

# Rules and Regulations

Federal Register

Vol. 73, No. 205

Wednesday, October 22, 2008

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## FEDERAL RESERVE SYSTEM

### 12 CFR Part 225

[Regulation Y; Docket No. R-1336]

#### Capital Adequacy Guidelines: Treatment of Perpetual Preferred Stock Issued to the United States Treasury Under the Emergency Economic Stabilization Act of 2008

**AGENCY:** Board of Governors of the Federal Reserve System (Board).

**ACTION:** Interim final rule with request for public comment.

**SUMMARY:** In order to support and facilitate the timely implementation and acceptance of the capital purchase program announced by the U.S. Department of Treasury (Treasury) and promote the stability of banking organizations and the financial system, the Board has adopted this interim final rule (interim final rule or rule). The rule specifically permits bank holding companies that issue new senior perpetual preferred stock to the Treasury under the capital purchase program announced by the Secretary of the Treasury on October 14, 2008, to include such capital instruments in Tier 1 capital for purposes of the Board's risk-based and leverage capital rules and guidelines for bank holding companies.

**DATES:** The interim final rule will become effective on October 17, 2008. Comments must be received by November 21, 2008.

**ADDRESSES:** You may submit comments, identified by Docket No. R-1336, 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](mailto: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, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://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 form in Room MP-500 of the Board's Martin Building (20th and C Street, NW) between 9 a.m. and 5 p.m. on weekdays.

**FOR FURTHER INFORMATION CONTACT:**

Norah M. Barger, Deputy Director, (202) 452-2402, or John Connolly, Senior Project Manager, (202) 452-3621, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Assistant General Counsel, (202) 452-5270, Mark E. Van Der Weide, Assistant General Counsel, (202) 452-2263, or Benjamin W. McDonough, Senior Attorney, (202) 452-2036, Legal Division; Board of Governors of the Federal Reserve System, 20th Street and Constitution Ave., NW., Washington, DC 20551. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), (202) 263-4869.

**SUPPLEMENTARY INFORMATION:** On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 (Act)<sup>1</sup> into law. The Act expressly provides that it is intended, among other things, "to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States."<sup>2</sup> Pursuant to the authorities granted by the Act, and in order to restore liquidity and stability to the financial system, on October 14, 2008, the Secretary of the Treasury announced a program within the Troubled Asset Relief Program (TARP) established by section 102 of the

<sup>1</sup> Division A of Public Law No. 110-342, 122 Stat. 3765 (2008).

<sup>2</sup> See Act, § 2.

Act to provide capital to eligible banks, bank holding companies and savings associations (collectively, banking organizations), as well as certain other financial institutions. Treasury has announced that eligible banking organizations will be able to submit applications to participate in the capital purchase program (the Capital Purchase Program) until November 14, 2008.

Under the Capital Purchase Program, the Treasury will provide capital to an eligible banking organization by purchasing newly issued senior perpetual preferred stock (Senior Perpetual Preferred Stock) of the banking organization. The Senior Perpetual Preferred Stock issued under the Capital Purchase Program will be perpetual preferred stock in the issuing banking organization and will be senior to the issuer's common stock and *pari passu* with the issuer's existing preferred shares (other than preferred shares which by their terms rank junior to any existing preferred shares). All Senior Perpetual Preferred Stock issued by bank holding companies will provide for cumulative dividends. The aggregate amount of Senior Perpetual Preferred Stock that may be issued by a banking organization to Treasury must be (i) not less than one percent of the organization's risk-weighted assets, and (ii) not more than the lesser of (A) \$25 billion and (B) three percent of its risk-weighted assets. Treasury expects the issuance and purchase of the Senior Perpetual Preferred Stock to be completed no later than December 31, 2008.

To be eligible for the Capital Purchase Program, the Senior Perpetual Preferred Stock must include several features, which are designed to make it attractive to a wide array of generally sound banking organizations and encourage such banking organizations to replace the Senior Perpetual Preferred Stock with private capital once the financial markets return to more normal conditions.

In particular, the Senior Perpetual Preferred Stock will have an initial dividend rate of five percent per annum, which will increase to nine percent per annum five years after issuance. In addition, the stock will be callable by the banking organization at par after three years from issuance and may be called at an earlier date if the stock will be redeemed with cash proceeds from

the banking organization's issuance of common stock or perpetual preferred stock that (i) qualifies as Tier 1 capital of the organization and (ii) the proceeds of which are no less than 25 percent of the aggregate issue price of the Senior Perpetual Preferred Stock. In all cases, the redemption of the Senior Perpetual Preferred Stock will be subject to the approval of the banking organization's appropriate Federal banking agency. In addition, following the redemption of all the Senior Perpetual Preferred Stock, a banking organization shall have the right to repurchase any other equity security of the organization (such as warrants or equity securities acquired through the exercise of such warrants) held by Treasury.

The Board recognizes that some of the features of the Senior Perpetual Preferred Stock would otherwise render the preferred stock ineligible for Tier 1 capital treatment or limit its inclusion in Tier 1 capital under the Board's capital guidelines for bank holding companies. Bank holding companies generally may not include in Tier 1 capital perpetual preferred stock (whether cumulative or noncumulative) that has a dividend step-up rate. Furthermore, the amount of cumulative perpetual preferred stock that a bank holding company may include in its Tier 1 capital currently is subject to a 25 percent limit.<sup>3</sup>

The Board has adopted this interim final rule to provide that the Senior Perpetual Preferred Stock may be included without limit in the Tier 1 capital of bank holding companies.<sup>4</sup> The Senior Perpetual Preferred Stock will be issued to Treasury as part of a nationwide program, established by Treasury under the Act, to provide capital to eligible banking organizations that already are in generally sound financial condition in order to increase the capital available to banking organizations and thereby promote stability in the financial markets and the banking industry as a whole. These actions are being taken under special powers granted by Congress to the

Secretary of the Treasury to achieve these important public policy objectives. A bank holding company also may redeem the Senior Perpetual Preferred Stock only with the approval of the Board. The dividend step-up rate for the Senior Perpetual Preferred Stock is included in the instrument to help achieve a fundamental public policy objective in the United States—the replacement of the equity capital provided by the U.S. government with private capital in a prompt fashion, consistent with the safety and soundness of the banking organization. Each of these factors is important to the determinations made by the Board with respect to the appropriate capital treatment of the Senior Perpetual Preferred Stock.

For these reasons and in order to support and facilitate the timely implementation and acceptance of the Capital Purchase Program and promote the stability of banking organizations and the financial system, the Board has adopted this interim final rule to permit bank holding companies that issue new Senior Perpetual Preferred Stock to the Treasury under the TARP to include such stock without limit as Tier 1 capital for purposes of the Board's risk-based and leverage capital rules and guidelines for bank holding companies.<sup>5</sup>

The Board expects bank holding companies that issue Senior Perpetual Preferred Stock, like all other bank holding companies, to hold capital commensurate with the level and nature of the risks to which they are exposed. In addition, the Board expects bank holding companies that issue Senior Perpetual Preferred Stock to appropriately incorporate the dividend features of the Senior Perpetual Preferred Stock into the organization's liquidity and capital funding plans.

The Board notes that as a matter of prudential policy and practice it generally has not allowed capital instruments with a dividend rate step-up to be included in Tier 1 or Tier 2 capital. The Board has long expressed concern that a rate step-up undermines the permanence of a capital instrument and poses safety and soundness concerns.<sup>6</sup> In light of these concerns, the

Board previously has declined to allow, as would otherwise have been permitted by the 1998 Sydney Agreement of The Basel Committee on Banking Supervision, capital instruments with a moderate dividend step-up (up to 100 bps) to be included in Tier 1 capital up to a limit of 15 percent of Tier 1 capital. The Board also notes that capital instruments with step-up provisions issued by banking organizations in other countries that are members of the Basel Committee have become callable over the last several months. These securities have been widely redeemed, even though the stepped-up rate has been economical for the issuer. Such redemptions could lead to the undesirable outcome of the issuer either refinancing the capital instrument at a higher rate, placing further stress on an institution that may already be in strained condition, or simply not replacing the instrument, further depleting its capital resources.

However, as discussed above, issuance of the Senior Perpetual Preferred Shares is consistent with a strong public policy objective, which is to increase the capital available to banking organizations generally in the current environment and thereby promote stability in the financial markets and the banking industry as a whole. In addition, the Board notes that other terms and public policy considerations related to the Senior Perpetual Preferred Stock mitigate supervisory concerns over the rate step-up feature. Issuers of this instrument generally will not be allowed to repurchase other stock or increase common dividends for three years after issuance without the consent of the Treasury. These restrictions promote in an important way not only the overall safety and soundness of the issuer, but also the retention of the highest form of capital, common equity. Moreover, as discussed above, the Senior Perpetual Preferred Stock includes features designed to incentivize issuers to redeem the stock and replace it with Tier 1 qualifying perpetual equity as soon as practicable, a feature that also fosters a higher quality of capital. These features, which are unique to the Senior Perpetual Preferred Stock, countervail in many respects the Board's concerns with regard to a step-up feature.

preset increase, whereas institutions whose condition has deteriorated are less likely to be able to do so. Moreover, just when these latter institutions would be in the most need of conserving capital, they would be under strong pressure to redeem the debt as an alternative to paying higher rates and, thus, would accelerate depletion of their own resources." See 12 CFR 250.166(b)(4) at n. 4.

<sup>3</sup> See 12 CFR part 225, Appendix A, sections II.A.1.a.ii., II.A. a.iv.(1), II.A.1.b.i. and II.A.1.c.ii.(2).

<sup>4</sup> This interim final rule addresses only regulatory capital. Details about the Capital Purchase Program, including eligibility requirements and the general terms and conditions of the Senior Perpetual Preferred Stock and warrants associated with such stock, are available on the Treasury's Web site at <http://www.treas.gov>. Banking organizations interested in participating in the Capital Program should contact Treasury and their appropriate Federal banking agency. The Board is issuing this rule for bank holding companies only at this time. The Board continues to work with Treasury, the other Federal banking agencies, and other parties on other capital and related matters associated with the Capital Purchase Program.

<sup>5</sup> See 12 CFR part 225, Appendix A and Appendix D.

<sup>6</sup> For example, in a 1992 policy statement on subordinated debt, the Board noted: "Although payments on debt whose rates increase over time on the surface may not appear to be directly linked to the financial condition of the issuing organization, such debt (sometimes referred to as expanding or exploding rate debt) has a strong potential to be credit sensitive in substance. Organizations whose financial condition has strengthened are more likely to be able to refinance the debt at a rate lower than that mandated by the

In light of the instrument- and circumstances-specific nature of the Board's determination, the Board strongly cautions bank holding companies against construing the inclusion of the Senior Perpetual Preferred Stock in Tier 1 capital as in any way detracting from the Board's longstanding stance regarding the unacceptability of a rate step-up in other regulatory capital instruments.

The Board requests comment on all aspects of this rule.

**Regulatory Analysis**

*Administrative Procedure Act*

Pursuant to sections 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. 553(b) and (d)), the Board finds that there is good cause for issuing this interim final rule and making the rule effective on October 17, 2008, and that it is impracticable, unnecessary, or contrary to the public interest to issue a notice of proposed rulemaking and provide an opportunity to comment before the effective date. The Board has adopted the rule in light of, and to help address, the continuing unusual and exigent circumstances in the financial markets. The rule will allow bank holding companies to immediately count the Senior Perpetual Preferred Stock as Tier 1 capital for purposes of their risk-based and leverage capital ratios and will help promote stability in the banking system and financial markets. The Board believes it is important to provide bank holding companies immediately with guidance concerning the capital treatment of the Senior Perpetual Preferred Stock so that bank holding companies may make appropriate judgments concerning their participation in the Capital Purchase Program. The Board is soliciting comment on all aspects of the rule and will make such changes that it considers appropriate or necessary after review of any comments received.

*Regulatory Flexibility Act*

The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA), generally requires that an agency prepare and make available for public comment an initial regulatory flexibility analysis in connection with a notice of proposed rulemaking.<sup>7</sup> Under regulations issued by the Small Business Administration,<sup>8</sup> a small entity includes a bank holding company with assets of \$175 million or less (a small bank holding company). As of June 30, 2008, there were 2,636 small bank holding companies.

The exact number of small bank holding companies that would be impacted by this rule will depend on the number of such entities that participate in the Capital Purchase Program.

As a general matter, the Board's risk-based and leverage capital rules and guidelines for bank holding companies apply only to a bank holding company that has consolidated assets of \$500 million or more. Accordingly, this interim final rule will not affect any small bank holding company and, for this reason, the Board hereby certifies that the rule will not have a significant impact on a substantial number of small bank holding companies.

*Paperwork Reduction Act*

In accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3506), the Board has reviewed the interim final rule to assess any information collections. There are no collections of information as defined by the Paperwork Reduction Act in the interim final rule.

*Solicitation of Comments on Use of Plain Language*

Section 722 of the GLBA required the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Board invites comment on how to make the interim final rule easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could the rule be more clearly stated?
- Are the requirements in the rule clearly stated? If not, how could the rule be more clearly stated?
- Do the regulations contain technical language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes would make the regulation easier to understand?
- Would more, but shorter, sections be better? If so, which sections should be changed?
- What else could we do to make the regulation easier to understand?

**List of Subjects in 12 CFR Part 225**

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

**Board of Governors of the Federal Reserve System**

**12 CFR Chapter II**

**Authority and Issuance**

■ For the reasons stated in the preamble, the Board of Governors of the Federal Reserve System amends part 225 of chapter II of title 12 of the Code of Federal Regulations as follows:

**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. In appendix A to part 225:

■ a. Revise section II.A.1.a.ii.; and

■ b. Revise footnote 8 in section II.A.1.c.ii.(2) to read as follows:

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

II. \* \* \*

A. \* \* \*

1. \* \* \*

a. \* \* \*

ii. Qualifying noncumulative perpetual preferred stock, including related surplus, and senior perpetual preferred stock issued to the United States Department of the Treasury (Treasury) under the Troubled Asset Relief Program (TARP) established by the Emergency Economic Stabilization Act of 2008, Division A of Public Law No. 110–342 (which for purposes of this appendix shall be considered qualifying noncumulative perpetual preferred stock), including related surplus;

\* \* \*

c. \* \* \*

ii. \* \* \*

(2) \* \* \*

<sup>8</sup> Notwithstanding this provision, senior perpetual preferred stock issued to the Treasury under the TARP established by the Emergency Economic Stabilization Act of 2008, Division A of Public Law No. 110–342, may be included in tier 1 capital. In addition, traditional convertible perpetual preferred stock, which the holder must or can convert at a fixed number of common shares at a preset price, generally qualifies for inclusion in tier 1 capital provided all other requirements are met.

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, October 16, 2008.

**Jennifer J. Johnson,**  
*Secretary of the Board.*

[FR Doc. E8–25117 Filed 10–17–08; 11:15 am]

**BILLING CODE 6210–02–P**

<sup>7</sup> See 5 U.S.C. 603(a).

<sup>8</sup> See 13 CFR 121.201.