

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

April 9, 2002

**BANKING SUPERVISION AND REGULATION:
DERIVATIVE CONTRACTS**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Derivative Contracts Hedging Trust Preferred Stock (SR 02-10)

In recent weeks, bank holding companies seeking to hedge the interest rate risk on their issues of trust preferred stock have been offered derivative contracts. These contracts have terms that could conflict with the strict conditions for the inclusion of the trust preferred stock in tier 1 capital.¹

The terms in question take effect when the bank holding company defers dividend payments on the trust preferred stock subject to the hedge. When such a deferral event occurs, the contracts provide that the derivative counterparty will defer on a cumulative basis its swap payments due to the banking organization while the bank holding company continues to make payments to the derivative counterparty. The Federal Reserve has supervisory concerns where the contract terms for deferral on swap payments are not symmetrical and require the banking organization to make payments to the swap counterparty without receiving payments from the counterparty. Contracts structured in this manner undermine the loss-absorbing capacity of the hedged trust preferred stock and, consequently, its eligibility for Tier 1 capital.

In order for trust preferred stock to be included in Tier 1 capital, the issuing bank holding company must have the ability to defer payments for at least twenty consecutive quarters without giving rise to an event of default. Such a deferral feature, which typically is cumulative in trust preferred stock, is essential in a Tier 1 instrument because it allows the issuer to conserve its cash resources at a time when its financial condition is deteriorating. Where an issue of trust preferred stock is hedged by a swap with asymmetrical deferral terms as described above, however, the cash resources conserved through deferral would be paid out to the swap counterparty. This outflow of cash would not be offset by receipt of payments in from the counterparty, so such a contract defeats the cash-conserving purpose of the deferral mechanism on the trust preferred stock and undermines the instrument's loss-absorbing capacity.

Trust preferred stock issues that are covered by an interest rate derivative contract with asymmetrical terms such as those described above are not eligible to be included in Tier 1 capital. When a banking organization hedges trust preferred stock through an interest rate swap with a deferral feature, the deferral terms on the swap must be symmetrical for both the organization and its counterparty and must not potentially drain the organization's resources in a time of stress. A "plain vanilla" swap where neither the banking organization nor its counterparty may defer payments generally is an acceptable instrument for hedging the interest rate risk on trust preferred stock included in Tier 1.

¹ The conditions set forth in the Board's October 21, 1996 release authorizing the inclusion of trust preferred stock in tier 1 capital include a condition that distributions to investors in trust preferred stock be deferrable for a minimum five-year deferral period.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>.

For additional information about the above matter, please contact our Banking Supervision and Regulation Department at (415) 974-2936.

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