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Handbook: Examination
Subject: Capital Adequacy
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Outdated - See OCC 2015-38

TO:

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Examinations, Supervision, and Consumer Protection

SUBJECT: Capital Raising using a Subordinated Organization and Creating a Noncontrolling Interest

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Banking organizations have been considering a variety of different recapitalization efforts including capital issued through a subordinate organization. This generally involves the sale or contribution of assets to a subsidiary or other lower tier organization in exchange for the common stock of the subsidiary, along with selling an equity interest in the subsidiary to third parties. The purpose of the transaction is to create a noncontrolling interest (also referred to as a minority interest) that, when consolidated in the balance sheet of the banking organization, would be included in the banking organization's Tier 1 capital. However, ***many of these noncontrolling (minority) interest transactions do not meet the regulatory requirements for Tier 1 capital*** as they do not provide meaningful capital support to the consolidated banking organization.

The federal banking agencies are concerned that banking organizations may consummate transactions in which noncontrolling interests are created assuming that these interests would *automatically* qualify as Tier 1 capital. They do not. Rather, their inclusion in capital is determined on a case-by-case basis depending upon the facts and details of the proposed transaction. Accordingly, the agencies are developing new guidance related to noncontrolling interests in Tier 1 capital that will encourage banking organizations considering such transactions to contact their primary Federal supervisor before the transaction is consummated.

Recently the GAAP guidance regarding minority interests changed. FAS 160 (now ASC 810 - Consolidations) was issued in December 2007 and was effective beginning in 2009. This guidance did several things including:

1. changed the terminology from minority interest to the new term, noncontrolling interest;

2. changed the presentation location of noncontrolling interest to the equity section of the parent, rather than the liability section or mezzanine, but clearly and separately displays noncontrolling interest from the parent organization's equity.

OTS Capital Policy staff has reviewed several recent proposals for the creation of and inclusion of noncontrolling interests in Tier 1 capital, and we anticipate that more are on the way. Often, the proposals are submitted by institutions under extreme pressure to raise capital quickly; as a result, the transactions are generally still in the developmental phase when submitted to Capital Policy staff, without full evaluation by the institution and without having afforded regional staff sufficient opportunity to review. Unfortunately, these transactions often do little more than create the appearance of capital as they provide questionable economic benefit to the institution along with seemingly low risk, high return benefits to the new noncontrolling investors. It is important to bear in mind that raising capital by way of noncontrolling interests is generally *not favored* by the agencies for Tier 1 capital, especially for stressed institutions, because in many cases the noncontrolling interest provides little or no meaningful capital support to the entire institution.

For inclusion in Tier 1 capital, noncontrolling interests must, at a minimum, satisfy the following criteria:

- The proposed interest ***must*** count as equity capital under GAAP.

- The proposed noncontrolling interest generally must be a cash investment. Contribution of other types of assets generally is not acceptable. For example, a transaction to contribute other types of financial assets, fixed assets, or intangible assets in exchange for the noncontrolling equity interest would not be acceptable.

- Where assets are transferred to a subsidiary, it is important that proper valuations of the assets be performed at the time of transfer and on an on-going basis. Without appropriate valuations, whether the minority shareholders are making a low or no risk investment cannot be properly assessed.

- The type of capital instrument issued to the owners of the noncontrolling interest must provide the same terms and conditions as other qualifying Tier 1 capital instruments issued directly by an institution, namely common stock and noncumulative perpetual preferred stock. Merely titling an instrument "noncumulative perpetual preferred stock" is not sufficient. Rather, it must provide the same loss absorbing qualities as a Tier 1 capital instrument of the institution.

- Common stock and retained earnings must be the predominant form of bank equity. Generally, OTS limits noncontrolling interest to no more than 25% of capital. Where there are other significant supervisory concerns, the limit is lower.

- The noncontrolling interest cannot represent an essentially risk-free or low-risk investment for the holders of the investment in the subsidiary. An example would be a situation where the institution retains most of the risk of loss, the external investment is small relative to the value of the assets transferred by the institution to the subsidiary, and the outside investors are entitled to significant returns after built in loss protections.

- In determining whether an instrument provides sufficient capital support for the institution, OTS may consider, in certain instances, whether there is an exchange feature that provides for exchange of the instrument issued by the subordinate organization for a similar instrument of the institution. The exchange feature would be triggered by the institution falling below the PCA well capitalized level, or where the supervisor determines that the institution is in danger of falling below the well capitalized level.

Procedurally, institutions considering capital transactions involving the creation of noncontrolling interests should provide the following information for regional review:

1. A complete term sheet that details the exact terms and conditions of the noncontrolling shareholder's investment, and that demonstrates that the capital instrument used meets the conditions for inclusion in Tier 1 capital (e.g., common stock or noncumulative perpetual preferred stock).

2. An accounting opinion as to whether the proposed interest will qualify as GAAP equity and in what amount (after considering valuation allowances/reserves and OCI). Supporting documents should clearly indicate how valuations were determined.

3. Pro forma cash flow projections, and pro forma financial statements showing the savings association's balance sheet (consolidated and unconsolidated) before and after the transaction.

4. An analysis of the economic advantages to the savings association over time and how this transaction provides meaningful capital support to the organization. In those transactions where there is an exchange feature, this would likely include discussion of how the exchange feature would function.

Regional staff should be afforded the opportunity to fully review a final or near-final proposal and satisfy itself that the transaction is consistent with GAAP, provides meaningful capital support to the savings association and does not represent an essentially risk free investment for the investors. Regional staff should consult DC Capital Policy staff with questions about the includability of the noncontrolling (minority) interest in Tier 1 capital.

For more information, please contact David Riley, Senior Analyst (Capital Policy) at (202) 906-6669.

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