

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-1235]

Capital Adequacy Guidelines for Bank Holding Companies; Small Bank Holding Company Policy Statement; Definition of a Qualifying Small Bank Holding Company

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule with request for comments.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is proposing to raise the asset size threshold and revise the other criteria for determining whether a bank holding company (BHC) qualifies for the Board's Small Bank Holding Company Policy Statement (Regulation Y, Appendix C) (Policy Statement) and an exemption from the Board's risk-based and leverage capital adequacy guidelines for BHCs (Regulation Y, Appendices A and D) (Capital Guidelines). The proposal would increase the asset size threshold from \$150 million to \$500 million in consolidated assets for determining whether a BHC would qualify for the Policy Statement and an exemption from the Capital Guidelines; modify the qualitative criteria used in determining whether a BHC that is under the asset size threshold nevertheless would not qualify for the Policy Statement or the exemption from the Capital Guidelines; and clarify the treatment under the Policy Statement of subordinated debt associated with trust preferred securities.

DATES: Comments must be received no later than [INSERT DATE 60 DAYS AFTER PUBLICATION IN FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by Docket No. R-1235, by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at

<http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board's web site at www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Barbara Bouchard, Deputy Associate Director (202/452-3072 or barbara.bouchard@frb.gov), Mary Frances Monroe, Manager (202/452-5231 or mary.f.monroe@frb.gov), William Tiernay, Supervisory Financial Analyst (202/872-7579 or william.h.tiernay@frb.gov), Supervisory and Risk Policy; Robert Maahs, Manager, Regulatory Reports (202/872-4935 or robert.maahs@frb.gov); or Robert Brooks, Supervisory Financial Analyst (202/452-3103 or robert.brooks@frb.gov), Applications, Division of Banking Supervision and Regulation; or Mark Van Der Weide, Senior Counsel (202/452-2263 or mark.vanderweide@frb.gov), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), contact 202/263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

The Board issued the Policy Statement in 1980 to facilitate the transfer of ownership of small community-based banks in a manner that is consistent with bank safety and soundness. The Board generally has discouraged the use of debt by BHCs to finance the acquisition of banks or other companies because high levels of debt at a BHC can impair the ability of the BHC to serve as a source of strength to its subsidiary banks. The Board has recognized, however, that small BHCs have less access to equity financing than larger BHCs and that, therefore, the transfer of ownership of small banks often requires the use of acquisition debt. Accordingly, the Board adopted the Policy Statement to permit the formation and expansion of small BHCs with debt levels that are higher than what would be permitted for larger BHCs. The Policy Statement contains several conditions and restrictions that are designed to ensure that small BHCs that operate with the higher levels of debt permitted by the Policy Statement do not present an undue risk to the safety and soundness of their subsidiary banks.

Currently, the Policy Statement applies to BHCs with pro forma consolidated assets of less than \$150 million that (i) are not engaged in any nonbanking activities involving significant leverage; (ii) are not engaged in any significant off-balance sheet activities; and (iii) do not have a significant amount of outstanding debt that is held by the general public (“qualifying small BHCs”). Under the Policy Statement, qualifying small BHCs may use debt to finance up to 75 percent of the purchase price of an acquisition (that is, they may have a debt-to-equity ratio of up to 3:1), but are subject to a number of ongoing requirements. The principal ongoing requirements are that a qualifying small BHC (i) reduce its parent company debt in such a manner that all debt is retired within 25 years of being incurred; (ii) reduce its debt-to-equity

ratio to .30:1 or less within 12 years of the debt being incurred; (iii) ensure that each of its subsidiary insured depository institutions is well capitalized; and (iv) refrain from paying dividends until such time as it reduces its debt-to-equity ratio to 1.0:1 or less. The Policy Statement also specifically provides that a qualifying small BHC may not use the expedited applications procedures or obtain a waiver of the stock redemption filing requirements applicable to BHCs under the Board's Regulation Y (12 CFR 225.4(b), 225.14, and 225.23) unless the BHC has a pro forma debt-to-equity ratio of 1.0:1 or less.

The Board adopted the risk-based capital guidelines in 1989 to assist in the assessment of the capital adequacy of BHCs. The risk-based capital guidelines establish for BHCs minimum ratios of tier 1 capital and total capital to risk-weighted assets. One of the Board's principal objectives in adopting the risk-based capital guidelines was to make regulatory capital requirements more sensitive to differences in risk profiles among banking organizations. Supplemental to the risk-based capital guidelines, the Board in 1991 adopted the tier 1 leverage measure, a minimum ratio of tier 1 capital to total assets, to further assist in the assessment of the capital adequacy of BHCs with the principal objective of placing a constraint on the maximum degree to which a banking organization can leverage its equity capital base. Because qualifying small BHCs may, consistent with the Policy Statement, operate at a level of leverage that generally is inconsistent with the Capital Guidelines, the Capital Guidelines provide an exemption for qualifying small BHCs.

II. The Proposal

New Asset Threshold of \$500 Million

When the Board issued the Policy Statement in 1980, \$150 million in consolidated assets represented a reasonable threshold for identifying those BHCs that might need additional

flexibility for the purpose of enabling the transfer of ownership of small community-based banks. However, over the last two decades, inflation, industry consolidation, and the normal asset growth of BHCs have caused the \$150 million threshold to lose much of its relevance.

For these reasons, the Board proposes to increase the asset size threshold for qualifying small BHCs in the Policy Statement from \$150 million to \$500 million in pro forma consolidated assets. While approximately 55 percent of all top tier BHCs currently qualify for the Policy Statement, under this proposal that number would increase to 85 percent and would encompass approximately 4,400 BHCs. The Board notes that raising the threshold to \$500 million, as proposed, goes well beyond the level (approximately \$340 million) that would be appropriate to adjust the current threshold for inflation since the Board adopted the Policy Statement. The Board believes that raising the threshold to \$500 million represents an appropriate balance between the goals of facilitating the transfer of ownership of small banks, on the one hand, and ensuring capital adequacy and access to necessary supervisory information on the other hand. The proposal also would make a conforming change to the asset size threshold in the Capital Guidelines.

The Board does not believe that raising the asset threshold above \$500 million would be appropriate at this time. BHCs that have more than \$500 million in consolidated assets typically have sufficient access to equity markets and other sources of funding to enable them to finance acquisitions with a lower proportion of debt-to-equity than smaller BHCs.

Other Criteria for Identifying a Qualifying Small BHC

As noted above, a BHC currently qualifies for the Policy Statement and is exempt from the Capital Guidelines only if the BHC falls below the asset threshold and (i) does not engage in any nonbanking activities involving significant leverage; (ii) does not engage in any significant

off-balance sheet activities; and (iii) does not have a significant amount of outstanding debt that is held by the general public. The Board also is proposing to revise these qualitative criteria for determining whether a small BHC qualifies for the Policy Statement and generally is exempt from the Capital Guidelines.

Specifically, the Board proposes to amend these criteria to provide that a BHC with less than \$500 million in consolidated assets does not qualify for the Policy Statement (and is subject to the Capital Guidelines) if the BHC (i) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conducts significant off-balance sheet activities, including securitizations or managing or administering assets for third parties, either directly or through a nonbank subsidiary; or (iii) has a material amount of debt or equity securities (other than trust preferred securities) outstanding that are registered with the Securities and Exchange Commission (SEC). The proposal also would make conforming changes to the Capital Guidelines.

The Board expects that few BHCs with consolidated assets of less than \$500 million would meet any of these criteria. In those cases where a BHC's management is uncertain whether the BHC meets any of these criteria, management should consult with the BHC's appropriate Reserve Bank.

The Board believes these changes to the eligibility criteria under the Policy Statement are necessary or appropriate to reflect changes in the banking industry over the last two decades, including the nature of operations of many small BHCs. The enactment of the Gramm-Leach-Bliley Act in 1999 expanded significantly the range of nonbanking activities in which BHCs may engage, both directly and through their nonbank subsidiaries. Therefore, the Board is proposing to revise the criteria so as to exclude from the Policy Statement any BHC that engages in

significant nonbanking activities or off-balance sheet activities, either directly or through a nonbank subsidiary. The more limiting reference to significantly leveraged nonbanking activities would be deleted, since nonleveraged activities may also entail significant risk, such as operational risk. The examples provided -- securitizations and managing or administering assets for third parties -- highlight two areas of off-balance sheet activities that may involve substantially larger operations and risk than balance sheet measures would indicate. These examples are not intended to be exclusive and other activities may well present similar concerns. The revision of the final criterion to exclude from the Policy Statement any BHC that has outstanding a material amount of SEC-registered debt or equity securities reflects the fact that SEC registrants typically exhibit a degree of complexity of operations and access to multiple funding sources that warrants excluding them from the Policy Statement and subjecting them to consolidated capital requirements. Moreover, the application of consolidated reporting requirements to these BHCs should not impose significant additional burden, as they are required to have consolidated financial statements for SEC reporting purposes.

The Board is of the view that the amended criteria represent a prudent balance of its interest in expanding the Policy Statement treatment to a larger pool of small BHCs, while ensuring that larger and more complex BHCs remain well capitalized and continue to serve as a source of strength to their subsidiary banks.

In addition, the Board is proposing to amend the Policy Statement and the Capital Guidelines to make explicit the Federal Reserve's existing authority to require on a case by case basis that a qualifying small BHC maintain consolidated capital when such action is warranted for supervisory reasons.

In addition to the foregoing, a qualifying small BHC may voluntarily elect to comply with the Capital Guidelines.

Treatment of Subordinated Debt Associated with Trust Preferred Securities

The Policy Statement currently does not address the treatment of subordinated debt that is issued in connection with the issuance of trust preferred securities.¹ Currently, for purposes of the Policy Statement, such subordinated debt on the parent company balance sheet is not treated as debt; however, the cash-flow impact of the subordinated debt is included in the Board's review of the financial condition of a BHC. The Board is now proposing to clarify that subordinated debt associated with trust preferred securities would be considered debt for most purposes under the Policy Statement. In particular, such subordinated debt would be included as debt in determining whether (i) a qualifying small BHC's acquisition debt is 75 percent or less of the purchase price; or (ii) a qualifying small BHC's debt-to-equity ratio is greater than 1.0:1 (the ratio above which a qualifying small BHC is subject to dividend restrictions and is not permitted to use the expedited applications processing procedures or obtain a waiver of stock redemption filing requirements under Regulation Y).² However, in order to provide for more equitable treatment between qualifying small BHCs and larger BHCs that are subject to the Capital Guidelines,³ a qualifying small BHC may exclude from debt an amount of subordinated debt

¹ Trust preferred securities are undated cumulative preferred securities issued out of a special purpose entity, usually in the form of a trust, in which a BHC owns all of the common securities. The special purpose entity's sole asset is a deeply subordinated note issued by the BHC that typically has a fixed maturity of 30 years.

² The Board also would consider subordinated debt associated with the issuance of trust preferred securities as covered by any supervisory debt commitments with the Federal Reserve.

³ A BHC that is subject to the Capital Guidelines generally may count an amount of qualifying trust preferred securities as tier 1 capital up to 25 percent of the sum of the BHC's core 1 capital elements. 12 CFR part 225, appendix A, § II.A.1.b.

associated with trust preferred securities equaling up to 25 percent of a small BHC's equity (as defined in the Policy Statement), less parent company goodwill in determining compliance with these requirements.

In addition, in order to give qualifying small BHCs sufficient time to conform their debt structures, the Board is proposing to provide for a five-year transition period during which subordinated debt associated with trust preferred securities issued on or prior to the publication date of this proposed rule would not be considered debt under the Policy Statement. Such a transition period generally would be consistent with the five-year transition period afforded to larger BHCs to meet the Board's risk-based capital guidelines with respect to trust preferred securities.⁴ However, in the event that a qualifying small BHC issues additional subordinated debt associated with a new issuance of trust preferred securities after the date of this proposed rule, the temporary non-debt status of all the qualifying small BHC's existing subordinated debt associated with trust preferred securities would be terminated.

In any event, subordinated debt associated with trust preferred securities would not be included as debt in determining compliance with the 12-year debt reduction and 25-year debt retirement requirements of the Policy Statement.

Small BHC Regulatory Reporting

In order to assist the Federal Reserve in monitoring the financial health and operations of BHCs, the Board requires all BHCs to file certain reports with the Federal Reserve. One of the most important of the Federal Reserve reporting requirements is the Financial Statements for Bank Holding Companies (FR Y-9 series of reports; OMB No. 7100-0128). Currently, BHCs with consolidated assets of less than \$150 million (and that also meet qualitative criteria similar

⁴ See 12 CFR part 225, appendix A, § II.A.1.b.ii.

to those in the Policy Statement) submit limited summary parent-only financial data semiannually on the FR Y-9SP. Currently, BHCs with consolidated assets of \$150 million or more submit parent only financial data on the FR Y-9LP and consolidated financial data on the FR Y-9C quarterly.

In the near future, the Federal Reserve plans to propose for comment revisions to the FR Y-9 series of reports for 2006 (2006 proposal). Pending approval, these revisions would include increasing the FR Y-9SP reporting threshold from \$150 million to \$500 million and conforming the FR Y-9SP reporting exception criteria to the proposed qualitative exception criteria under the Policy Statement and the Capital Guidelines. Under the 2006 proposal, BHCs that meet the criteria for filing the FR Y-9SP would be exempt from filing the FR Y-9LP and FR Y-9C. Conversely, BHCs subject to the Capital Guidelines, including small BHCs that do not qualify under the revised Policy Statement and qualifying small BHCs that voluntarily elect to comply with the Capital Guidelines, would file the FR Y-9LP and the FR Y-9C on a quarterly basis.

Comments

The Board seeks comments on all aspects of this proposal. Interested parties are encouraged to provide comments on the proposed increase to the asset threshold for the Policy Statement and the Capital Guidelines, and on whether the proposed \$500 million threshold should be further adjusted over time based upon an index and, if so, what would constitute an appropriate index for this purpose. Interested parties also are encouraged to provide comments on the proposed qualitative criteria that would determine whether the Policy Statement or the Capital Guidelines apply to a BHC with consolidated assets of less than \$500 million.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the Board has determined that this proposed rule would not have a significant impact on a substantial number of small entities, as defined in the Regulatory Flexibility Act. However, the proposed rule would reduce regulatory burden by exempting most BHCs with total consolidated assets of between \$150 million and \$500 million from the application of the Board's Capital Guidelines. Moreover, although the proposal would treat subordinated debt associated with trust preferred securities as debt for most purposes under the Policy Statement, the proposal provides a substantial five-year transition period for subordinated debt associated with trust preferred securities issued on or prior to the publication date of the proposed rule.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1.), the Board has reviewed this proposed rulemaking under the authority delegated to the Board by the Office of Management and Budget. The Board has determined that this proposed rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*). As mentioned previously, related amendments to the FR Y-9 series of reports will be proposed separately for comment in the near future.

Plain Language

Section 722 of the Gramm-Leach-Bliley Act requires the Federal banking agencies to use "plain language" in all proposed and final rules published after January 1, 2000. In light of this requirement, the Board has sought to present the proposed rule in a simple and straightforward

manner. The Board invites comments on whether there are additional steps it could take to make the rule easier to understand.

List of Subjects

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

Federal Reserve System

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the preamble, part 225 of chapter II of title 12 of the Code of Federal Regulations is proposed to be amended as set forth below:

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

1. 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(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909; 15 U.S.C. 6801 and 6805.

2. Appendix A to part 225 is amended as follows:

- a. In section I, the fifth undesignated paragraph is revised.
- b. In section I, footnote 4 is removed and reserved.

Appendix A to part 225 – Capital Adequacy Guidelines for Bank Holding Companies: Risk Based measure

I. * * *

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The risk-based guidelines apply on a consolidated basis to any bank holding company with consolidated assets of \$500 million or more. The risk-based guidelines also apply on a consolidated basis to any bank holding company with consolidated assets of less than \$500 million if the holding company (i) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conducts significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; or (iii) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission (SEC). The Federal Reserve may apply the risk-based guidelines at its discretion to any bank holding company, regardless of asset size, if such action is warranted for supervisory purposes.

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3. Appendix C to part 225 is amended as follows:

a. In section 1, the first undesignated paragraph is revised.

b. In section 1, footnote 1 is removed and reserved.

c. In section 2.A., a new paragraph is added after the first paragraph in footnote 3.

Appendix C to Part 225 – Small Bank Holding Company Policy Statement

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1. * * *

This policy statement applies only to bank holding companies with pro forma consolidated assets of less than \$500 million that (i) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet

activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. The Board may in its discretion exclude any bank holding company, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes.

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2. * * *

A. * * *

³ * * *

Subordinated debt associated with trust preferred securities generally would be treated as debt for purposes of paragraphs 2C, 3A, 4Ai, and 4Bi of this policy statement. A bank holding company, however, may exclude from debt an amount of subordinated debt associated with trust preferred securities up to 25 percent of the holding company's equity (as defined below) less goodwill on the parent company's balance sheet in determining compliance with the requirements of such paragraphs of the policy statement. In addition, a bank holding company that has not issued subordinated debt associated with trust preferred securities after [INSERT DATE OF PUBLICATION OF PROPOSED RULE IN FEDERAL REGISTER] may exclude from debt any subordinated debt associated with trust preferred securities until [INSERT DATE FIVE YEARS AFTER DATE OF PUBLICATION OF PROPOSED RULE IN FEDERAL REGISTER]. Subordinated debt associated with trust preferred securities will not be included as debt in determining compliance with any other requirements of this policy statement.

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4. Appendix D to part 225 is amended as follows:
 - a. In section I., paragraph b. is revised.
 - b. In section I.b., footnote 2 is removed and reserved.

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

I. * * *

b. The tier 1 leverage guidelines apply on a consolidated basis to any bank holding company with consolidated assets of \$500 million or more. The tier 1 leverage guidelines also apply on a consolidated basis to any bank holding company with consolidated assets of less than \$500 million if the holding company (i) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conducts significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; or (iii) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. The Federal Reserve may apply the tier 1 leverage guidelines at its discretion to any bank holding company, regardless of asset size, if such action is warranted for supervisory purposes.

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By order of the Board of Governors of the Federal Reserve System, September 1, 2005.

Jennifer J. Johnson (signed)
Jennifer J. Johnson
Secretary of the Board