



July 9, 2004

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

Re: Risk Based Capital Standards: Trust Preferred Securities and the Definition of Capital
Docket No. R-1193; 69 FR 28851 (May19, 2004)

Dear Ms. Johnson:

America's Community Bankers ("ACB")¹ is pleased to comment on the proposed rule issued by the Board of Governors of the Federal Reserve System (the "Board"), *Risk Based Capital Standards: Trust Preferred Securities and the Definition of Capital*.² The Board's proposal will allow bank holding companies ("BHCs") to continue including outstanding and prospective issuances of trust preferred securities in Tier 1 capital, subject to some stricter quantitative and qualitative limitations.

ACB Position

ACB supports the Board's proposal that will allow the continued inclusion of trust preferred securities in the Tier 1 capital of BHCs. Despite the new quantitative and qualitative restrictions in the proposal, ACB believes that its member banks will be able to continue utilizing this essential source of capital funding. More importantly, this will permit smaller BHCs to maintain participation in pooled offerings that provide these BHCs and their subsidiary community banks better penetration into capital markets for Tier 1 capital, while strengthening their capital bases.

ACB recognizes that the Board's revised 25 percent limit of core capital elements, net of goodwill, will certainly result in restrictions on the level of trust preferred securities a BHC may hold under the current capital guidelines. Because such a large number of banks rely so heavily

¹ America's Community Bankers represents the nation's community banks. ACB members, whose aggregate assets total more than \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

² 69 Fed. Reg. 28851 (May19, 2004)

on trust preferred securities as a capital funding tool, ACB is concerned that the three-year transition period could potentially be insufficient for these banks to accommodate the new restrictions. This could prove to be more troublesome for banks that possess a higher level of goodwill as a result of recent acquisitions. ACB urges the Board to reconsider the impact that the proposal would have on the capital levels of banks with sizeable amounts of goodwill, as a result of netting goodwill at the March 31, 2007 transition date, and the potential impact on the capital adequacy of these institutions. ACB suggests that the Board consider extending the transition period to five years, or possibly having a progressive approach to netting the goodwill (i.e., in three years net 50 percent of goodwill, four years 75 percent, and five years 100 percent.)

Background

Since 1996, when the Board explicitly approved the inclusion of minority interests in the form of trust preferred securities in BHC Tier 1 capital, many BHCs have utilized trust preferred securities as a valuable source of capital funding. The proceeds of trust preferred securities offerings are typically down-streamed to the subsidiary banks in the form of common stock and have proven to be essential in funding expansion and strengthening banks' capital positions.

Trust preferred securities are undated cumulative preferred securities issued out of a special purpose entity ("SPE"), usually a trust, in which the BHC owns all of the common securities. The continued inclusion of trust preferred securities in Tier 1 capital was questioned last year, when the Financial Accounting Standards Board ("FASB") issued Interpretation 46, Consolidation of Variable Interest Entities ("FIN 46") in January 2003 and a revised version ("FIN 46R") in December 2003. As an unintended consequence of FIN 46, the accounting industry generally concluded that BHCs could no longer consolidate the trust that issues the trust preferred securities in their financial statements prepared under GAAP. The result, upon adopting FIN 46, was that the trust preferred securities would no longer be treated as a minority interest in the equity accounts of a consolidated subsidiary on a BHC's consolidated balance sheet. Instead, the BHC would have to reflect the deeply subordinated note issued to the now deconsolidated SPE, or trust, as a liability.

Because FIN 46 and FIN 46R had changed the financial reporting requirements of trust preferred securities under GAAP, the Board and other agencies were faced with reconsidering the regulatory capital treatment of the instruments. Many stakeholders in the banking industry were concerned that the Board could potentially conclude that trust preferred securities would no longer qualify as Tier 1 capital, given the change in the accounting treatment of the instruments. Aside from capital adequacy concerns, there were some potential competitive disadvantages that could have arisen if BHCs were no longer permitted to include trust preferred securities in their Tier 1 capital calculations. Savings and loan holding companies do not have consolidated capital requirements, so institutions regulated by the Office of Thrift Supervision ("OTS") would not have been impacted if the Board had decided to disallow trust preferred securities from qualifying as Tier 1 capital for BHCs.

Proposed Rule

Under existing regulations, BHCs are permitted to aggregate qualifying trust preferred securities and other cumulative preferred stock as Tier 1 capital to the extent that the amount of these instruments does not exceed 25 percent of the sum of “core capital elements.”³ The proposed rule will essentially retain the inclusion of trust preferred securities in Tier 1 capital, but after a three-year transition period ending on March 31, 2007, the aggregate amount of trust preferred securities and other “restricted core capital elements”⁴ may not exceed 25 percent of the amount of all “core capital elements,” including restricted core capital elements, *net of goodwill*. The Board recognized in the proposal that the change to net goodwill from the core capital elements, and subsequent determination of the 25 percent limit, will certainly result in a tightening of the current 25 percent limit, which is determined on a basis that does not exclude goodwill. Under the proposal, excess amounts of trust preferred securities would generally continue to be includable in Tier 2 capital, subject to certain restrictions.

The Board’s rationale for deducting goodwill, and the related reduction of trust preferred securities qualifying as Tier 1, is that this “will help ensure that a BHC is not unduly leveraging its tangible equity to issue restricted core capital elements.” The Board also stated that the goodwill deduction is consistent with the Basel Committee’s consultative paper on the new capital accord, or Basel II.

The Board’s proposal would also require that internationally active BHCs limit the amount of restricted core capital elements to 15 percent of the core capital elements, net of goodwill. This limit is currently informally “encouraged” by the Board. Lastly, the proposal also provides for a phase-out period, whereas trust preferred securities must be removed as an element of Tier 1 capital five years prior to maturity. At that time, the instrument may be included in Tier 2 capital, subject to the same phase-out currently applicable to limited life preferred stock.⁵

Savings Associations

Savings and loan holding companies, regulated by the OTS, are not impacted by the Board’s proposal. The OTS has not issued any corresponding guidance on the capital treatment of trust preferred securities. Proceeds of trust preferred securities issuances are generally reflected as cash on the subsidiary federal savings association balance sheet, so FIN 46 and FIN 46R have little or no impact on savings associations’ treatment of trust preferred securities. Nonetheless, there remains a possibility that the OTS could treat the Board’s revised capital standard as a “rebuttable presumption.”

³ Core capital elements are: (i) qualifying common shareholders equity; (ii) qualifying noncumulative and cumulative perpetual preferred stock (and related surplus); (iii) qualifying minority interests in the equity accounts of consolidated subsidiaries; and (iv) qualifying trust preferred securities.

⁴ Restricted core capital elements under the proposal includes: (i) trust preferred securities; (ii) cumulative perpetual preferred stock; and (iii) Class B and Class C minority interests

⁵ i.e., one-fifth each year and totally excluded during last year of maturity.

Conclusion

ACB agrees with the Board's conclusion in the proposal that the change in GAAP accounting of a capital instrument should not necessarily change the regulatory capital treatment of the instrument. As such, we appreciate the Board's recognition of the benefits that the pooling of trust preferred securities offers to small BHCs and banks, and the related importance on the instruments' continued inclusion in Tier 1 capital. Should you have any questions, please contact the undersigned at 202-857-3121 or via email at cbahin@ACBankers.org, or Dennis Hild at 202-857-3158 or via e-mail at dhild@ACBankers.org.

Sincerely,



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