



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

January 23, 2006

Courtney D. Allison, Esq.  
Senior Vice President and  
Assistant General Counsel  
Wachovia Corporation  
Legal Division  
One Wachovia Center  
301 South College Street  
Charlotte, North Carolina 28288

Dear Ms. Allison:

This responds to your inquiry on behalf of Wachovia Corporation (“Wachovia”), Charlotte, North Carolina, regarding the appropriate risk-based capital treatment for Wachovia’s issuance of trust preferred securities that are mandatorily convertible into noncumulative perpetual preferred securities at a date certain. Specifically, you have requested that the Board permit Wachovia, as a bank holding company (BHC), to include in its tier 1 capital trust preferred securities that mandatorily convert into noncumulative perpetual preferred securities on the same terms and subject to the same quantitative limit as trust preferred securities that mandatorily convert into common stock.

### Background

Under the Board’s risk-based capital adequacy guidelines for BHCs (“Capital Guidelines”), an internationally active BHC generally must limit its restricted core capital elements to 15 percent of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability (“15 percent limit”).<sup>1</sup> The Capital

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<sup>1</sup> On March 4, 2005, the Board adopted a final rule amending the Capital Guidelines to change the criteria for the inclusion of capital instruments in BHCs’ tier 1 capital (the “tier 1 rule”). The final tier 1 rule changed the limits for the inclusion of restricted core capital elements in tier 1 capital, effective March 31, 2009. *See Risk-Based Capital Standards: Trust*

Guidelines contain an exception to the 15 percent limit, however, for restricted core capital elements in the form of qualifying mandatory convertible preferred securities. The Capital Guidelines permit an internationally active BHC to include restricted core capital elements in tier 1 capital up to 25 percent of its tier 1 capital (“25 percent limit”), so long as the restricted core capital elements that exceed the 15 percent limit are in the form of qualifying mandatory convertible preferred securities.<sup>2</sup>

The Capital Guidelines provide the following flexible regulatory definition of qualifying mandatory convertible preferred securities:

Qualifying mandatory convertible preferred securities generally consist of the joint issuance by a bank holding company to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralize with the securities, that obligates the investors to purchase a fixed amount of the bank holding company's common stock, generally in three years.<sup>3</sup>

Supplementary information accompanying the final tier 1 rule explains that qualifying mandatory convertible preferred securities:

provide a source of capital that is generally superior to other restricted core capital elements because they are effectively replaced by common stock, the highest form of tier 1 capital, within a few years of issuance. The high quality of these instruments is indicated by the rating agencies’ assignment of greater equity strength to mandatory convertible trust preferred securities than to cumulative or noncumulative perpetual preferred stock, even though mandatory convertible preferred securities, unlike perpetual securities, are not included in GAAP equity until the common stock is issued.<sup>4</sup>

Unlike the mandatory convertible securities described in the Capital Guidelines and the supplementary information to the final tier 1 rule, Wachovia’s securities would mandatorily convert to noncumulative

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*Preferred Securities and the Definition of Capital*, 70 Fed. Reg. 11827 (March 10, 2005).

<sup>2</sup> 12 CFR part 225, App. A, section II.A.1.b.

<sup>3</sup> 12 CFR part 225, App. A, section II.A.1.b., fn. 5.

<sup>4</sup> See *Risk-Based Capital Standards*, supra note 1 at 11831.

perpetual preferred stock instead of common stock. Therefore, you have asked the Board to clarify whether trust preferred securities that mandatorily convert to noncumulative perpetual preferred stock are eligible for the exception to the 15 percent limit afforded to qualifying mandatory convertible preferred securities under the Capital Guidelines.

### Board Interpretation

Although the regulatory definition of qualifying mandatory convertible preferred securities specifically describes an instrument convertible into common stock, that regulatory definition describes the typical, and not the exclusive, form of qualifying mandatory convertible preferred securities. For the reasons set forth below, the Board believes that qualifying mandatory convertible preferred securities also include instruments convertible into noncumulative perpetual preferred securities.

The Board based its favorable treatment of mandatory convertible preferred securities principally on the certainty that the issuer will, within a relatively short time period, replace the securities with a tier 1 capital component that is not a restricted core capital element. Although common stock remains the highest form of tier 1 capital, noncumulative perpetual preferred stock is also a high form of tier 1 capital and is not a restricted core capital element. Like common stock, noncumulative perpetual preferred securities are perpetually available to absorb losses incurred by the issuer, constitute equity under generally accepted accounting principles, and allow the issuer to waive dividends on a noncumulative basis. By allowing the noncumulative waiver of dividends, noncumulative perpetual preferred securities avoid the accumulation of deferred dividends, which could possibly impede an issuer's ability to raise additional equity during times of stress.

Accordingly, the Board has determined that qualifying mandatory convertible preferred securities that convert to noncumulative perpetual preferred securities qualify for inclusion in the tier 1 capital of internationally active BHCs (and other BHCs) in excess of the 15 percent limit applicable to the restricted core capital elements of internationally active BHCs, provided that all other terms and conditions of the securities meet the Board's requirements. Under this interpretation, Wachovia may include restricted core capital elements in its tier 1 capital up to the generally applicable 25 percent limit, provided that (as of the effective date of

the final tier 1 rule) restricted core capital elements in excess of the 15 percent limit are in the form of qualifying mandatory convertible preferred securities converting into common stock or noncumulative perpetual preferred securities. Notwithstanding this determination, the Board reaffirms its longstanding view that voting common equity is the strongest form of tier 1 capital.

This determination is based on the specific facts and circumstances described in your correspondence with Board staff and this letter. Any material change in those facts and circumstances could result in a different conclusion and should be reported to Board staff. If you have any questions about this matter, please contact Norah Barger (202-452-2402) or John Connolly (202-452-3621) in the Division of Banking Supervision and Regulation, or Mark Van Der Weide (202-452-2263) in the Legal Division.

Very truly yours,

*(signed)*

Jennifer J. Johnson  
Secretary of the Board

cc: Federal Reserve Bank of Richmond