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FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–1193]

Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is amending its risk-based capital standards for bank holding companies to allow the continued inclusion of outstanding and prospective issuances of trust preferred securities in the tier 1 capital of bank holding companies, subject to stricter quantitative limits and qualitative standards. The Board also is revising the quantitative limits applied to the aggregate amount of cumulative perpetual preferred stock, trust preferred securities, and minority interests in the equity accounts of most consolidated subsidiaries (collectively, restricted core capital elements) included in the tier 1 capital of bank holding companies. The new quantitative limits become effective after a five-year transition period. In addition, the Board is revising the qualitative standards for capital instruments included in regulatory capital consistent with longstanding Board policies. The Board is adopting this final rule to address supervisory concerns, competitive equity considerations, and changes in generally accepted accounting principles and to strengthen the definition of regulatory capital for bank holding companies.

EFFECTIVE DATE: This final rule is effective on April 11, 2005. The Board will not object if a banking organization wishes to apply the provisions of this final rule beginning on the date it is published in the **Federal Register**.

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SUPPLEMENTARY INFORMATION:

Background

Trust Preferred Securities and Other Tier 1 Capital Components

The Board's risk-based capital guidelines for bank holding companies (BHCs), which are based on the 1988 Basel Accord, as well as the leverage capital guidelines for BHCs, allow BHCs to include in their tier 1 capital the following items that are defined as core (or tier 1) capital elements: common stockholders' equity; qualifying noncumulative perpetual preferred stock (including related surplus); qualifying cumulative perpetual preferred stock (including related surplus); and minority interest in the equity accounts of consolidated subsidiaries. Since 1989, qualifying cumulative perpetual preferred securities have been limited to 25 percent of a BHC's core capital elements. Tier 1 capital generally is defined as the sum of core capital elements less deductions for all, or a portion of, goodwill, other intangible assets, credit-enhancing interest-only strips receivable, deferred tax assets, non-financial equity investments, and certain other items required to be deducted in computing tier 1 capital.

The Board's capital guidelines allow minority interest in the equity accounts of consolidated subsidiaries of a BHC to be included in the BHC's tier 1 capital because such minority interest represents capital support from third-party investors for a subsidiary controlled by a BHC and consolidated on its balance sheet. Nonetheless, minority interest does not constitute equity on the BHC's consolidated balance sheet because minority interest typically is available to absorb losses only within the subsidiary that issues it and is not generally available to absorb losses in the broader consolidated banking organization. Under the Board's existing capital rule, minority interest is not subject to a specific numeric sub-limit within tier 1 capital, although the includable amount of minority interest is restricted by the rule's directive that voting common stock generally should be the dominant form of tier 1 capital. Minority interest in the form of cumulative preferred stock, however, generally has been subject to the same 25 percent sub-limit as qualifying cumulative preferred stock issued directly by a BHC.

In 1996, the Board explicitly approved the inclusion in BHCs' tier 1 capital of minority interest in the form of trust preferred securities for most of the same reasons that the Board proposed in its May 2004 proposed rule to allow the continued inclusion of trust preferred securities in BHCs' tier 1 capital. In particular, two key features of trust preferred securities—their long lives approaching economic perpetuity and their dividend deferral rights (allowing deferral for 20 consecutive quarters) approaching economically indefinite deferral—are features that provide substantial capital support.

Trust preferred securities are undated cumulative preferred securities issued out of a special purpose entity (SPE), usually in the form of a trust, in which a BHC owns all of the common securities. The SPE's sole asset is a deeply subordinated note issued by the BHC. The subordinated note, which is senior only to a BHC's common and preferred stock, has terms that generally mirror those of the trust preferred securities, except that the junior subordinated note has a fixed maturity of at least 30 years. The terms of the trust preferred securities allow dividends to be deferred for at least a twenty-consecutive-quarter period without creating an event of default or acceleration. After the deferral of dividends for this twenty-quarter period, if the BHC fails to pay the cumulative dividend amount owed to investors, an event of default and acceleration occurs, giving investors the right to take hold of the subordinated note issued by the BHC. At the same time, the BHC's obligation to pay principal and interest on the underlying junior subordinated note accelerates and the note becomes immediately due and payable. A key advantage of trust preferred securities to BHCs is that for tax purposes the dividends paid on trust preferred securities, unlike those paid on directly issued preferred stock, are a tax deductible interest expense. The Internal Revenue Service ignores the trust and focuses on the interest payments on the underlying subordinated note. Because trust preferred securities are cumulative, they have been limited since their inclusion in tier 1 capital in 1996, together with a BHC's directly issued cumulative perpetual preferred stock, to no more than 25 percent of a BHC's core capital elements.

In 2000, the first pooled issuance of trust preferred securities came to market. Pooled issuances generally constitute the issuance of trust preferred securities by a number of BHCs to a pooling entity that issues to the market asset-backed securities representing interests in the BHCs' pooled trust preferred securities. Such pooling arrangements, which have become increasingly popular and typically involve thirty or more separate BHC issuers, have made the issuance of trust preferred securities possible for even very small BHCs, most of which had not previously enjoyed capital market access for raising tier 1 capital.

Asset-Driven Preferred Securities

In addition to issuing trust preferred securities, banking organizations have also issued asset-driven securities, particularly real estate investment trust (REIT) preferred securities. REIT preferred securities generally are issued by SPE subsidiaries of a bank that qualify as REITs for tax purposes. In most cases the REIT issues noncumulative perpetual preferred securities to the market and uses the proceeds to buy mortgage-related assets from its sole common shareholder, its parent bank. By qualifying as a REIT under the tax code, the SPE's income is not subject to tax at the entity level, but is taxable only as income to the REIT's investors upon distribution. Two key qualifying criteria for REITs are that REITs must hold predominantly real estate assets and must pay out annually a substantial portion of their income to investors. To avoid the situation where preferred stock investors in a REIT subsidiary of a failing bank are effectively over-collateralized by high quality mortgage assets of the parent bank, the Federal banking agencies have required REIT preferred securities to have an exchange provision to qualify for inclusion in tier 1 capital. The exchange provision provides that upon the occurrence of certain events, such as the parent bank becoming undercapitalized or being placed into receivership, the noncumulative REIT preferred securities will be exchanged either automatically or upon the directive of the parent bank's primary Federal supervisor for directly issued noncumulative perpetual preferred securities of the parent bank. In the absence of the exchange provision, the REIT preferred securities would provide little support to a deteriorating or failing parent bank or to the FDIC, despite possibly comprising a substantial amount of the parent bank's tier 1 capital (in the form of minority interest).

While some banking organizations have issued a limited amount of REIT preferred and other asset-driven securities, most BHCs prefer to issue trust preferred securities because they are relatively simple and standard instruments, do not tie up liquid assets, are easier and more cost-efficient to issue and manage, and are more transparent and better understood by the market. Also, BHCs generally prefer to issue trust preferred securities at the holding company level rather than REIT preferred securities at the bank level because it gives them greater flexibility in using the proceeds of such issuances.

Revised GAAP Accounting for Trust Preferred Securities

Prior to the Board's issuance of its proposed rule last May, the Financial Accounting Standards Board (FASB) revised the accounting treatment of trust preferred securities through the issuance in January 2003 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). Since then the accounting industry and BHCs have dealt with the application of FIN 46 to the consolidation by BHC sponsors of trusts issuing trust preferred securities. In late December 2003, when FASB issued a revised version of FIN 46 (FIN 46R), the accounting authorities generally concluded that such trusts must be deconsolidated from their BHC sponsors' financial statements under GAAP. The result is that, for GAAP accounting purposes, trust preferred securities generally continue to be accounted for as equity at the level of the trust that issues them, but the instruments may no longer be treated as minority interest in the equity accounts of a consolidated subsidiary on a BHC's consolidated balance sheet. Instead, under FIN 46 and FIN 46R, a BHC must reflect on its consolidated balance sheet the deeply subordinated note the BHC issued to the deconsolidated SPE.

A change in the GAAP accounting for a capital instrument does not necessarily change the regulatory capital treatment of that instrument. Although GAAP informs the definition of regulatory capital, the Board is not bound to use GAAP accounting concepts in its definition of tier 1 or tier 2 capital because regulatory capital requirements are regulatory constructs designed to ensure the safety and soundness of banking organizations, not accounting designations established to ensure the transparency of financial statements. In this regard, the definition of tier 1 capital since the Board adopted its risk-based capital rule in 1989 has differed from GAAP equity in a number of ways. The Board has determined that these differences are consistent with its responsibility for ensuring the soundness of the capital bases of banking organizations under its supervision. These differences are not differences between regulatory reporting and GAAP accounting requirements, but rather are differences only between the definition of equity for purposes of GAAP and the definition of tier 1 capital for purposes of the Board's regulatory capital requirements for banking organizations.

Nevertheless, consistent with longstanding Board direction, BHCs are required to follow GAAP for regulatory reporting purposes. Thus, BHCs should, for both accounting and regulatory reporting purposes, determine the appropriate application of GAAP (including FIN 46 and FIN 46R) to their trusts issuing trust preferred securities. Accordingly, there should be no substantive difference in the treatment of trust preferred securities issued by such trusts, or the underlying junior subordinated debt, for purposes of regulatory reporting and GAAP accounting.

Proposed Rule

In May 2004, the Board issued a proposed rule, *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital* (69 FR 28851, May 19, 2004). Under the proposal, BHCs would be allowed explicitly to include outstanding and prospective issuances of trust preferred securities in their tier 1 capital.

The Board, however, also proposed subjecting these instruments and other restricted core capital elements to tighter quantitative limits within tier 1 and more stringent qualitative standards. The proposed rule defined other restricted core capital elements to include qualifying cumulative perpetual preferred stock (including related surplus) and minority interest other than in the form of common equity or noncumulative perpetual preferred stock directly issued by a U.S.

depository institution or foreign bank subsidiary of a BHC.

The Board generally proposed limiting restricted core capital elements to 25 percent of the sum of core capital elements, net of goodwill, for BHCs. However, consistent with the 1998 Sydney Agreement of the Basel Committee on Banking Supervision (Sydney Agreement), the proposal also stated that internationally active BHCs generally would be expected to limit restricted core capital elements to 15 percent of the sum of core capital elements, net of goodwill. The proposed rule defined internationally active BHCs to include BHCs that have significant activity in non-U.S. markets or are candidates for use of the Advanced Internal Ratings-Based (AIRB) approach under the revised Basel Accord, International Convergence of Capital Measurement and Capital Standards (June 2004) (the Mid-year Text). The proposal provided an approximately three-year transition period, through March 31, 2007, before BHCs would be required to comply with the proposed revised quantitative limits and qualitative standards.

The Board also proposed to incorporate explicitly in the rule the Board's long-standing policy that the junior subordinated debt underlying trust preferred securities generally must meet the criteria for qualifying tier 2 subordinated debt set forth in the Board's 1992 subordinated debt policy statement, 12 CFR 250.166. As a result, trust preferred securities qualifying for tier 1 capital would be required to have underlying junior subordinated debt that complies with the Board's long-standing acceleration and subordination requirements for tier 2 subordinated debt. Under the proposal, noncompliant junior subordinated debt issued before May 31, 2004 would be grandfathered as long as the terms of the junior subordinated debt met certain criteria.

Comments Received and Final Rule

In response to the proposed rule, the Board received thirty-eight comments. All commenters but one supported the Board's proposal to continue to include outstanding and prospective issuances of trust preferred securities in BHCs' tier 1 capital. Many commenters, however, had some reservations with other aspects of the proposal. These aspects included the deduction of goodwill for purposes of determining compliance with the generally applicable 25 percent tier 1 sub-limit on restricted core capital elements; the 15 percent restricted core capital elements supervisory threshold for internationally active BHCs; the length of the transition period; the technical requirements for the junior subordinated debt underlying trust preferred securities; the grandfathering period for noncompliant issuances of underlying junior subordinated debt; other qualitative requirements for trust preferred securities eligible for inclusion in tier 1 capital; the treatment of restricted core capital elements for purposes of the small BHC policy statement; and the explicit inclusion in the proposed rule of the Board's longstanding policy to restrict the amount of non-voting equity elements included in tier 1 capital. The comments received, as well as the Board's discussion and resolution of the issues raised, are discussed further below.

Continued Inclusion of Trust Preferred Securities in BHCs' Tier 1 Capital

Almost all of the comment letters agreed that the continued inclusion of trust preferred securities in the tier 1 capital of BHCs was appropriate from financial, economic, and public policy perspectives. The commenters encouraged the Board to adopt its proposal to continue to include trust preferred securities in BHCs' tier 1 capital.

Only the comment letter from the Federal Deposit Insurance Corporation opposed the proposal, based primarily on its view that instruments that are accounted for as a liability under GAAP should not be included in tier 1 capital, a view the Board had previously considered before issuance of its proposal. The comment letter also argued that trust preferred securities should be excluded from tier 1 capital because they are not perpetual, have cumulative dividend structures, do not allow for the perpetual deferral of dividends, are treated as debt by rating agencies, put stress on subsidiary banks to pay dividends to BHCs to service trust preferred dividends, and give a capital raising preference to banks with BHCs.

After reconsideration of the issues raised by the FDIC and other commenters, the Board has decided to adopt this final rule allowing the continued limited inclusion of outstanding and prospective issuances of trust preferred securities in BHCs' tier 1 capital. The Board does not believe that the change in GAAP accounting for trust preferred securities has changed the prudential characteristics that led the Board in 1996 to include trust preferred securities in the tier 1 capital of BHCs. In arriving at this decision, the Board also considered its generally positive supervisory experience with trust preferred securities, domestic and international competitive equity issues, and supervisory concerns with alternative tax-efficient instruments.

A key consideration of the Board has been the ability of trust preferred securities to provide financial support to a consolidated BHC because of their deep subordination and the ability of the BHC to defer dividends for up to 20 consecutive quarters. The Board recognizes that trust preferred securities, like other forms of minority interest that have been included in banks' and BHCs' tier 1 capital since 1989, are not included in GAAP equity and cannot forestall a BHC's insolvency. Nevertheless, trust preferred securities are available to absorb losses more broadly than most other minority interest in the consolidated banking organization because the issuing trust's sole asset is a deeply subordinated note of its parent BHC. Thus, if a BHC defers payments on its junior subordinated notes underlying the trust preferred securities, the BHC can use the cash flow anywhere within the consolidated organization. Dividend deferrals on equity issued by the typical operating subsidiary, on the other hand, absorb losses and preserve cash flow only within the subsidiary; the cash that is freed up generally is not available for use elsewhere in the consolidated organization.

As noted, the Board also considered its generally positive supervisory experience with trust preferred securities, particularly for BHCs that limit their reliance on such securities. The instrument has performed much as expected in banking organizations that have encountered financial difficulties; in a substantial number of instances, BHCs in deteriorating financial condition have deferred dividends on trust preferred securities to preserve cash flow. In addition, trust preferred securities have proven to be a useful source of capital funding for BHCs, which often downstream the proceeds in the form of common stock to subsidiary banks, thereby strengthening the banks' capital bases. For example, in the months following the events of September 11, 2001, a period when the issuance of most other capital instruments was extremely difficult, BHCs were able to execute large issuances of trust preferred securities to retail investors, demonstrating the financial flexibility this instrument offers.

Trust preferred securities have reduced the cost of tier 1 capital for a wide range of BHCs. Approximately 800 BHCs have outstanding over $85 billion of trust preferred securities, the popularity of which stems in large part from their tax-efficiency. Eliminating the ability to include trust preferred securities in tier 1 capital would eliminate BHCs' ability to benefit from this tax-advantaged source of funds, which would put them at a competitive disadvantage to both U.S. and non-U.S. competitors. With respect to the latter, the Board is aware that foreign competitors have issued as much as $125 billion of similar tax-efficient tier 1 capital instruments.

Furthermore, in reviewing existing alternative tax-efficient tier 1 capital instruments available to BHCs, the Board concluded that in several ways trust preferred securities are a superior instrument to such alternative capital instruments, such as REIT preferred securities and other asset-driven securities, which continue to be included in minority interest under FIN 46 and FIN 46R. In this regard, trust preferred securities are available to absorb losses throughout the BHC and do not affect the BHC's liquidity position. In addition, trust preferred securities are relatively simple, standardized, and well-understood instruments that are widely issued by both corporate and banking organizations. Moreover, issuances of trust preferred securities tend to be broadly distributed and transparent and, thus, easy for the market to track.

Under this final rule, trust preferred securities will be includable in the tier 1 capital of BHCs, but subject to tightened quantitative limits for trust preferred securities and a broader range of tier 1 capital components defined as restricted core capital elements. Specifically, restricted core capital elements are defined to include qualifying cumulative perpetual preferred stock (and related surplus), minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class B minority interest), minority interest related to qualifying common or qualifying perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank (Class C minority interest), and qualifying trust preferred securities.

Restricted core capital elements includable in the tier 1 capital of a BHC are limited to 25 percent of the sum of core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability, as discussed further below. In addition, as amplified below, internationally active BHCs would be subject to a further limitation. In particular, the amount of restricted core capital elements (other than qualifying mandatory convertible preferred securities discussed below) that an internationally active BHC may include in tier 1 capital must not exceed 15 percent of the sum of core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability.

Deduction of Goodwill in Computing Tier 1 Limits on Restricted Core Capital Elements

Fifteen comment letters opposed the deduction of goodwill from core capital elements in calculating the applicable tier 1 capital sub-limit for restricted core capital elements. Commenters noted that goodwill represents the going concern value paid by banking organizations in acquisitions and mergers and that GAAP, since 2001, has treated goodwill as a non-amortizing asset that is reduced annually, if appropriate, to reflect impairment. A result of the 2001 accounting change is that over the coming years BHCs making acquisitions will accrue higher amounts of goodwill as a percentage of assets than they have in the past. Some of these commenters argued that this would make the proposal's ''net of goodwill'' approach grow increasingly burdensome for BHCs making acquisitions and would potentially reduce merger and acquisition activity in the banking sector.

Other commenters indicated that while they concurred with the Board's reasons for the goodwill deduction—limiting the extent to which BHCs can leverage their tangible equity capital—they believed this goal could be achieved through increased supervisory scrutiny, particularly at community and smaller regional banking organizations, which are subject to less market discipline than larger organizations that routinely access the capital markets. Some commenters also stated that the proposed rule would have a disproportionately binding impact on BHCs that acquire and operate fee-based businesses, including trust and custody businesses, because such BHCs typically have higher market-to-book values and levels of goodwill than other BHCs. A few commenters argued that the interplay of the proposed 15 percent of tier 1 capital supervisory threshold for internationally active BHCs, coupled with the requirement to deduct goodwill in computing compliance with the threshold, would significantly constrain the ability of many large U.S. banking organizations to raise tier 1 capital effectively and competitively.

In addition, a number of commenters suggested that if the Board nonetheless decides to finalize the proposed goodwill deduction, it should do so on a basis that nets any associated deferred tax liability from the amount of goodwill deducted. The basis for this suggestion is that if the value of goodwill is totally eliminated, the deferred tax liability associated with the goodwill also would be eliminated. In effect, the maximum loss that a BHC would suffer from elimination of the value of its goodwill would be the amount represented by its goodwill net of any associated deferred tax liability. Netting the associated deferred tax liability from the goodwill deducted would be consistent with the methodology some rating agencies use in determining tangible equity ratios.

The Board believes that the tier 1 capital sub-limits for restricted core capital elements should be keyed more closely than at present to BHCs' tangible equity—that is, core capital elements less goodwill—and has decided to require the deduction of goodwill as proposed. Goodwill generally provides value for a banking organization on a going concern basis, but this value declines as the organization deteriorates and has little if any value in the event of insolvency or bankruptcy. The deduction approach is in line with the current practice of most G–10 countries, as well as with the Mid-year Text. Although goodwill is also deducted from the sum of a BHC's core capital elements in computing its tier 1 capital, the Board does not believe that deducting it from the sum of core capital elements for purposes of computing the tier 1 sub-limit for restricted core capital elements constitutes a double deduction of goodwill. The Board, however, agrees it would be appropriate to modify the goodwill deduction by netting from the amount of goodwill deducted any associated deferred tax liability. Accordingly, the final rule limits restricted core capital elements to a percentage of the sum of core capital elements, net of goodwill less any associated deferred tax liability.

15 Percent Standard for Internationally Active BHCs

The proposed rule stated that the Board would generally expect internationally active banking organizations to limit the aggregate amount of restricted core capital elements included in tier 1 capital to 15 percent of the sum of all core capital elements (including restricted core capital elements), net of goodwill. The proposal defined an internationally active banking organization as one that has significant activity in non-U.S.

markets or that is considered a candidate for the AIRB approach under the Mid-year Text. The proposed rule specifically requested comment on the definition of an internationally active banking organization.

The Board had several reasons for proposing a lower quantitative standard on the inclusion of restricted core capital elements in the tier 1 capital of internationally active banking organizations. First, because these BHCs are the largest and most complex U.S. banking organizations, it is important for the protection of the financial system to ensure the strength of their capital bases. In this regard, the 15 percent standard is generally consistent with the current expectations of investors and the rating agencies.

In addition, the G–10 banking supervisors participating in the Basel Committee on Banking Supervision agreed in the Sydney Agreement to limit the percentage of a banking organization's tier 1 capital that is composed of innovative securities, which, as defined, would include trust preferred securities, to no more than 15 percent of its tier 1 capital. Although the Board has informally encouraged internationally active BHCs to comply with this standard since 1998, the Board's proposal would have formalized its commitment to this standard.

Eight commenters argued that the 15 percent standard was too restrictive, although most agreed that 25 percent would be appropriate. A number of commenters argued that there is no need for the lower percentage standard for internationally active BHCs because market discipline already restrains their issuance of restricted core capital elements. Also, these commenters stated that the transparent U.S. accounting and disclosure standards remove any material obstacles to investors' ability to analyze the capital components and capital strength of large U.S. banking organizations. Other commenters argued that only BHCs that the Board requires to use the AIRB approach for calculating regulatory capital requirements should be subject to the 15 percent standard and that BHCs that opt-in to the AIRB approach should not be subject to the 15 percent standard because such BHCs may have no international activities and the lower limit could deter them from adopting the advanced risk management approaches necessary to qualify for use of the AIRB approach. Some commenters believed, on the contrary, that if the 15 percent standard were applied to AIRB BHCs, it should be applied to both mandatory and opt-in AIRB BHCs to ensure a level playing field. Several commenters stated that if the 15 percent standard were extended to all AIRB BHCs, institutions should be allowed to permanently grandfather all existing restricted core capital elements.

In light of the comments received, and after further reflection on the issues concerned, the Board has decided to apply the 15 percent limitation only to internationally active BHCs. For this purpose, an internationally active BHC is a BHC that (1) as of its most recent year-end FR Y–9C reports has total consolidated assets equal to $250 billion or more or (2) on a consolidated basis, reports total on-balance sheet foreign exposure of $10 billion or more on its filings of the most recent year-end FFIEC 009 Country Exposure Report. This definition closely proxies the definition proposed for mandatory advanced AIRB banking organizations in the Advance Notice of Proposed Rulemaking to implement the Mid-year Text, which was issued on August 4, 2003. Thus, the 15 percent limit would not apply to banking organizations that opt-in to the AIRB. In arriving at this definition of internationally active, the Board took into account the possible effects of the proposed application of the 15 percent limitation on the capital-raising efforts of moderate-sized BHCs that may opt in to the AIRB approach in the future. The Board also has decided to turn the 15 percent general supervisory expectation into a regulatory limitation to ensure the soundness of the capital base of the largest U.S. banking organizations and to formalize the application of the Sydney Agreement to such banking organizations by regulation. The Board will generally expect and strongly encourage opt-in AIRB BHCs 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 BHCs. The Board intends to set forth the 15 percent tier 1 sub-limit for internationally active BHCs, as well as this expectation and encouragement for opt-in AIRB BHCs, in its forthcoming notice of proposed rulemaking for U.S. implementation of the Basel Mid-year Text.

Although BHCs that are not internationally active BHCs are not required to comply with the 15 percent tier 1 capital sub-limit, these BHCs are encouraged to ensure the soundness of their capital bases. The Board notes that the quality of their capital components will continue to be part of the Federal Reserve's supervisory assessment of capital adequacy.

The Board has also decided to exempt qualifying mandatory convertible preferred securities from the 15 percent tier 1 capital sub-limit applicable to internationally active BHCs. Accordingly, under the final rule, the aggregate amount of restricted core capital elements (excluding mandatory convertible preferred securities) that an internationally active BHC may include in tier 1 capital must not exceed the 15 percent limit applicable to such BHCs, whereas the aggregate amount of restricted core capital elements (including mandatory convertible preferred securities) that an internationally active BHC may include in tier 1 capital must not exceed the 25 percent limit applicable to all BHCs.

Qualifying mandatory convertible preferred securities generally consist of the joint issuance by a BHC to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralize with the securities, that obligates the investors to purchase a fixed amount of the BHC's common stock, generally in three years. Typically, prior to exercise of the purchase contract in three years, the trust preferred securities are remarketed by the initial investors to new investors and the cash proceeds are used to satisfy the initial investors' obligation to buy the BHC's common stock. The common stock replaces the initial trust preferred securities as a component of the BHC's tier 1 capital, and the remarketed trust preferred securities are excluded from the BHC's regulatory capital.[1]

Allowing internationally active BHCs to include these instruments in tier 1 capital above the 15 percent sub-limit (but subject to the 25 percent sub-limit) is prudential and consistent with safety and soundness. 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. The high quality of these instruments is indicated by the rating agencies' assignment of greater equity strength to mandatory convertible trust preferred securities than to cumulative or noncumulative perpetual preferred stock, even though mandatory convertible preferred securities, unlike perpetual preferred securities, are not included in GAAP equity until the common stock is issued. Nonetheless, organizations wishing to issue such instruments are cautioned to have their structure reviewed by the Federal Reserve prior to issuance to ensure that

[1] The reasons for this exclusion include the fact that the terms of the remarketed securities frequently are changed to shorten the maturity of the securities and include more debt-like features in the securities, thereby no longer meeting the characteristics for capital instruments includable in regulatory capital.

they do not contain features that detract from its high capital quality.

Transition Period

Sixteen institutions advocated a transition period of at least five years, instead of the proposed three-year period. A primary reason stated by the commenters was that a significant volume of banking organizations' trust preferred securities were issued after March 2002 with ''no-call'' periods of at least five years (meaning the no-call periods expire at various dates after March 2007). BHCs issuing such instruments in the first quarter of 2004, for example, could call the securities in the first quarter of 2009. These commenters contended that a five-year transition period would allow affected BHCs substantially more flexibility in managing their compliance with the new standards through a combination of redeeming outstanding trust preferred securities with expired no-call periods and generating capital internally through the retention of earnings. Commenters also contended that a five-year transition period would coincide more closely with implementation of Basel II.

The Board has decided, consistent with the comments received, to extend the transition period from the end of the first quarter of 2007 to the end of the first quarter of 2009 to give BHCs more time to conform their capital structures to the revised quantitative limits. The result of this extension is that the revised quantitative limits will become applicable to BHCs' restricted core capital elements for reports and capital computations beginning on March 31, 2009, the reporting date for the first quarter of 2009.

Non-Voting Instruments Includable in Tier 1 Capital

Five commenters objected to the Board's reiteration in the proposal of its long-standing standard in the current capital guidelines that voting common stock should be the dominant form of a BHC's tier 1 capital. These commenters further objected to the proposed incorporation into the capital guidelines of the Board's longstanding written policy that excess amounts of non-voting tier 1 elements generally will be reallocated to BHCs' tier 2 capital. Concerns were expressed that this treatment could result in the exclusion from tier 1 capital of noncumulative perpetual preferred stock and non-voting common stock, even though these elements are included in GAAP equity and can fully absorb losses of the issuing BHC.

Several commenters indicated that investments in noncumulative perpetual preferred stock and non-voting common stock are often made by government-sponsored enterprises and large BHCs seeking to make community development investments in small banking organizations. These commenters noted that the non-voting feature is necessary to achieve the dual public goals of ensuring that such small community-focused banking organizations have adequate capital to enable them to continue making community development loans, while maintaining their control structures. Preservation of control is also needed for qualification under various legislative and regulatory programs designed for community development. In addition, commenters noted that, because of other legal and business factors, the investing government-sponsored enterprises and large BHCs want to avoid acquiring control of these small, community-focused BHCs.

The reasoning behind the Board's current and proposed standards on the inclusion of non-voting elements in tier 1 capital, which have been in place since 1989 and continue to be appropriate, is that individuals having voting control over a BHC's chosen business strategies should have a substantial financial stake at risk from the success or failure of the BHC's activities. Supervisory experience over the years has shown that the absence of such an equity stake by those controlling a BHC's strategies and activities can give such owners an incentive for the BHC to pursue high-risk business strategies. Such behavior creates a moral hazard problem for the deposit insurance fund and the public because, while the banking organization may become profitable if the strategy succeeds, the deposit insurance fund and the public are left to deal with a failed banking organization if the strategy fails.

The Board has decided, as proposed, to retain in the final rule the standard that voting common stock should be the dominant form of a BHC's tier 1 capital. The final rule continues to caution that excessive non-voting elements generally will be reallocated to tier 2 capital. This language provides a limited degree of flexibility, principally for smaller community banking organizations, depending on the facts and circumstances of a particular situation. The Federal Reserve has exercised this flexibility in the past, for example, to aid compliance with the Board's voting common stock standard by small privately-held community banking organizations reaching $150 million in assets and becoming subject to the Board's risk-based capital requirements for the first time. Because of significant concerns about the possible effects on the safe and sound operation of a BHC if controlling parties do not have economic stakes in the BHC proportionate to their voting control, the Federal Reserve will, as a general matter, heighten its supervisory scrutiny of the corporate governance and financial strategies of BHCs when the predominance of voting common equity in tier 1 capital begins to erode.

Disallowed Terms for Instruments Included in Tier 1 Capital

Two institutions requested that BHCs be allowed to include moderate dividend step-ups in their tier 1 trust preferred securities. Currently, step-up features are not allowed in any tier 1 capital instrument or in tier 2 subordinated debt. These commenters stressed that allowing step-up features in capital instruments would allow BHCs to reduce their cost of capital and level the playing field with foreign bank competitors, almost all of which include step-up features in their tier 1 capital instruments (subject to the 15 percent limit on innovative instruments). As the commenters noted, limited step-ups are permitted for these instruments under the Sydney Agreement.

After considering these comments, the Board has decided to continue prohibiting step-up provisions in tier 1 capital instruments and tier 2 subordinated debt. Because such features provide the issuer with the incentive to redeem an instrument, step-ups change the economic nature of instruments from longer-term to shorter-term. The resulting short-term tenor of such capital instruments is inconsistent with the Board's view that regulatory capital should provide long-term, stable support to a BHC. This view is consistent with the market expectation that BHCs will almost always redeem such instruments on the step-up date to preserve market access for future capital raising initiatives. Basically, investors view a step-up provision as an informal commitment by a BHC issuer to call such securities at the time of the step up. Failure to honor this informal commitment to redeem could impair an institution's ability to continue issuing securities to the market.

Two BHCs asked the Board to eliminate its longstanding requirement for the presence of a call option in qualifying trust preferred securities included in tier 1 capital. This requirement was based on the market standard prevailing at the time trust preferred securities were approved for inclusion in tier 1 capital. The market for trust preferred securities at that time was strictly retail but since has expanded to include institutional investors. Unlike retail investors, who tend to focus on yield, non-retail investors charge for call options because they give the issuer flexibility to call the instrument should interest rates decline or the institution's condition improve, allowing refinancing at a cheaper rate. Investors have no control over this option, which the BHC issuer is most likely to exercise just as the securities become more valuable in the hands of the investor.

The Board continues to believe that the flexibility call options provide to BHCs is beneficial from both a financial and supervisory perspective. This potential benefit to BHCs is reflected in the substantial rate reductions that BHCs with trust preferred securities issued in 1996 or 1997 have been able to achieve in the recent period of declining interest rates by redeeming their trust preferred securities and replacing them with new issuances at lower rates. Nonetheless, the Board does not require call provisions in perpetual preferred stock included in tier 1 capital, where they would be even more useful from the same financial and supervisory perspectives due to the perpetual nature of these instruments. For these reasons, as well as to accommodate the expansion of the investor base to include the institutional market, the Board will no longer require that qualifying trust preferred securities include call provisions.

Technical Requirements for the Underlying Junior Subordinated Debt and the Grandfathering Period for Noncompliant Issuances

A substantial number of commenters asked the Board to extend the effective date for conformance with the technical requirements for junior subordinated debt underlying trust preferred securities from May 31, 2004, as proposed, to the effective date of the final rule. The Board, in response to these comments, has decided to extend the grandfathering date for junior subordinated debt with nonconforming provisions, but satisfying certain grandfathering criteria, to April 15, 2005. The Board has determined that this extension of the grandfathering date is appropriate given the number of technical legal issues that were raised by commenters.

The Board's proposed rule, in general, would have clarified that the terms of junior subordinated debt must comply with the criteria applicable to tier 2 subordinated debt under the proposed rule as well as the Board's 1992 subordinated debt policy statement, 12 CFR 250.166, as supplemented by SR 92–37 (Oct. 15, 1992). However, acceleration of the junior subordinated debt after the nonpayment of interest for a period of 20 consecutive quarters would be permitted.

A substantial number of banking organizations and other commenters have provided detailed comment on the need for various additional provisions in the indentures governing junior subordinated debt and the trust agreements governing trust preferred securities. In particular, commenters requested clarification of the technical requirements related to the deferability, acceleration, and subordination terms of junior subordinated debt and trust preferred securities in light of the existing subordinated debt policy statement.

One issue upon which commenters sought Board clarification was the maximum permissible length of the deferral notice period provided in the terms of junior subordinated debt. The indentures for junior subordinated debt have prescribed various periods within which a BHC must provide notice to the trustee of its intention to defer interest on junior subordinated debt, which in turn enables the trustee to defer the payment of dividends on trust preferred securities. Because the requirement for a long notice period could impede a BHC from deferring dividends when it needs to do so, or when the Federal Reserve directs it to do so, the proposed rule would have restricted the notice period for deferral to no more than five business days from the payment date. In response to commenters' concern that this was too short a period and would interfere with widespread market practice, the final rule permits a deferral notice period of up to 15 business days before the payment date. This would allow, for example, a five-business-day notice to the trustee prior to the record date and a ten-business-day period between the record date and the payment date.

The proposed rule sought to ensure that the junior subordinated debt is subordinated to senior debt and other subordinated debt issued by the BHC. Commenters sought clarification in the final rule that junior subordinated debt does not have to be subordinated to, and can be pari passu with, trade accounts payable and other accrued liabilities arising in the ordinary course of business. This interpretation is consistent with the Board's subordinated debt policy statement; accordingly, junior subordinated debt may be pari passu with obligations to trade creditors. In addition, junior subordinated debt underlying one issuance of trust preferred securities may be pari passu with junior subordinated debt underlying another issue of trust preferred securities, just as an issue of perpetual preferred stock may be pari passu with another issuance of perpetual preferred stock. In addition, the terms of junior subordinated debt may provide that it may be senior to, or pari passu with, deeply subordinated capital instruments that the Federal Reserve may in the future authorize for inclusion in tier 1 capital.

Some commenters sought clarification about whether junior subordinated debt needs to be subordinated to senior obligations (and senior only to common and preferred stock) with regard not only to priority of payment in a BHC's bankruptcy, but also to priority of interest payments while a BHC is a going concern. If a BHC has a non-deferrable debt that is subordinated in right of payment to its junior subordinated debt, the BHC could not defer payment on its deferrable junior subordinated debt without causing an event of default on its non-deferrable subordinated debt, thereby undermining the ability of the junior subordinated debt to absorb losses on an ongoing basis. Accordingly, junior subordinated debt must not be senior in liquidation, or in the priority of payment of periodic interest, to non-deferrable debt.

Some commenters sought clarification of the permissibility of indenture provisions that prohibit interest deferral on junior subordinated debt if a default event has occurred. Such provisions are permissible only if the event of default is one that is authorized to trigger the acceleration of principal and interest under the final rule. Thus, an indenture provision that prohibits deferral upon a default that arises from failure to follow the proper deferral process or upon any other event of default that the final rule does not allow to trigger acceleration is unacceptable.

Commenters concurred with the proposal to allow the acceleration of principal and interest on junior subordinated debt in the event of the voluntary or involuntary bankruptcy of a BHC, but sought clarification of the acceptability in junior subordinated debt indentures of other acceleration events. Consistent with the 1992 interpretation of the subordinated debt policy statement set forth in SR 92–37, junior subordinated debt also may accelerate in the event that a major bank subsidiary of the BHC goes into receivership. Junior subordinated debt also may accelerate if the trust issuing the trust preferred securities goes into bankruptcy or is dissolved, unless the junior subordinated notes have been redeemed or distributed to the trust preferred securities investors or the obligation is assumed by a successor to the BHC.

The Board notes that it generally is also permissible for perpetual preferred stock to provide voting rights to investors upon the non-payment of dividends, or for junior subordinated debt and trust preferred securities to provide voting rights to investors upon the deferral of interest and dividends, respectively. However, these clauses conferring voting rights may contain only customary provisions, such as the ability to elect one or two directors to the board of the BHC issuer, and may not be so adverse as to create a substantial disincentive for the banking organization to defer interest and dividends when necessary or prudent.

Small BHC Policy Statement

In the preamble of the proposed rule, the Board solicited comment on certain clarifications that it may make either by rulemaking or through supervisory guidance to the treatment of qualifying trust preferred securities issued by small BHCs (that is, BHCs with consolidated assets of less than $150 million) under the Small Bank Holding Company Policy Statement. The policy generally exempts small BHCs from the Board's risk-based capital and leverage capital guidelines. Instead, small BHCs generally apply the risk-based capital and leverage capital guidelines on a bank-only basis and must only meet a debt-to-equity ratio at the parent BHC level.

One approach discussed in the proposal was generally to treat the subordinated debt associated with trust preferred securities issued by small BHCs as debt for most purposes under the Small BHC Policy Statement (other than the 12-year debt reduction and 25-year debt retirement standards), except that an amount of subordinated debt up to 25 percent of a small BHC's GAAP total stockholders' equity, net of goodwill, would be considered as neither debt nor equity. This approach would result in a treatment for trust preferred securities issued by BHCs subject to the Small BHC Policy Statement that would be more in line with the treatment of these securities that the Board is finalizing for larger BHCs subject to the Federal Reserve's risk-based capital guidelines.

Commenters made two recommendations. The first was that the Board should analyze more thoroughly the potential effect of the proposed revisions on small BHCs. The second comment was that the Board should provide for a transition period of at least five years at a minimum. The Board intends to issue supervisory guidance on this matter in the near future.

Regulatory Flexibility Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board has determined that this final rule does not have a significant impact on a substantial number of small entities in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The Board has determined that this final rule does not have a significant impact on a substantial number of small banking organizations because the vast majority of small banking organizations are not subject to the final rule, are already in compliance with the final rule, or will readily come into compliance with the final rule within the five-year transition period.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR part 1320 Appendix A.1.), the Board has reviewed this final rule under the authority delegated to the Board by the Office of Management and Budget. The Board has determined that this final rule does not contain a collection of information pursuant to the Paperwork Reduction Act.

Plain Language

Section 722 of the Gramm-Leach-Bliley Act of 1999 requires the use of ''plain language'' in all proposed and final rules published after January 1, 2000. The Board invited comments on whether the proposed rule was written in ''plain language'' and how to make the proposed rule easier to understand. No commenter indicated that the proposed rule should be revised to make it easier to understand. The final rule is substantially similar to the proposed rule, and the Board believes the final rule is written plainly and clearly.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, Banking, Confidential business information, Crime, Currency, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, Banking, Holding companies, Reporting and recordkeeping requirements, Securities.

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

■ 1. The authority citation of part 208 continues to read as follows:

Authority: 12 U.S.C. 24, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1831w, 1831x, 1835a, 1882, 2901–2907, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318, 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

Appendix A to Part 208—[Amended]

■ 2. In Appendix A to part 208, remove Attachments II and III.

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

■ 3. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909; 15 U.S.C. 6801 and 6805.

■ 4. Amend Appendix A to part 225 as follows:
■ a. In section II:
■ i. Designate the three undesignated paragraphs as paragraphs (i), (ii), and (iii) and revise newly redesignated paragraphs (i), (ii) and (iii).
■ ii. Remove footnote 8 [Reserved]; redesignate footnotes 9, 10, and 11 as footnotes 13, 14, and 15 respectively; and redesignate footnotes 14 through 61 as footnotes 17 through 64 respectively.
■ b. In section II.A., revise the heading.
■ c. Revise section II.A.1.
■ d. In section II.A.2.,
■ i. Revise the heading.
■ ii. Revise paragraph b and newly redesignated footnote 15.
■ iii. Revise paragraph d. and add new footnote 16.
■ e. In section II.B.2., add a sentence at the end of newly redesignated footnote 19.
■ f. In section III.C.2., revise newly redesignated footnotes 40 and 41.
■ g. Remove Attachments II and III.

Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

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II. Definition of Qualifying Capital for the Risk-Based Capital Ratio

(i) A banking organization's qualifying total capital consists of two types of capital components: ''core capital elements'' (tier 1 capital elements) and ''supplementary capital elements'' (tier 2 capital elements). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below. To qualify as an element of tier 1 or tier 2 capital, an instrument must be fully paid up and effectively unsecured. Accordingly, if a banking organization has purchased, or has directly or indirectly funded the purchase of, its own capital instrument, that instrument generally is disqualified from inclusion in regulatory capital. A qualifying tier 1 or tier 2 capital instrument must be subordinated to all senior indebtedness of the organization. If issued by a bank, it also must be subordinated to claims of depositors. In addition, the instrument must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

(ii) On a case-by-case basis, the Federal Reserve may determine whether, and to what extent, any instrument that does not fit wholly within the terms of a capital element set forth below, or that does not have the characteristics or the ability to absorb losses commensurate with the capital treatment specified below, will qualify as an element of tier 1 or tier 2 capital. In making such a determination, the Federal Reserve will consider the similarity of the instrument to instruments explicitly addressed in the guidelines; the ability of the instrument to absorb losses, particularly while the organization operates as a going concern; the maturity and redemption features of the instrument; and other relevant terms and factors.

(iii) The redemption of capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Consequently, an organization should consult with the Federal Reserve before redeeming any equity or other capital instrument included in tier 1 or tier 2 capital prior to stated maturity if such redemption could have a material effect on the level or composition of the organization's capital base. Such consultation generally would not be necessary when the instrument is to be redeemed with the proceeds of, or replaced by, a like amount of a capital instrument that is of equal or higher quality with regard to terms and maturity and the Federal Reserve considers the organization's capital position to be fully sufficient.

A. The Definition and Components of Qualifying Capital

1. *Tier 1 capital.* Tier 1 capital generally is defined as the sum of core capital elements less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, nonfinancial equity investments, and other items that are required to be deducted in accordance with section II.B. of this appendix. Tier 1 capital must represent at least 50 percent of qualifying total capital.

a. *Core capital elements (tier 1 capital elements).* The elements qualifying for inclusion in the tier 1 component of a banking organization's qualifying total capital are:

i. Qualifying common stockholders' equity;

ii. Qualifying noncumulative perpetual preferred stock (including related surplus);

iii. Minority interest related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class A minority interest); and

iv. Restricted core capital elements. The aggregate of these items is limited within tier 1 capital as set forth in section II.A.1.b. of this appendix. These elements are defined to include:

(1) Qualifying cumulative perpetual preferred stock (including related surplus);

(2) Minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class B minority interest);

(3) Minority interest related to qualifying common stockholders' equity or perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank (Class C minority interest); and

(4) Qualifying trust preferred securities.

b. *Limits on restricted core capital elements*—i. *Limits.* (1) The aggregate amount of restricted core capital elements that may be included in the tier 1 capital of a banking organization must not exceed 25 percent of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Stated differently, the aggregate amount of restricted core capital elements is limited to one-third of the sum of core capital elements, excluding restricted core capital elements, net of goodwill less any associated deferred tax liability.

(2) In addition, the aggregate amount of restricted core capital elements (other than qualifying mandatory convertible preferred securities [5]) that may be included in the tier 1 capital of an internationally active banking organization [6] must not exceed 15 percent of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability.

(3) Amounts of restricted core capital elements in excess of this limit generally may be included in tier 2 capital. The excess amounts of restricted core capital elements that are in the form of Class C minority interest and qualifying trust preferred securities are subject to further limitation within tier 2 capital in accordance with section II.A.2.d.iv. of this appendix. A banking organization may attribute excess amounts of restricted core capital elements first to any qualifying cumulative perpetual preferred stock or to Class B minority interest, and second to qualifying trust preferred securities or to Class C minority interest, which are subject to a tier 2 sublimit.

ii. *Transition.*

(1) The quantitative limits for restricted core capital elements set forth in sections II.A.1.b.i. and II.A.2.d.iv. of this appendix become effective on March 31, 2009. Prior to that time, a banking organization with restricted core capital elements in amounts that cause it 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 that the organization complies with these limits as of March 31, 2009.

(2) Until March 31, 2009, the aggregate amount of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities that a banking organization may include in tier 1 capital is limited to 25 percent of the sum of the following core capital elements: qualifying common stockholders' equity, Qualifying noncumulative and cumulative perpetual preferred stock (including related surplus), qualifying minority interest in the equity accounts of consolidated subsidiaries, and qualifying trust preferred securities. Amounts of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities in excess of this limit may be included in tier 2 capital.

(3) Until March 31, 2009, internationally active banking organizations generally are expected to limit the amount of qualifying cumulative perpetual preferred stock (including related surplus) and qualifying trust preferred securities included in tier 1 capital to 15 percent of the sum of core capital elements set forth in section II.A.1.b.ii.2. of this appendix.

c. *Definitions and requirements for core capital elements*—i. *Qualifying common stockholders' equity.*

(1) *Definition.* Qualifying common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in qualifying common stockholders' equity.

(2) *Restrictions on terms and features.* 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 component of qualifying common stockholders' equity, regardless of

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[5] Qualifying mandatory convertible preferred securities generally consist of the joint issuance by a bank holding company to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralize with the securities, that obligates the investors to purchase a fixed amount of the bank holding company's common stock, generally in three years. A bank holding company wishing to issue mandatorily convertible preferred securities and include them in tier 1 capital must consult with the Federal Reserve prior to issuance to ensure that the securities' terms are consistent with tier 1 capital treatment.

[6] For this purpose, an internationally active banking organization is a banking organization that (1) as of its most recent year-end FR Y–9C reports total consolidated assets equal to $250 billion or more or (2) on a consolidated basis, reports total on-balance-sheet foreign exposure of $10 billion or more on its filings of the most recent year-end FFIEC 009 Country Exposure Report.

whether or not it is called common equity. Terms or features that grant other preferences also may call into question whether the capital instrument would be deemed to be qualifying common stockholders' equity. Features that require, or provide significant incentives for, the issuer to redeem the instrument for cash or cash equivalents will render the instrument ineligible as a component of qualifying common stockholders' equity.

(3) *Reliance on voting common stockholders' equity.* Although section II.A.1. of this appendix allows for the inclusion of elements other than common stockholders' equity within tier 1 capital, voting common stockholders' equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within tier 1 capital. Thus, banking organizations should avoid over-reliance on preferred stock and nonvoting elements within tier 1 capital. Such nonvoting elements can include portions of common stockholders' equity where, for example, a banking organization has a class of nonvoting common equity, or a class of voting common equity that has substantially fewer voting rights per share than another class of voting common equity. Where a banking organization relies excessively on nonvoting elements within tier 1 capital, the Federal Reserve generally will require the banking organization to allocate a portion of the nonvoting elements to tier 2 capital.

ii. *Qualifying perpetual preferred stock.*

(1) *Qualifying requirements.* Perpetual preferred stock qualifying for inclusion in tier 1 capital has no maturity date and cannot be redeemed at the option of the holder. Perpetual preferred stock will qualify for inclusion in tier 1 capital only if it can absorb losses while the issuer operates as a going concern.

(2) *Restrictions on terms and features.* Perpetual preferred stock included in tier 1 capital may not have any provisions restricting the banking organization's ability or legal right to defer or waive dividends, other than provisions requiring prior or concurrent deferral or waiver of payments on more junior instruments, which the Federal Reserve generally expects in such instruments consistent with the notion that the most junior capital elements should absorb losses first. Dividend deferrals or waivers for preferred stock, which the Federal Reserve expects will occur either voluntarily or at its direction when an organization is in a weakened condition, must not be subject to arrangements that would diminish the ability of the deferral to shore up the banking organization's resources. Any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as tier 1 capital only if the redemption is subject to prior approval of the Federal Reserve. Features that require, or create significant incentives for the issuer to redeem the instrument for cash or cash equivalents will render the instrument ineligible for inclusion in tier 1 capital. For example, perpetual preferred stock that has a credit-sensitive dividend feature—that is, a dividend rate that is reset periodically based, in whole or in part, on the banking organization's current credit standing—generally does not qualify for inclusion in tier 1 capital.[7] Similarly, perpetual preferred stock that has a dividend rate step-up or a market value conversion feature—that is, a feature whereby the holder must or can convert the preferred stock into common stock at the market price prevailing at the time of conversion—generally does not qualify for inclusion in tier 1 capital.[8] Perpetual preferred stock that does not qualify for inclusion in tier 1 capital generally will qualify for inclusion in tier 2 capital.

(3) *Noncumulative and cumulative features.* Perpetual preferred stock that is noncumulative generally may not permit the accumulation or payment of unpaid dividends in any form, including in the form of common stock. Perpetual preferred stock that provides for the accumulation or future payment of unpaid dividends is deemed to be cumulative, regardless of whether or not it is called noncumulative.

iii. *Qualifying minority interest.* Minority interest in the common and preferred stockholders' equity accounts of a consolidated subsidiary (minority interest) represents stockholders' equity associated with common or preferred equity instruments issued by a banking organization's consolidated subsidiary that are held by investors other than the banking organization. Minority interest is included in tier 1 capital because, as a general rule, it represents equity that is freely available to absorb losses in the issuing subsidiary. Nonetheless, minority interest typically is not available to absorb losses in the banking organization as a whole, a feature that is a particular concern when the minority interest is issued by a subsidiary that is neither a U.S. depository institution nor a foreign bank. For this reason, this appendix distinguishes among three types of qualifying minority interest. Class A minority interest is minority interest related to qualifying common and noncumulative perpetual preferred equity instruments issued directly (that is, not through a subsidiary) by a consolidated U.S. depository institution[9] or foreign bank[10] subsidiary of a banking organization. Class A minority interest is not subject to a formal limitation within tier 1 capital. Class B minority interest is minority interest related to qualifying cumulative perpetual preferred equity instruments issued directly by a consolidated U.S. depository institution or foreign bank subsidiary of a banking organization. Class B minority interest is a restricted core capital element subject to the limitations set forth in section II.A.1.b.i. of this appendix, but is not subject to a tier 2 sub-limit. Class C minority interest is minority interest related to qualifying common or perpetual preferred stock issued by a banking organization's consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank. Class C minority interest is eligible for inclusion in tier 1 capital as a restricted core capital element and is subject to the limitations set forth in sections II.A.1.b.i. and II.A.2.d.iv. of this appendix. Minority interest in small business investment companies, investment funds that hold nonfinancial equity investments (as defined in section II.B.5.b. of this appendix), and subsidiaries engaged in nonfinancial activities are not included in the banking organization's tier 1 or total capital if the banking organization's interest in the company or fund is held under one of the legal authorities listed in section II.B.5.b. of this appendix. In addition, minority interest in consolidated asset-backed commercial paper programs (ABCP) (as defined in section III.B.6. of this appendix) that are sponsored by a banking organization are not included in the organization's tier 1 or total capital if the organization excludes the consolidated assets of such programs from risk-weighted assets pursuant to section III.B.6. of this appendix.

iv. *Qualifying trust preferred securities.*

(1) A banking organization that wishes to issue trust preferred securities and include them in tier 1 capital must first consult with the Federal Reserve. Trust preferred securities are defined as undated preferred securities issued by a trust or similar entity sponsored (but generally not consolidated) by a banking organization that is the sole common equity holder of the trust. Qualifying trust preferred securities must allow for dividends to be deferred for at least twenty consecutive quarters without an event of default, unless an event of default leading to acceleration permitted under section II.A.1.c.iv.(2) has occurred. The required notification period for such deferral must be reasonably short, no more than 15 business days prior to the payment date. Qualifying trust preferred securities are otherwise subject to the same restrictions on terms and features as qualifying perpetual preferred stock under section II.A.1.c.ii.(2) of this appendix.

(2) The sole asset of the trust must be a junior subordinated note issued by the sponsoring banking organization that has a minimum maturity of thirty years, is subordinated with regard to both liquidation

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[7] Traditional floating-rate or adjustable-rate perpetual preferred stock (that is, perpetual preferred stock in which the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically in relation to an independent index based solely on general market interest rates), however, generally qualifies for inclusion in tier 1 capital provided all other requirements are met.

[8] Traditional convertible perpetual preferred stock, which the holder must or can convert into a fixed number of common shares at a preset price, generally qualifies for inclusion in tier 1 capital provided all other requirements are met.

[9] U.S. depository institutions are defined to include branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks.

[10] For this purpose, a foreign bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

and priority of periodic payments to all senior and subordinated debt of the sponsoring banking organization (other than other junior subordinated notes underlying trust preferred securities). Otherwise the terms of a junior subordinated note must mirror those of the preferred securities issued by the trust.[11] The note must comply with section II.A.2.d. of this appendix and the Federal Reserve's subordinated debt policy statement set forth in 12 CFR 250.166 [12] except that the note may provide for an event of default and the acceleration of principal and accrued interest upon (a) nonpayment of interest for 20 or more consecutive quarters or (b) termination of the trust without redemption of the trust preferred securities, distribution of the notes to investors, or assumption of the obligation by a successor to the banking organization.

(3) In the last five years before the maturity of the note, the outstanding amount of the associated trust preferred securities is excluded from tier 1 capital and included in tier 2 capital, where the trust preferred securities are subject to the amortization provisions and quantitative restrictions set forth in sections II.A.2.d.iii. and iv. of this appendix as if the trust preferred securities were limited-life preferred stock.

2. *Supplementary capital elements (tier 2 capital elements)* * * *

b. *Perpetual preferred stock.* Perpetual preferred stock (and related surplus) that meets the requirements set forth in section II.A.1.c.ii.(1) of this appendix is eligible for inclusion in tier 2 capital without limit.[15]

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d. *Subordinated debt and intermediate-term preferred stock*—i. *Five-year minimum maturity.* Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as tier 2 capital. If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.

ii. *Other restrictions on subordinated debt.* Subordinated debt included in tier 2 capital must comply with the Federal Reserve's subordinated debt policy statement set forth in 12 CFR 250.166.[16] Accordingly, such subordinated debt must meet the following requirements:

(1) The subordinated debt must be unsecured.

(2) The subordinated debt must clearly state on its face that it is not a deposit and is not insured by a Federal agency.

(3) The subordinated debt must not have credit-sensitive features or other provisions that are inconsistent with safe and sound banking practice.

(4) Subordinated debt issued by a subsidiary U.S. depository institution or foreign bank of a bank holding company must be subordinated in right of payment to the claims of all the institution's general creditors and depositors, and generally must not contain provisions permitting debt holders to accelerate payment of principal or interest upon the occurrence of any event other than receivership of the institution. Subordinated debt issued by a bank holding company or its subsidiaries that are neither U.S. depository institutions nor foreign banks must be subordinated to all senior indebtedness of the issuer; that is, the debt must be subordinated at a minimum to all borrowed money, similar obligations arising from off-balance sheet guarantees and direct credit substitutes, and obligations associated with derivative products such as interest rate and foreign exchange contracts, commodity contracts, and similar arrangements. Subordinated debt issued by a bank holding company or any of its subsidiaries that is not a U.S. depository institution or foreign bank must not contain provisions permitting debt holders to accelerate the payment of principal or interest upon the occurrence of any event other than the bankruptcy of the bank holding company or the receivership of a major subsidiary depository institution. Thus, a provision permitting acceleration in the event that any other affiliate of the bank holding company issuer enters into bankruptcy or receivership makes the instrument ineligible for inclusion in tier 2 capital.

iii. *Discounting in last five years.* As a limited-life capital instrument approaches maturity, it begins to take on characteristics of a short-term obligation. For this reason, the outstanding amount of term subordinated debt and limited-life preferred stock eligible for inclusion in tier 2 capital is reduced, or discounted, as these instruments approach maturity: one-fifth of the outstanding amount is excluded each year during the instrument's last five years before maturity. When remaining maturity is less than one year, the instrument is excluded from tier 2 capital.

iv. *Limits.* The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and limited-life preferred stock as well as, beginning March 31, 2009, qualifying trust preferred securities and Class C minority interest in excess of the limits set forth in section II.A.1.b.i. of this appendix that may be included in tier 2 capital is limited to 50 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix). Amounts of these instruments in excess of this limit, although not included in tier 2 capital, will be taken into account by the Federal Reserve in its overall assessment of a banking organization's funding and financial condition.

B. * * *

2. * * *

a. * * * The aggregate amount of investments in banking or finance subsidiaries[19]

* * * * *

III. * * *

C. * * *

2. * * *

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[11] Under generally accepted accounting principles, the trust issuing the preferred securities generally is not consolidated on the banking organization's balance sheet; rather the underlying subordinated note is recorded as a liability on the organization's balance sheet. Only the amount of the trust preferred securities issued, which generally is equal to the amount of the underlying subordinated note less the amount of the sponsoring banking organization's common equity investment in the trust (which is recorded as an asset on the banking organization's consolidated balance sheet), may be included in tier 1 capital. Because this calculation method effectively deducts the banking organization's common stock investment in the trust in computing the numerator of the capital ratio, the common equity investment in the trust should be excluded from the calculation of risk-weighted assets in accordance with footnote 17 of this appendix. Where a banking organization has issued trust preferred securities as part of a pooled issuance, the organization generally must not buy back a security issued from the pool. Where a banking organization does hold such a security (for example, as a result of an acquisition of another banking organization), the amount of the trust preferred securities includable in regulatory capital must, consistent with section II.(i) of this appendix, be reduced by the notional amount of the banking organization's investment in the security issued by the pooling entity.

[12] Trust preferred securities issued before April 15, 2005, generally would be includable in tier 1 capital despite noncompliance with sections II.A.1.c.iv. or II.A.2.d. of this appendix or 12 CFR 250.166 provided the non-complying terms of the instrument (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 organization.

* * * * *

[15] Long-term preferred stock with an original maturity of 20 years or more (including related surplus) will also qualify in this category as an element of tier 2 capital. If the holder of such an instrument has the right to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined for risk-based capital purposes as the earliest possible date on which the holder can put the instrument back to the issuing banking organization. In the last five years before the maturity of the stock, it must be treated as limited-life preferred stock, subject to the amortization provisions and quantitative restrictions set forth in sections II.A.2.d.iii. and iv. of this appendix.

[16] The subordinated debt policy statement set forth in 12 CFR 250.166 notes that certain terms found in subordinated debt may provide protection to investors without adversely affecting the overall benefits of the instrument to the issuing banking organization and, thus, would be acceptable for subordinated debt included in capital. For example, a provision that prohibits a bank holding company from merging, consolidating, or selling substantially all of its assets unless the new entity redeems or assumes the subordinated debt or that designates the failure to pay principal and interest on a timely basis as an event of default would be acceptable, so long as the occurrence of such events does not allow the debt holders to accelerate the payment of principal or interest on the debt.

* * * * *

[19] * * * For purposes of this section, the definition of banking and finance subsidiary does not include a trust or other special purpose entity used to issue trust preferred securities.

a. * * * U.S. depository institutions [40] and foreign banks [41]; * * *

* * * * *

■ 5. Amend Appendix D to part 225, as follows:

■ a. In section I.b., amend the first sentence by changing the phrase ''to consolidated basis'' to ''on a consolidated basis'' and the second sentence by changing the word ''that'' to ''than.''

■ b. In section II.b., remove footnote 3 and redesignate footnote 4 as footnote 3.

■ c. In section II.c., revise the second sentence.

Appendix to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

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II. * * *

c. * * * This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Federal Reserve policy and practice with regard to leverage guidelines. * * *

* * * * *

By order of the Board of Governors of the Federal Reserve System, March 4, 2005.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 05–4690 Filed 3–9–05; 8:45 am]

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[40] *See* footnote 9 of this appendix for the definition of a U.S. depository institution. For this purpose, the definition also includes U.S.-chartered depository institutions owned by foreigners. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.

[41] *See* footnote 10 of this appendix for the definition of a foreign bank. Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the United States) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries.

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 23

[Docket No. CE217; Special Conditions No. 23–156–SC]

Special Conditions: AMSAFE, Incorporated; Mooney Models M20K, M20M, M20R, and M20S; Inflatable Three-Point Restraint Safety Belt With an Integrated Airbag Device

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final special conditions.

SUMMARY: These special conditions are issued for the installation of an AMSAFE, Inc., Inflatable Three-Point Restraint Safety Belt with an Integrated Airbag Device on Mooney models M20K, M20M, M20R, and M20S. These airplanes, as modified by AMSAFE, Inc., will have novel and unusual design features associated with the lap belt portion of the safety belt, which contains an integrated airbag device. The applicable airworthiness regulations do not contain adequate or appropriate safety standards for this design feature. These special conditions contain the additional safety standards that the Administrator considers necessary to establish a level of safety equivalent to that established by the existing airworthiness standards.

DATES: Effective February 25, 2005.

FOR FURTHER INFORMATION CONTACT: Mr. Mark James, Federal Aviation Administration, Aircraft Certification Service, Small Airplane Directorate, ACE–111, 901 Locust, Kansas City, Missouri, 816–329–4137, fax 816–329–4090, e-mail: *mark.james@faa.gov.*

SUPPLEMENTARY INFORMATION

Background

On April 13, 2004, AMSAFE, Inc., Aviation Inflatable Restraints Division, 1043 North 47th Avenue, Phoenix, AZ 85043, applied for a supplemental type certificate for the installation of an inflatable lap belt restraint with a standard upper torso restraint (or shoulder harness) in Mooney models M20 (K, M, R, and S). The Mooney models M20 (K, M, R, and S) are single-engine, multiplace airplanes.

The inflatable restraint system is a three-point safety belt restraint system consisting of a traditional shoulder harness and an inflatable airbag lap belt. The inflatable portion of the restraint system will rely on sensors to electronically activate the inflator for deployment. The inflatable restraint system will be made available on the pilot, copilot, and passenger seats of these airplanes.

In an emergency landing, the airbag will inflate and provide a protective cushion between the occupant's head and structure within the airplane. This will reduce the potential for head and torso injury. The inflatable restraint behaves in a manner that is similar to an automotive airbag, but in this case, the airbag is integrated into the lap belt. While airbags and inflatable restraints are standard in the automotive industry, the use of an inflatable three-point restraint system is novel for general aviation operations.

The FAA has determined that this project will be accomplished by providing the same level of safety as the current Mooney models M20 (K, M, R, and S). The FAA has two primary safety concerns with the installation of airbags or inflatable restraints:

- That they perform properly under foreseeable operating conditions; and
- That they do not perform in a manner or at such times as to impede the pilot's ability to maintain control of the airplane or constitute a hazard to the airplane or occupants.

The latter point has the potential to be the more rigorous of the requirements. An unexpected deployment while conducting the takeoff or landing phases of flight may result in an unsafe condition. The unexpected deployment may either startle the pilot or generate a force sufficient to cause a sudden movement of the control yoke. Either action could result in a loss of control of the airplane, the consequences of which are magnified due to the low operating altitudes during these phases of flight. The FAA has considered this when establishing these special conditions.

The inflatable restraint system relies on sensors to electronically activate the inflator for deployment. These sensors could be susceptible to inadvertent activation, causing deployment in a potentially unsafe manner. The consequences of an inadvertent deployment must be considered in establishing the reliability of the system. AMSAFE, Inc., must show either that the effects of an inadvertent deployment in flight are not a hazard to the airplane or that an inadvertent deployment is extremely improbable. In addition, general aviation aircraft are susceptible to a large amount of cumulative wear and tear on a restraint system. The potential for inadvertent deployment may increase as a result of this cumulative damage. Therefore, the impact of wear and tear on inadvertent deployment must be considered. Due to the effects of this cumulative damage, a life limit must be established for the appropriate system components in the restraint system design.

There are additional factors to be considered to minimize the chances of inadvertent deployment. General aviation airplanes are exposed to a unique operating environment, since the same airplane may be used by both experienced and student pilots. The effect of this environment on inadvertent deployment must be understood. Therefore, qualification testing of the firing hardware/software must consider the following: