

## FINANCIAL SERVICES ADVISORY

March 7, 2005

### TRUST PREFERRED SECURITIES AND OTHER CAPITAL INSTRUMENTS: THE FEDERAL RESERVE'S NEW CAPITAL RULES

The Federal Reserve Board released its final rules (the "Rule") on the capital treatment of trust preferred securities ("TPS") and other capital instruments on March 1, 2005. The Rule largely reflects the Federal Reserve's May 2004 rule proposal (the "Proposal"), and comprehensively integrates prior Federal Reserve guidance on capital instruments, especially those issued by bank holding company ("BHC") subsidiaries.

The Rule will take effect in early April 2005, thirty days after publication in the Federal Register. The Rule extends the transition period for compliance with the new restricted core capital elements from March 31, 2007, to March 31, 2009, to permit adversely affected TPS issuers to redeem outstanding TPS subject to common five-year no-call lockouts. Even with the phase-in and the continuation of Tier 1 capital treatment for most outstanding TPS, planning is required now. Key changes effected by the Rule include:

- Tier 1 capital treatment continues for TPS that also meet the tests for qualified perpetual preferred stock and subordinated debt, but the amount of TPS eligible for Tier 1 treatment is reduced.
- REIT preferred securities and any other equity in the form of minority interests ("Minority Interests") raised through securities issued by consolidated BHC subsidiaries that are not depository institutions, and depository institution subsidiaries' qualifying cumulative preferred stock, will be included with TPS up to an aggregate of 25 percent of Tier 1 capital with TPS as "restricted core capital elements."
- The Tier 2 capital treatment of various capital instruments is clarified.
- During the last five years prior to maturity, TPS will be included only as Tier 2 capital, with the amount counting as Tier 2 capital being reduced 20 percent each year, similar to the current capital treatment of subordinated debt.

#### BACKGROUND

In December 2003, the Financial Accounting Standards Board ("FASB") adopted its revised interpretation of FASB Statement No. 140 ("FIN 46R"), which clearly required deconsolidation of the statutory trusts that issued TPS. Absent Federal Reserve action, this deconsolidation would eliminate TPS as Tier 1 capital, since TPS qualified as capital only because the BHC consolidated the statutory trust issuers of TPS and could treat the investors in TPS as minority interests. In early July 2003, when it appeared that the initial version of FIN 46 would require deconsolidation of statutory trusts that issued

TPS, the Federal Reserve issued a supervisory letter stating that, until the Fed had conducted further analysis of TPS and reached a determination about the appropriate capital treatment, TPS would remain includable in Tier 1 capital up to 25 percent.

While FIN 46R and the de-consolidation of the statutory trusts that issue TPS spurred the Federal Reserve to act, the Rule provides a comprehensive framework that consolidates prior Federal Reserve policies and interpretations and takes into account Basle II capital concepts for larger, internationally active banking organizations. The Federal Reserve determined, that while BHCs must report using GAAP, the Federal Reserve is not bound by GAAP in defining capital and setting capital requirements for regulatory purposes.

## THE NEW RULE

The Rule defines more specifically certain capital instruments that qualify for Tier 1 or Tier 2 capital treatment. Certain instruments, including qualifying TPS and cumulative perpetual preferred stock, and certain Minority Interests in consolidated subsidiaries, are called “restricted core capital elements.” Restricted core capital elements include most minority interests in BHC subsidiaries, and all restricted core capital elements can be included in Tier 1 capital up to 25 percent of Tier 1 capital (including the restricted core capital elements).

Three different classes of Minority Interests, each with different capital consequences, are recognized by the Rule:

- Class A – qualifying common stock and noncumulative perpetual preferred stock in consolidated depository institution subsidiaries. Class A minority interests are included without limitation as Tier 1 capital by BHCs.
- Class B – qualifying noncumulative perpetual preferred stock in consolidated depository institution subsidiaries. These Class B interests are included as Tier 1 capital, subject to the limits on “restricted core capital elements.” Any excess is includable without limit in Tier 2 capital.
- Class C – qualifying common stock and perpetual preferred stock in nondepository consolidated subsidiaries. Class C interests are included as Tier 1 capital subject to the limits on “restricted core capital elements” and also are subject to a limit on Tier 2 capital. REIT preferred securities and any other minority interest issued by a non-depository subsidiary are treated as Class C interests. Certain minority interests, such as interests in SBICs and subsidiaries conducting off-balance sheet, asset-backed commercial paper conduit programs, are not included as a Class C element.

Qualifying TPS are expressly included as a separate element of Tier 1 capital, and not as a Minority Interest.

The Rule provides these capital limits:

- The total amount of the four restricted core capital elements – qualifying TPS, qualifying cumulative perpetual preferred stock, and Class B and C minority

- interests, cannot exceed 25 percent of all core capital elements, net of goodwill (less any associated deferred tax liability) and intangibles.
- “Internationally active” banking organizations – generally, bank holding companies with total consolidated assets of \$250 billion or more on a consolidated basis and foreign exposures of \$10 billion or more – are limited to restricted core capital elements of up to 15 percent of core capital, net of goodwill (less any associated deferred tax liability) and intangibles. This is generally consistent with rating agency limits on TPS for BHCs with rated debt. The “internationally active” definition approximates the definition proposed for the latest Advanced Internal Ratings Based (“AIRB”) approach under Basle II issued August 4, 2003. In contrast to the Proposal, the 15 percent limit does not apply to banking organizations that opt into AIRB, although the Federal Reserve generally expects and strongly encourages opt-in AIRB holding companies to plan for and come into compliance with the 15 percent limit on restricted core capital elements as they approach the criteria for internationally active bank holding companies.
  - Internationally active organizations also may include, outside the 15 percent Tier 1 capital sublimit, “qualifying mandatory convertible preferred securities.” Such qualifying mandatory convertible preferred securities generally are subject to the 25 percent Tier 1 sublimit.
  - Excess amounts of the restricted core capital elements, as well as subordinated debt and limited life preferred stock, are included as Tier 2 capital. Currently, subordinated debt and limited life preferred stock are includable in Tier 2 only up to 50 percent of Tier 1 capital. This limit remains in place, and the Rule adds two more instruments which count against this 50 percent limit: (1) TPS and (2) Class C minority interests. Thus, as of March 31, 2009, the total of subordinated debt, limited life preferred stock, and excess amounts of qualifying TPS and Class C minority interests, are includable in Tier 2 up to 50 percent of Tier 1 capital, less net goodwill and intangibles.

In applying the Tier 1 and Tier 2 capital limits and sub-limits, goodwill first must be deducted from capital. This deduction is not currently required in applying capital limits to such instruments as subordinated debt. This deduction requirement is derived from Basle II.

Several existing capital principles will continue under the Rule. Voting common equity without dividend or liquidation preferences must be at least a majority of total capital. Tier 2 capital cannot exceed Tier 1 capital. Capital instruments cannot contain or be covered by any covenants, terms or restrictions that are inconsistent with safe and sound banking practices. Losses must be absorbed first by the most junior capital instruments.

Dual class common stock used to be popular as an anti-takeover measure, especially among smaller public bank holding companies with large family ownerships. More recently, dual classes of common stock are being used in “going private transactions” to avoid SEC registration and reporting. Both uses require a great deal of thought and planning in light of the new Rule, the heightened liability of directors in going private

transactions, negative investor perceptions of such capital structures and required securities law disclosures. The Federal Reserve has significant concerns about the possible effects on BHCs' appetite for risk where their controlling parties do not have economic stakes in the BHC that are proportionate to their voting control. BHCs trying to escape the governance and other requirements of the Sarbanes-Oxley Act of 2002 by going private should consider that the Federal Reserve will, as a general matter, heighten its supervisory scrutiny of the corporate governance and financial strategies of BHCs using dual classes of common stock, especially where the predominance of voting common equity and Tier 1 capital begins to erode.

Super-voting or super-dividend paying dual classes of common stock may be deducted from the Tier 1 capital base, reducing the amount of TPS and other restricted core elements available. Nonvoting common stock and voting common equity with substantially fewer voting rights per share than other common shares, and voting common equity that pays preferential or higher dividends than other common shares may also be subject to Federal Reserve requirements that a portion of the nonvoting elements be allocated to Tier 2 instead of Tier 1 capital. This introduces risks into the capital structure of BHCs. Further, the Rule states that any capital instrument that has a stated maturity date or a preference with regard to the liquidation of the payment of dividends is not deemed to be a component of common stockholders' equity regardless of whether it is called common equity.

## QUALIFYING TPS

The Federal Reserve, consistent with the themes of the Proposal, tightened the prerequisites for qualifying TPS as Tier 1 capital. The Rule provides these explicit TPS requirements:

- Consultation with the Federal Reserve prior to TPS being issued as Tier 1 capital.
- Dividends on TPS must be deferrable for at least 20 consecutive quarters without causing an event of default.
- Any notification period for deferral of dividends must be short, and no longer than 15 business days prior to the scheduled payment date.
- TPS must meet the requirements for qualifying perpetual preferred stock, and after May 31, 2004, should be "undated," which means that these have no maturity date.
- The sponsoring BHC no longer must have a call option on the TPS. The Federal Reserve dropped the call requirement in order to expand institutional investor interest in TPS and to potentially reduce TPS rates. While the Federal Reserve's bases for this deletion are questionable, the Federal Reserve continues to clearly favor call features as financially useful and beneficial to BHCs.
- During the last five years of maturity, the TPS must be treated solely as Tier 2 capital and the amount included as Tier 2 capital must be amortized at 20 percent per year on a straight-line basis.

- The sole asset of the trust issuing TPS must be a junior subordinated note, issued by the sponsoring BHC, that has a minimum maturity of 30 years, is subordinated to all senior and all other subordinated debt of the BHC, and otherwise mirrors the terms of the preferred securities issued by the trust.
- The junior subordinated note must comply with the Fed's subordinated debt policy statement (12 C.F.R. § 250.166), but may provide for default and acceleration of principal and accrued interest upon deferral of payments in excess of 20 consecutive quarters.

## EFFECTIVE DATE

The Rule is effective 30 days after publication in the Federal Register. The limits on restricted core capital elements become effective March 31, 2009. However, before then, "a banking organization with restricted core capital elements in amounts that cause them to exceed these limits must consult with the Federal Reserve on a plan for ensuring that the banking organization is not unduly relying on these elements in its capital base and, where appropriate, for reducing such reliance to ensure compliance by March 31, 2009."

The Federal Reserve recognized that there is over \$85 billion of outstanding TPS, that it generally has had favorable supervisory experiences with TPS, and that TPS are effective, tax-efficient instruments. The Rule provides that outstanding TPS issued before April 15, 2005, will not be disqualified as Tier 1 capital for noncompliance with the Rule, if these existing TPS have terms that are (1) commonly used by BHCs, (2) do not provide the holder an "unreasonably high degree of protection, except in bankruptcy," and (3) "do not effectively allow a holder in due course of the note to stand ahead of the issuer's senior or subordinated debt holders in a bankruptcy of the issuer, including no higher priority than a subordinated debt holder."

## OTHER CHANGES TO THE CAPITAL RULES

The Rule clarifies the characteristics required of various other capital instruments, and provides more stringent qualitative standards. In addition to changing the TPS rules, other changes in the regulatory capital rules, include:

- If a BHC purchases a direct or indirect investment in its own TPS, such investment must be excluded from capital. For example, a BHC that has issued TPS to a pool and purchased securities in that pool, must deduct the notional amount of the pool securities in calculating its assets and capital. Acquiring BHCs will be subject to the same deduction upon the acquisition of a target that has issued TPS to a pool where the acquirer has an investment.
- Common stock may not be included in Tier 1 capital if it contains investor preferences, including preferential dividends, voting or liquidation rights. This will adversely affect most BHCs with two or more classes of common stock.

- BHCs must have discretion to waive or defer dividends on all stock, including TPS, to include such stock as capital. Any provisions restricting the issuer's ability or legal right to defer or waive dividends, other than deferrals or waivers on more junior instruments, will cause such instruments to be reclassified as other than Tier 1 capital.
- The Federal Reserve expects the most junior capital elements to absorb losses first with the next most senior capital instrument absorbing losses next, etc.
- Credit sensitive features, including dividend rate step-up and/or market value conversion features where the holder converts preferred into common stock at the market price at the time of conversion, disqualify TPS and preferred stock from Tier 1 capital treatment.
- Perpetual preferred stock with a feature permitting redemption at the option of the issuer qualifies as Tier 1 capital, only if the redemption is expressly subject to prior Federal Reserve approval. Any other features that require or create significant incentives for the issuer to redeem the instrument for cash or cash equivalents will make the instrument ineligible for Tier 1 treatment.
- Noncumulative perpetual preferred stock generally may not permit the accumulation or payment of unpaid dividends in any manner, including "payment-in-kind" dividends paid in shares of issuer common stock. Any provision of perpetual preferred stock that provides for the accumulation of future payments of unpaid dividends is deemed to be cumulative whether or not it is called noncumulative. A common optional redemption provision in preferred stock allows redemption "at par plus all unpaid dividends." It is uncertain whether such a provision will taint the capital treatment of perpetual preferred stocks.
- Perpetual preferred stock does not require any call provisions in a manner similar to the Rule's provisions on TPS.
- The junior subordinated debt held by TPS issuer trusts may rank *pari passu* with obligations to the BHC's trade creditors and junior subordinated debt underlying other issues of TPS. The Federal Reserve has given BHCs some flexibility to create new capital instruments by allowing such junior subordinated debt to be senior to or *pari passu* with deeply subordinated capital instruments that the Federal Reserve in the future authorizes for inclusion in Tier 1 capital.
- It is clear that junior subordinated debt must *not* be senior in liquidation, and in the priority of periodic interest payments, to non-deferrable debt of the issuing BHC.
- Consistent with the subordinated debt rules, it is now expressly clear that the maturity of junior subordinated debt underlying TPS may accelerate if the trust issuing the TPS goes into bankruptcy or is dissolved or if the BHC or its principal bank subsidiary is in bankruptcy or liquidation.

- Perpetual preferred stock generally provides limited voting rights to investors upon the continued nonpayment of dividends and these are permitted consistent with customary provisions such as the right to elect one or two directors to the BHC board.
- All redemptions of capital instruments prior to their stated maturity should be done only with prior consultation with the Federal Reserve, especially if there is a material effect on the level or composition of the issuer's capital base.
- Any instrument that has a stated maturity date or that has a preference with regard to the liquidation or payment of dividends is not a component of common stockholders' equity. BHCs with existing REIT subsidiary preferred stock that has been publicly issued to raise capital should consider the limitations of the new Rule, including the sublimits on Class B and C minority interests.
- "Mandatory convertible preferred securities" are described by the Federal Reserve generally as TPS with a forward purchase contract fully collateralized by the TPS that obligate investors to purchase a fixed amount of BHC common stock generally within three years. Often the TPS are remarketed by the initial investors to new investors and the cash proceeds are used to satisfy the initial investors' obligations to buy the BHC common stock. The common stock replaces the initial TPS as part of Tier capital. The remarketed TPS are excluded from regulatory capital since the terms are changed to shorten the maturity of securities that include more debt-like features and are no longer qualifying trust preferred.

The Proposal indicated a desire to integrate the proposed capital rules with the Federal Reserve's Small BHC Policy Statement (Reg. Y, Appendix C). Generally, small BHCs with under \$150 million of assets are not subject to the risk-based or leverage capital guidelines, and can incur acquisition debt up to 75 percent of total equity. While the Proposal considered allowing small BHCs to issue TPS and subordinated debt up to 25 percent of GAAP shareholders' equity less goodwill, without being considered debt or equity, the Rule unfortunately defers these proposals.

## THINGS TO DO NOW

BHCs should consider the following:

- BHCs should review the terms of their outstanding TPS issues to make sure that these will be counted as capital after March 31, 2009. If these will not count as Tier 1 capital, issuers should consider exercising their rights to redeem outstanding TPS, and replacing these with new TPS that count as Tier 1 capital under the Rule. Redemption of outstanding TPS would be especially attractive where the TPS' interest rates or other terms are less favorable than currently available.
- BHCs that have purchased interests in TPS pools or collateralized debt obligations ("CDOs") that hold TPS issued by such BHC should consider redeeming and refunding such TPS, or selling their interests in the pools or CDOs to avoid the pending hit to capital caused by such investments. Acquirers should analyze

- any target's issuance and holdings of TPS or CDOs to make sure that they do not lose capital as a result of an acquisition.
- Acquirers should consider using other capital instruments, including common stock, noncumulative perpetual preferred stock and subordinated debentures, in addition to TPS, to fund their M&A activity, since the amount of permissible TPS will be based upon capital after deduction for existing and new goodwill and other intangibles related to acquisitions. Active acquirers should calculate their capital position under the Rule to make sure that their existing capital will be sufficient. The Rule will reduce the availability of leverage through TPS and other debt-type instruments to fund acquisitions with instruments included as regulatory capital. This may reduce M&A premiums by increasing the cost of capital, and may make "merger of equals" transactions with low or no premiums more attractive, since these do not result in significant additions to intangibles.
  - Issuers with two or more classes of common stock should consider amending their charters to eliminate the multi-class structure. This structure generally has led to the publicly-held common being undervalued and has made acquisitions using common stock more difficult. There are better alternatives for purposes of discouraging takeovers, or going private transactions, that involve less regulatory and investor scrutiny and risks.
  - BHCs should consider whether the terms of their existing capital instruments comply with the new Rule. Only TPS are grandfathered under the new Rule with respect to outstanding instruments. Issuers considering new instruments should consult with the Federal Reserve to make sure that the Federal Reserve understands the instrument in light of the new Rule and that cumulative features on preferred perpetual stock are not introduced accidentally as a result of redemption or other features requiring payment of missed dividends.
  - While market pricing of TPS has continued to decline, especially in pool or conduit situations, issuers should carefully weigh any request for a noncall feature. The Rule's change to no longer require TPS to have call features may have the unintended effect of increasing the cost of call features on TPS and other instruments issued to institutional investors. BHC issuers should generally seek a call right to preserve their financial flexibility, especially in light of TPS' 30-year term.
  - Small BHCs considering going private, leveraged buyouts or Subchapter S conversions, will continue to find TPS and subordinated debt attractive under the Rule.

Please contact any of us to discuss the Rules. We will be pleased to help you analyze the Rule's effects on your institution and possible actions that you should consider.

This *Financial Services Advisory* is published by Alston & Bird LLP ([www.alston.com](http://www.alston.com)) to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered advertising under applicable court rules.

If you have any questions or would like additional information, please contact your Alston & Bird attorney, any member of the Alston & Bird Financial Services and Products Group or any of the following attorneys who contributed to this *Financial Services Advisory*:

---

Ralph F. MacDonald, III  
404-881-7582  
[cmacdonald@alston.com](mailto:cmacdonald@alston.com)  
Atlanta, GA

Dwight C. Smith, III  
202-756-3325  
[dcsmith@alston.com](mailto:dcsmith@alston.com)  
Washington, DC

Mark C. Kanaly  
404-881-7975  
[mkanaly@alston.com](mailto:mkanaly@alston.com)  
Atlanta, GA

**ATLANTA**  
One Atlantic Center  
1201 West Peachtree Street  
Atlanta, GA 30309-3424  
404-881-7000

**CHARLOTTE**  
Bank of America Plaza  
101 South Tryon Street  
Suite 4000  
Charlotte, NC 28280-4000  
704-444-1000

**NEW YORK**  
90 Park Avenue  
New York, NY 10016-1387  
212-210-9400

**RESEARCH TRIANGLE**  
3201 Beechleaf Court  
Suite 600  
Raleigh, NC 27604-1062  
919-862-2200

**WASHINGTON, D.C.**  
601 Pennsylvania Avenue, N.W.  
North Building, 10th Floor  
Washington, D.C. 20004-2601  
202-756-3300

[www.alston.com](http://www.alston.com)

If you would like to receive future Financial Service Advisories electronically, please forward your contact information including e-mail address to [financialservices@alston.com](mailto:financialservices@alston.com). Be sure to put "subscribe" in the subject line.