FEDERAL RESERVE ISSUES PROPOSED RULES ON TRUST PREFERRED AND OTHER CAPITAL INSTRUMENTS

MAY 10, 2004

SUMMARY

On May 6, 2004 the Board of Governors of the Federal Reserve System issued its long-awaited proposed rulemaking notice[1] addressing the issue of whether, following the issuance of FIN 46/46R, trust preferred securities will continue to qualify as tier 1 capital for bank holding companies. As expected, the Board proposed to continue including trust preferred securities as tier 1 capital, but in reduced amounts: following a three year transition period, the quantitative limitations for the amount of trust preferred that may be included in tier 1 capital would be:

- 15% of core capital elements, net of goodwill, for internationally active bank holding companies, and

- 25% of core capital elements, net of goodwill, for all other bank holding companies.

Under the current capital guidelines for bank holding companies, quantitative limits on the inclusion of trust preferred securities in tier 1 capital are calculated based on equity capital *before* deduction of goodwill and other intangibles, so the proposed change is likely to reduce the issuing capacity of some bank holding companies, particularly those that have completed significant purchase accounting transactions. In addition, the 25%/15% limits will also include most types of minority interests in consolidated subsidiaries, further reducing the amount of trust preferred that may be included in tier 1 capital. However, contrary to some speculation over the past few months, the Board decided to apply the lower 15 percent limit to only a handful of "internationally active" U.S. bank holding companies.

In addition, the proposed rule would treat trust preferred securities as tier 2 capital during the last five years before maturity and would require the same phase-out of capital credit during that period that limited-life preferred stock is currently subject to (i.e., the principal amount that may be counted as tier 2 capital is reduced by 20 percent during each of the last five years before maturity, so that in the final year none of it counts as tier 2 capital).

---

[1] The proposed rule will be published in the Federal Register but is available now on the Board's website (www.federalreserve.gov).

Although the proposed rule make virtually no substantive changes in the permitted terms for trust preferred securities, it does specify that for trust preferred securities issued on or after May 31, 2004 the underlying subordinated debt must comply fully with existing rules for tier 2 subordinated debt, except that acceleration of principal will be permitted if there is a default in the payment of interest after the end of the deferral period. Since most existing trust preferred securities also provide for acceleration upon a covenant breach or a principal payment default, these terms will need to be modified in issuances made on or after May 31, 2004. Some other technical changes may also be required to the subordination provisions, as discussed below.

The Board also used the proposed rule as a vehicle to consolidate in one place a variety of Board and staff interpretations and supervisory guidance issued over the past decade (including some unpublished staff positions), such as the prohibition on dividend step-ups in tier 1 capital instruments.

The comment period for the proposed rule ends on July 11, 2004 and a final rule is not likely until at least several months later. However, none of the significant provisions in the proposed rule have retroactive effect and the reduction in the quantitative limits for trust preferred as a component of tier 1 capital would not take effect until March 31, 2007. It is unlikely that the proposed rule will result in a significant increase in trust preferred issuance activity or, except for the technical changes noted above, change the terms of the securities being issued.

Any questions concerning this memorandum may be directed to Gary Rice (212-455-7345, grice@stblaw.com), Lee Meyerson (212-455-3675, lmeyerson@stblaw.com), Maripat Alpuche (212-455-3971, malpuche@stblaw.com), or John L. Walker (212-455-7365, jwalker@stblaw.com). If you did not receive this memorandum by e-mail and would like to receive this or future memoranda by e-mail, please provide your e-mail address to Sue Bussy (sbussy@stblaw.com).

INTRODUCTION

With the adoption of the risk-based capital guidelines in 1989, the Board moved to a more restricted definition of what counted as core capital, eliminating various hybrid instruments that had qualified under the old rules. In 1992, when the risk-based capital rules were fully phased in, only common stockholder's equity, qualifying cumulative and noncumulative preferred stock, and minority interests in equity accounts of consolidated subsidiaries qualified as tier 1 capital.

On October 21, 1996, the Board issued a press release, a little over a page in length, stating that it had approved trust preferred securities for inclusion in the tier 1 capital of bank holding companies. Trust preferred securities are cumulative preferred securities issued by a subsidiary of a bank holding company that holds only a deeply subordinated note issued by the

bank holding company; dividend distributions to holders may be deferred for a minimum of five years. They are attractive to issuers because they are term instruments that qualify as tier 1 capital but—unlike any other U.S. tier 1 instrument—dividends are tax deductible. Bank holding companies have issued over $77 billion of trust preferred securities since 1996.

Trust preferred securities technically qualified as tier 1 capital as a minority interest in the equity accounts of a consolidated subsidiary, although it was surprising that the Board, which had emphasized the importance of common equity in tier 1, permitted the inclusion in tier 1 of what was essentially long term, deeply subordinated debt that would not itself have qualified as tier 2 capital. The Board's 1996 press release treated trust preferred as a form of cumulative preferred stock and stated (incorrectly) that trust preferred, together with any other qualifying cumulative preferred stock, could comprise up to 25 percent of a bank holding company's tier 1 capital.[2]

In 1998, the Basel Committee on Banking Supervision issued its own press release that addressed the inclusion of innovative capital instruments in tier 1 capital. The press release stated that such capital instruments would be included up to 15 percent of tier 1 capital, provided that they met certain criteria. The Basel Committee press release caused speculation that the Board would restrict bank holding company inclusion of trust preferred to 15 percent of tier 1 capital. The Board encouraged internationally active bank holding companies to use the lower limit, but took no formal action.

As discussed above, trust preferred securities were included in tier 1 capital on the grounds that they came within the category "minority interests in consolidated subsidiaries". With the adoption by FASB of FIN 46 and FIN 46R in 2003, the trust that issues the preferred is no longer consolidated with the bank holding company and the preferred issued by the trust is therefore no longer considered a minority interest in a consolidated subsidiary. Prior to the effective date of FIN 46 in July 2003, the Board advised bank holding companies that they should continue to include trust preferred securities in tier 1 capital until further notice.

THE PROPOSED RULE

Impact of FIN 46R on Tier 1 Capital Treatment

Although bank holding companies are required to follow U.S. generally accepted accounting principles for purposes of regulatory reporting, the Board is not required to follow GAAP in defining tier 1 or tier 2 capital, which, as the Board stated in the proposed rule, "are regulatory constructs designed to ensure the safety and soundness of banking organizations, not accounting designations designed to ensure the transparency of financial statements."[3] In

[2] As discussed below, the Board currently calculates this limit prior to deducting goodwill and other intangibles, while tier 1 capital is calculated after deducting goodwill and other intangibles.

[3] Proposed rule, at page 8.

light of the fact that foreign banks are permitted under the 1998 Basel Committee press release to include similar instruments in their capital and the demonstration over time that trust preferred securities provide financial support to banking organizations in deteriorating financial condition, the Board decided to continue to permit trust preferred to be included in bank holding company tier 1 capital even though, as a matter of GAAP, trust preferred is no longer recorded as a minority interest.

Proposed Distinctions Among Types of Minority Interests

The 1996 press release included trust preferred, which is cumulative, in the 25 percent limit on the inclusion of cumulative preferred stock in tier one capital, but the current capital guidelines do not generally impose a limit on the amount of "minority interest in consolidated subsidiaries" that may be included in tier 1 capital. The Board took the opportunity of the proposed rule to draw some distinctions among minority interests as capital, restricting the inclusion of some but not others in tier 1 and tier 2 capital.

As a general matter, the Board noted, minority interests in a subsidiary provide support for the subsidiary and do not necessarily provide support that can easily be shifted elsewhere in the consolidated organization. This is equally true if the minority interest is issued by a depository institution, but because the purpose of the bank holding company capital rules is to ensure the safety and soundness of depository institutions, the Board is not concerned that capital provided to a depository institution might not be available to support its parent bank holding company. On the other hand, the Board is concerned that minority interests issued by nonbank subsidiaries of a bank holding company not form an undue portion of its capital, because the capital of such a subsidiary may not be readily available to support other parts of the bank holding company, most notably its depository institution subsidiaries. Accordingly, the Board proposes to treat minority interests issued by a depository institution subsidiary of a bank holding company more favorably than minority interests issued by other subsidiaries of the bank holding company. The Board proposes to establish three classes of minority interests:

Class A Minority Interest. Minority interests related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary would not be subject to limitations on inclusion in tier 1 or tier 2 capital of the bank holding company.

Class B Minority Interest. Minority interests related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary would not be subject to limitations on inclusion in tier 2 capital of the bank holding company, but would be subject to the 25 percent or 15 percent limit on "restricted core capital elements" (cumulative perpetual preferred stock, trust preferred securities, Class B minority interest, and Class C minority interest) in the holding company's tier 1 capital. Note that cumulative preferred stock of a U.S. depository institution would qualify only as tier 2, not tier 1, capital of that institution.

Class C Minority Interest. Minority interests related to qualifying common stockholder's equity or qualifying perpetual preferred stock in a consolidated subsidiary that is not a U.S. depository institution or foreign bank subsidiary would be subject to limitations on inclusion in both tier 1 and tier 2 capital of the bank holding company, as discussed below. The Board's release makes it clear this is intended to cover preferred stock issued by a REIT or other special purpose subsidiary of a bank.

Quantitative Limits on the Inclusion of Restricted Core Capital Elements in Capital

The proposed rule sets an aggregate limit on restricted core capital elements for a bank holding company of 25 percent of core capital elements[4], net of goodwill. This test is more restrictive than the current limit for trust preferred and cumulative preferred securities, which does not deduct goodwill prior to calculating the 25 percent limit or explicitly include minority interests in consolidated subsidiaries. The proposed rule states that this approach is consistent with the proposed New Capital Accord being prepared by the Basel Committee on Banking Supervision, which would set limits for innovative capital instruments on a basis that deducts goodwill from core capital elements.

In addition, the proposed rule would limit the amount of qualifying trust preferred securities and Class C minority interests in excess of the restricted core capital limit that can be included in tier 2 capital: the inclusion of such elements, together with subordinated debt and limited-life preferred stock, in tier 2 capital, would be limited to 50 percent of tier 1 capital.

The proposed rule would also provide that during the last five years prior to maturity of the underlying subordinated note, trust preferred securities must be treated as limited-life preferred stock, excluding it from tier 1 capital and amortizing it out of tier 2 capital at the rate of 20 percent per year. This would be a new requirement, although not a surprising one.

The Board also proposes to amend the capital guidelines "to make explicit the Board's general expectation that internationally active BHC's limit the amount of restricted core capital elements to 15 percent of the sum of core capital elements, including restricted core capital elements, net of goodwill."[5] This proposal derives from the 1998 Basel press release regarding innovative capital instruments, which includes such a limit. The proposed rule indicates that an "internationally active BHC" is one that has "significant activity in non-U.S. markets" or that would be a "candidate" for the Advanced Internal Ratings Based Approach under the Board's proposed implementation of the Basel New Capital Accord. In the Board's Advance Notice of Proposed Rulemaking for implementation of the Basel New Capital Accord it stated that the Advanced Internal Ratings Based Approach would be required for a banking organization that

---

[4] "Core capital" is qualifying common stockholders equity; qualifying perpetual preferred stock (including related surplus); Class A, B and C minority interests; and qualifying trust preferred.

[5] Proposed rule, at page 13.

has (i) total commercial bank assets of $250 billion or more, *or* (ii) total on-balance sheet foreign exposures of $10 billion or more.

The limits on restricted core capital would become fully effective on March 31, 2007. Bank holding companies that currently exceed the new limits are expected to consult with the Board on a plan to achieve compliance by that date.

Clarifications on Qualifying Trust Preferred Securities and Other Instruments

The proposed rule states that qualifying trust preferred must be perpetual and provide for a minimum of twenty consecutive quarters of dividend deferral, as well as a call at the bank holding company's option commencing no later than ten years from issuance. These requirements are consistent with the 1996 Board press release, as modified by oral guidance from Board staff.

In addition, the sole asset of the trust[6] must be a bank holding company note with a minimum maturity of 30 years and subordinated to all other subordinated debt of the bank holding company. The terms of the note must comply with the Board's criteria for subordinated debt that qualifies as tier 2 capital (12 C.F.R. 250.166), except that it may become due and payable upon default in the payment of interest after any deferral period expires. (Of course, unlike other subordinated debt, it also must have a minimum maturity of 30 years and be subordinated to other subordinated debt.) Most outstanding trust preferred securities generally meet these requirements, with the following exceptions:

- the underlying subordinated note generally permits acceleration if there is a default in the payment of principal or a breach of a covenant; and
- the definition of "senior indebtedness" often includes a variety of minor exceptions, such as indebtedness to employees and to subsidiaries and non-recourse indebtedness, that are not found in typical tier 2 subordinated notes.

In addition, due to the absence of specific guidance in the 1996 press release as to what was meant by subordinated debt, some issuers may have issued trust preferred backed by subordinated debt with other nonconforming terms. The proposed rule states that such securities will continue to count as tier 1 capital provided that the "non-complying terms of the subordinated note (i) have been commonly used by banking organizations, (ii) do not provide an unreasonably high degree of protection to the holder in circumstances other than bankruptcy of the banking organization, and (iii) do not effectively allow a holder in due course of the note to stand ahead of senior or subordinated debt holders in the event of bankruptcy of the banking

[6] In order to avoid deconsolidation under FIN 46/46R, some issuers and investment banks had considered modifying the trust preferred structure to include other assets of unaffiliated third parties in the trust.

organization."[7] In any event, trust preferred securities issued on or after May 31, 2004 will need to comply with these new restrictions. Compliance should be simple in most cases and any necessary changes can be made in the prospectus supplement and in either an indenture supplement or the board resolutions setting the terms of the subordinated notes for a particular trust preferred offering.

The proposed rule also would incorporate into the capital guidelines a variety of Board and staff positions on capital instruments that had been adopted over the years but not published in a readily-accessible place:

- Capital instruments with rate step-ups or features that permit the holder to convert preferred stock into common stock at the then-prevailing market price do not qualify as tier 1 capital. The latter was a long-standing concern of Board staff because of the possibility that declines in the issuer's common price would trigger a "death spiral" in which the issuer would be legally committed to issue ever-increasing amounts of its common stock to pay off the preferred stock, which would in turn further depress the issuer's common stock price, thereby shutting it out of the capital markets.

- Common stock, in order to qualify without limit as tier 1 capital, must be "plain vanilla" common stock. The corporate law of Delaware and some other states permits companies to issue multiple classes of common stock, some of which may have dividend or liquidation preferences, minimum dividend requirements or other features more commonly associated with preferred stock. However, Board staff has traditionally taken the position that it does not want to engage in philosophical analyses of what constitutes common stock for purposes of defining tier 1 capital.

- Non-voting and low-voting common stock should constitute a minority of tier 1 capital. The proposed rule indicates that the Board may reallocate a portion of the capital attributable to non-voting or low-voting common stock to tier 2 if the Board determines that the amount of such securities is excessive.

- The Board will not give tier 1 treatment to preferred stock that contains features creating "significant incentives" for future redemption (e.g. escalating dividend rates or redemption premiums).

- Perpetual preferred stock that provides for the payment of unpaid dividends in the form of common stock (a feature of some European tier 1 capital instruments) will be treated as cumulative, rather than non-cumulative, preferred stock.

Bank holding companies must consult with the Federal Reserve prior to issuing trust preferred. The proposed rule more broadly states that bank holding companies "should consult with the Federal Reserve before redeeming any equity or debt capital instrument prior to stated

[7] Proposed rule, at footnote 10.

maturity if such redemption could have a material effect on the level or composition of the organization's capital base."[8] Although this is a requirement to consult rather than to obtain approval, it seems at odds with Regulation Y, which does not require well managed and well capitalized bank holding companies to obtain approval prior to redeeming equity securities and does not require other bank holding companies to obtain such approval unless they redeem 10 percent or more of their capital in a twelve-month period. Most outstanding trust preferred securities already contain a provision prohibiting redemption without the approval of the issuer's applicable bank regulator, if such approval is required by applicable law or regulation.

SIMPSON THACHER & BARTLETT LLP

[8] Proposed rule, at 20. In contrast, perpetual preferred stock qualifies as tier 1 capital only if redemption is subject to the Board's prior approval.