Insights: Alerts

Revised Capital Framework for Depository Institution Holding Companies Organized as LLCs and Partnerships

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Written by Gary R. Bronstein, Christina M. Gattuso, Stephen F. Donahoe, Suzanne A. Walker, Edward G. Olifer

The Federal Reserve Board (the "Board") has adopted amendments to the Board's regulatory capital framework ("Regulation Q"), that clarify how the revised regulatory capital framework applies to depository institution holding companies that are not organized as traditional stock corporations, such as limited liability companies and partnerships, and how instruments issued by such institutions may qualify as regulatory capital. In addition, the final rule amends Regulation Q to temporarily exclude from Regulation Q certain savings and loan holding companies ("SLHCs") that are trusts and depository institution holding companies that are employee stock ownership plans ("ESOPs").

The final rule, which became effective January 1, 2016, established a compliance date of July 1, 2016, to allow time for entities to review their capital structures.

Application of Regulation Q to Non-Stock Holding Companies

The final rule clarifies that capital issued by a non-stock company would qualify as common equity Tier 1 ("CET1") capital if it has loss absorbency and subordination features similar to those of common stock. Further, the final rule provides that mandatory distribution features in capital instruments issued by either a partnership or limited liability company would disqualify such capital from CET1.

Partnerships

Under the final rule, for partnerships, the general and limited partnership interests would typically qualify as CET1 capital, provided the other criteria of CET1 are met. Moreover, unlimited liability of the general partner is not relevant in the context of CET1 eligibility, provided that the general partner and limited partners share losses equally to the extent of the assets in the partnership and the general partner is liable after the assets of the partnership are exhausted. As a result, any feature allocating losses among classes that is disproportionate to amounts invested, such as mandatory distributions, minimum rates of return, and allocations of earlier distributions could result in a partnership interest failing to qualify as CET1 capital.

Limited Liability Companies

The final rule clarifies that in a limited liability company with multiple classes of ownership, capital would qualify as CET1 if all ownership classes share equally in losses and are placed at the same level of seniority in bankruptcy or liquidation, even if the classes have disproportionate allocations of profits from a distribution, provided the other criteria of CET1 are met. A limited liability company could have multiple ownership classes qualify as CET1 capital, if

all such classes shares proportionately in any losses and receives distributions proportionately up to a specific annual rate of return, with one class receiving the remainder of the distribution if distribution exceeds such point. Under the final rule, the Board will evaluate each distribution separately to determine whether losses are shared equally by all holders of CET1 instruments. Where multiple classes of ownership each carry its own economic rights, the Board will evaluate each class separately to determine qualification as CET1 capital.

Under the final rule, a reallocation of distributions among classes upon the occurrence of an event or other types of clawback features may result in an unequal sharing of losses, and therefore, such capital would not qualify as CET1. The final rule clarifies that reallocations that are limited to reversing prior disproportionate allocations of profits would not raise this concern.

Application of Regulation Q to Estate Trust SLHCs

Under the final rule, the Board extended the temporary exemption from Regulation Q of personal and family trusts, but not business trusts, due to the anticipated significant burden and expense required to develop and implement the systems necessary to prepare financial statements in accordance with GAAP. The Board anticipates the exemption to stay in place pending development by the Board of an alternative capital regime for estate trust SLHCs.

Application of Regulation Q to ESOPs

In the final rule, the Board adopted the proposed temporary exclusion for ESOPs from Regulation Q without modification. In the interim, the Board will evaluate compliance with Regulation Q by assessing the regulatory capital of a banking organization that has an ESOP holding company within its structure.

Practical Guidance

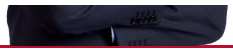
Companies organized as limited liability companies or partnerships that are subject to Regulation Q and have issued capital instruments should review their capital structures for compliance with the final rule. In connection with the review these companies should consider whether a modification of their capital structure (including issuing additional qualifying capital) or governing documents is necessary to comply with the final rule. Additionally, business trust SLHCs are expected to prepare their financial statements in accordance with GAAP by July 1, 2016 and should take steps to comply with this requirement.

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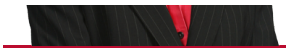
Related People





Gary R. Bronstein
t 202.508.5893
gbronstein@ktslaw.com



Christina M. Gattuso
t 202.508.5884
cgattuso@ktslaw.com



Stephen F. Donahoe
t 202.508.5818
sdonahoe@ktslaw.com



Suzanne A. Walker
t 202.508.5856
suwalker@ktslaw.com



Edward G. Olifer
t 202.508.5852
eolifer@ktslaw.com