FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 7674
July 24, 1975]

PROPOSED AMENDMENTS TO REGULATIONS D AND Q

Issuance of Subordinated Debt

*To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

Following is the text of a statement issued July 2 by the Board of Governors of the Federal Reserve System:

The Board of Governors of the Federal Reserve System today issued for comment guidelines to be applied by the Board in evaluating requests for approval of new subordinated debt issues proposed by State member banks as an addition to the bank's capital structure.

The guidelines were issued in connection with proposed amendments, being issued at the same time, to Regulation D (Reserve Requirements) and Regulation Q (Interest on Deposits) with respect to issuance of subordinated debt. The regulatory revisions would apply to all member banks.

Comment on the Board's proposals is invited through August 29, 1975.

The regulatory amendments were proposed as a means of providing greater flexibility in the requirements member banks must meet when they issue subordinated notes and debentures for the purpose of adding to the bank's capital structure.

The proposed amendments to Regulations D and Q would:

1. Replace the present requirement that an obligation of a member bank have an original maturity of at least seven years with a provision for average maturity of seven years under certain conditions.

—As an alternative, the Board is considering whether the seven-year minimum maturity should be retained for unamortized issues, and a ten-year maturity be set for amortized issues, with repayment beginning anytime, provided that all scheduled repayments are made annually and none is less than that of the year before. For amortized issues, this could result in a five-year average maturity.

2. Permit a bank's obligations, under certain circumstances to be issued in denominations of less than the present minimum of $500, with prior Board approval.

3. Require the approval of the appropriate Federal bank regulatory agency for redemption of a debt issued prior to maturity, including any repayment in connection with acceleration of maturity in the event of default.

If adopted, the amendments—and guidelines—would apply to applications for new debt issues acted upon after the effective date of the amendments.

The guidelines—applying to State member banks—proposed in connection with the Board's consideration of the proposed regulatory amendments, would be used by the Board in deciding whether to approve bank plans for new issues of subordinated notes and debentures as an addition to the bank's capital structure.

The Comptroller of the Currency has advised the Board that he is considering use of the same guidelines in evaluating applications from national banks for approval of supplemental debt issues.

Application of these proposed criteria is intended among other things, to promote the accumulation by State member banks issuing new debt of an adequate cushion of equity capital, to assure that a bank's earnings are adequate to service additional debt, to protect against undue concentration of maturing debt in any one year, and to prevent the inclusion of terms in such issues that could be regarded as being in conflict with the public interest.

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In issuing the guidelines for comment, the Board stressed that they are not to be regarded—and would not be administered—as a rigid set of rules in addition to those set forth in Regulations D and Q. Rather, they would be administered flexibly, taking into account the circumstances of particular banks. These circumstances might include the urgency of the bank's need for additional equity capital, the availability of new equity, the prospective growth of the bank, the impact of unusual income and expenses on recent earnings, and the relative strength of nonbank affiliates or subsidiaries. The Board provided a set of numerical examples to assist banks in evaluating the proposed guidelines.

The proposed guidelines are:

1. Debt to equity ratio: The total amount of outstanding subordinated capital notes and debentures of a bank, including the debt proposed to be issued, should not exceed 50 per cent of the bank's equity capital base. Banks with significant asset or management problems generally would not be presumed to be entitled to go this high. For this test, a bank's equity capital base includes capital stock, surplus, undivided profits, capital reserves and all reserves for losses on loans or securities.

2. Earnings coverage test: In general, average adjusted net income of a State member bank during the preceding five years should exceed total fixed charges by a multiple of at least three. Before tax net income would include securities gains or losses, exclude extraordinary charges and credits, and would be adjusted where necessary to reflect actual loan loss experience in lieu of other provision for loan loss. Total fixed charges include annual interest charges before taxes on all existing debt as well as the new debt proposed to be issued, including all outstanding mortgage debt and capital notes and debentures, plus one-third of lease charges.

This guideline sets forth further requirements for the debt of a bank that is a subsidiary of a holding company.

3. Retained earnings test: Annual *pro forma* amortization on all subordinated notes and debentures, including the issue proposed, should not exceed 50 per cent of a State member bank's average retained earnings over the preceding five years. Retained earnings include net income after taxes minus dividends declared on common and preferred stocks. *Pro forma* amortization would be ascertained by dividing the original amount of an issue by the number of years from the date of issue to maturity. The Board said that considerable discretion would be used in the administration of this test, to the end that the particular circumstances of individual banks were given due weight.

4. Accumulation of equity over the life of the debt: Over the lifetime of the debt, the issuing bank would be expected to replace a debt issue with equity, in equal annual amounts, by the time of maturity.

5. Debt retirement: Where the amount to be repaid on a debt issue at maturity, together with scheduled repayments in that year on other debt of the bank would exceed 15 per cent of the bank's capital base at the date of a new issue, the bank shall provide for reducing the amount of debt outstanding at maturity by a sinking fund or other debt retirement arrangement, or have the right to call such an obligation for redemption at least five years before maturity.

6. Interbank transactions: In general, the Board does not intend to approve a capital note or debenture issued by a State member bank directly or indirectly to another bank, except in compelling circumstances.

7. Covenants in conflict with the public interest: No contract governing the issuance of a subordinated capital note or debenture by a State member bank shall include any covenants, restrictions or other terms that are determined by the Board to be inconsistent with the public interest.

Printed on the following pages is the text of the proposed amendments to Regulations D and Q. Comments thereon should be submitted by August 29, 1975, and may be sent to our Bank Regulations Department.

Alfred Hayes,
President.

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PROPOSED AMENDMENTS TO REGULATIONS D & Q

ISSUANCE OF SUBORDINATED DEBT

FEDERAL RESERVE SYSTEM

[12 CFR Part 204 and 217]

[Reg. D and Reg. Q]

RESERVES OF MEMBER BANKS AND INTEREST ON DEPOSITS

Definition of Deposits—Subordinated Notes

The Board of Governors proposes to amend Regulations D (12 CFR 204) and Q (12 CFR 217) to provide greater flexibility to the requirements for exemption from deposit treatment under both regulations where a member bank issues certain subordinated notes and debentures for the purpose of adding to the bank's capital structure. These amendments would (1) modify the present requirement that an obligation have an original maturity of seven years or more to permit an obligation (or an issue of obligations) to have an average maturity of seven years or more under certain conditions; (2) modify the present requirement that an obligation must be in an amount of at least $500 to permit exceptions to be made by the appropriate Federal banking agency to the $500 minimum denomination (a) to facilitate sale of convertible debt where, in order to satisfy preemptive rights of shareholders, the bank would be required to issue a convertible obligation of less than $500 face amount; (b) to maintain a ratable unit offering to holders of preemptive rights where a subordinated debt obligation is issued exclusively as a part of a unit including shares of stock which are subject to such preemptive rights; (c) to satisfy shareholders' ratable claims where an obligation is issued wholly or partially in exchange for shares of voting stock or assets pursuant to a plan of merger, consolidation, reorganization, or other transaction where the issuer will acquire either a majority of such shares of voting stock or all or substantially all of the assets of the entity whose assets are being acquired; and (3) require the issuing bank to receive the approval of the appropriate Federal banking agency of any redemption prior to maturity or any payment pursuant to acceleration of maturity in event of default. Under the proposal, the Board would retain the option to deny a request that it waive the amount limitation in those instances in which it determines that reasonable alternatives are available to the party seeking the waiver. If adopted, the amendments would apply to applications for new debt issues acted upon after the effective date of the amendments and would not affect the status of any outstanding issues. In all cases, the appropriate Federal banking agency is the Comptroller of the Currency for national banks and the Board of Governors for State member banks.

Since 1966, the Board has exempted from reserve requirements of Regulation D and interest rate limits of Regulation Q certain subordinated debt issues of member banks by providing an exception to the definition of deposits under Regulations D and Q. Upon review of the existing regulation, the Board believes that, in certain circumstances, greater flexibility should be available to permit member banks to receive approval from the appropriate Federal banking agency for subordinated note and debenture issues that may not conform to the existing regulatory requirements.

Under the proposal, regular debt amortization or retirement could begin at any time so long as the weighted average maturity of the obligation or issue of obligations would be at least seven years and so long as once the reduction of principal begins, all scheduled repayments of principal shall be made annually in an amount no less than the previous scheduled payment. As an alternative, the Board is considering whether the seven-year minimum maturity should be retained for unamortized issues and a ten-year minimum maturity be set for amortized issues, with repayment beginning at any time after the date of issue provided that once repayment of principal begins, all scheduled repayments shall be made annually in an amount no less than the prior scheduled repayment.

The proposed exception to the $500 minimum denomination would facilitate sale of convertible debt where, in order to satisfy preemptive rights of stockholders, an issuing bank would be required to issue obligations in face amounts less than $500. An exception to the $500 minimum denomination is also proposed where, in order to maintain a ratable unit offering to holders of preemptive rights in the case of a subordinated debt obligation issued exclusively as part of a unit which includes shares of stock which are subject to such preemptive rights, an issuing bank would be required to issue obligations in face amounts less than $500. The third proposed exception to the $500 minimum denomination requirement would apply where an issuing bank would be required to issue obligations in face amounts less than $500 in order to satisfy shareholders' ratable claims in the case of an obligation which is issued wholly or partially in exchange for shares of voting stock or assets pursuant to a plan of merger, consolidation, reorganization, or other transaction in which the issuer will acquire either a majority of such share of voting stock or all or substantially all the assets of another entity.

The provisions requiring prior approval of redemption and payment pursuant to acceleration of maturity are meant to permit the appropriate Federal banking agency to assess the impact of such payment on the capital structure of the bank.

Pursuant to its authority under section 19 of the Federal Reserve Act (12 U.S.C. 461) to define the terms used in that section, its authority to examine member banks under section 9 of the Federal Reserve Act (12 U.S.C. 325), its authority to take action to stop unsafe and unsound banking practices (12 U.S.C. 1818b), and related provisions of the law, the Board proposes to amend Regulation D (12 CFR 204) and Regulation Q (12 CFR 217) as follows:

1. Section 204.1 would be amended by revising paragraph (f)(3) as follows:

§ 204.1 Definitions.

* * * * *

(f) *Deposits as including certain promissory notes and other obligations.* For the purposes of this Part, the term "deposits" also includes a member bank's liability on any promissory note, acknowledgement of advance, due bill, banker's acceptance, or similar obligation (written or oral) that is issued or undertaken by a member bank as a means of obtaining funds to be used in its banking business, except any such obligation that:

* * * * *

(3)(i) Bears on its face, in bold-face type, the following: "This obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation"; is subordinated to the claims of depositors, is unsecured, and is ineligible as collateral for a loan by the issuing bank and also expressly states said provisions on its face; has a maturity of at least seven years, or, in the case of an obligation or issue that provides for scheduled repayments of principal, has an average maturity[6] of at least seven years* and provides that once repayment of principal begins, all scheduled repayments shall be made annually in an amount no less than the prior scheduled repayment; is issued subject to a requirement that no repayment (other than an approved regularly scheduled repayment), including but not limited to a payment pursuant to acceleration of maturity, may be made without the prior written approval of the appropriate Federal banking agency;[7] is in an amount of at least $500 except that the appropriate Federal banking agency may approve the issuance of an obligation that is less than $500 if the obligation is convertible into common stock and, in order to satisfy the preemptive rights of shareholders, the issuing bank would be required to issue obligations in an amount of less than $500, or if the obligation is issued exclusively as part of a unit including shares

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[6] The "average maturity" of an obligation or issue repayable in scheduled periodic payments shall be the time-weighted average of all such scheduled payments.

* The Board is also considering whether the 7-year minimum maturity should be retained for unamortized issues and a 10-year minimum maturity be set for amortized issues with repayment beginning at any time after the date of issue provided that, once repayment of principal begins, all scheduled repayments shall be made annually in an amount no less than the prior scheduled repayment.

[7] For the purposes of this part, the "appropriate Federal banking agency" is the Comptroller of the Currency in the case of a national bank and the Board of Governors in the case of a State member bank.

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of stock which are subject to such preemptive rights and, in order to maintain a ratable unit offering to holders of preemptive rights, the issuing bank would be required to issue obligations in an amount of less than $500, or where, in the case of an obligation issued wholly or partially in exchange for shares of voting stock or assets pursuant to a plan of merger, consolidation, reorganization, or other transaction where the issuer will acquire either a majority of such shares of voting stock or all or substantially all of the assets of the entity whose assets are being acquired, and in order to satisfy shareholders' ratable claims, the issuing bank would be required to issue obligations in an amount of less than $500; and has been approved by the appropriate Federal banking agency as an addition to the capital structure of the issuing bank; or (ii) meets all of the requirements in the preceding clause except maturity and with respect to which the appropriate Federal banking agency has determined that exigent circumstances require the issuance of such obligation without regard to the provisions of this part; or (iii) was issued or publicly offered before June 30, 1970, with an original maturity of more than two years; or

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2. Section 217.1 of Regulation Q would be amended by revising the introductory paragraph in paragraph (f) & (f) (3) as follows:

§ 217.1 Definitions

* * * * *

(f) *Deposits as including certain promissory notes and other obligations.* For the purposes of this Part, the term "deposits" also includes a member bank's liability on any promissory note, acknowledgment of advance, due bill, or similar obligation (written or oral) that is issued or undertaken by a member bank principally as a means of obtaining funds to be used in its banking business, except any such obligation that:

* * * * *

(3) (i) Bears on its face, in bold-face type, the following: "This obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation"; is subordinated to the claims of depositors, is unsecured, and is ineligible as collateral for a loan by the issuing bank and also expressly states said provisions on its face; has a maturity of at least seven years, or, in the case of an obligation or issue that provides for scheduled repayments of principal, has an average maturity[6] of at least seven years[*] and provides that once repayment of principal begins, all scheduled repayments shall be made annually in an amount no less than the prior scheduled repayment; is issued subject to a requirement that no repayment (other than an approved regularly scheduled repayment), including but not limited to a payment pursuant to acceleration of maturity, may be made without the prior written approval of the appropriate Federal banking agency;[7] is in an amount of at least $500 except that the appropriate Federal banking agency may approve the issuance of an obligation that is less than $500 if the obligation is convertible into common stock and, in order to satisfy the preemptive rights of shareholders, the issuing bank would be required to issue obligations in an amount of less than $500, or if the obligation is issued exclusively as part of a unit including shares of stock which are subject to such preemptive rights and, in order to maintain a ratable unit offering to holders of preemptive rights, the issuing bank would be required to issue obligations in an amount of less than $500, or where, in the case of an obligation issued wholly or partially in exchange for shares of voting stock or assets pursuant to a plan of merger, consolidation, reorganization, or other transaction where the issuer will acquire either a majority of such shares of voting stock or all or substantially all of the assets of the entity whose assets are being acquired, and in order to satisfy shareholders' ratable claims, the issuing bank would be required to issue obligations in an amount of less than $500; and has been approved by the appropriate Federal banking agency as an addition to the capital structure of the issuing bank; or (ii) meets all of the requirements in the preceding clause except maturity and with respect to which the appropriate Federal banking agency has determined that exigent circumstances require the issuance of such obligation without regard to the provisions of this part; or (iii) was issued or publicly offered before June 30, 1970, with an original maturity of more than two years.

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In connection with its consideration of the regulatory amendments proposed herein, the Board also has determined that State member banks should be provided with guidance as to the criteria to be applied by the Board in evaluating requests for approval of new issues of subordinated notes and debentures "as an addition to the bank's capital structure."

In acting upon requests from State member banks for approval of proposed issues of subordinated notes and debentures, the Board takes into account various aspects of the applicant's financial condition and its prospective capacity to service the proposed debt in view of the bank's earnings history and capital structure. Application of these criteria is intended also to promote the accumulation by debt-issuing banks of an adequate cushion of equity capital, protect against undue concentrations of maturing debt in any one year, and prevent the inclusion of terms in such issues that could be regarded as in conflict with the public interest. In addition, it is stressed that the guidelines set forth below, as applied by the Board are not intended to provide or be administered in a manner resulting in a rigid set of requirements in addition to those set forth in Regulations D and Q. Rather, they are to be administered flexibly, taking into account the special circumstances of particular applicants. (These might include the urgency of the bank's need for additional capital and the accessibility of additional equity, the prospective growth of the bank, the impact of unusual income and expense developments on recent earnings, and the relative strength of earnings of nonbank affiliates or subsidiaries.)

By publication of these guidelines which the Board intends to use in its evaluation of applications for such exemption, the Board also invites comments from the public on these criteria at the same time as comments are received on the regulatory amendments proposed herein.

The Comptroller of the Currency has advised the Board that he is considering use of the same guidelines in evaluating applications from national banks for approval of subordinated debt issues pursuant to 12 CFR 14.5.

GUIDELINE-CRITERIA FOR EVALUATING DEBT ISSUES AS ADDITION TO A STATE MEMBER BANK'S CAPITAL STRUCTURE

1. *Maximum ratio of debt to equity.* The total amount of subordinated notes and debentures outstanding, including the debt proposed to be issued, should not exceed 50 per cent of a bank's equity capital base. However, banks with significant asset or management problems generally would not be presumed to be entitled to issue debt capital up to the 50 per cent ceiling. A bank's equity capital base, for purposes of this test, is considered to include capital stock, surplus, undivided profits, capital reserves, and all reserves for losses on loans and securities.

2. *Earnings coverage test.* The total of fixed charges as a result of any issue of subordinated notes or debentures should not exceed 33⅓ per cent of a State member bank's average net income before taxes and before fixed charges over the preceding five years. Therefore, in general, average adjusted net income should exceed total fixed charges by a multiple of at least three. For purposes of this test, before-tax net income would include securities gains or losses, exclude extraordinary charges and credits, and would be adjusted where necessary to reflect actual loan loss experience rather than other "provision for loan loss." Total fixed charges include annual interest

[6] The "average maturity" of an obligation or issue repayable in scheduled periodic payments shall be the time-weighted average or all such scheduled payments.

[*] The Board is also considering whether the 7-year minimum maturity should be retained for unamortized issues and a 10-year minimum maturity be set for amortized issues, with repayment beginning at any time after the date of issue provided that once repayment of principal begins, all scheduled repayments shall be made annually in an amount no less than the prior scheduled repayment.

[7] For the purposes of this part, the "appropriate Federal banking agency" is the Comptroller of the Currency in the case of a national bank and the Board of Governors in the case of a State member bank.

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charges before taxes on all existing debt as well as the new debt proposed to be issued. Fixed charges on existing debt would include interest on all outstanding mortgage debt and subordinated notes and debentures, plus one-third of lease contracts.

In applying this test to a bank that is a subsidiary of a holding company which shows a net deficit on its nonbank operations, the amount of such deficit, calculated on a before-tax basis, would be substracted from net income as derived from the paragraph above. To determine the amount, if any, of net deficit on nonbank operations, net income before taxes of the bank would be substracted from consolidated net income before taxes of the holding company. For multibank holding companies, the nonbank net deficit generally would be allocated among subsidiary banks in proportion to their net income. Ordinarily, the adjustment would be based on data for the most recent year, but, in some cases, an average (covering not more than the most recent five years) would be more representative of prospective earnings experience. This adjustment, in effect, would reduce the allowable amount of new fixed interest expense which could be asumed by any bank whose nonbank affiliates, including the parent holding company, incur an aggregate net deficit. The offset against the bank's earnings recognizes the possibility that the parent might have to rely on dividends from the bank in order to cover a nonbank deficit, thereby reducing the bank's ability to maintain or build its equity capital.

3. *Retained earnings test.* Annual *pro forma* amortization on all subordinated notes and debentures, including the proposed debt issue, should not exceed 50 per cent of a State member bank's average retained earnings over the preceding five years. Retained earnings under this criterion are considered to include net income after taxes minus dividends declared on common and preferred stock. For each issue of subordinated debt, including a proposed new issue, annual pro forma amortization would be calculated by dividing the original amount of the issue by the number of years from date of issue to maturity. Total pro forma amortization would be the sum of annual pro forma amortization for all outstanding and proposed issues.

Considerable discretion would be used in the administration of this test. In some circumstances, banks which have issued additional shares of equity capital during the five-year period for which average retained earnings are calculated would receive credit for these new issues as if they had been part of retained earnings. In addition, some banks which have outstanding substantial amounts of relatively short-term subordinated debt prior to the issuance of these guidelines would be granted special consideration in the application of the retained earnings test to proposed new issues, so long as the new issues were part of a specified program aimed at replacing shorter-term debt with longer-term debt.

4. *Accumulation of equity over the life of the debt.* Each State member bank issuing subordinated notes and debentures would be expected to accumulate equity, in equal annual installments from retained earnings, in an amount sufficient to increase equity capital by the full amount of outstanding and newly issued debt over the lifetime of the debt. In effect, this requirement would provide for replacement of each debt issue with equity by maturity.

5. *Provision for debt retirement.* Where the residual amount of a proposed new debt issue to be repaid at maturity, together with scheduled repayments in that year on other debt-type capital and mortgage indebtedness, would exceed 15 per cent of the bank's present capital base, the bank shall either provide for reducing the amount of debt outstanding at maturity by a sinking fund or other debt-retirement arrangement or have the right to call such obligations for redemption at least five years before maturity.

6. *Approval of interbank debt transactions.* In general, the Board does not intend to approve a subordinated note or debenture issued by a State member bank directly or indirectly (through a holding company or otherwise) to another bank as an addition to the issuing bank's capital structure unless specifically authorized as such an addition by the Board of Governors upon a presentation and finding of compelling circumstances. Such transactions provide no additional capital protection for the banking system as a whole and ordinarily will be discouraged.

7. *Covenants in conflict with the public interest.* No indenture or other contract covering the issuance of a subordinated note or debenture by a State member bank shall include any covenants, restrictions, or other terms which are determined by the Board to be inconsistent with the public interest. Examples of such terms are those regarded as impairing the ability of the bank to comply with statutory or regulatory requirements regarding disposition of assets or incurrence of additional debt, limiting the ability of the Board or the chartering authority to take any necessary action to resolve a problem bank situation, unduly interfering with the ability of the bank to conduct normal banking operations, or imposing terms and conditions on the bank that are unduly harsh or onerous.

Examples of Proposed Guideline Criteria 1, 2 and 3

The following calculations demonstrate the application of Tests 1, 2, and 3 of the guideline-criteria for evaluating debt issues. The data used in the calculations are for a hypothetical bank, wholly-owned by a one-bank holding company. Where applicable, items that are reported in the Consolidated Report of Income and Consolidated Report of Condition are designated by their line numbers on the required reports. For example, [RI-A10] refers to net income as reported in Section A, line 10 of the Report of Income. Total assets, as reported on line 14 of the Report of Condition would be identified as [RC-14]. All dollar amounts are in thousands of dollars. (Banks that are required to file a Consolidated Report of Condition including foreign and domestic subsidiaries would use amounts shown in that report, rather than those shown in the Consolidated Report of Condition including only domestic subsidiaries.)

The hypothetical bank presently has outstanding two issues of subordinated debt:

(1) $8,000—8 percent Subordinated debentures, due Sept. 15, 1987.

(2) $7,000—10 percent Capital notes, due June 30, 1980.

It proposes, on January 1, 1975, to issue $9 million of additional subordinated debt on terms described in the illustrations that follow.

Test 1: Maximum Ratio of Debt to Equity

Guideline. The total amount of subordinated notes and debentures outstanding, including subordinated debt proposed to be issued, should not exceed 50 percent of a bank's equity capital base.

Calculations

Item	Amount
1. Subordinated notes and debentures outstanding, Dec. 31, 1974 (RC-34)	$15,000
2. Equity capital, total, Dec. 31, 1974 (RC-35)	50,000
3. Total reserves on loans and securities, Dec. 31, 1974 (RC-33)	10,000
4. Equity capital base (line 2 plus line 3)	60,000
5. Current ratio of subordinated debt to equity capital base (line 1 divided by line 4)	.25
6. Amount of proposed new issue	9,000
7. Subordinated debt, including proposed new issue (line 1 plus line 6)	24,000
8. Ratio of subordinated debt, including proposed new issue, to equity capital base (line 7 divided by line 4)	.40

Conclusion. Since the ratio of subordinated debt, including the proposed new issue (line 8), does not exceed 50 percent, test 1 is met.

Test 2: Earnings Coverage Test

Guideline. In general, average annual adjusted net income over the past 5 years should exceed total fixed charges, including the annual interest charge on the proposed new issue, by a multiple of at least 3.

Calculations

Item	Amount
9. Income before income taxes and securities gains or losses, 1970–74 average (RI-A3)	$9,740
10. Net securities gains or losses, before tax effect, 1970–74 average (RI-A6 (col. 1))	290
11. Provision for loan losses, 1970–74 average (RI-A21)[1]	230
12. Net chargeoffs on loans, 1970–74 average (RI-D6 (col. 1 plus 2) minus RI-D3 (col. 1 plus 2))[1]	260

[1] Banks using actual net chargeoffs as the amount of their provision for loan losses need make no entries in lines 11 and 12.

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13. Nonbank deficit of holding company, if any, 1974 [2] (enter only if negative number) .... (800)
14. Average adjusted net income before income taxes, 1970–74 (line 9 plus line 10 plus line 11 minus line 12 plus line 13) 9,200

15. Interest on subordinated notes and debentures, 1974 (RI–A2f) .. 1,340
16. Interest on mortgage debt, 1974 .. 660
17. ⅓ of lease payments on bank premises and equipment, 1974 .. 1,000

18. Fixed charges on present obligations (line 15 plus line 16 plus (line 17) 3,000

19. Average adjusted net income before fixed charges on present obligations (line 14 plus line 18) 12,200
20. Current earnings coverage ratio (line 19 divided by line 18) 4.07
21. Annual interest charge on proposed new issue (assumes a 9 percent annual rate) 810

[2] This adjustment to net income is made only if the bank is a subsidiary of a holding company that incurs a net deficit in its nonbank operations. The nonbank deficit, calculated on a before-tax basis, is the negative difference obtained by subtracting the consolidated net income of the bank from the consolidated net income of the holding company, both adjusted in the manner illustrated in lines 9 through 12 of this example. Ordinarily, the adjustment for a nonbank deficit would be based on data for the most recent year, but in some cases, an average covering no more than the most recent 5 years would be more representative of prospective earnings experience.

22. Average adjusted net income, before fixed charges on present obligations and interest charge on proposed new issue (line 19 plus line 21) 13,010

23. Fixed charges on present obligations and interest charge on proposed new issue (line 18 plus line 21) 3,810

24. Earnings coverage ratio, including interest charge on proposed new issue (line 22 divided by line 23) 3.41

Conclusion. The earnings coverage ratio, including the interest charge on the proposed new issue (line 24) equals 3.41 and therefore meets the requirements of test 2.

TEST 3: RETAINED EARNINGS TEST

Guideline. Average annual retained earnings over the past 5 years should exceed the annual pro forma amortization on all subordinated notes and debentures, including the proposed new issue, by a multiple of at least 2. Two illustrations are provided below. The first example (lines 30a through 32a) assumes a final maturity of 10 years. The second example (lines 30b through 32b) assumes a final maturity of 20 years.

Calculations

25. Net income, 1970–74 average (RI–A10) $8,000

26. Cash dividends declared on common and preferred stock, 1970–74 average (RI–B3a plus RI–B3b) 4,000

27. Average annual retained earnings, 1970–74 (line 25 minus line 26) 4,000

28. Pro forma amortization of existing debt (total of col. 4 below) .. 1,533

(1) Description of issue	(2) Amount of original issue	(3) Years from date of issue to date of maturity	(4) Pro forma amortization (col. 2 divide by col. 3)
8 percent subordinated debentures	$8,000	15	$533
10 percent capital notes	7,000	7	1,000
Total	15,000		1,533

29. Current retained earnings ratio (line 27 divided by line 28) 2.61

Assuming a 10-year final maturity on proposed new issue:

30a. Pro forma amortization of proposed new issue (line 6 divided by a final maturity of 10 years) $900

31a. Total pro forma amortization, including proposed new issue line 38 plus line 30a) 2,433

32a. Retained earnings ratio, including proposed new issue (line 27 divided by line 31a) 1.64

Conclusion. Under an assumed final maturity of 10 years for the proposed new issue, the bank's retained earnings ratio of 1.64 (line 32a) would not meet the minimum requirement of test 3.

Calculations

Assuming a 20-year final maturity on proposed new issue:

30b. Pro forma amortization of proposed new issue (line 6 divided by a final maturity of 20 years) $450

31b. Total pro forma amortization, including proposed new issue (line 28 plus line 30b) 1,983

32b. Retained earnings ratio, including proposed new issue (line 27 divided by line 31b) 2.02

Conclusion. The longer final maturity of 20 years results in a retained earnings ratio of 2.02 (line 32b) which passes the minimum acceptable ratio for test 3.

To aid in the consideration of the proposed amendments to Regulations D and Q by the Board and to facilitate the evaluation of the appropriateness and effectiveness of the guideline-criteria set forth herein, interested persons are requested to submit relevant data, views, or arguments. Any such material should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received not later than August 29, 1975. Such material will be made available for inspection and copying upon request, except as provided in § 261.6(a) of the Board's rules regarding availability of information.

By order of the Board of Governors, July 1, 1975.

[SEAL] THEODORE E. ALLISON, *Secretary of the Board.*

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