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

MARCH 7, 2005

SUMMARY

On March 1, 2005 the Board of Governors of the Federal Reserve System issued in final form a rule that it had proposed in May 2004 to address whether, following the issuance of FIN 46/46R, trust preferred securities will continue to qualify as tier 1 capital for bank holding companies.[1] As expected, the final rule provides that trust preferred securities will continue to count as tier 1 capital, but in reduced amounts: following a five-year transition period, the quantitative limitations for the amount of trust preferred, together with other "restricted core capital elements", that may be included in tier 1 capital will be:

- 15% of core capital elements, net of goodwill less any associated deferred tax liability, for internationally active bank holding companies, and
- 25% of core capital elements, net of goodwill less any associated deferred tax liability, 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 final rule will reduce the issuing capacity of some bank holding companies, particularly those that have completed significant purchase accounting transactions. Also, the 25%/15% limits apply to all "restricted core capital elements", which include most types of minority interests in consolidated subsidiaries as well as trust preferred and cumulative perpetual preferred stock, further reducing the amount of trust preferred that may be included in tier 1 capital. The limits on restricted core capital elements will become fully effective on March 31, 2009.

In addition, the final rule will treat trust preferred securities as tier 2 capital during the last five years before maturity and will 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 final rule will be published in the Federal Register but is available now on the Board's website (www.federalreserve.gov).

Although the final rule makes few substantive changes in the permitted terms for trust preferred securities, it does specify that for trust preferred securities issued on or after April 15, 2005 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. The Board had initially included this requirement in its proposed rule with a grandfather date of May 31, 2004, so most issuers previously had modified their trust preferred registration statements to conform to this requirement. However, in response to comments and questions the Board received on the proposed rule, the Board provided additional clarification on a number of technical provisions that are included in trust preferred securities. As a result, many issuers will need to make further revisions to their trust preferred registration statements to comply with the Board's technical pronouncements in the final rule.

The Board also used the final rule as a vehicle to formally adopt 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.

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

Under the risk-based capital rules for bank holding companies, only common stockholder's equity, qualifying cumulative and noncumulative preferred stock, and minority interests in equity accounts of consolidated subsidiaries qualify as tier 1 capital. In 1996 the Board interpreted the guidelines to permit the inclusion of trust preferred securities in tier 1 capital as minority interests in the equity accounts of a consolidated subsidiary.

In 1998, the Basel Committee on Banking Supervision announced that innovative capital instruments could constitute up to 15 percent of tier 1 capital, provided that they met certain criteria. The Board encouraged internationally active U.S. bank holding companies to restrict their trust preferred issuances to 15 percent of core capital, but did not impose a formal limit.

With the adoption by FASB of FIN 46 and FIN 46R in 2003, the trust that issues trust preferred is no longer consolidated with the bank holding company and the preferred securities issued by the trust are therefore no longer considered a minority interest in a consolidated subsidiary. Prior to the effective date of FIN 46 the Board advised bank holding companies that they should continue to include trust preferred securities in tier 1 capital until further notice.

The final rule confirms that bank holding companies may continue to include qualifying trust preferred securities in tier 1 capital.

LIMITS ON INCLUDING RESTRICTED CORE CAPITAL ELEMENTS IN CAPITAL

The risk-based capital guidelines for bank holding companies define tier 1 capital as core capital less goodwill and certain other items.[2] "Core capital" is defined to include common stockholders' equity, qualifying noncumulative perpetual preferred stock, qualifying cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries. Of the core capital elements, only qualifying cumulative perpetual preferred stock is subject to an explicit limit in the current guidelines, which is 25 percent of core capital. Trust preferred securities are not addressed by the current guidelines, but the Board includes them with qualifying cumulative perpetual preferred securities for purposes of the 25 percent limit.

The final rule amends the capital guidelines to restrict the inclusion of some types of minority interests in bank holding company regulatory capital on the grounds that, while minority interests in a subsidiary provide support for the subsidiary, they do not necessarily provide support that can easily be shifted elsewhere in the consolidated organization. This concern does not apply to minority interests in depository institution subsidiaries because the purpose of the bank holding company capital rules is to ensure the safety and soundness of depository institutions. The final rule establishes three classes of minority interests:

- *Class A Minority Interests:* qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary.
- *Class B Minority Interests:* qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary.
- *Class C Minority Interests:* 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.

The final rule revises the definition of "core capital" to mean: qualifying common stockholders equity; qualifying perpetual preferred stock (including related surplus); Class A, B and C minority interests; and qualifying trust preferred. The rule adds the concept of

[2] Tier 1 capital is defined as the sum of core capital elements less goodwill, other intangible assets, interest-only strip receivables and nonfinancial equity investments that are required to be deducted under the capital guidelines.

"restricted core capital elements", which include cumulative perpetual preferred stock, trust preferred securities, Class B minority interests, and Class C minority interests. The rule limits the aggregate amount of "restricted core capital elements" that may be included in tier 1 capital of a bank holding company to

- 15 percent of core capital (other than qualifying mandatorily convertible preferred securities), net of goodwill less any associated deferred tax liability, in the case of internationally active bank holding companies, and

- 25 percent of core capital, net of goodwill less any associated deferred tax liability, in the case of all other bank holding companies.

The final rule also limits the amount of qualifying trust preferred securities and Class C minority interests in excess of the restricted core capital limit that may be included in tier 2 capital. The inclusion of such elements, together with subordinated debt and limited-life preferred stock, in tier 2 capital, will be limited to 50 percent of tier 1 capital.

The final rule applies limits to more types of capital instruments than the current guidelines (which restrict only trust preferred and cumulative preferred securities). In addition, the final rule, unlike the current guidelines, deducts goodwill prior to calculating the limits. A number of comment letters opposed the deduction of goodwill from core capital elements in calculating the limits, pointing out that banking organizations are accumulating more goodwill due to the 2001 switch to purchase accounting for acquisitions. The Board rejected these comments, stating that the exclusion of goodwill from core capital is necessary in light of the fact that the value of goodwill declines if the condition of a banking organization declines. However, the Board did accept a related request that the deduction of goodwill be net of any associated deferred tax liability on the grounds that, if the value of the goodwill were eliminated, then the associated deferred tax liability would also be eliminated.

The 15 percent limit for internationally active banks would formalize a Board policy that was informally adopted after a 1998 Basel announcement (cited above) regarding innovative capital instruments, which includes such a limit. The proposed rule stated that "internationally active banks" meant those that had significant activities in non-U.S. markets or are "candidates" to adopt the Advanced Internal Ratings-Based approach under the Board's proposed implementation of the Basel New Capital Accord. It was unclear from the proposed rule whether the 15 percent limit would be applied only to bank holding companies that were required to adopt the Advanced Internal Ratings-Based approach or would also apply to those that "opted in" to that approach. Comments on the proposed rule argued that the latter would include many bank holding companies that are not internationally active and that might be deterred by application of the 15 percent limit from adopting the Advanced Internal Ratings-Based approach. The Board accepted this comment and the final rule will apply the 15 percent limit only to those bank holding companies that are required to adopt the Advanced Internal Ratings-Based approach; that is, it will be applied to bank holding companies that (i) on their most recent year-end FR Y-9C reports have total consolidated assets of $250 billion or more, *or* (ii) on a consolidated basis, report total on-balance sheet foreign exposures of $10 billion or

more on their most recent year-end FFIEC 009 Country Exposure Report. However, the Board indicated it would expect bank holding companies that opt in to the Advanced Internal Ratings-Based approach to come into compliance with the 15% limit as they approach the criteria for internationally active bank holding companies.

In the final rule, the Board also decided to exclude qualifying mandatory convertible preferred securities from the 15 percent tier 1 limit applicable to internationally active bank holding companies. Securities of this type consist of units in which trust preferred securities are paired with forward purchase contracts obligating the holders to purchase shares of the issuer's common stock on a specified future date, usually three years after issuance.[3] The Board explained that these "securities provide a source of capital that is generally superior to other restricted core capital elements because they are effectively replaced by common stock, the highest form of tier 1 capital, within a few years of issuance". Qualifying mandatory convertible preferred securities remain subject to the 25 percent sub-limit that is applicable to all bank holding companies.

The limits on restricted core capital will become fully effective on March 31, 2009, two years later than contemplated in the proposed rule.

CLARIFICATIONS ON PERMISSIBLE FEATURES OF TRUST PREFERRED AND OTHER CAPITAL INSTRUMENTS

The proposed rule would have continued the requirement that qualifying trust preferred include a call at the bank holding company's option commencing no later than ten years from issuance. The Board received comments requesting that this requirement be omitted on the grounds that the market for trust preferred securities has expanded to include institutional investors, and the presence of a call option results in more expensive offerings to such investors. The Board stated that it continued to believe that call options provide valuable flexibility to bank holding companies, but, noting that a call option is not required in qualifying perpetual preferred stock, in the final rule the Board omitted the call option requirement for qualifying trust preferred securities.

[3] Marshall & Ilsley issued securities of this type, under the tradename SPACES, in 2004. The Board stated that such securities require investors to purchase a "fixed amount" of common stock. However, in such offerings investors typically receive less stock if the price of the stock rises, but do not receive more stock if the price falls. This difference should not be of concern to the bank regulators (who are typically concerned if investors receive more stock as the price of the stock falls, thereby increasing the dilution to existing stockholders and creating downward pressure on the issuer's stock price at a time when it may have urgent capital raising needs).

Qualifying trust preferred must provide for a minimum of twenty consecutive quarters of dividend deferral. The proposed rule would have restricted the advance notice period for an issuer to elect to begin deferring interest payments on the underlying junior subordinated debt to no more than five business days from the payment date. Commenters objected that this was too short a period. In response, the Board provided in the final rule that the deferral notice period may be up to fifteen business days before the payment date.

The sole asset of the trust that issues qualifying trust preferred securities must be a bank holding company note with a minimum maturity of 30 years and that is subordinated to all other senior and subordinated debt of the bank holding company. The final rule, like the proposed rule, states that 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.) The proposed rule set an effective date of May 31, 2004 to comply with this requirement. Most outstanding trust preferred securities generally met this requirement, with the following exceptions:

- the underlying subordinated note generally permitted acceleration if there is a default in the payment of principal or a breach of a covenant; and
- the definition of "senior indebtedness" often included 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 response to the proposed rule, most issuers modified their trust preferred registration statements to conform to this requirement. However, the Board received a substantial number of comments and questions as to whether various technical provisions of typical trust preferred securities complied with the Board's rule for tier 2-qualifying subordinated debt. As a result, the Board extended its grandfather date for compliance with this requirement to April 15, 2005, and noted the following technical clarifications:

- junior subordinated debt underlying qualifying trust preferred can be pari passu with trade accounts payable and other accrued liabilities arising in the ordinary course of business;
- junior subordinated debt needs to be subordinated to senior obligations not only with respect to the priority of payments in bankruptcy but also with respect to the priority of interest payments while the bank holding company is a going concern; and
- indentures may prohibit deferral of interest if an event of default has occurred only if such event of default is a permissible basis for acceleration. In other words, an event of default arising under the indenture because of a covenant breach or a failure to follow the correct deferral procedure may not

bar an issuer from exercising its right to defer interest payments on the junior subordinated debt.

The final rule also will 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. Similarly, subordinated debt with a rate step-up feature will not qualify as tier 2 capital.

- 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. The risk-based capital guidelines, as amended by the final rule, state that a capital instrument that has a stated maturity date or that has a preference with regard to liquidation or the payment of dividends is not deemed to be a common equity under the capital rules. Features that provide significant incentives for the issuer to redeem the instrument will also render the instrument ineligible as qualifying common equity.

- Non-voting and low-voting common stock, as well as preferred stock, should constitute a minority of tier 1 capital. The final rule indicates that the Board may reallocate a portion of the capital attributable to non-voting or low-voting common stock or other non-voting securities 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.

Except as otherwise noted above, the final rule will take effect on July 1, 2005.

SIMPSON THACHER & BARTLETT LLP