	2/2007	103.975	106.20	7.26

Issue	Valuation Benchmark	LIBOR OAS*	Pricing Benchmark	Spread
Chase Cap III L+55	Swap Curve	143	3 mo LIBOR	138
JPM 7.95 2/2027	Swap Curve	46	Long bond 5.375 2/15/31	180

* LIBOR OAS is computed at 18% volatility, with a 3% mean reversion for the fixed rate alternative. The floating rate OAS is calculated using forward three-month LIBOR rates derived from the swap curve to project future discount rates and interest cash flows, less the value of the deeply discounted call option. Goldman Sachs analysts have reviewed this approach in their published research.

- Net impact is to receive 6.13 percent fixed for five years, with exposure to JPM/Chase. The 3-month LIBOR exposure nets to zero as you receive floating from the security and pay floating on the swap. Consult your accounting advisor for the FAS 133 implications of this tactic.
- Compare this tactic to purchasing 5-year JPM/Chase notes yielding 5.19 percent (JPM 6.875 01/07). The yield pickup of 94 bps seems reasonable for accepting credit exposure to Trust Preferreds.
- In addition, the discount price is appealing to some investors looking at a marketplace seemingly comprised of premium securities. Note that the floating rate bond is subject to a par call in 2007 if there is a tax law change.

Conclusion. Non-financial firms also use capital securities as a source of long-term capital. For example, Enron's use of Capital Securities as a form of leveraged finance has been in the news during the first part of 2002. This security class, like any other bank asset and liability, is neither intrinsically good nor bad. It is prudent, as with any asset or liability, to consider credit risk, including concentration risk, of the issuer(s) and interest rate risk of the underlying structure prior to proceeding with either investing or issuance. Many banks have been willing to undertake the necessary due diligence in order to profitably use Capital Securities on both sides of the balance sheet.

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