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M E M O R A N D U M

May 11, 2004

To Our Clients and Friends

Re: Federal Reserve Board's Proposed Rule on Risk-Based Capital Standards

The Federal Reserve Board ("Board") has issued a proposed rule to allow the continued inclusion of outstanding and prospective issuances of trust preferred securities¹ in the tier 1 capital² of bank holding companies ("BHCs") subject to stricter quantitative limits and qualitative standards. The Board is also proposing to revise the quantitative limits applied to the restricted core capital elements included in the tier 1 capital of BHCs and to revise the qualitative standards for capital instruments included in regulatory capital. Comments are due by July 11.

This proposed rule only applies to BHCs' determination of tier 1 capital requirements. For accounting and regulatory reporting purposes BHCs should continue to follow GAAP in their treatment of capital instruments, including trust preferred securities.

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. They allow for at least twenty consecutive quarters of dividend deferral, after which the investors have the right to take hold of the sole asset in the trust, a deeply subordinated note issued by the BHC which has terms that generally mirror those of the trust preferred securities, except that the subordinated debt has a fixed maturity of at least thirty years.

² Tier 1 or core capital elements include common stockholders' equity, qualifying noncumulative perpetual preferred stock (including related surplus), qualifying cumulative perpetual preferred stock (including related surplus) and minority interest in the equity accounts of consolidated subsidiaries.

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QUANTITATIVE STANDARDS FOR TIER 1 (CORE) CAPITAL

The Board's proposed rule permits BHCs to continue to include outstanding and prospective issuances of trust preferred securities in tier 1 capital subject to stricter quantitative limits which would apply to a broader range of capital instruments issued by BHCs. The Board's proposed rule would:

- impose no tier 1 capital limits on minority interest related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated US depository institution or foreign bank subsidiary (Class A minority interest);
- impose a limit on the aggregate amount of a BHC's restricted core capital elements of 25 percent of core capital elements, net of goodwill.³
Restricted core capital elements include:
 - cumulative perpetual preferred stock,
 - trust preferred securities,
 - minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated US depository institution or foreign bank subsidiary (Class B minority interest), and
 - minority interest in the form of qualifying common stockholders' equity or qualifying perpetual preferred stock (and related surplus) in a consolidated subsidiary that is neither a US depository institution nor a foreign bank (Class C minority interest);
- permit qualifying cumulative perpetual preferred stock and Class B minority interest in excess of the 25 percent limit to be included in tier 2 capital with no sublimit;
- permit qualifying trust preferred securities and Class C minority interest in excess of the 25 percent limit to be included in tier 2 capital but be limited, together with subordinated debt and limited-life preferred stock, to 50 percent of tier 1 capital;
- require internationally active BHCs to limit the amount of restricted core capital elements to 15 percent of the sum of core capital elements, including restricted core capital elements, net of goodwill.

These revised limitations on restricted core capital elements would become effective as of March 31, 2007.

³ By netting goodwill from the calculation of the 25 percent limit, the Board is tightening the current 25 percent limit.

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QUALITATIVE STANDARDS FOR TIER 1 (CORE) CAPITAL

Consistent with long-standing policies, the Board in its proposed rule:

- requires BHCs to consult with the Board before issuing trust preferred securities;
- specifies criteria trust preferred securities must meet to be eligible for inclusion in tier 1 capital;
- clarifies that common stockholders' equity may not possess terms or features that create investor preferences and strengthens language on the need for voting common equity to be the dominant form of tier 1 capital;
- emphasizes the need for a BHC to have the unrestricted ability to waive preferred dividends and the Board's expectation that this will be done when a BHC is in a weakened condition;
- sets forth the general exclusion from tier 1 capital of preferred instruments with dividend rate step-ups or market value conversion features;
- incorporates into the guidelines for subordinated debt a reference to the Federal Reserve's subordinated debt policy which outlines a number of technical requirements that subordinated debt included in capital requirements must meet.

A copy of the proposed rule can be found on our web site - http://www.schwartzandballen.com/whats_new.html.

If you have any questions, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.