

December 14, 2015

Bank Capital Requirements

Federal Reserve Issues Final Rule Clarifying the Application of the Common Equity Tier 1 Capital Requirement to the Capital Structures of "Non-Stock Form" Depository Institution Holding Companies

SUMMARY

On December 4, 2015, the Federal Reserve adopted a final rule (the "*Final Rule*") clarifying the application of its definition of common equity tier 1 capital ("*CET1*") to ownership interests in bank holding companies ("*BHCs*") and savings and loan holding companies ("*SLHCs*") that are organized in "non-stock form" as limited liability companies ("*LLCs*") or partnerships (collectively, "*non-stock holding companies*").¹ The Final Rule provides several examples of how the definition of CET1 would apply to ownership interests issued by non-stock holding companies, including with respect to features that are commonly found in the capital structures of non-stock holding companies such as: (i) the unlimited liability for the general partner of a partnership; (ii) disproportionate allocation of profits and/or losses among classes of equity; (iii) mandatory distributions; (iv) liquidation preferences; and (v) "clawbacks" or reallocations of prior distributions.

In addition, the Final Rule grants an exemption from the Federal Reserve's capital requirements for SLHCs that are personal or family trusts (and not business trusts) and non-stock holding companies that are employee stock ownership plans ("*ESOPs*"), until such time as the Federal Reserve finalizes future regulations to apply its capital framework to such organizations.

The Final Rule will become effective on January 1, 2016, but permits organizations to rely on its guidance prior to its effective date. Non-stock holding companies whose capital instruments do not qualify as CET1 due to the requirements of the Final Rule are permitted to treat such instruments as CET1 until July 1, 2016.

BACKGROUND

Under the Federal Reserve's and the other banking agencies' 2013 revised capital framework,² covered banking organizations, including certain BHCs and SLHCs, are required to maintain a minimum ratio of CET1 to risk weighted assets of 4.5 percent (exclusive of buffers and surcharges).³ This ratio is designed to ensure that covered banking organizations "hold sufficient high-quality regulatory capital that is available to absorb losses on a going-concern basis."⁴ The capital framework imposes a set of eligibility requirements for an instrument to be included as CET1,⁵ that are intended to capture common stock and other instruments that are the most subordinated form of capital of a banking organization, and "are thus available to absorb losses first."⁶

Non-stock holding companies are typically privately held and are often structured as non-stock entities for, among others, tax, estate planning, and investment purposes. The equity of these organizations may include features that are not typically found in the common stock of publicly-held corporations.

Following the adoption of the revised capital framework, non-stock holding companies "sought clarification as to how the CET1 requirement would apply in light of their capital structures."⁷ To address these requests, on December 12, 2014, the Federal Reserve invited comment on a proposed rule to provide guidance to non-stock holding companies regarding the application of the CET1 requirement.⁸ The Final Rule adopts this proposal substantially as proposed.

OVERVIEW

The Final Rule acknowledges that non-stock holding companies often have "multiple classes of capital instruments that allocate profit and loss from a distribution differently among classes,"⁹ and provides several examples of features that are commonly found in instruments issued by such non-stock entities in discussing whether these features disqualify the instruments from CET1 treatment. Each of the examples is discussed below. The Federal Reserve notes that non-stock holding companies should analyze each class separately to determine their qualification as CET1 or any other class of capital components. Key themes from the Federal Reserve's analysis of these examples include:

- *Voting/Management Control is Irrelevant:* The Final Rule confirms that disparate voting rights, or the control of the management or affairs by one of the classes of equity (for example, general partnership interests), does not disqualify that or other classes of equity from CET1 treatment if all of the other eligibility criteria are met.
- *Instruments Must Bear First Losses Equally:* The Federal Reserve stresses that any features that "limit or could limit the ability of capital instruments to bear first losses or effectively absorb losses" are inconsistent with the capital framework's eligibility criteria for CET1. In a number of examples, the Federal Reserve found that features that alter the *pro rata* loss sharing among instruments will disqualify any instrument that disproportionately benefits from CET1 treatment.
- *Disproportionate Profit Sharing is Permissible:* Under the Final Rule, classes of instruments that provide for differing allocations of profits can each qualify as CET1 so long as the classes, together, share proportionately in any losses relative to the holder's contributed capital.

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Although the examples refer specifically to non-stock entities, the Final Rule acknowledges that the criteria reflected in its examples could apply to any type of legal entity.¹⁰

EXAMPLES OF FEATURES IN CAPITAL INSTRUMENTS

Single Class Membership LLC

In the first example, the Final Rule discusses the treatment of an LLC with a single class of membership interests that provides that all holders share in losses and dividends in an amount proportionate to their ownership share.¹¹ Under this example, assuming all of the other eligibility criteria are met, this membership interest would qualify as CET1.

Unlimited Liability: General and Limited Partnership Interests

Next, the Final Rule analyzes a limited partnership or similar entity with both general partnership and limited partnership interests where the holders of both classes, together, receive distributions and bear losses in amounts that are allocated proportionately to the holder's capital contributions, with the general partner having unlimited liability for the residual debts of the partnership. According to the Final Rule, both the general and limited partnership interests would qualify as CET1, provided that the interests "share losses equally to the extent of the assets of the partnership," in amounts relative to the contributed capital.¹² The Final Rule notes that for purposes of analyzing the CET1 eligibility criteria, the residual unlimited liability of the general partner is not relevant because "the general partner's unlimited liability is similar to a guarantee provided by the general partner, rather than a feature of the general partnership interest."¹³ Likewise, as noted above, the Federal Reserve notes that the general partner's control over the management of the entity is "not relevant for purposes of satisfying the CET1 eligibility criteria." Rather, the subordination of the interests and the allocation of losses are the relevant determining factors.¹⁴

Liquidation Preferences: Junior and Senior Classes of Capital Interests

In another example, an LLC issues two types of membership interests, Class A and Class B, that have equal voting rights and rights to operating distributions, but, in liquidation, the Class B interests must receive the entirety of their contributed capital prior to any liquidating distributions to the Class A interests. Under this example, the Class B interests would not qualify as CET1 because they are not the most subordinated claims due to their preference over the Class A interests in liquidation. However, if all other eligibility criteria are satisfied, the Class A interests would qualify as CET1.¹⁵

Proportionate Loss Sharing with Unequal Profit Sharing

The Final Rule also analyzes an LLC with two classes of membership interests, Class A and Class B, where the interests share proportionately in all losses and receive proportionate shares of distributed capital (whether in liquidation or otherwise), but, for distributed profits, the Class B interests receive double the proportional share of the holders of the Class A interests if profits exceed a certain threshold. In this context, the Final Rule states that both the Class A and Class B interests would qualify as CET1,

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despite the unequal profit sharing because all losses and all distributions of contributed capital are shared equally amongst both classes of interests in an amount proportionate to the holder's contributed capital.¹⁶

Unequal Loss Sharing

However, with respect to an LLC where the holders of Class A interests bear a disproportionately low level of any losses relative to the Class B interests, the Final Rule states that the Class A interests cannot qualify as CET1 because they do not bear losses proportionately with the Class B interests and are structurally preferred to the Class B interests. The Class B interests would qualify as CET1 assuming all other criteria are met.¹⁷ The Final Rule notes that the entity can revise its capital structure such that the Class A and Class B interests share equally in losses in an amount proportionate to the holder's contributed capital to qualify for CET1 treatment, regardless of the allocation of profits (similar to the example described above).¹⁸

Mandatory Distributions

Consistent with the eligibility requirements for CET1, the Final Rule provides that any "class of capital instruments that provides holders with rights to mandatory distributions would not qualify as [CET1] because a holding company must have full discretion at all times to refrain from paying any dividends and making any other distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restriction on the holding company."¹⁹

"Clawbacks": Reallocations of Prior Distributions

In the last example, the Final Rule considers an LLC with two classes of membership interests, Class A and Class B, which provide that the Class A interest, upon the occurrence of certain events, must return a portion of their earlier distributions to the LLC, which then distributes them to the Class B interests. Under the Final Rule's guidance, if the "clawback" conditions include the reallocation of prior distributions to cover aggregate losses, then the Class B interests would not qualify as CET1. However, if the conditions solely provide for the reallocation of profits, then each class would qualify as CET1 so long as the allocation of losses is proportionate to the holder's contributed capital and both interests are the most subordinated claims.²⁰

PERSONAL/FAMILY TRUSTS AND ESOPS

The Final Rule grants an exemption from the Federal Reserve's capital requirements for SLHCs that are personal or family trusts and not business trusts, recognizing the significant burden that the capital framework would cause for these trusts because most do not prepare financial statements under U.S. Generally Accepted Accounting Principles and do not issue capital instruments that would qualify as regulatory capital. Likewise, the Final Rule also grants an exemption for non-stock holding companies that are ESOPs noting certain complexities regarding the accounting treatment of the ESOP's assets (which may be consolidated on the BHC's or SLHC's balance sheet) as compared to the regulatory treatment (where many ESOPs would be considered the top-tier entity due to its ownership of the capital

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stock of the BHC or SLHC). The exemptions will remain in place until the Federal Reserve finalizes future regulations applying its capital framework to such organizations.²¹

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ENDNOTES

1 80 Fed. Reg. 76374 (December 9, 2015).
2 See Regulation Q, 12 C.F.R. Part 217.
3 12 C.F.R. § 217.10(a)(1).
4 80 Fed. Reg. 76378, 76375.
5 12 C.F.R. § 217.20(b).
6 80 Fed. Reg. 76378, 76375.
7 *Id.*
8 79 Fed. Reg. 75759 (December 19, 2014).
9 12 C.F.R. § 217.501(b)(2).
10 12 C.F.R. § 217.501(c), note 4.
11 12 C.F.R. § 217.501(c)(1).
12 12 C.F.R. § 217.501(c)(2)(ii).
13 *Id.*
14 12 C.F.R. § 217.501(b)(2), note 2; 80 Fed. Reg. 76378, 76377.
15 12 C.F.R. § 217.501(c)(3).
16 12 C.F.R. § 217.501(c)(4).
17 12 C.F.R. § 217.501(c)(5).
18 12 C.F.R. § 217.501(c)(5)(ii)(B).
19 12 C.F.R. § 217.501(c)(6)(ii).
20 12 C.F.R. § 217.501(c)(7)(ii).
21 12 C.F.R. § 217.502.

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