FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

DONALD E. POWELL
CHAIRMAN

July 2,2004

Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Re: Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital (Docket No. R-1193)

Dear Mr. Chairman:

The following comments are respectfully submitted by the Federal Deposit Insurance Corporation on the Board of Governors' recent notice of proposed rulemaking (NPR) that would retain trust preferred securities in the Tier 1 capital of bank holding companies (BHCs). This proposal would continue to allow trust preferred securities and certain other securities (which include cumulative preferred stock, trust preferred securities, Class B minority interests, and Class C minority interests) to comprise up to 25 percent of the Tier 1 capital, net of goodwill, and would affirm the Federal Reserve's expectation that internationally-active BHCs limit these capital elements to 15 percent of Tier 1 capital, net of goodwill. The FDIC believes that trust preferred securities should be excluded from Tier 1 capital after an appropriate transition period.

The FDIC's concerns, described in more detail below, are as follows. Trust preferred securities do not provide a degree of capital support that is consistent with their receiving the Tier 1 designation reserved for high-quality capital instruments. BHCs' use of trust preferred securities, as compared with other Tier 1 capital instruments, increases pressure on FDIC-insured subsidiaries to service the obligations associated with the securities. We are also concerned that the Federal Reserve has, in effect, used its exclusive authority over BHC capital requirements to confer a competitive advantage on BHC subsidiaries relative to stand-alone *banks*.

The remainder of this letter provides factual background on trust preferred securities, **a** discussion of the FDIC's principle concerns with their inclusion in BHCs' Tier 1 capital, responses to specific points raised in the NPR, and concludes with the FDIC's recommended treatment of these instruments.

<u>Background</u>

In general, issuance of trust preferred securities is a "double leverage" transaction whereby the BHC issues deeply-subordinated debt to a special-purpose vehicle and uses the proceeds of the debt issuance to infuse capital into the banking subsidiary. Dividends received from the bank are used to assist the BHC in the servicing of the debt issuance. However, regardless of the ability of the bank to provide cash flow to the BHC by way of dividend payments, the BHC bears a legal obligation to repay the debt issuance in accordance with the contractual terms of the debenture.

Specifically, trust preferred securities are cumulative preferred securities issued through a limited-life, special-purpose vehicle (usually a trust) that is owned by a BHC. The trust uses the proceeds of the trust preferred security issuance to purchase a deeply-subordinated debenture from the BHC. The BHC is allowed to deduct interest payments made on the debenture for purposes of calculating income tax.

Furthermore, for income tax purposes trust preferred securities are classified as an interest in a grantor trust, which requires investors to treat income from these securities in the same manner that they would otherwise treat income from the subordinated debenture issued by the BHC. Thus, investors must treat dividend income received from trust preferred securities as ordinary income and corporate investors may not take a dividends-received deduction with respect to trust preferred dividends.

Trust preferred securities are generally undated securities with terms and conditions that mimic those of the subordinated debenture issued by the BHC. Additionally, trust preferred securities are mandatorily redeemable under certain circumstances, including the termination of the trust. However, trust preferred securities typically have an effective life of only 30 years, since most trust agreements provide for the trust to terminate upon the maturity of the subordinated debenture issued by the BHC.

Prior to the issuance of Financial Accounting Standards Board (FASB) Interpretation No. **46,** Consolidation of Variable Interest Entities (FIN **46),** and its revision, FIN **46R,** in January and December 2003, respectively, the trust was consolidated on the financial statements of the BHC because the BHC held all of the common equity in the trust The subordinated debt issued by the BHC to the trust was eliminated in consolidation and was not reflected on the BHC's financial statements; however, the trust's issuance of the trust preferred securities was recorded as a minority interest in a consolidated subsidiary by the BHC. Because of this reporting treatment in consolidated BHC reports filed with the Federal Reserve, BHCs requested, and received, permission from the Federal Reserve to treat these securities as Tier 1 capital, subject to certain limits. Tier 1 capital treatment was afforded to BHCs on these issuances, provided that the trust preferred securities provided for the deferral of dividend payments for at least 20 consecutive quarters.

Beginning in 2002, the FASB reviewed the consolidation rules under Accounting Research Bulletin No. 51, which led to the issuance of FIN **46** and its later revision in 2003. Under FIN 46R, the typical trust that issues trust preferred securities is considered a "variable interest entity" because the holders of the equity investment at risk lack adequate decision-making authority over the trust's activities. FIN 46R states that only the variable interest holder who is the primary beneficiary of a variable interest entity, if there is one, can consolidate the entity on its financial statements. However, the BHC's equity investment in the trust is not considered to be at risk and, therefore, it is not a variable interest.

Accordingly, for a typical trust, the BHC is not the primary beneficiary and can no longer consolidate the trust on its financial statements. The accounting consequence of not consolidating the trust is that the subordinated debenture issued by the BHC to the trust would be reported as a liability on the BHC's consolidated balance sheet. The trust preferred securities would not be reflected on the BHC's consolidated balance sheet.

In addition, the FASB completed the first phase of a review of the accounting for certain hybrid capital instruments and issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (FAS 150), in May 2003. As written, FAS 150 applies to the trust preferred securities issued by a trust that is consolidated by the sponsoring BHC and the standard states that these securities must be reported as liabilities on the BHC's consolidated financial statements. In reaching this accounting conclusion, the FASB determined that the trust preferred securities are "mandatorily redeemable" because they "must be redeemed upon maturity of the debentures" and "represent obligations to transfer assets to redeem the shares," which means that they meet the current definition of liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements. Although the FASB subsequently deferred indefinitely this balance sheet classification requirement for those mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by a subsidiary on its financial statements, but would have to be classified as liabilities on the parent's consolidated financial statements, the FASB is clearly seeking to align the financial reporting treatment of trust preferred securities with their substance as mandatorily redeemable instruments.

Hence, under both FIN 46R and FAS No. 150, the FASB has determined that the issuance of trust preferred securities, regardless of whether the trust is consolidated, should result in the reporting of these instruments as liabilities rather than equity on the sponsoring BHC's consolidated financial statements.

<u>Principle concerns</u>

<u>Quality of capital</u>. The NPR presents the scenario of a U.S. bank regulatory agency conferring Tier 1 capital status on financial instruments that are explicitly categorized as liabilities under *GAAP*. The various definitions of capital that accountants, financial analysts and bank regulators have traditionally used shared one common theme: one way or another, capital measured the net worth of a business after all liabilities were deducted, or, viewed from a different perspective, the funds contributed to a business by the owners or stockholders. By including liabilities in the definition of Tier 1 capital, the NPR departs from such traditional notions of the meaning of the term "capital."

The liabilities of a banking organization or its subsidiaries should not be included in its Tier 1 capital base. If the proceeds of trust preferred securities are used to finance activities that prove unprofitable, or assets that ultimately must be written down, the banking organization is still saddled with a long-term contractual obligation to pay all promised dividends—a situation that is the antithesis of the term "capital support." The danger to an organization that is bound by fixed obligations, while its profitability or the value of its assets diminishes, is the conceptual basis for the exclusion of liabilities from a prudential definition of Tier 1 capital.

All U.S. banking agencies have recognized for regulatory purposes an important distinction between Tier 1 capital and Tier 2 capital. The Tier 1 capital designation has traditionally been reserved for high quality capital instruments that have a number of attributes including permanence, a lack of cumulative dividend or debt obligations, and the ability to absorb unexpected losses on a going concern basis. Tier 2 capital instruments are those that provide some degree of capital support but are of lesser quality than those elements included in Tier 1. For example, the U.S. banking agencies have allowed banks to include a limited amount of subordinated debt in Tier 2 capital, but not Tier 1 capital. Consistency with the principles embodied in the capital regulation of banks would therefore suggest that trust preferred securities be included only in BHCs' Tier 2 capital.

The NPR argues that recent accounting changes do not change the economic substance of the capital support provided by trust preferred securities. It further notes that "...the Federal Reserve is not bound by *GAAP* accounting in its definition of Tier 1 or Tier 2 capital because these are regulatory constructs designed to ensure the safety-and-soundness of banking organizations, not accounting designations designed to ensure the transparency of financial statements." (The NPR is correct on these points.) The U.S. banking agencies' regulatory capital definitions are governed by safety-and-soundness considerations and the economic substance of risks banking organizations assume. A change in accounting does not necessarily imply a change in definition of regulatory capital.

In this case, however, the accounting change reflects economic reality, namely the burden of mandatory dividends that these instruments place on an organization. The accounting of trust preferred securities as liabilities of the BHC under *GAAP* is consistent with the treatment afforded these instruments by the financial markets, by independent rating agencies, by banks as investors in trust preferred securities, by taxing authorities, and by the regulators who supervise these entities.' In specific, we understand that Moody's Investors Services (Moody's) has recently reaffirmed their long held opinion of trust preferred securities as debt in their evaluation of highly-rated BHCs. According to Moody's: "[w]e have always considered trust preferred securities to be far more debt-like in nature, and have generally not assigned them any 'equity credit' in evaluating the capital structure of highly rated issuers."[2] Likewise, the Office of the Comptroller of the Currency (OCC) has indicated in various interpretative letters[3] that trust preferred securities are in substance, debt obligations, and thus, can be considered a permissible investment for national banks given their fixed and cumulative dividends, limited voting rights, and limited life. Thus, the change in *GAAP* is entirely in line with the views taken by the bank

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[1] Standard and Poor's considers trust preferred securities to represent a weak form of capital and limits its inclusion to only 10% of adjusted total equity for their analyses. See "Financial Institutions Criteria," Standard & Poors, January 1999

[2] "Impact on Federal Reserve's Proposed Rule for Trust Preferred Securities on Moody's Ratings for U.S. Banks," Moody's Investors Service, May 2004.

[3] "Interpretive Letter # 901." Office of the Comptroller of the Currency, May 2001.

regulators and by private sector evaluators of the ultimate creditworthiness of financial institutions.

In short, trust preferred securities provide a lesser quality of capital support because they give rise on the BHC balance sheet to cumulative dividend obligations with a contractual maturity that are binding on the organization regardless of the performance of its asset portfolio, whose ultimate non-payment could constitute default, and the deferral of which could taint the BHC in the eyes of the market. Additionally, our understanding is that upon deferral, the BHC must record a liability for the amount of deferred interest that is due at the end of each period that is deferred, and that this accrued liability compounds at the dividend rate until all deferred dividends are paid. Such a condition is more reflective of a debt obligation than as a form of equity includable in the agencies' Tier 1 capital definition. The capital support that trust preferred securities provide should be recognized only in Tier 2 capital.

Pressure on FDIC-insured subsidiaries. **As** indicated above, investors in trust preferred securities have a contractual right to full payment of principal and interest and, if such payments are deferred, their claim on the trust both cumulates and compounds. The requirement to service this obligation can place undue pressure on other entities within a BHC, including FDIC-insured bank subsidiaries, regardless of whether such payments are in the subsidiary bank's financial interest. While the ability to defer dividend payments may provide an organization with temporary relief, there is strong market pressure to keep such payments current, or to bring them current in the event of payment deferral.

The NPR states, "...in numerous instances, BHCs in deteriorating financial condition have deferred dividends on trust preferred securities to preserve cash flow." The FDIC is, however, aware of some instances where BHCs have taken extreme measures to avert a deferral of dividends on trust preferred securities. The most problematic examples have arisen when the BHC must rely heavily on dividends received from the bank to service the trust preferred-related subordinated debt.

In particular, the FDIC has noticed certain instances were the BHC has issued trust preferred securities in an amount greater than the proceeds which are infused into the bank as capital. In these instances, the excess is used by the BHC to meet the service needs of the debt should the bank be unable to generate sufficient dividend income. This significantly increases the net cost of capital as well as the future demand for dividends from the bank subsidiary.

Also, there have been instances where the banking subsidiary has been unable to pay dividends to the BHC, or the BHC has recognized that the banking subsidiary will soon be prevented by regulators from making dividend payments. On some occasions, the FDIC has observed that the BHC has issued additional trust preferred securities to provide liquidity. This liquidity was not used for a capital infusion into the ailing bank; rather, it was used to service the debt generated by prior trust preferred issuances. Thus, the future dividend requirements of the bank will be exceptionally high, potentially inducing the bank to increase its risk profile.

However, the most troubling situations that the FDIC has encountered have arisen when the banking subsidiary has begun to show warning signs of difficulties, such as flagging net income. On occasion, the BHC has increased the dividend pressure on the banking subsidiary at the time it can ill-afford to pay dividends. This dividend pressure was generated either by the desire of the BHC to increase its liquidity position for debt service before the bank regulators ordered the bank to stop making dividend payments, or because the normal debt service requirements were far greater than the current income generated by the bank. From time to time, banks have paid dividends that far exceed their current net income or have paid dividends when they are experiencing a net loss. In these instances, the banks are essentially cannibalizing themselves to meet the debt service requirements of the trust preferred securities that were used to infuse capital into the bank in a prior period.

We believe that the FDIC and other banking regulators have been extremely successful at identifying these situations at an early stage and taking immediate action to preserve the capital at the bank level. However, while these extremes have been effectively handled by the banking regulators, they do provide a critical insight into the quality and meaningfulness of the capital support provided trust preferred securities.

In times of financial distress at the banking level, the debt service requirements of trust preferred securities has the potential to force the bank to increase its risk profile in order to increase cash liquidity for dividend payments, divert income from critical internal investment needs, and to take other actions that lead them away from safe and sound banking practices.

Inconsistency with established standards for the attributes of Tier 1 caoital. On October ***27,*** 1998, the Basel Committee on Banking Supervision issued a public statement titled "Instruments Eligible for Inclusion in Tier 1 Capital." The 1998 statement included the following language:

> In order to protect the integrity of Tier 1 capital, the Committee has determined that minority interests in equity accounts of consolidated subsidiaries that take the form of SPVs should only be included in Tier 1 capital if the underlying instrument meets the following requirements which must, at a minimum, be fulfilled by **all** instruments included in Tier 1 [emphasis added to the word "all"].

The statement then lists a number of conditions, including the following, which are identical to conditions U.S. regulators require for inclusion in Tier **1** capital at the bank level[4]:

- "non-cumulative"
- "able to absorb losses within the bank on a going-concern basis"
- "permanent"

Because of their cumulative dividend obligations, trust preferred securities would not qualify as Tier 1 capital under the conditions described in the 1998 public statement. In addition, for a troubled organization that has elected to defer dividends, trust preferred securities have an effective maturity of five years, after which the cumulative dividend obligation must be brought

[4] With regard **to** institutions regulated by the OCC, see: Risk-Based Capital Guidelines, 12 CFR, pt.3, Appendix **A** (2004). With regard to institutions regulated by the FDIC, ***see:*** Statement of Policy on Risk-based Capital, 12 CFR, **pt.** 325, Appendix **A** (2004). With regard to institutions regulated by the OTS, see: Capital, 12 CFR, pt. 567.

current or a default may occur. Even in the absence of deferral, trust preferred securities are "permanent" only in the sense of being binding long-term commitments by the organization to make regular fixed dividend payments for the life of the debenture, which is typically **30** years or less. Trust preferred securities cannot absorb losses on a going-concern basis because they give rise to a fixed liability that can only be avoided in the event of default. Deferral of dividends can conserve cash flow for five years but this would not offset any losses as the dividend obligation continues to accrue.

Although trust preferred securities do not meet the conditions for inclusion in Tier 1 capital listed in the 1998 public statement, the BCBS also agreed that the conditions listed do not apply at the bank holding level in the U.S. The Federal Reserve is using its flexibility to argue that trust preferred securities provide sufficient capital protection to merit inclusion in Tier 1 despite their not meeting established standards normally expected of other Tier 1 instruments. The unilateral decision of an important bank regulator such as the Federal Reserve to depart from established prudential standards is of concern to the FDIC. Competition among banks puts pressure on various regulators to harmonize their standards, and moves by individual regulators to relax standards puts pressure on other regulators to follow suit. The FDIC recommends the Federal Reserve build upon the momentum generated by recent FASB pronouncements to reverse the course it set in 1996, and begin the process of eliminating these debt instruments from Tier 1 capital.

Competitive equity. The U.S. banking agencies do not permit banks to include trust preferred securities in Tier 1 capital, for a number of the reasons described in this letter. The Federal Reserve allows BHCs to include these instruments in Tier 1, and thus BHC's bank Subsidiaries can indirectly benefit from trust preferred securities as a source of down-streamed equity from the parent. The Federal Reserve has, in effect, used its authority over BHC capital requirements to create an un-level playing field in which stand-alone banks operate at a disadvantage to banks that are subsidiaries of BHCs.

The $77 billion of trust preferred securities issued by U.S. BHCs, and the enthusiasm community banks and their holding companies are showing for participating in poolings of these securities, shows that there is a financial advantage to issuing trust preferred securities. The ability to meet a not-insubstantial portion of an organization's Tier 1 capital requirement – which otherwise would be met mostly with relatively expensive and dilutive common equity – with tax-deductible debt financing, is a thing of value.

Access to all the financial advantages of issuing trust preferred securities is not available to stand-alone banks. The NPR states, "No alternative Tier 1 structure to trust preferred securities has emerged that can be similarly pooled and issued to the capital markets by small banking organizations." The BHC structure is the predominant form of organization for commercial banks in the U.S.: as of year-end 2003, over 81 percent of U.S. commercial banks were subsidiaries of BHCs. The predominance of the BHC structure is attributable to tax considerations and a host of factors beyond the structure of capital regulation. Nevertheless, differences in the level and composition of effective consolidated capital requirements could, over time, tend to influence banking organizations' choice of organizational forms.

The FDIC is also cognizant of industry concerns that the exclusion of trust preferred securities from Tier 1 capital could place domestic banking organizations at a competitive disadvantage with foreign banks and non-bank financial firms. This concern, however, should not result in debt being transformed into something it is not – Tier 1 capital. BHCs could still enjoy the tax efficiencies offered by trust preferred securities to accommodate their business strategies if these instruments were included in Tier 2 capital. The FDIC strongly supports future work aimed at strengthening and harmonizing the definitions of Tier 1 capital used in various countries and across banks' organizational forms.

Response to specific NPR arguments in favor of allowing trust preferred securities to be included in the Tier 1 capital of BHCs.

1. "...trust preferred securities have long lives that approach economic perpetuity and deferral rights that, at twenty consecutive quarters, approach economically indefinite deferral."

To the extent trust preferred securities are perpetual, they are perpetual fixed obligations that burden the organization. Once a BHC defers its dividends, the obligation effectively matures in five years. It has not been unknown for banking organizations in the U.S. and abroad to experience prolonged periods of weakness of five or more years. Because the marketplace views these instruments as debt, deferrals could affect the BHC's ability to tap debt markets. And unlike other forms of Tier 1 capital, the dividend obligations cumulate at compound interest during the deferral period.

2. "...if a BHC defers payments on trust preferred securities, the cash flow preserved can be used anywhere within the consolidated organization."

This is correct, subject to the concerns enumerated in the response to item 1 above. The benefits of deferring dividends, in addition to being mitigated *ex post* by the cumulative nature of the obligations and the market repercussions of deferral, come at a substantial *ex ante* cost. Trust preferred securities are an expensive form of debt. Additionally, the leveraged nature of the capital infusion into a bank subsidiary from the issuance of these securities will most likely significantly increase the bank's risk profile. Hence, on a risk-adjusted basis, the cost of the already-expensive debt rises even further.

3. "REIT-preferred securities and other asset driven structures trap high quality, liquid assets in a subsidiary that the banking organization would have difficulty accessing to meet immediate liquidity needs."

Implicitly, the NPR may be suggesting that disallowing trust preferred securities in Tier 1 would drive BHCs towards the use of less satisfactory means to achieve tax efficiencies. REIT-preferred securities and other structures have some characteristics, including non-cumulative dividends, that offer better capital support to an insured bank than do trust preferred securities. Nevertheless, some aspects of these structures merit review including, at a minimum, a need to clarify the structures that provide capital support consistent with a Tier 1 capital designation. Consistent with this concern, the FDIC has proposed to the Federal Reserve and the other Federal banking agencies, an interagency review of, and request for comment on, the attributes of hybrid capital instruments that would provide meaningful capital support to FDIC-insured banks.

4. In times of stress, BHCs can issue trust preferred securities more easily than other capital instruments.

It is cheaper and easier for banking organizations to issue debt than to issue equity. If the definition of Tier 1 capital were expanded to include other forms of debt in addition to trust preferred securities, for example, BHCs would find it even easier to raise capital. Arguing for a less stringent definition of capital on the grounds that organizations find it easier to raise such new forms of capital may not be consistent with prudential considerations.

5. "From a competitive equity point of view, poolings of trust preferred securities have permitted small BHCs for the first time to access the capital markets for Tier 1 capital, which larger BHCs have long enjoyed."

Small BHCs could participate in poolings of trust preferred securities even if these securities were included only in Tier 2 capital. These organizations are essentially gaining access to long term debt, and the question addressed by the NPR and this letter is whether such debt should be treated as Tier 1 capital.

Recommendation

The FDIC recommends that trust preferred securities' recognition in BHC Tier 1 capital be phased out using transitional arrangements of the Federal Reserve's choosing; after the transition period, these instruments would receive only Tier **2** capital treatment. An interagency review of other hybrid capital instruments at the bank level and an ANPR soliciting comment on the attributes of these instruments that provide meaningful capital support should be completed expeditiously.

If you our your staff would like to discuss the subject further, please contact George French, Deputy Director of our Division of Supervision and Consumer Protection, at 898-3929. A

Sincerely,

Donald E. Powell