KENNEDY, BARIS & LUNDY, L.L.P.
ATTORNEYS AT LAW
SUITE P-15
4701 SANGAMORE ROAD
BETHESDA, MD 20816
(301) 229-3400
FAX: (301) 229-2443

TEXAS OFFICE:
SUITE 2550
112 EAST PECAN STREET
SAN ANTONIO, TX 78205
(210) 228-9500
FAX: (210) 228-0781

WASHINGTON DC OFFICE:
SUITE 320
1225 NINETEENTH STREET, NW
WASHINGTON, DC 20036
(202) 835-0313
FAX: (202) 835-0319

June 30, 2004

**VIA EMAIL**
Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

RE: Proposed Risk-Based Capital Standards – Trust Preferred Securities and the Definition of Capital
Docket No. R-1193

Dear Ms. Johnson:

We appreciate the opportunity to submit comments on the Board's proposed revisions to the risk-based capital standards. Our comments are divided into two parts, the first relating to the treatment of trust preferred securities and the second relating to other aspects of the definition of core capital elements.

**Trust Preferred Securities**

We applaud the Board's analysis of the regulatory capital treatment of trust preferred securities, and its continued support for these capital instruments. Over the past several years, we have assisted numerous community banking institutions in analyzing and issuing trust preferred securities, both independently and through pooling vehicles. Trust preferred securities can play a valuable role in an institution's capital structure, by providing relatively low cost capital to institutions, in a timely manner, without adverse impact on shareholder returns, and without the financial and administrative burdens of public reporting necessitated by other capital raising methods, while at the same time providing a source of at-risk funds which are capable of supporting the growth, and absorbing the losses, of the institution.

We generally support the Board's proposal on trust preferred securities and the related treatment of minority interests and restricted core capital elements, but propose certain technical comments or suggestions for clarification, as set forth in the appendix to this letter.

We also encourage the Board to extend the May 31, 2004 "grandfather" date, contained in footnote 10 to the proposal, for trust preferred securities where the underlying subordinated debentures would not meet the requirements of 12 CFR §250.166, to a date after the adoption of the final rules. We have represented, or are aware of, many holding companies that have issued, or plan to issue, trust preferred securities after June 1, 2004 but prior to the comment deadline and the expected issuance of final rules. These issues will be effected through several different established pooling vehicles. We have been advised by counsel for each of the pooling vehicles with whom our clients have dealt, that they have been in contact with the staff of the Federal Reserve, have submitted changes to the trust preferred documents intended to reflect the requirements of the Board's proposal, have received comments from staff and reflected those comments in the forms of documents. However, the manner in which the several vehicles have addressed the proposal has varied. In light of these variations, and the potential for the final rules to differ from those proposed, it is possible that trust preferred securities issued in the period between June 1, 2004 and the issuance of final rules may not comply with the final rules, despite the efforts of the issuers and pooling vehicles. While it might be possible for an issuer to call the trust preferred for early redemption as a result of the change in capital rules, such redemptions could require payment of a premium, and issuance of new compliant trust preferred securities would involve significant additional expense. While amendment of the trust preferred documents might also be possible, it could entail significant effort and expense. We believe it would be unfair and unreasonable to penalize issuers of trust preferred in the interim period and the organizers of the pooling vehicles who attempted in good faith to comply with the proposed rules. Moving the grandfather date would eliminate these adverse effects, and because the terms of the trust preferred will be no more favorable to creditors than trust preferred securities issued prior to June 1, 2004, will not have adverse effects on the safety or soundness of the issuing organizations.

**Qualifying Stockholders' Equity**

While we strongly support the Board's proposed treatment of trust preferred securities, we believe equally strongly that the Board's proposed definition of qualifying common stockholders' equity unjustifiably limits the nature of qualifying capital elements, and inappropriately attempts to inject non-capital related considerations into the definition of the capital elements. Moreover, elements of the proposed definitions are vague, inject inappropriate discretion into the determination of core capital elements and drastically impinge on the ability of bank holding companies to engage in capital planning.

The status of an instrument as capital should be subject to clear, discernible rules based on bright line distinctions, and not a subjective, relativistic analysis based in amorphous concepts. We believe that the Federal Reserve has, or can develop, tools that are more precise and more directly targeted to the goal of insuring capital adequacy, and with which it will be easier for banking organizations to comply.

*The Proposal is Inconsistent in its Underlying Analysis of Capital.* As the Board recognized throughout its analysis of trust preferred securities and minority interests, the fundamental characteristic of capital is the ability of the instrument to absorb losses of the banking organization. The issue of the relative voting power among different classes of common and/or preferred stock is one of corporate governance and contractual obligations among the security holders, and is irrelevant to whether the security and its holders can be required to absorb the losses of the organization. Given that the voting and non-voting elements are both susceptible to absorbing the organizations' losses, why would a freely contracted differential in voting rights result in different regulatory capital treatment? If the proposal is an outgrowth of the recent emphasis on corporate governance and transparency, we believe that holding company capital regulations are not an appropriate venue for addressing such issues.

*The Proposed Definition is Vague and Overbroad.* The proposed rule states that bank holding companies should avoid "over-reliance" on preferred stock or other non-voting, or limited voting, elements within tier 1 capital. The proposal indicates that where the organization "excessively" relies on non-voting elements, the Federal Reserve "generally" will require that "a portion" of the non-voting elements be allocated to tier 2 capital. This definition creates substantial uncertainty for an institution which has or desires equity instruments which do not squarely fall within the proposed definition of common voting equity[1]. For example, the concepts of "over-reliance" on non-voting elements and "excessive reliance" on non-voting common equity, and "significant incentives" to redeem an instrument, each of which could disqualify all, or an unknown portion, of the class of securities from treatment as tier 1 capital, are without concrete contextual guidance as to the level of such instruments which can be included in common equity and tier 1 capital, or the full nature of the instruments that might disqualify them because of incentives to redeem.

Apart from the broad discretion that examiners and the Federal Reserve would have as a result of the vagueness and imprecision of the definition, an institution would have risk under the proposed regulations as a result of the potential for the status of an instrument as capital to change over time, as a result of changes in the financial condition of the institution. For example, if an institution which has non-voting common equity elements in an amount deemed not excessive as of the date of issuance incurs losses, reducing its retained earnings, could the losses and change in the institution's equity result in a change in the capital treatment of the non-voting elements? We believe that the proposed definition would give the Federal Reserve the discretion to effect such a disqualifying change. Such a change based on post-issuance circumstances

[1] The emphasis on common voting equity would also seem to preclude the existence of non-corporate form bank holding companies, such as limited liability companies, limited partnerships, limited liability partnerships, business trusts, etc. It is not clear how, for example, interests in a limited liability company or limited partnership, which are by definition, generally not voting interests, would be treated under the proposed definition. In light of the fact that there are bank holding companies which have these forms, the proposal would have to be revised in this respect.

would merely exacerbate the adverse effect of losses incurred in the ordinary course of business, and would thus be inappropriate and not in the interests of the regulated holding companies or the banking system.

The effect of any reclassification of an instrument based on subjective factors or post-issuance events would not only make an institution's capital planning more difficult, the adverse reclassification of capital instruments could make further capital raising more difficult, which would not be in the best interests of the organization or the regulatory system.

The Federal Reserve has a significant interest in insuring that an organization does not redeem or repurchase equity at a time when it is financially weak or undergoing fiscal stress. However, there are better, more accurate and less vague tools available to the Federal Reserve to accomplish its proper supervisory objectives. These tools currently include prior notice requirements for the purchase or redemption of equity securities in an amount in excess of 10% of the organization's consolidated net worth where it is not, or would not remain, well capitalized.[2] Under the proposed rule, prior Federal Reserve approval would be required for redemption of subordinated debentures underlying qualified trust preferred securities, and for certain other qualifying instruments included in tier 1 capital. Similarly clear and surgical rules can be fashioned to bolster the Federal Reserve's ability to monitor and preserve the fiscal integrity of banking organizations, in addition to its review of institutions during the application and examination process.

*The Proposal Unduly Limits the Flexibility of Banking Organizations.* The practical effect of the proposal's imprecision and vagueness would be to preclude the use of any capital structure that does not fall squarely within the proposal's guidelines. A reasonable Board of Directors, or organizing group for a *de novo* organization, may not seek to implement such a capital structure, as to do so would subject the organization to significant uncertainty as to its future capital status and potential significant expense in justifying its capital treatment. We do not believe such a wholesale disregard of creative capital instruments is warranted, or in the best interests of banking organizations. Boards of Directors should have the flexibility, consistent with safety and soundness, to establish capital structures that are in the best interests of their organization and shareholders, based on their organization's particular needs. There are numerous situations where the creation of equity structures with differential voting rights, or with rights of repurchase or redemption at the option of the company, may be in the best interests of a banking organization and the regulatory system. For example:

- For institutions with severe capital problems or management issues, a class of multiple vote common equity may be a practical prerequisite to obtaining new financing or new competent management. As the alternative may be acquisition, failure or extended status as a troubled institution, the ability to creatively manage the equity structure may be in the best interests of the specific organization, the

[2] 12 CFR §225.4(b)

affected communities and shareholders, and the banking and supervisory system as a whole.

- A multiple class, or differential voting, dividend or redemption right, capital structure may facilitate capital investment in a banking organization, where the investor wishes to remain passive. Among other investments, a multiple class or differential right equity structure could facilitate investments in troubled organizations, minority organizations, community oriented *de novo* organizations, or community development banking organizations. A number of large holding companies or government sponsored enterprises have used nonvoting capital instruments to make investments in minority owned institutions. By creating uncertainty about an institution's ability to count nonvoting equity instruments in capital the proposal may make it even more difficult for minority institutions to access capital.
- A multiple class equity structure with differential voting rights, or with rights of redemption, may be a practical means of effecting estate planning, or transfer of operational control and ownership, for closely held organizations, or those with a small significant shareholder group.[3] Again, a creative equity structure may in the best interests of all affected constituencies.

No adverse effect on an institution's safety or soundness would result from the use of differential voting rights under any of these circumstances. Any impact on the safety or soundness of an organization would arise only from the distinct exercise of the ability or power to repurchase or redeem a capital instrument at a time when the institution cannot spare the capital. The Board has significant authority to prohibit such an outlay of capital, and has and can fashion precise tools toward its proper supervisory objectives. An effective bar on the use of capital instruments with differential voting powers is an inappropriately crude tool to use to meet those objectives.

*Conclusion.* In light of the inevitable uncertainty that would result from the implementation of the proposed definition of qualifying common equity as written, we urge the Board to reconsider its emphasis on the aspects of capital instruments that are intended to define corporate and financial relationships between classes of security holders who are all subject to absorbing the losses of an institution, and focus instead on readily definable and quantifiable factors that would further the Board's proper and laudable goal of insuring the financial strength of banking organizations. This emphasis would not only better enable organizations to plan their capital strategies and comply with the Board's policies, but would significantly simplify monitoring and application by the Federal Reserve.

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[3] Any such redemption or repurchase rights could be included in the organization's charter documents, or in separate contractual agreements between the shareholder and the organization. It is not clear if different sources of the "significant incentive" would result in different capital treatment of the instrument under the proposal. We do not believe any basis exists for making such a distinction

We thank you for the opportunity to provide these comments. We would be pleased to further discuss the proposal and our comments with the staff, or to provide any further information you may require. Please do not hesitate to contact the undersigned at 301.229.3400 (x18), or by email at nmgruber@kblbanklaw.com, if we can be of further assistance.

Sincerely,

Noel M. Gruber

## Appendix
## Technical Comments and Suggested Revisions

1. Proposed Part 225 Appendix A Section II(A)(1)(c)(iv) provides, *inter alia*, that:

- Qualifying trust preferred securities must allow for dividends to be deferred for at least twenty consecutive quarters without an event of default and any notification period for deferral must be reasonably short, generally no more than one business week.

    - The proposal should be clarified to indicate what date, the dividend payment date or the record date for the payment, the one business week notice should precede.

- The subordinated note issued by the sponsoring banking organization, must be subordinated to all senior and all other subordinated debt of the banking organization.

    - As many banking institutions have, or may in the future have, multiple series of outstanding trust preferred securities, the proposal should be clarified to provide that the subordinated note is subordinate to all other senior and subordinated debt of the banking organization, *other than subordinated debt issued in connection with other trust preferred securities, with which the subordinated note should rank pari passu in all respects.*

- The note may have terms providing for an event of default and acceleration of principal and accrued interest upon deferral of payments for twenty or more consecutive quarters but otherwise must comply with the Federal Reserve's subordinated debt policy statement set forth in 12 CFR §250.166.

    - The proposal should be revised to clarify that in order to benefit from the twenty quarter deferral of interest payment without an event of default, an issuer must validly exercise its rights to defer interest payments under the indenture related to the debentures. The proposal should also be revised to provide that the failure to pay interest when due, combined with the failure to cure or give notice of the exercise of the issuer's right to defer interest payments by the due date of the next interest payment, may be the basis for the acceleration of principal. Issuers should not be permitted to blatantly disregard the obligations reflected in the indenture, or the procedures included for the protection and benefit of the issuer and investors. Similarly the failure to pay principal and premium, if any, on the debentures on the date fixed for the voluntary early redemption of debentures should be a permitted acceleration event. The absence of such provisions could result in the limitation of the rights of the purchasers of trust preferred securities, which could result in increased cost, or reduced availability of, trust preferred securities, without a commensurate benefit to the issuing holding company. An issuer can readily avoid an acceleration by vigilantly acting on its right to declare a deferral of interest payments, or by prudent exercise of early redemption rights, which would generally require prior approval of the Federal Reserve.

2. The Board's subordinated debt provisions at 12 CFR §250.166 should be revised in connection with the trust preferred proposal. Under most, if not all, trust preferred securities documents, the underlying subordinated debentures may be distributed to holders of trust preferred securities under certain circumstances, including in connection with the liquidation of the trust, or where changes in law would result in changed tax treatment of the securities or the trust, changed capital treatment of the securities or changed treatment of the trust under the Investment Company Act of 1940. In order that the debentures may continue to qualify for treatment as tier 2 capital following such a distribution, §250.166 should be amended to provide that any subordinated debenture originally issued in connection with compliant trust preferred securities, or trust preferred securities eligible to be grandfathered under footnote 10, would automatically be eligible for treatment as tier 2 capital.

3. We note that Section II(i) of the proposal provides that "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." Similarly footnote 9 provides that "[w]here a banking organization has issued trust preferred securities pursuant to a pooling arrangement, 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 included 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 pool."

We appreciate and support the principal reflected by these statements. However, in light of the statement at page 15 of the proposal that "[t]his provision is not intended to capture unintentional, indirect funding of capital instruments but rather intentional arrangements that undermine the concept that instruments included in regulatory capital must be fully paid up," we request clarification as to what constitutes unintentional, indirect funding. It would appear to us that the acquisition scenario referred to in footnote 9 would be unintentional and indirect within the meaning of the discussion at page 15. In a similar vein, we suggest consideration be given to providing clear guidance in other circumstances potentially involving unintentional indirect financing of a capital security, including, for example: (i) a capital security is purchased, either directly from the company or in the secondary market, using funds provided by a preexisting line of credit at the company's subsidiary bank, not established for the purpose of financing the purchase and not secured by the purchased security, and for which no specific draw approval from the bank is required; (ii) funds provided by such a line of credit are used to repay debt owed to a third party lender incurred for the purpose of purchasing the security; and (iii) margin debt extended in an account at a broker dealer affiliate of a banking organization in which company capital securities are held.