Definition of Capital

1. If an instrument with a step-up feature was includable in tier 2 capital under the general risk-based capital rules, and otherwise meets all other criteria for tier 2 capital instruments in the regulatory capital rule, and the instrument is not called on the step-up date, may the instrument be included in tier 2 capital under the regulatory capital rule?[2]

Such instruments with step-up features that were included in tier 2 capital prior to May 19, 2010, by a depository institution holding company that are not eligible for grandfathering (under section 300(c)), or prior to September 12, 2010, by a depository institution, are subject to the phase-out provisions for non-qualifying capital instruments under section 300(c) of the regulatory capital rule. However, if such an instrument remains outstanding once its interest rate has been "stepped-up," and the instrument meets all other criteria for tier 2 capital instruments under the regulatory capital rule, it may be included in tier 2 capital since the instrument no longer has any terms or features that create an incentive for the issuer to redeem the instrument prior to maturity.

2. If an instrument that was includable in tier 2 capital under the general risk-based capital rule has a call date that is associated with a step-up in the distant future, may that call date be considered the maturity date in order to avoid having the instrument subject to the phase-out provisions of the regulatory capital rule?[3]

No, the step-up date is not a factor in determining the maturity date. The regulatory capital rule prohibits any feature in tier 2 capital instruments that would create significant incentives to redeem such instruments prior to maturity (see section 20(d)(1)(iv) of the regulatory capital rule). Thus, if the instrument has a significant incentive to redeem and was issued and included in tier 2 capital prior to May 19, 2010, by a depository institution holding company not eligible for grandfathering (under section 300(c)), or prior to September 12, 2010, by a depository institution, the instrument is subject to the phase-out provisions in section 300(c) of the regulatory capital rule. If the instrument was issued after those dates, it may not be included in regulatory capital.

3. Is the regulatory capital amortization schedule for tier 2 capital instruments outlined in section 20(d)(1)(iv) considered a "significant incentive" to redeem?

No. The amortization schedule is not considered a significant incentive to redeem. The amortization schedule is not a term or feature of the instrument but a regulatory requirement.

4. Can convertible instruments be included in regulatory capital even if they are convertible less than five years after issuance?

Convertibility of a capital instrument within five years of issuance does not preclude its qualification as regulatory capital if the instrument is convertible into a capital instrument of a higher quality (see section 20(d)(1)(iv), note 12 of the Board's and OCC's regulatory capital rule and footnote 13 of the FDIC's regulatory capital rule). For example, a non-common stock

[2] This FAQ assumes that the instrument was not issued under the Small Business Jobs Act of 2010 or prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008.

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additional tier 1 or tier 2 capital instrument that converts into common stock can be included in additional tier 1 capital or tier 2 capital (as appropriate), even if the contractual conversion date requires conversion less than five years after issuance, so long as the instrument meets all the relevant eligibility criteria in the regulatory capital rule.

5. Are investments in the capital of Federal Reserve Banks and Federal Home Loan Banks (FHLB) in the form of common stock considered investments in the capital of unconsolidated financial institutions that would be subject to the regulatory capital rule's 10 percent common equity tier 1 capital deduction threshold?

No. The relevant definitions in section 2 of the regulatory capital rule exclude investments in sovereigns (sovereigns include central banks as well as Federal Reserve districts) and government sponsored enterprises (which include FHLBs). See section 2 of the regulatory capital rule.

6. Should banking organizations risk weight mortgage servicing assets (MSA) and significant investments in the capital of unconsolidated financial institutions that are not deducted from capital on a gross (pre-tax) basis, or should they risk weight such assets net of associated deferred tax liabilities?

These assets are subject to risk weighting on a gross (pre-tax) basis. The ability to net associated deferred tax liabilities against deductible assets is only applicable for purposes of calculating the amount of the assets that must be deducted, not for purposes of calculating the risk weighted amount of such assets.

7. Are foreign currency translation adjustments and accumulated net gains/losses on cash flow hedges related to the hedging of items that are not fair-valued on the balance sheet (which are components of accumulated other comprehensive income (AOCI)) subject to the transitional provisions in the regulatory capital rule?

No. Consistent with the general risk-based capital rules, under the regulatory capital rule, foreign currency translation adjustments are included in regulatory capital and accumulated net gains and losses on cash flow hedges related to the hedging of items that are not fair-valued on the balance sheet are excluded from regulatory capital. These items are thus not subject to the transition provisions and, accordingly, are not listed in section 300(b)(3) of the regulatory capital rule.

8. If the U.S. Treasury sells to a third party preferred shares issued by a depository institution holding company (DIHC) under the Emergency Economic Stabilization Act of 2008 (troubled asset relief program (TARP) shares) and the DIHC included the TARP shares in tier 1 capital, are TARP shares held by that third party eligible for inclusion in additional tier 1 capital under the regulatory capital rule?

Yes. Although the shares do not meet the eligibility requirements under the regulatory capital rule, the shares were issued prior to October 4, 2010 pursuant to the Emergency Economic Stabilization Act and are explicitly grandfathered under the regulatory capital rule. See section 20(c)(3) of the regulatory capital rule.

9. DIHC A has TARP shares outstanding and held by third-party investors. DIHC B acquires DIHC A. Instead of purchasing the TARP shares from the investors for cash, DIHC B exchanges the TARP shares issued by DIHC A for newly issued preferred shares

that have identical terms to the TARP shares (for example, the preferred shares issued by DIHC B are cumulative and have a step-up, and are classified as a new instrument under generally accepted accounting principles (GAAP)). Are the shares issued by DIHC B eligible for inclusion in additional tier 1 capital?

No. The shares issued by DIHC B were not issued prior to October 4, 2010, and were not issued pursuant to the Emergency Economic Stabilization Act. The terms of the newly issued shares are not consistent with the eligibility criteria under the regulatory capital rule. See section 20 of the regulatory capital rule.

10. Are interest payments on tier 2 capital instruments included in the scope of "distributions" under the capital conservation buffer framework?

Interest payments on subordinated debt instruments that qualify as tier 2 capital are generally not considered a "distribution" for purposes of the capital conservation buffer framework, as that term is defined in section 2 of the regulatory capital rule. However, interest payments on trust preferred securities (TruPS) (if the TruPS are included in the tier 2 capital of the issuer) are included in the scope of distributions under the capital conservation buffer if the banking organization has full discretion to defer interest payments on those instruments (permanently or temporarily) without triggering an event of default.