Comptroller of the Currency Administrator of National Banks

Washington, DC 20219

March 10, 2000

Interpretive Letter #894 October 2000 12 CFR 3

This is in response to your letter dated [], concerning a tax-deductible capital instrument developed by Lehman Brothers. The OCC has determined that the capital instrument described in this letter would qualify as bank-level Tier 1 capital up to a maximum of 15% of total Tier 1 capital.

Background

[] (the "Bank") intends to organize a limited liability company under Delaware law (the "Subsidiary") and hold all of the common stock of the Subsidiary. The common stock will represent at least 7% of the total capitalization of the Subsidiary. The Bank will control the Subsidiary through its ownership of 100% of the common stock of the Subsidiary and therefore consolidate the Subsidiary's operations with its own under generally accepted accounting principles.

The Subsidiary will also issue non-cumulative, perpetual, fixed-rate Preferred Securities to third party investors. The beneficial interest in the Subsidiary held by the Preferred Securities investors will be shown as a minority interest on the Bank's consolidated financial statements. Dividends on the Preferred Securities will be paid only if the Subsidiary receives timely payments from its underlying assets. The Preferred Securities will be redeemable by the Subsidiary only with the prior approval of the OCC.

The Subsidiary will invest 95% of the proceeds of the Preferred Securities in a Subordinated Debenture issued by the Bank and 5% of the proceeds in other assets that meet prescribed credit and maturity criteria ("Eligible Assets"). The Subordinated Debenture will have a thirty-year maturity and pay interest at a similar rate and at the same frequency as dividends payable on the Preferred Securities.

The Bank may defer the interest payments up to five years. After exercising this deferral option, the Bank may not make any payment on the Subordinated Debenture without the prior approval of the OCC. Non-payment on the Subordinated Debenture will not constitute an event of default unless the OCC has approved a payment. When interest payments resume after a deferral period, the Subsidiary will pay only the current period Preferred dividends; the Preferred Security holders are not entitled to missed dividends. Accrued deferred interest payments on the Subordinated Debenture will ultimately be repaid to the Bank through dividends on the common stock of the Subsidiary. Any accrued deferred interest payments will be invested in Eligible Assets until the common dividend payment date. The Subsidiary and the Bank can pay regular common dividends only if dividends have been declared and paid on the Preferred Securities.

The Subordinated Debenture will rank junior to the Bank's depositors, senior and subordinated debt holders and general trade creditors. The Bank may not redeem the Subordinated Debenture at the end of its 30-year term without prior approval of the OCC, and no event of default will occur if the OCC does not grant such approval. The Subordinated Debenture will not appear on the Bank's consolidated financial statements.

Upon maturity and repayment of the Subordinated Debenture, the Subsidiary will invest the resulting proceeds in qualifying Eligible Assets. These assets are anticipated to include mortgages and mortgage-backed securities and may be purchased from the Bank on an arms-length basis. The Preferred Securities investors may elect to exchange their shares for perpetual, noncumulative preferred stock of the Bank ("Bank Preferred") if the yield on the Eligible Assets is insufficient to cover the dividends on the Preferred Securities.

The Preferred Securities will be mandatorily exchanged for Bank Preferred following the maturity of the Subordinated Debenture if any of the following events occurs: (1) the Bank becomes undercapitalized under the prompt corrective action regulations, 12 C.F.R. §6.4(b), (2) the OCC anticipates that the Bank will become undercapitalized in the near term, or (3) the Bank undergoes a receivership, conservatorship, winding up or dissolution.

Eligibility for Tier 1

Section 2(a)(2) of Appendix A of 12 CFR 3 establishes the components of Tier 1 capital: (1) common stockholder's equity, (2) noncumulative perpetual preferred stock and related surplus, and (3) minority interests in the equity account of consolidated subsidiaries. It is OCC policy to look to the terms underlying the minority interest to determine if the requirements for Tier 1 capital are met.

¹ While the Subordinated Debenture is outstanding, the value of the Eligible Assets is limited to 8% of the total value of the Subsidiary's assets (15% if the Bank has deferred interest payments on the Subordinated Debenture). If the value of the Eligible Assets exceeds those limits, the excess will be distributed to the Bank.

The OCC analyzed the Preferred Securities to determine if they meet the noncumulative and perpetual requirements of Appendix A. The terms of the Preferred Securities specify that missed dividend payments will not be paid to investors, preserving cash at the Bank in the event of financial stress. The Subsidiary will receive cumulative interest payments from the Subordinated Debenture, if the Bank has exercised its deferral option and subsequently received OCC approval to resume interest payments. However, any payments received by the Subsidiary in excess of the Preferred dividend for one period will not be paid to the Preferred investors. The Subsidiary will either return any excess cash to the Bank via a common dividend or invest in Eligible Assets.

The Bank Preferred must also meet the noncumulative requirement because of the exchange provision. The Bank Preferred terms specify that the dividends are noncumulative and payable in a similar manner to dividends on the Preferred Securities.

To qualify as a Tier 1 capital instrument under Section 2(a)(2) of Appendix A of 12 CFR 3, a security must be perpetual. This requirement is intended to ensure that a bank is not forced to redeem the capital instrument by a specific maturity date or by the investors through the exercise of an option, particularly during times of financial stress. The Preferred Securities proposed by the Bank do not have a maturity date. The terms of the Preferred Securities permit the Bank to call the securities after five years; however, the Bank may only do so with prior OCC approval. The Preferred investors do not have the right to put the Preferred Securities to the Bank. There are no scheduled increases in the dividend rate or other provisions that might effectively date the life of the Preferred Securities. Although the initial asset of the Subsidiary, the Subordinated Debenture, is a dated instrument, the terms of the Preferred Securities provide for the reinvestment of the proceeds so that the Preferred Securities remain outstanding beyond the life of the Subordinated Debenture.

In addition to the criteria of Section 2(a)(2) of Appendix A of 12 CFR 3, the OCC looks at a capital instrument's ability to contribute to a bank's ability to absorb losses as established in 12 CFR §3.4. The proceeds of the Preferred Securities are loaned to the Bank and are available to absorb losses during the life of the Subordinated Debenture. Two features of the Preferred Securities ensure that they continue to be available to the Bank to absorb losses after the maturity of the Subordinated Debenture. First, the mandatory exchange feature of the Preferred Securities requires the exchange of the Subsidiary Preferred for Bank Preferred under conditions that indicate financial difficulties at the Bank. Second, the investors have the ability to exchange the Preferred Securities for Bank Preferred if the income generated by the Eligible Assets is insufficient to pay the Preferred dividends. After such an exchange the investors would have access to Bank earnings as a source for their dividends and no longer be restricted to the earnings of the Eligible Assets. This feature provides a way to address potential investor concerns and may forestall pressure from the investors for a redemption of the Preferred Securities, providing another avenue to ensure that the proceeds continue to be invested in the Bank and are available to absorb any losses incurred by the Bank.

Conclusion

The OCC believes that the terms of the Preferred Securities described above satisfy both the noncumulative and perpetual requirements for Tier 1 capital as defined in Section 2(a)(2) of Appendix A of 12 CFR 3. The Preferred Securities are therefore eligible to be included in Tier 1 capital; however, they should not exceed 15% of Tier 1 capital. This limit is consistent with the Basel Committee on Banking Supervision's statement of October 21, 1998 on innovative Tier 1 capital instruments.

This eligibility applies only to preferred securities that meet the description in this letter. If you have further questions, please do not hesitate to contact the resident OCC examiners or the Capital Policy Division on 202-874-5070.

Sincerely yours,

-signed-

Tommy Snow Director, Capital Policy