



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 28, 2006

Interpretive Letter #1067
August 2006

Dear []:

This letter replies to your request dated November 8, 2005 seeking guidance on the appropriate treatment of the service costs on innovative capital instruments for purposes of 12 USC 60. The Office of the Comptroller of the Currency (OCC) considers distributions paid on innovative capital instruments included in a national bank's Tier 1 and Tier 2 capital as bank dividends that should be included in the dividend paying capacity calculation outlined in 12 USC 60(b). You have requested clarification regarding possible interpretations of the treatment of the distributions in the section 60 calculation. The OCC has determined that the inclusion of the gross service cost on the innovative capital instruments in dividends paid, and an upward adjustment to net income by an equal amount, is consistent with the intent of 12 USC 60.

Under the OCC's risk-based capital regulations, one of the components of a national bank's Tier 1 capital may be "minority interests in the equity accounts of consolidated subsidiaries." See 12 CFR 3, Appendix A 2(a)(3). A bank may establish an operating subsidiary with the sole purpose of raising Tier 1 capital in the form of minority interests. When such subsidiaries of a bank issue preferred stock to third party investors, the funds raised are eligible for inclusion in a bank's Tier 1 capital, with prior OCC approval, as long as the instrument issued by the subsidiary meets the same criteria as an instrument issued directly by a bank. For purposes of this letter, these types of instruments are considered "innovative capital instruments." Subject to conditions, the OCC has approved two types of innovative capital instruments, preferred stock issued by a real estate investment trust¹ (REIT preferred) and a noncumulative, perpetual trust preferred security² (bank trust preferred). The amount of innovative capital instruments eligible for inclusion in Tier 1 capital is limited to a total of 25 percent of Tier 1 capital, with a sub limit of 15 percent for bank trust preferred. If a bank subsidiary raises an amount in excess of the limit, the OCC has determined that the excess may be included in Tier 2 capital subject to the limits of 12 CFR 3, Appendix A 2(b)(4).

¹ OCC Corporate Decision 97-109, December 1997.

² OCC Interpretative Letter 894, October 2000.

The operating subsidiary that issues an innovative capital instrument is controlled by the bank and consolidated on the financial statements of the bank. The bank reports the innovative capital instrument issued to third party investors on its balance sheet as a minority interest in the equity accounts of a consolidated subsidiary. While for regulatory purposes that account may be recognized as risk-based capital, you represented that under GAAP, the minority interest account is considered a liability and any distributions or service costs of the instrument to the third party investors are considered an expense, reducing net income.

OCC regulations require national banks to combine book figures of operating subsidiaries with those of the bank for purposes of complying with statutory or regulatory limits such as 12 USC 60. *See also* 12 CFR 5.34 (e)(4)(i). Consistent with its recognition of the innovative capital instruments as Tier 1 capital, the OCC considers any distributions paid on the innovative capital instruments to third-party investors as distributions on bank capital, i.e. dividends. Therefore, the distributions are combined with the dividends of a bank's directly issued capital instruments for purposes of compliance with 12 USC 60(b). Section 60(b) and its implementing regulation 12 CFR 5.64 require a national bank to obtain prior OCC approval to declare a dividend if the total amount of all dividends exceeds the bank's net income for the current year plus the retained net income of the prior two years (dividend capacity). When determining its compliance with section 60(b), a national bank must include in its "total amount of all dividends" any distributions paid by operating subsidiaries to minority investors on capital instruments included in Tier 1 or Tier 2 capital. However, as you noted in your letter, such distributions have already been subtracted from earnings in the determination of net income. You requested clarification as to whether the bank's dividend capacity should reflect the payout of the distributions twice, as both an expense and a dividend.

The purpose of the earnings limitation in section 60(b) is to prevent a bank from paying dividends out of needed capital funds, but not to interfere with the normal dividend policies of national banks. *See* S. Rep. No. 730, 86th Cong., 1st Sess. – (1959), *reprinted in* 1959 U.S.C.C.A.N. 2232, 2238. The double deduction of the distributions on innovative capital instruments interferes with a bank's future ability to pay dividends by reducing the dividend capacity a second time for distributions already reflected in net income. Therefore, it would be appropriate for a bank to adjust its net income for distributions on innovative capital instruments that are treated as dividends for purposes of the regulatory dividend capacity calculation. To effect such an adjustment, the OCC will permit a bank to add back to its net income, for purposes of 12 USC 60 and 12 CFR 5.64, the gross amount of the distributions on innovative capital instruments that have been subtracted from earnings in the calculation of net income. If the resulting dividend capacity calculation indicates that the bank has insufficient capacity to pay the distributions on the innovative capital instruments under section 60(b), the bank must request OCC approval prior to making such distributions.

The adjustment described in this letter is subject to periodic supervisory review. Although a distribution on an innovative capital instrument may be permissible under section 60(b), the distribution also is subject to all other statutes and regulations governing bank dividend payments. For example, the distribution would not be permissible if after payment of the distribution, the bank would be undercapitalized. *See* 12 USC 1831o (d)(1)(A). If the bank does

not have sufficient undivided profits to cover a proposed distribution on an innovative capital instrument, under 12 CFR 5.63, such a distribution should be treated as a reduction in capital subject to 12 USC 59 and 12 CFR 5.46.

This interpretation applies to all national banks that have issued innovative capital instruments and included such instruments in regulatory capital. The OCC intends to publish this letter in redacted form in its monthly publication "Interpretations and Actions."

If you have further questions, please contact the resident OCC examiners, or Margot Schwadron in the Capital Policy Division at (202) 874-6022.

Sincerely,

signed

Tommy Snow
Director
Capital Policy