FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 81-224
November 25, 1981

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Recommended Definition of Bank Capital

TO ALL STATE MEMBER BANKS AND
BANK HOLDING COMPANIES IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

To promote uniformity among the three Federal bank regulatory agencies, the Federal Financial Institutions Examination Council has recommended that the agencies adopt a broadened definition of bank capital in determining the adequacy of capital in the banks they supervise. The Council requested action by December 7, 1981.

Printed on the following pages are copies of the Council's recommended definition of commercial bank capital and the press release which more fully explains their views.

Questions regarding the recommended definition of bank capital should be directed to Marvin C. McCoy, Extension 6657, or U. (Earl) Anderson, Extension 6275, of this Bank's Bank Supervision and Regulations Department.

Additional copies of this circular will be furnished upon request to the Department of Communications, Financial and Community Affairs of this Bank, Extension 6289.

Sincerely yours,

William H. Wallace

William H. Wallace
First Vice President

Federal Financial Institutions **Examination Council**, Washington, D.C. 20219

Press Release

For immediate release November 9, 1981

The Federal Financial Institutions Examination Council today recommended to the three bank regulatory agencies represented on the Council[1/] that they adopt a broadened definition of bank capital in determining the adequacy of capital in the banks they supervise. The definition is being recommended to promote uniformity among the Federal bank regulators.

The Council requested action by the agencies by December 7. The Council acted after receiving comment on a proposal published in June.

The Council recommended that bank capital should be defined as consisting of two elements -- primary and secondary capital, as follows:

--Primary capital would consist of common and perpetual preferred stock, surplus and undivided profits, contingency and other capital reserves, mandatory convertible instruments and 100 percent of the allowances for possible loan losses.

--Secondary capital would consist of limited-life preferred stock and subordinated notes and debentures. Further, secondary capital would:

--Amount to no more than 50 percent of the amount of primary capital, and

--Financing instruments in secondary capital would be phased out of the bank's capital as they approached maturity.

1/ The Comptroller of the Currency (supervisor of national banks), the Federal Reserve Board (supervisor of State chartered banks that are members of the Federal Reserve System), and the Federal Deposit Insurance Corporation (supervisor of insured State nonmember banks).

Limited-life preferred stock and subordinated notes and debentures were viewed by the Council as having some, but not all, of the characteristics of capital and thus would be considered eligible for consideration as secondary capital if:

1. These instruments have an original weighted average maturity of at least 7 years;

2. Any serial or installment repayments, once begun, are made at least annually, with each payment no less than the previous one;

3. Together, such financing equals no more than half of the amount of primary capital; and

4. The percent of such issues considered as capital declines by a fifth each year when their maturity is less than five years distant. This would mean that such instruments would have no capital value when they have a maturity of less than a year.

The Council made clear that,although its recommendation was aimed at promoting uniformity among the Federal bank regulators, they have the flexibility to depart from the guidelines when the circumstances of a particular case warrant it. With respect to any existing secondary capital, the Council suggested that in implementing the restrictions on secondary capital, the agencies give consideration to the supervisory policies in effect at the time of issue.

A large majority of those commenting on the Council's proposed definition supported the division of capital into primary and secondary components and agreed with the Council's placement of subordinated debt and limited-life preferred stock in the secondary capital category.

Based on comments received, the Council decided to drop its proposed requirement that secondary capital instruments have an original final maturity of 10 years. Commentors noted that this requirement seemed redundant in view of the requirement that secondary capital issues have an original weighted average maturity of 7 years and the required amortization schedule for capital eligibility.

The Council had asked for comments on four specific questions in addition to general comments on its proposal. After a review of the public comments, the Council decided that: (1) limited-life preferred stock was properly placed in the secondary capital category; (2) subordinated debt and limited-life preferred stock issues that are convertible into primary capital instruments, but do not have a mandatory convertible feature, should continue to be regarded as secondary capital until such conversion actually is effected; (3) a minimum size on subordinated debt issues higher than the one currently imposed by Federal Reserve Regulations D and Q and FDIC Regulation 329.10 should not be adopted, and (4) no limit should be placed on the amount of debt that a bank can sell to other banks.

The Council's recommended definition of commercial bank capital is attached.

Attachment

RECOMMENDED DEFINITION OF BANK CAPITAL TO BE USED IN DETERMINING CAPITAL ADEQUACY

Primary Components of Bank Capital

The primary components of bank capital are considered to be:

- common stock
- perpetual preferred stock
- surplus
- undivided profits
- contingency and other capital reserves
- mandatory convertible instruments (capital instruments with covenants mandating conversion into common or perpetual preferred stock)
- allowance for possible loan losses

Secondary Components of Bank Capital

It is recognized that other financial instruments can, with certain restrictions, be considered as part of bank capital because they possess some, though not all, of the features of capital. These instruments are:

- Limited-life preferred stock
- Subordinated notes and debentures

Restrictions Relating to Secondary Components

The secondary components will be considered as bank capital under the conditions listed below.

- The issue must have an original weighted average maturity of at least seven years.
- If the issue has a serial or instalment repayment program, all scheduled repayments shall be made at least annually, once contractual repayment of principal begins, and the amount repaid in a given year shall be no less than the amount repaid in the previous year.
- The aggregate amount of limited-life preferred stock and subordinated debt qualifying as secondary capital may not exceed 50 percent of the amount of primary capital.
- As the secondary components approach maturity, redemption or payment, the outstanding balance of all such instruments -- including those with serial note payments, sinking fund provisions, or an amortization schedule -- will be amortized in accordance with the following schedule:

Years to Maturity	Percent of Issue Considered Capital
Greater than or equal to 5	100
Less than 5 but greater than or equal to 4	80
Less than 4 but greater than or equal to 3	60
Less than 3 but greater than or equal to 2	40
Less than 2 but greater than or equal to 1	20
Less than 1	0

(No adjustment in the book amount of the issue is required or expected by this schedule. Adjustment will be made by a memorandum account.)