

further detail in the proposed rule, the cumulative and non-cumulative preferred stock and the subordinated debt would be subject to additional limitations based on comparisons of the individual components of allowable capital.

When first implemented, the Basel Standards allowed national bank supervisors discretion in counting goodwill as capital during a transition period. Thus, we solicit comment on whether goodwill should be included in allowable capital for a particular transition period and, if so, the length of the transition period.

An entity's debt is not ordinarily includible in its regulatory capital. However, because debt can provide a long-term source of working capital to the entity and may have many of the characteristics of capital, the Basel Standards permit unrestricted long-term subordinated debt⁷⁰ to count as regulatory capital. Under paragraph (a)(3)(ii) of proposed Rule 17i-7, consistent with the Basel Standards, subordinated debt could be included in allowable capital if it meets four criteria. First, the original weighted average maturity of the SIBHC's subordinated debt must be at least five years. Second, the subordinated debt instrument must state clearly on its face that repayment of the debt is not protected by the Securities Investor Protection Corporation ("SIPC") or any Federal agency. Third, the debt must be unsecured and subordinated in right of payment to all senior indebtedness of the SIBHC. Fourth, the terms of the subordinated debt agreement may permit acceleration only in the event of bankruptcy or reorganization of the SIBHC under Chapters 7 (liquidation) or 11 (reorganization) of the U.S. Bankruptcy Code.

The four criteria subordinated debt would have to satisfy to be included in allowable capital are necessary to help assure permanency of capital and to inform subordinated lenders of the risks associated with being a subordinated lender. Funds lent under a subordinated debt agreement necessarily are subject to the risks of the SIBHC's business and must be available to pay other creditors if the SIBHC defaults on other obligations. Although the customers of certain of the SIBHC's affiliates may be entitled to the protection of SIPC under specific circumstances, subordinated lenders of the SIBHC would not be entitled to that protection.

Under the proposal, to be included in allowable capital, subordinated debt would be required to be unsecured and subordinated in right of payment to all of the SIBHC's senior debt. Debt that, upon default, can be repaid by conversion of collateral or before other debt could not be considered subordinated in right of repayment to all senior indebtedness of the SIBHC because the debt effectively would have priority over at least some other debt.

Subordinated debt instruments that permit acceleration of payment upon events other than bankruptcy or reorganization of the SIBHC would not qualify for inclusion in allowable capital under the proposed rules.⁷¹ Acceleration clauses raise significant supervisory concerns because repayment of the debt could be accelerated at a time when an SIBHC is experiencing financial difficulties. Acceleration, therefore, could inhibit an SIBHC's ability to resolve its financial problems in the normal course of business and force the company into involuntary bankruptcy.

We request comment on the inclusion of subordinated debt in allowable capital generally and on the following questions in particular:

- Is five years the appropriate maturity for subordinated debt to be included in allowable capital? Would another term, whether longer or shorter, be more appropriate?
- To be included in allowable capital, should subordinated debt be subject to negative pledge provisions that, for example, would restrict an SIBHC's ability to pledge the equity securities of a subsidiary to secure the debt or to sell a subsidiary unless the buyer agreed to assume liability for some portion of the debt?
- Should subordinated debt that is subject to acceleration events other than bankruptcy or reorganization of the SIBHC under the Bankruptcy Code be included in allowable capital?
- What should be the maximum amount of subordinated debt that is includible in allowable capital?
- What are the additional costs of issuing subordinated debt versus long-term debt of the same maturity?

⁷¹ The prohibition on acceleration of payment also would prohibit inclusion of credit sensitive subordinated debt in allowable capital. Credit sensitive subordinated debt ties payments to the financial condition of a borrower/holding company or its affiliates. This feature of the debt forces a holding company to make increased payments as its financial condition deteriorates and, therefore, acts as a de facto acceleration clause that may deplete the holding company's resources and increase the likelihood of default on debt. Furthermore, a credit requirement clause potentially would allow a subordinated lender to obtain payment before senior creditors.

Some industry participants have suggested that certain long-term debt that cannot be accelerated should be included in allowable capital because at the SIBHC level there is no protected class of creditors, and therefore there is no significant difference between that type of long-term debt and subordinated debt. In addition, they assert that subordinated debt is more costly to an entity than long-term debt that cannot be accelerated because of the restrictive provisions associated with, and the lack of an active trading market for, subordinated debt.

We solicit comment on whether long-term debt, subject to appropriate limitations, should be included in allowable capital. Specifically, we request comment on the following issues:

- If long-term debt is included in allowable capital, what restrictions should apply?
- Would trading in its long-term debt provide a more reliable indication of the credit quality of the SIBHC than subordinated debt and, if so, why?
- Does a holder of its subordinated debt have a greater incentive to monitor the financial condition of the SIBHC than a holder of its long-term debt because its claim is more junior?
- Are there debt instruments other than subordinated debt that provide an equivalent market signal about the credit quality of the issuer?
- Is there a material difference between the depth of the market for the long-term debt of an SIBHC and the depth of the market for its subordinated debt and, if so, how would any such difference impact the cost of financing for the SIBHC?
- Would there be any other adverse effects if the SIBHC were permitted to include long-term debt in allowable capital?
- If long-term debt could be included in allowable capital, what, if any, requirements should apply to the maturity date of the long-term debt? What events of acceleration should be permissible?
- Should long-term debt be subject to a negative pledge, that, for example, would restrict an SIBHC's ability to pledge the equity securities of a subsidiary to secure the debt or to sell a subsidiary unless the pledgor or buyer agreed to assume liability for some portion of the debt?
- What other provisions concerning the inclusion of long-term debt in allowable capital should be considered?

⁷⁰ By contract, subordinated debt is debt that is subordinated in right of payment to all senior indebtedness of the company.