



This document is scheduled to be published in the Federal Register on 12/19/2014 and available online at <http://federalregister.gov/a/2014-29561>, and on FDsys.gov

FEDERAL RESERVE SYSTEM

12 CFR Part 217

Docket No. R-1506

RIN 7100-AE 27

Regulatory Capital Rules: Regulatory Capital, Proposed Rule Demonstrating Application of Common Equity Tier 1 Capital Qualification Criteria; Regulation Q

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

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board is inviting public comment on amendments to the Board's revised capital framework (Regulation Q) that would illustrate how the Board would apply the common equity tier 1 capital qualification criteria to depository institution holding companies that are organized in forms other than as stock corporations ("proposed rule"). The proposed rule discusses some of the qualification criteria for common equity tier 1 capital under Regulation Q and provides examples of how the Board would apply the criteria in specific situations involving partnerships and limited liability companies. In addition, the proposed rule would amend Regulation Q to address unique issues presented by certain savings and loan holding companies that are trusts and by depository institution holding companies that are employee stock ownership plans.

DATES: Comments must be received by February 28, 2015.

ADDRESSES: You may submit comments, identified by *Docket No. R-1506 and RIN 7100-AE 27 “Regulatory Capital, Application of Common Equity Tier 1 Capital Qualification Criteria,”* by any of the following methods:

Board of Governors of the Federal Reserve System:

- **Agency Web site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/apps/foia/proposedregs.aspx>.
- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.
- **E-mail:** regs.comments@federalreserve.gov. Include the Board’s docket number in the subject line of the message.
- **Facsimile:** (202) 452–3819 or (202) 452–3102.
- **Mail:** Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.
- **Instructions:** All public comments are available from the Board’s Web site at <http://www.federalreserve.gov/apps/foia/proposedregs.aspx> as submitted, unless modified for technical

reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments also may be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Streets NW.) between 9:00 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Alison Thro, Assistant General Counsel, (202) 452-3236, Christine Graham, Counsel, (202) 452-3005, or Mark Buresh, Attorney, (202) 452-5270, Legal Division; or Thomas Boemio, Manager, (202) 452-2982, Juan Climent, Manager, (202) 872-7526, or Page Conkling, Supervisory Financial Analyst, (202) 912-4647, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551. Users of Telecommunication Device for Deaf (TDD) only, call (202) 263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

In July 2013, the Board approved a final rule¹ (Regulation Q) that enhances and replaces the capital adequacy guidelines for state member

¹ 78 FR 62018 (October 11, 2013) (codified at 12 part CFR 217).

banks² and bank holding companies³ (collectively, capital adequacy guidelines), and implements capital adequacy rules for savings and loan holding companies (other than those substantially engaged in commercial activities or insurance underwriting activities). Regulation Q increases the quality and quantity of capital that must be maintained by institutions subject to the rule by raising the minimum capital ratios and imposing more stringent criteria for capital instruments that are intended to qualify as regulatory capital. The definition of common equity tier 1 capital in Regulation Q is designed to ensure that qualifying instruments do not include features that would cause an organization's condition to weaken during a period of significant financial and economic stress.⁴

A. Description of the Proposed Rule

The proposed rule describes how the Board would apply the qualification criteria for common equity tier 1 capital under Regulation Q to instruments issued by bank holding companies and savings and loan holding companies (holding companies) that are organized as legal entities other than stock corporations.

² 12 CFR part 208, appendices A, B, and E.

³ 12 CFR part 225, appendices A, D, and E.

⁴ 12 CFR 217.20(b); 78 FR 62018, 62044.

The proposed rule focuses in particular on the qualification criteria that relate to the economic rights of common equity tier 1 capital instruments relative to the capital instruments issued by holding companies organized in forms other than as stock corporations. The proposed rule provides examples of instruments issued by limited liability companies and partnerships, discusses features that would prevent certain instruments from qualifying as common equity tier 1 capital, and offers potential solutions for holding companies to resolve these qualification issues. The examples provided in the proposed rule are based on structures that have been reviewed by the Board and demonstrate how the Board would apply the common equity tier 1 capital qualification criteria to capital instruments with the same or similar features. Holding companies should review their organizational documents consistent with this proposed rule in order to determine whether their capital instruments comply with the Regulation Q qualification criteria. If a holding company determines that some or all of its capital instruments do not meet the specific qualification criteria under Regulation Q, the company may need to take steps to ensure that it is in compliance with Regulation Q, including modifying its capital structure or the governing documentation of specific capital instruments.⁵

⁵ Entities whose capital instruments do not meet the qualification criteria

B. Timeframe for Implementation

Because the proposed rule provides specific guidance on the application of the qualification criteria to particular structures, the Board recognizes that some entities may need time to evaluate or revise their capital instruments. Therefore, the Board would expect that all holding companies organized in forms other than as stock corporations that are subject to Regulation Q and have issued capital instruments that would not qualify as common equity tier 1 capital due to § 217.20 because of the requirements set forth in proposed § 217.501 would be in compliance with the proposed rule by January 1, 2016, except as discussed below. The proposed rule would provide this temporary exemption to allow companies to make necessary changes to comply with Regulation Q.

C. Inapplicability of the Requirements to Estate Trust Savings and Loan Holding Companies

As noted above, Regulation Q implements capital adequacy rules for savings and loan holding companies (other than those substantially engaged in commercial activities or insurance underwriting activities).

Approximately 120 personal or family trusts (collectively, “estate trusts”)

under Regulation Q could potentially meet the minimum capital ratios in other ways, such as through retained earnings. *See e.g.*, 12 CFR 217.20(b)(2) through (5).

qualify as saving and loan holding companies and would be subject to Regulation Q beginning on January 1, 2015.⁶

The Board understands that many of the estate trust SLHCs do not issue capital instruments and would be unable to meet the minimum regulatory capital ratios under Regulation Q. Further, the Board understands that many of the estate trust SLHCs do not hold retained earnings due to their nature as non-business personal or family trusts. In order to comply with the technical requirements of Regulation Q, estate trust SLHCs would likely entail significant burden and expense to develop and implement the management information systems necessary to prepare financial statements.

To address these issues, the Board is developing a proposal to apply alternative regulatory capital requirements to estate trust SLHCs that take into account their existing capital structure and activities, consistent with section 171 of the Dodd-Frank Act. Until the Board adopts such a proposal or until further notice, the Board will not require estate trust SLHCs to comply with Regulation Q. The proposed rule would temporarily exempt estate trusts from the requirements of Regulation Q until the Board adopts alternative regulatory requirements.

⁶ See 12 U.S.C. 1467a(a)(3)(B); 12 U.S.C. 1841(b); 12 CFR 238.2(m)(2); 12 CFR 225.2(d)(3) (testamentary trust exemption).

D. Inapplicability of the Requirements to Employee Stock Ownership Plans that are Depository Institution Holding Companies

Employee Stock Ownership Plans (ESOPs) are entities created as part of employee benefits arrangements that hold shares of the sponsoring entities' stock. There are ESOPs that are bank holding companies and savings and loan holding companies (ESOP holding companies), generally due to their ownership interest in the banking organization that sponsors the ESOP. Under generally accepted accounting principles, the assets and liabilities of ESOP holding companies are consolidated onto the balance sheet of the organization that sponsors the ESOP, which would be either a depository institution or a holding company that may be subject to Regulation Q.⁷ The Board is developing a proposal to revise Regulation Q to clarify the treatment of ESOP holding companies under the regulatory capital rules. Until the Board adopts such a proposal or until further notice, the Board will evaluate the compliance of the ESOP with Regulation Q by looking to the regulatory capital of the sponsor banking organization. The proposed rule would temporarily exempt ESOP holding companies from Regulation Q until the Board finalizes the clarifying revisions.

⁷ See the American Institute of Certified Public Accountants (AICPA) Statement of Position 93-6.

II. Request for Comment

The Board invites comment on the proposed rule and specifically invites comment on following aspects of the proposed rule:

1. What features of capital instruments that are not described in the proposed rule could affect whether a capital instrument of a non-stock corporation qualifies as common equity tier 1 capital?
2. What features of capital instruments issued by non-stock corporations could raise issues with qualification as additional tier 1 or tier 2 capital similar to the issues related to qualification as common equity tier 1 capital discussed in the proposed rule?
3. How might the Board revise the proposed rule to better illustrate the application of the common equity tier 1 capital qualification criteria to the structures discussed?

III. Regulatory Analysis

A. Paperwork Reduction Act (PRA)

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320, Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. The proposed rule contains no requirements subject to the PRA.

B. Regulatory Flexibility Act Analysis

The Board is providing an initial regulatory flexibility analysis with respect to this proposed rule. As discussed above, the proposed rule describes how the Board would apply the qualification criteria for common equity tier 1 capital under Regulation Q to instruments issued by depository

institution holding companies and state member banks that are organized as legal entities other than stock corporations. The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* (RFA), generally requires that an agency prepare and make available an initial regulatory flexibility analysis in connection with a notice of proposed rulemaking. Under regulations issued by the Small Business Administration, a small entity includes a bank holding company, bank, or savings and loan holding company with assets of \$550 million or less (small banking organization).⁸ As of June 30, 2014, there were approximately 657 small state member banks, 3,719 small bank holding companies, and 254 small savings and loan holding companies.

The proposed rule would apply to top-tier depository institution holding companies and state member banks that are subject to Regulation Q. As a result, many small bank holding companies would not be affected because they are subject to the Board's Small Bank Holding Company policy statement rather than Regulation Q.⁹ Small state member banks and small covered savings and loan holding companies would be affected.

However, the Board does not believe that the proposed rule would have a

⁸ *See* 13 CFR 121.201. Effective July 14, 2014, the Small Business Administration revised the size standards for banking organizations to \$550 million in assets from \$500 million in assets. 79 FR 33647 (June 12, 2014).

⁹ *See* 12 CFR 217.1.

significant impact on small banking organizations because the Board considers the proposed rule to clarify the common equity tier 1 capital qualification criteria, and provide specific guidance on the application of the qualification criteria to entities subject to Regulation Q.

Therefore, there are no significant alternatives to the proposed rule that would have less economic impact on small bank holding companies. As discussed above, the projected reporting, recordkeeping, and other compliance requirements of the proposed rule are expected to be minimal. The Board does not believe that the proposed rule duplicates, overlaps, or conflicts with any other Federal rules. In light of the foregoing, the Board does not believe that the proposed rule, if adopted in final form, would have a significant economic impact on a substantial number of small entities. Nonetheless, the Board seeks comment on whether the proposed rule would impose undue burdens on, or have unintended consequences for, small organizations, and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with the purpose of the proposed rule. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

C. Plain Language

Section 722 of the Gramm-Leach-Bliley Act requires the Board to use plain language in all proposed and final rules published after January 1, 2000. The Board has sought to present the proposed rule in a simple straightforward manner, and invite comment on the use of plain language.

For example:

- Have the agencies organized the material to suit your needs? If not, how could they present the proposed rule more clearly?
- Are the requirements in the proposed rule clearly stated? If not, how could the proposed 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 achieve that?
- Is the section format adequate? If not, which of the sections should be changed and how?
- What other changes can the Board incorporate to make the regulation easier to understand?

List of Subjects in 12 CFR Part 217

Administrative practice and procedure, Banks, Banking, Capital, 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 set forth in the preamble, part 217 of chapter II of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 217 – CAPITAL ADEQUACY OF BANK HOLDING COMPANIES, SAVINGS AND LOAN HOLDING COMPANIES AND STATE MEMBER BANKS (REGULATION Q)

1. The authority citation for part 217 continues to read as follows:

Authority: 12 U.S.C. 248(a), 321–338a, 481–486, 1462a, 1467a, 1818, 1828, 1831n, 1831o, 1831p–1, 1831w, 1835, 1844(b), 1851, 3904, 3906–3909, 4808, 5365, 5368, 5371.

2. Add subpart I to read as follows:

Subpart I – Application of Capital Rules

Sec.

217.501 The Board’s Regulatory Capital Framework for Depository Institution Holding Companies Organized as Non-Stock Companies.

217.502 Application of the Board’s Regulatory Capital Framework to Employee Stock Ownership Plans that are Depository Institution Holding Companies and Certain Trusts that are Savings and Loan Holding Companies.

§ 217.501 The Board’s Regulatory Capital Framework for Depository Institution Holding Companies Organized as Non-Stock Companies.

(a) Applicability. (1) This rule applies to all depository institution holding companies that are not organized in corporate form and are subject to the Board’s regulatory capital rules (Regulation Q, 12 CFR part 217).³⁰

(2) Notwithstanding §§ 217.2 and 217.10, a bank holding company or covered savings and loan holding company that is not organized in corporate form and has issued capital instruments that do not qualify as common equity tier 1 capital under § 217.20 because of the requirements set forth in this section may treat such capital instruments as common equity tier 1 capital until January 1, 2016.

³⁰ See 12 CFR 217.1(c)(1) through (3).

(b) *Common equity tier 1 criteria applied to capital instruments issued by non-stock companies.* (1) Subpart C of this part provides criteria for capital instruments to qualify as common equity tier 1 capital. This section describes certain of these criteria and how the criteria apply to capital instruments issued by bank holding companies and certain savings and loan holding companies that are organized as legal entities other than stock corporations, such as limited liability companies (LLCs), partnerships, and similar structures.

(2) Holding companies are organized using a variety of legal structures, including corporate forms, LLCs, partnerships, and similar structures.³¹ In the Board's experience, some depository institution holding companies that are organized in non-stock form issue multiple classes of capital instruments that allocate distributions of profit and loss differently among classes, which may affect the ability of those classes to qualify as common equity tier 1 capital.³²

³¹ A stock corporation's common stock should satisfy the common equity tier 1 capital criteria so long as the common stock does not have unusual features, such as a limited duration.

³² Notably, voting powers or other means of exercising control are not relevant for purposes of satisfying the common equity tier 1 capital qualification criteria. Thus, the fact that a partner or member that controls a holding company as general partner or managing member is not material to this discussion.

(3) Common equity tier 1 capital is defined in section 217.20(b) of this part. To qualify as common equity tier 1 capital, capital instruments must satisfy a number of criteria. This section provides examples of the application of certain common equity tier 1 capital criteria that relate to the economic interests in the company represented by particular capital instruments.

(c) *Examples.* The following examples show how the criteria for common equity tier 1 capital apply to particular partnership or LLC structures.³³

(1) *LLC with one class of membership interests.* (i) An LLC issues one class of membership interests that provides that all holders of the interests bear losses and receive dividends proportionately to their levels of ownership.

(ii) Provided that the other criteria are met, the membership interests would qualify as common equity tier 1 capital.

(2) *Partnership with limited and general partners.* (i) A partnership has two classes of interests: general partnership interests and limited partnership interests. The general partners and the limited partners bear

³³ Although the examples refer to specific types of legal entities for purposes of illustration, the substance of the Regulation Q criteria reflected in the examples applies to all types of legal entities.

losses and receive distributions proportionately to their capital contributions. In addition, the general partner has unlimited liability for the debts of the partnership.

(ii) Provided that the other criteria are met, the general and limited partnership interests would qualify as common equity tier 1 capital. The fact of unlimited liability of the general partner is not relevant to the common equity tier 1 capital qualification criteria, provided that the general partner and limited partners share losses equally to the extent of the assets of the partnership, and the general partner is liable after the assets of the partnership are exhausted. In this regard, the general partner's unlimited liability is similar to a guarantee provided by the general partner, rather than a feature of the partnership interest.

(3) *LLC with two classes of membership interests.* (i) An LLC issues two types of membership interests, Class A and Class B, holders of which share proportionately in all losses and in the return of contributed capital. The holders of these membership interests also share proportionately in profit distributions up to the point where all holders receive a specific annual rate of return on capital contributions. To the extent that the company makes additional distributions, holders of Class B receive double their

proportional share and holders of Class A receive the remainder of the distribution.

(ii) Class A and Class B would qualify as common equity tier 1 capital, provided that under all circumstances they share losses proportionately for as long as the company controls a depository institution, and they satisfy the other criteria. Although distributions to holders of the classes can become different, this can only occur in a profit situation, and the holders bear losses equally.

(iii) The common equity tier 1 capital qualification criteria in Regulation Q do not require that holders of all classes of capital instruments that qualify as common equity tier 1 capital share equally in distributions of profits, provided that under all circumstances losses are shared proportionately.

(4) *Senior and junior classes of capital instruments.* (i) An LLC issues two types of membership interests, Class A and Class B. Holders of Class A and Class B participate equally in operating distributions and have equal voting rights. However, in liquidation, holders of Class B interests must receive their entire amount of contributed capital in order for any distributions to be made to holders of Class A interests.

(ii) Class B interests have a preference over Class A interests in liquidation and, therefore, would not qualify as common equity tier 1 capital as they are not the most subordinated claim (criterion (i); § 217.20(b)(1)(i)) and do not share losses proportionately (criterion (viii); § 217.20(b)(1)(viii)).

(A) If all other criteria are satisfied, Class A interests would qualify as common equity tier 1 capital.

(B) Class B interests may qualify as additional tier 1 capital, or tier 2 capital, if the Class B interests meet the applicable qualification criteria.

(5) *Mandatory distributions.* (i) A partnership agreement contains provisions that require distributions to holders of one or more classes of capital instruments on occurrence of particular events, such as upon specific dates or following a significant sale of assets, but not including final liquidating distributions.

(ii) Classes of capital instruments that provide holders with rights to mandatory distributions would not qualify as common equity tier 1 capital (criterion (vi); § 217.20(b)(1)(vi)). Companies must ensure that they have a sufficient amount of capital instruments that do not have such rights, and that meet the other criteria of common equity tier 1 capital, in order to meet the requirements of Regulation Q.

(6) *Payment waterfalls.* (i) The terms of Class A and Class B interests include a payment “waterfall” that differentiates distribution rights between holders of Class A and Class B interests, such that the Class B interests bear a disproportionately high level of the first loss in liquidation. Unlike the example in paragraph (c)(3) of this section, the different participation rights apply to distributions in loss situations, including losses at liquidation.

(ii) Because the Class A interests do not bear a proportional interest in the losses (criterion (ii); § 217.20(b)(1)(ii)), they would not qualify as common equity tier 1 capital.

(A) Companies with such structures may revise their capital structures in order to provide for a sufficiently large class of capital instruments that proportionally bear first losses in liquidation (i.e., the Class B interests in this example).

(B) Alternatively, companies could address such issues by revising their capital structure to ensure that all classes of capital instruments that are intended to qualify as common equity tier 1 capital share equally in losses in liquidation consistent with criteria (i), (ii), (vii), and (viii) (§ 217.20(b)(1)(i), (ii), (vii), and (viii)), even if each class of capital instruments has different rights to distributions of profits, as in Example 3.

(7) Clawback features. (i) The terms of LLC membership interests provide that, under certain circumstances, holders of Class A interests must return a portion of earlier distributions, which are then distributed to holders of Class B interests (often called a “clawback”).

(ii) If a class of capital instruments is advantaged by such a provision (i.e., Class B in this example), such that the advantaged class might not bear losses equally and pro rata in the event of liquidation with the class of capital instruments whose holders are required to return earlier distributions, the advantaged class would not qualify as common equity tier 1 capital.

(A) Companies must ensure that the classes of capital instruments that are intended to qualify as common equity tier 1 capital would remain the most subordinated classes (sharing losses on a pro rata basis) in liquidation under all circumstances (criterion (i); § 217.20(b)(1)(i)).

(B) Companies also may be able to satisfy the requirements of Regulation Q by revising the timing of distributions so that holders a class of capital instruments do not receive, and are not allocated, distributions that later may be subject to a clawback while the company controls or may control a depository institution.

§ 217.502 Application of the Board’s Regulatory Capital Framework to Employee Stock Ownership Plans that are Depository Institution Holding Companies and Certain Trusts that are Savings and Loan Holding Companies.

(a) *Employee stock ownership plans.* Notwithstanding § 217.1(c), a bank holding company or covered savings and loan holding company that is an employee stock ownership plan is exempt from this part until the Board adopts regulations that directly relate to the application of capital regulations to employee stock ownership plans.

(b) *Personal or family trusts.* Notwithstanding § 217.1(c), a covered savings and loan holding company is exempt from this part if it is a personal or family trust and not a business trust until the Board adopts regulations that apply capital regulations to such a covered savings and loan holding company.

By order of the Board of Governors of the Federal Reserve System, December 12, 2014.

**Robert deV. Frierson,
Secretary of the Board.**

BILLING CODES: 6210-01P

[FR Doc. 2014-29561 Filed 12/18/2014 at 8:45 am; Publication Date: 12/19/2014]