FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT

September 15, 1987

DALLAS, TEXAS 75222

Circular 87-65

TO: The Chief Executive Officer of all member banks, bank holding companies and others concerned in the Eleventh Federal Reserve District

SUBJECT

Slip sheet with amendments to Regulation Y -- Bank Holding Companies and Change in Bank Control

DETAILS

The Board of Governors of the Federal Reserve System has published amendments in slip-sheet form to Regulation Y, effective July 1987. The new slip sheet should be inserted in Volume 2 of your Regulations Binders.

ATTACHMENTS

Attached is a slip-sheet to Regulation Y.

MORE INFORMATION

For more information, please contact Dean A. Pankonien of this Bank's Legal Department at (214) 651-6228.

Sincerely yours,

William H Wallace

Amendments to Regulation Y Bank Holding Companies and Change in Bank Control July 1987*

1. *Effective November 7, 1986, section 225.25(b)(8) is revised to read as follows:*

(8) *Insurance agency and underwriting.*

(i) *Credit insurance.* Acting as principal, agent, or broker for insurance (including home mortgage redemption insurance) that is—

(A) directly related to an extension of credit by the bank holding company or any of its subsidiaries; and

(B) limited to ensuring the repayment of the outstanding balance due on the extension of credit[7] in the event of the death, disability, or involuntary unemployment of the debtor.

(ii) *Finance company subsidiary.* Acting as agent or broker for insurance directly related to an extension of credit by a finance company[8] that is a subsidiary of a bank holding company, if—

(A) the insurance is limited to ensuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and

(B) the extension of credit is not more than $10,000, or $25,000 if it is to finance the purchase of a residential manufactured home[9] and the credit is secured by the home; and

(C) the applicant commits to notify borrowers in writing that (*1*) they are not required to purchase such insurance from the applicant; (*2*) such insurance does not insure any interest of the borrower in the collateral; and (*3*) the applicant will accept more comprehensive property insurance in place of such single-interest insurance.

(iii) *Insurance in small towns.* Engaging in any insurance-agency activity in a place where the bank holding company or a subsidiary of the bank holding company has a lending office and that—

(A) has a population not exceeding 5,000 (as shown in the preceding decennial census); or

(B) has inadequate insurance agency facilities, as determined by the Board, after notice and opportunity for hearing.

(iv) *Insurance-agency activities conducted on May 1, 1982.* Engaging in any specific insurance-agency activity[10] if the bank holding company, or subsidiary conducting the specific activity, conducted such activity on May 1, 1982, or received Board approval to conduct such activity on or before May 1, 1982.[11] A bank holding company or subsidiary engaging in a specific insurance-agency activity under this clause may—

7 "Extension of credit" includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full-payout leases that meet the requirements of paragraph (b)(5) of this section.

8 "Finance company" includes all non-deposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual states as finance companies and that engage in a significant degree of consumer lending.

9 These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

10 Nothing contained in this provision shall preclude a bank holding company subsidiary that is authorized to engage in a specific insurance-agency activity under this clause from continuing to engage in the particular activity after merger with an affiliate, if the merger is for legitimate business purposes and prior notice has been provided to the Board.

11 For purposes of this paragraph, activities engaged in on May 1, 1982, include activities carried on subsequently as the result of an application to engage in such activities pending before the Board on May 1, 1982, and approved subsequently by the Board or as the result of the acquisition by such company pursuant to a binding written contract entered into on or before May 1, 1982, of another company engaged in such activities at the time of the acquisition.

* The complete regulation, as amended effective June 16, 1987, consists of—
- the pamphlet dated February 1984 (see inside cover) and
- this slip sheet.

Item 5 is new. All other items were included in the previous slip sheet, dated November 1986.

(A) engage in such specific insurance-agency activity only at locations—

(*1*) in the state in which the bank holding company has its principal place of business (as defined in 12 USC 1842(d));

(*2*) in any state or states immediately adjacent to such state; and

(*3*) in any state in which the specific insurance-agency activity was conducted (or was approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

(B) provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982, by such bank holding company or subsidiary.

(v) *Supervision of retail insurance agents.* Supervising on behalf of insurance underwriters the activities of retail insurance agents who sell—

(A) fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries; and

(B) group insurance that protects the employees of the bank holding company or its subsidiaries.

(vi) *Small bank holding companies.* Engaging in any insurance-agency activity if the bank holding company has total consolidated assets of $50 million or less. A bank holding company performing insurance-agency activities under this paragraph may not engage in the sale of life insurance or annuities except as provided in paragraphs (i) and (iii) of this section, and it may not continue to engage in insurance-agency activities pursuant to this provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed $50 million.

(vii) *Insurance-agency activities conducted before 1971.* Engaging in any insurance-agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance-agency activities prior to January 1, 1971, as a consequence of approval by the Board prior to January 1, 1971.

2. *Effective November 7, 1986, paragraph (9) of section 225.25(b) is removed and reserved.*

3. *Effective November 7, 1986, footnotes 8, 9, and 10 (in section 225.25(b)(10) and (11)) are redesignated 12, 13, and 14, respectively.*

4. *Effective December 15, 1986, section 225.25(b) is amended by revising paragraph (13) and adding new paragraphs (19), (20), (21), (22), (23), and (24) to read as follows:*

(13) *Real estate and personal property appraising.* Performing appraisals of real estate and tangible and intangible personal property, including securities.

* * * * *

(19) *Investment advice on financial futures and options on futures.* Providing investment advice, including counsel, publications, written analyses and reports, as a futures commission merchant (FCM) authorized pursuant to paragraph (18) of this subsection or as a commodity trading advisor (CTA) registered with the Commodity Futures Trading Commission, with respect to the purchase and sale of futures contracts and options on futures contracts for the commodities and instruments referred to in paragraph (18), provided that the FCM or CTA—

(i) does not trade for its own account except for the purpose of hedging a cash position in the related government security, bullion, foreign currency, or money market instrument; and

(ii) limits its advice to financial institutions and other financially sophisticated customers that have significant dealings or holdings in the underlying commodities, securities, or instruments.

(20) *Consumer financial counseling.* Providing advice, educational courses, and instructional materials to consumers on individual financial management matters, including debt consolidation, applying for a mortgage, bankruptcy, budget management, tax planning, retirement and estate planning, insurance and general investment management, provided—

(i) educational materials and presentations used by the counselor may not promote specific products and services;

(ii) the counselor advises each customer that the customer is not required to purchase any services from affiliates; and

(iii) the counselor does not obtain or disclose confidential information concerning its customers without the customer's written consent or pursuant to legal process.

This paragraph does not authorize the provision of advice on specific products or investments or the provision of portfolio investment advice or portfolio management, which are authorized under paragraphs (3) and (4)(iii) of this subsection subject to certain fiduciary standards. If consumer financial counseling is offered by a company that also offers securities-brokerage services pursuant to paragraph (15) of this subsection, the brokerage and counseling services must be provided by different personnel and in separate offices or in separate and distinctly marked areas.

(21) *Tax planning and preparation.* Providing individuals, businesses, and nonprofit organizations tax-planning and tax-preparation services, including advice and strategies to minimize tax liabilities, and the preparation of tax forms, provided—

(i) the materials used by the tax planner or preparer do not promote other specific products and services; and

(ii) the tax planner or preparer does not obtain or disclose confidential information concerning its customers without the customer's written consent or pursuant to legal process.

(22) *Check-guaranty services.* Authorizing a subscribing merchant to accept personal checks tendered by the merchant's customers in payment for goods and services and purchasing from the merchant validly authorized checks that are subsequently dishonored, provided that the check guarantor does not discriminate against checks drawn on unaffiliated banks.

(23) *Operating collection agency.* Collecting overdue accounts receivable, either retail or commercial, provided the collection agency—

(i) does not obtain the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies; and

(ii) does not provide preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

(24) *Operating credit bureau.* Maintaining files on the past credit history of consumers and providing that information to a credit grantor who is considering a borrower's application for credit, provided that the credit bureau does not provide preferential treatment to a customer of an affiliated financial institution.

5. *Effective June 16, 1987, section 225.43(a), (c)(2), and (d) is revised to read as follows:*

(a)(1) *Filing notice.* A notice required under this subpart shall be filed with the appropriate Reserve Bank and shall contain the information required by paragraph 6 of the Change in Bank Control Act (12 USC 1817(j)(6)), or prescribed in the designated Board form. With respect to personal financial statements required by paragraph 6(B) of the Change in Bank Control Act, an individual may include a statement of assets and liabilities as of a date within 90 days of filing the notice, a brief income summary, and a description of any subsequent material changes, subject to the authority of the Reserve Bank or the Board to require additional information.

(2) *Acceptance of notice.* The 60-day notice period specified in section 225.41 of this subpart shall commence on the date all required information is received by the appropriate Reserve Bank or the Board. The Reserve Bank shall notify the person or persons submitting a notice under this subpart of the date all such required infor-

mation is received and the notice is accepted for processing.

(3) *Publication.* (i) *Newspaper announcement.* A person(s) filing a notice under this subpart shall publish, in a form prescribed by the Board, an announcement soliciting public comment on the proposed acquisition. The announcement shall be published in a newspaper of general circulation in the community in which the head office of the state member bank to be acquired is located or, in the case of a proposed acquisition of a bank holding company, in the community in which its head office is located and in the community in which the head office of each of its subsidiary banks is located. The announcement shall be published no earlier than 10 calendar days prior to the filing of the notice with the appropriate Reserve Bank and no later than 10 calendar days after acceptance of the notice by the Reserve Bank. A copy of the announcement and the publisher's affidavit of publication shall be provided to the appropriate Reserve Bank.

(ii) *Contents of newspaper announcement.* The newspaper announcement shall state—

(A) the name of each person identified in the notice as a proposed acquiror of the bank or bank holding company and the percentage of shares proposed to be acquired;

(B) the name of the bank or bank holding company to be acquired, including, in the case of a bank holding company, the name of each of its subsidiary banks; and

(C) a statement that interested persons may submit comments on the notice to the Board or the appropriate Reserve Bank for a period of 20 days or such shorter period as may be provided pursuant to paragraph (a)(3)(v) of this section.

(iii) *Federal Register announcement.* The Board will, upon filing of a notice under this subpart, publish announcement in the *Federal Register* of receipt of the notice. The *Federal Register* announcement will contain the information required under paragraphs (a)(3)(ii)(A) and (a)(3)(ii)(B) of this section and a statement that interested persons may submit comments on the proposed acquisition for a period of 15 days or such shorter period as may be provided pursuant to paragraph (a)(3)(v) of this section. The Board may waive publication in the *Federal Register* if the Board determines that such action is appropriate.

(iv) *Delay of publication.* The Board may permit delay in the publication required under paragraphs (a)(3)(i) and (a)(3)(iii) if the Board determines, for good cause shown, that it is in the public interest to grant such a delay. Requests for delay of publication may be submitted to the appropriate Reserve Bank.

(v) *Shortening or waiving notice.* In circumstances requiring prompt action, the Board may shorten the public-comment period required under this paragraph. The Board may also waive the newspaper-publication and solicitation-of-public-comment requirements of this paragraph, or it may act on a notice before the expiration of a public-comment period, if it certifies in writing that disclosure of the notice, solicitation of public comment, or delay until expiration of the public-comment period would seriously threaten the safety or soundness of the bank or bank holding company to be acquired.

(4) *Consideration of public comments.* In acting upon a notice filed under this subpart, the Board shall consider all public comments received in writing within the period specified in the newspaper or *Federal Register* announcement, whichever is later. At the Board's option, comments received after this period may, but need not, be considered.

(5) *Standing.* No person (other than the acquiring person) who submits comments or information on a notice filed under this subpart shall thereby become a party to the proceeding or acquire any standing or right to participate in the Board's consideration of the notice or to appeal or otherwise contest the notice or the Board's action regarding the notice.

* * * * *

(c) * * *

(2) *Extensions of time period.* (i) The Board may extend the 60-day period in paragraph (c)(1) of this section for an

additional 30 days by notifying the acquiring person(s).

(ii) The Board may further extend the period during which it may disapprove a notice for two additional periods of not more than 45 days each if the Board determines that—

(A) any acquiring person has not furnished all the information required under paragraph (a) of this section;

(B) any material information submitted is substantially inaccurate;

(C) it is unable to complete the investigation of an acquiring person because of inadequate cooperation or delay by that person; or

(D) additional time is needed to investigate and determine that no acquiring person has a record of failing to comply with the requirements of the Bank Secrecy Act, subchapter II of chapter 53 of title 31, United States Code.

(iii) If the Board extends the time period under this paragraph, it shall notify the acquiring person(s) of the reasons therefor and shall include a statement of the information, if any, deemed incomplete or inaccurate.

(d)(1) *Investigation and report.* After receiving a notice under this subpart, the Board or the appropriate Reserve Bank shall conduct an investigation of the competence, experience, integrity, and financial ability of each person by and for whom an acquisition is to be made. The Board shall also make an independent determination of the accuracy and completeness of any information required to be contained in a notice under paragraph (a) of this section. In investigating any notice accepted under this subpart, the Board or Reserve Bank may solicit information or views from any person, including any bank or bank holding company involved in the notice, and any appropriate state, federal, or foreign governmental authority.

(2) The Board or the appropriate Reserve Bank shall prepare a written report of its investigation, which shall contain, at a minimum, a summary of the results of the investigation.

6. *Effective November 3, 1986, appendix A is amended to read as follows:*

APPENDIX A—Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks

The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively "banking organizations"). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustments commensurate with changes in the economy, financial markets, and banking practices.

Two principal measurements of capital are used—the primary capital ratio and the total capital ratio. The definitions of primary and total capital for banks and bank holding companies and formulas for calculating the capital ratios are set forth below in the definitional sections of these guidelines.

Capital Guidelines

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally, banking organizations are expected to operate above the minimum primary and total capital levels. Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

	Total Capital Ratio
Zone 1	Above 7.0%
Zone 2	6.0% to 7.0%
Zone 3	Below 6.0%

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance-sheet activities. The Board is concerned that some banking organizations may attempt to comply with the guidelines in ways that reduce their liquidity or increase risk. Banking organizations should avoid the practice of attempting to meet the guidelines by decreasing the level of liquid assets in relation to total assets. In assessing compliance with the guidelines, the Federal Reserve will take into account liquidity and the overall degree of risk associated with an organization's operations, including the volume of assets exposed to risk.

The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance-sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint-venture activities. The Federal Reserve will review the relationship of all on- and off-balance-sheet risks to capital and will require those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance-sheet risks into the assessment of capital adequacy.

The capital guidelines apply to both banks and bank holding companies on a consolidated basis.[1] Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Consequently, in evaluating the consolidated capital positions of banking organizations, the Board is placing greater weight on the building-block approach for assessing capital requirements. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by federal or state regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

Supervisory Action

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating circumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions.

The zone into which an organization's total capital ratio falls will normally trigger

[1] The guidelines will apply to bank holding companies with less than $150 million in consolidated assets on a bank-only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and principal shareholders of the banking organization or their related interests.

the following supervisory responses, subject to qualitative analysis:

- For institutions operating in zone 1, the Federal Reserve will consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.
- For institutions operating in zone 2, the Federal Reserve will pay particular attention to financial factors, such as asset quality, liquidity, off-balance-sheet risk, and interest rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.
- For institutions operating in zone 3, the Federal Reserve will—
  —consider that the institution is undercapitalized, absent clear extenuating circumstances;
  —require the institution to submit a comprehensive capital plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and
  —institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.

Treatment of Intangible Assets for Purpose of Assessing Capital Adequacy

In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that the determination of the future benefits and useful lives of certain intangible assets may involve a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve will carefully review the level and specific character of intangible assets in evaluating the capital adequacy of state member banks and bank holding companies.

The Federal Reserve recognizes that intangible assets may differ with respect to predictability of any income stream directly associated with a particular asset, the existence of a market for the asset, the ability to sell the asset, or the reliability of any estimate of the asset's useful life. Certain intangible assets have predictable income streams and objectively verifiable values and may contribute to an organization's profitability and overall financial strength. The value of other intangibles, such as goodwill, may involve a number of assumptions and may be more subject to changes in general economic circumstances or to changes in an individual institution's future prospects. Consequently, the value of such intangible assets may be difficult to ascertain. Consistent with prudent banking practices and the principle of the diversification of risks, banking organizations should avoid excessive balance-sheet concentration in any category or related categories of intangible assets.

Bank Holding Companies

While the Federal Reserve will consider the amount and nature of all intangible assets, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital (i.e., stated primary capital less all intangible assets) or those institutions with lesser, although still significant, amounts of goodwill will be subject to close scrutiny. For the purpose of assessing capital adequacy, the Federal Reserve may, on a case-by-case basis, make adjustments to an organization's capital ratios based upon the amount of intangible assets in excess of the 25 percent threshold level or upon the specific character of the organization's intangible assets in relation to its overall financial condition. Such adjustments may require some organizations to raise additional capital.

The Board expects banking organizations (including state member banks) contemplating expansion proposals to ensure that pro forma capital ratios exceed the minimum capital levels without significant reliance on intangibles, particularly goodwill. Consequently, in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles. In acting on applications, the Board will take into account the nature and amount of intangible assets and will, as appropriate, adjust capital ratios to include certain intangible assets on a case-by-case basis.

State Member Banks

State member banks with intangible assets in excess of 25 percent of tangible primary capital will be subject to close scrutiny. In addition, for the purpose of calculating capital ratios of state member banks, the Federal Reserve will deduct goodwill from primary capital and total capital. The Federal Reserve may, on a case-by-case basis, make further adjustments to a bank's capital ratios based on the amount of intangible assets (aside from goodwill) in excess of the 25 percent threshold level or on the specific character of the bank's intangible assets in relation to its overall financial condition. Such adjustments may require some banks to raise additional capital.

In addition, state member banks and bank holding companies are expected to review periodically the value at which intangible assets are carried on their balance sheets to determine whether there has been any impairment of value or whether changing circumstances warrant a shortening of amortization periods. Institutions should make appropriate reductions in carrying values and amortization periods in light of this review, and examiners will evaluate the treatment of intangible assets during on-site examinations.

Definition of Capital to Be Used in Determining Capital Adequacy

Primary Capital Components

The components of primary capital are—

- common stock,
- perpetual preferred stock (preferred stock that does not have a stated maturity date and that may not be redeemed at the option of the holder),
- surplus (excluding surplus relating to limited-life preferred stock),
- undivided profits,
- contingency and other capital reserves,
- mandatory convertible instruments,[2]
- allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves), and
- minority interest in equity accounts of consolidated subsidiaries.
- perpetual debt instruments (for bank holding companies but not for state member banks).

Limits on Certain Forms of Primary Capital

Bank holding companies. The maximum composite amount of mandatory convertible securities, perpetual debt, and perpetual preferred stock that may be counted as primary capital for bank holding companies is limited to 33.3 percent of all primary capital, including these instruments. Perpetual preferred stock issued prior to November 20, 1985, (or determined by the Federal Reserve to be in the process of being issued prior to that date) shall continue to be included as primary capital.

The maximum composite amount of mandatory convertible securities and perpetual debt that may be counted as primary capital for bank holding companies is limited to 20 percent of all primary capital, including these instruments. The maximum amount of equity commitment notes (a form of mandatory convertible securities) that may be counted as primary capital for a bank holding company is limited to 10

[2] See the definitional section below that lists the criteria for mandatory convertible instruments to qualify as primary capital.

percent of all primary capital, including mandatory convertible securities. Amounts outstanding in excess of these limitations may be counted as secondary capital provided they meet the requirements of secondary capital instruments.

State member banks. The composite limitations on the amount of mandatory convertible securities and perpetual preferred stock (perpetual debt is not primary capital for state member banks) that may serve as primary capital for bank holding companies shall not be applied formally to state member banks, although the Board shall determine appropriate limits for these forms of primary capital on a case-by-case basis.

The maximum amount of mandatory convertible securities that may be counted as primary capital for state member banks is limited to $16\frac{2}{3}$ percent of all primary capital, including mandatory convertible securities. Equity commitment notes, one form of mandatory convertible securities, shall not be included as primary capital for state member banks, except that notes issued by state member banks prior to May 15, 1985, will continue to be included in primary capital. Amounts of mandatory convertible securities in excess of these limitations may be counted as secondary capital if they meet the requirements of secondary capital instruments.

Secondary Capital Components

The components of secondary capital are—

- limited-life preferred stock (including related surplus) and
- bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

The secondary components must meet the following conditions to qualify as capital:

- The instrument must have an original weighted-average maturity of at least seven years.
- The instrument must be unsecured.
- The instrument must clearly state on its face that it is not a deposit and is not insured by a federal agency.
- Bank debt instruments must be subordinated to claims of depositors.
- For banks only, the aggregate amount of limited-life preferred stock and subordinate debt qualifying as capital may not exceed 50 percent of the amount of the bank's primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

Capital Ratios

The primary and total capital ratios for bank holding companies are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components}}{\text{Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

Total capital ratio:

$$\frac{\text{Primary capital components + Secondary capital components}}{\text{Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

The primary and total capital ratios for state member banks are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components} - \text{Goodwill}}{\text{Average total assets} + \text{Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)} - \text{Goodwill}}$$

Total capital ratio:

$$\frac{\text{Primary capital components} + \text{Secondary capital components} - \text{Goodwill}}{\text{Average total assets} + \text{Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)} - \text{Goodwill}}$$

Generally, period-end amounts will be used to calculate bank holding company ratios. However, the Federal Reserve will discourage temporary balance-sheet adjustments or any other "window dressing" practices designed to achieve transitory compliance with the guidelines. Banking organizations are expected to maintain adequate capital positions at all times. Thus, the Federal Reserve will, on a case-by-case basis, use average total assets in the calculation of bank holding company capital ratios whenever this approach provides a more meaningful indication of an individual holding company's capital position.

For the calculation of bank capital ratios, "average total assets" will generally be defined as the quarterly average total assets figure reported on the bank's Report of Condition. If warranted, however, the Federal Reserve may calculate bank capital ratios based upon total assets as of period-end. All other components of the bank's capital ratios will be based upon period-end balances.

Criteria for Determining Primary Capital Status of Mandatory Convertible Securities

Mandatory convertible securities are subordinated debt instruments that are eventually transformed into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as primary capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: equity contract notes (securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal) and equity commitment notes (securities that are redeemable only with the proceeds from the sale of common or perpetual preferred stock). Both equity commitment notes and equity contract notes qualify as primary capital for bank holding companies, but only equity contract notes qualify as primary capital for banks.

Criteria Applicable to Both Types of Mandatory Convertible Securities

a. The securities must mature in 12 years or less.

b. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank or bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities. Nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.

c. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

d. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. In the event that the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.

e. An issuer that intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (i.e. the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock) generally must make such a dedication during the quarter in which the new common or preferred stock is issued.[3] As a general rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.[4]

Additional Criteria Applicable to Equity Contract Notes

a. The note must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The obligation of the holder to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.

b. A stock purchase contract may be separated from a security only if (1) the holder of the contract provides sufficient collateral[5] to the issuer, or to an independent trustee for the benefit of the issuer, to ensure performance under the contract and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

Additional Criteria Applicable to Equity Commitment Notes

a. The indenture or note agreement must contain the following two provisions:

1. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation certified by an authorized agent of the issuer showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)

2. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.[6]

[3] Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

[4] The dedication procedure is necessary to ensure that the primary capital of the issuer is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as primary capital. De minimis amounts (in relation to primary capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year-end.

[5] Collateral is defined as (1) cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; or (4) other collateral as may be designated from time to time by the Federal Reserve.

[6] The funded portions of the securities will be deducted from primary capital to avoid double counting.

b. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve immediately will cease to treat the unfunded securities as primary capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment and will be taken into consideration by the Board in acting on statutory applications.

c. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

Criteria for Determining the Primary Capital Status of Perpetual Debt Instruments of Bank Holding Companies

a. The instrument must be unsecured and, if issued by a bank, must be subordinated to the claims of depositors.

b. The instrument may not provide the noteholder with the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.

c. The issuer shall not voluntarily redeem the debt issue without prior approval of the Federal Reserve, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.

d. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the isuer to defer interest payments on the perpetual debt in the event of, and at the same time as the elimination of dividends on all outstanding common or preferred stock of the issuer (or in the case of a guarantee by a parent company at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.

e. If issued by a bank holdng company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed by its parent, the debt may convert to the shares of the issuer or guarantor and such conversion may be triggered when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.