

FEDERAL RESERVE BANK  
OF NEW YORK

[ Circular No. 8792 ]  
April 9, 1980

FORMATION OF SMALL ONE-BANK HOLDING COMPANIES

Policy on Assessing Financial Factors

*To All Commercial Banks and Bank Holding Companies  
in the Second Federal Reserve District:*

The Board of Governors of the Federal Reserve System has issued a policy statement setting forth the criteria for assessing financial factors in considering applications for the formation of small one-bank holding companies. The new policy is designed to facilitate the change in ownership of small banks and to help maintain the safety and soundness of the banking system.

The following is quoted from the Board's announcement of the new policy:

The new policy applies to one-bank holding companies meeting both of the following conditions: total assets of approximately \$150 million or less and no significant nonbank activities that use large amounts of debt in their businesses.

It permits acquisition by one-bank holding companies of small community banks under revised terms. The new terms continue in more flexible form the Board's standing policy of permitting transfer of ownership of such banks on less demanding terms than those the Board applies in considering applications involving larger banks.

The Board gave this background to its proposal:

In acting on applications filed under the Bank Holding Company Act, the Board has adopted, and continues to follow, the principle that bank holding companies should serve as a source of strength for their subsidiary banks. . . .

The Board believes that a high level of debt at the parent holding company level impairs the ability of a bank holding company to provide financial assistance to subsidiary bank(s), and in some cases the servicing requirements on such debt may be a significant drain on the bank's resources. For these reasons, the Board has not favored the use of acquisition debt in formations of bank holding companies. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board, therefore, has permitted the formation of small one-bank holding companies with debt levels higher than would be permitted for larger or multibank holding companies.

While continuing to adhere to these principles, the Board has reexamined the factors which apply to small one-bank holding company applications with a view to improving the flexibility of these companies in dealing with their debt obligations.

Past policy called for repayment of all acquisition debt within 12 years, while maintaining a satisfactory level of capital in the company's bank subsidiary.

The revised policy provides that the holding company's debt to equity ratio be reduced to no more than 30 percent within 12 years, which is approximately the level maintained by many multibank holding companies.

This can be accomplished by direct debt repayment, or by building up equity through the retention of earnings, or both.

The new policy requires that capital in the subsidiary bank be maintained at no less than 8 percent of assets, and allows for reasonable holding company dividends and the use of preferred stock as equity under certain conditions.

A copy of the Board's policy statement is enclosed. Questions thereon may be directed to our Domestic Banking Applications Department (Tel. No. 212-791-5861).

ANTHONY M. SOLOMON,  
*President.*

FEDERAL RESERVE SYSTEM

POLICY STATEMENT  
FOR ASSESSING FINANCIAL FACTORS IN  
THE FORMATION OF SMALL ONE-BANK HOLDING COMPANIES  
PURSUANT TO THE BANK HOLDING COMPANY ACT  
(Docket No. R-0265)

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Policy Statement

SUMMARY: In the interest of improving the transferability of ownership of small community banks and facilitating local ownership of such institutions, as well as helping to maintain the safety and soundness of the banking system, the Federal Reserve Board has adopted a policy for assessing financial factors in the formation of small one-bank holding companies.

DATE: The policy statement is effective March 28, 1980.

POLICY STATEMENT  
OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
FOR ASSESSING THE FINANCIAL FACTORS IN  
THE FORMATION OF SMALL ONE-BANK HOLDING COMPANIES  
PURSUANT TO THE BANK HOLDING COMPANY ACT

In acting on applications filed under the Bank Holding Company Act, the Board has adopted, and continues to follow, the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely upon the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect upon the financial condition of the company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company level impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank and in some cases the servicing requirements on such debt may be a significant drain on the bank's resources. For these reasons the Board has not favored the use of acquisition debt in the formation of bank holding companies. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board therefore has permitted the formation of small one-bank holding companies with debt levels higher than would be permitted for larger or multibank holding companies. Approval of these applications has been given on the condition that the small one-bank holding companies demonstrate the ability to service the acquisition debt without straining the capital of their subsidiary bank and, further, that such companies restore their ability to serve as a source of strength for their subsidiary bank within a relatively short period of time.

In the interest of furthering its policy of facilitating the transfer of ownership in banks without diluting bank safety and soundness, the Board has reexamined the analytical framework and financial criteria it applies when considering the formation of small one-bank holding companies and has adopted certain revisions in its procedures and standards as described below.

The revised criteria shift the focus from debt repayment to the relationship between debt and equity at the parent holding company. The holding company will have the option of improving the relationship of debt to equity by repaying the principal amount of its debt or through the retention of earnings, or both. Under these procedures, newly organized small one-bank holding companies will be expected to reduce the relationship of their debt to equity over a reasonable period of time to a level comparable to that maintained by many large and multibank holding companies.

In general, this policy is intended to apply only to one-bank holding companies that would not have significant leveraged nonbank activities and whose subsidiary bank would have total assets of approximately \$150 million or less at the time the application is filed. Small one-bank holding companies formed before the effective date of this policy may switch to a plan that adheres to the intent of this policy provided they comply with criteria 2, 3, and 4 set forth below.

The criteria are as follows:

#### General

In evaluating applications filed pursuant to Section 3(a)(1) of the Bank Holding Company Act, as amended, when the applicant intends to incur debt to finance the acquisition of a small bank, the Board will take into account a full range of financial and other information, including the recent trend and stability of earnings of the bank, the past and prospective growth of the bank, the quality of the bank's assets, the ability of the applicant to meet debt servicing requirements without placing an undue strain on the bank's resources, and the record and competency of management of the applicant and the bank. In addition, the Board will require applicants to meet the minimum requirements set forth below. As a general rule, failure to meet any of these requirements will result in denial of the application; however, the Board reserves the right to make exceptions if the circumstances warrant.

#### 1. Minimum Down Payment

The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank to be acquired. When the owner(s) of the holding company incur debt to finance the purchase of the bank, such debt will be considered acquisition debt even though it does not represent an obligation of the bank holding company, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank or bank holding company.

#### 2. Maintenance of Adequate Capital

An applicant proposing to use acquisition debt must demonstrate to the satisfaction of the Board that any debt servicing requirements to which the bank holding company may be subject would not cause the subsidiary bank's ratio of

gross capital to assets to fall below 8 percent during the 12-year period following consummation of the acquisition. Gross capital is defined as the sum of total stockholders' equity, the allowance for possible loan losses, and subordinated capital notes and debentures.

### 3. Reduction in Parent Company Leverage

The applicant must demonstrate to the satisfaction of the Board that the parent holding company's ratio of debt to equity will decline to 30 percent within 12 years after consummation of the acquisition. The holding company must also demonstrate that it will be able to safely meet debt servicing and other requirements imposed by its creditors.

The term "debt," as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds.

The term "equity," as used in the ratio of debt to equity, means the total stockholders' equity of the bank holding company adjusted to reflect the periodic amortization of "goodwill" (defined as the excess of cost of any acquired company over the sum of the amounts assigned to identifiable assets acquired, less liabilities assumed) in accordance with generally accepted accounting principles. In determining the total amount of stockholders' equity, the bank holding company should account for its investments in the common stock of subsidiaries by the equity method of accounting.

Ordinarily the Board does not view redeemable preferred stock as a substitute for common stock in a one-bank holding company formation. Nevertheless, to a limited degree and under certain circumstances the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: 1) the preferred stock is redeemable only at the option of the issuer and 2) the debt to equity ratio of the holding company would be at or remain below 30 percent following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.

### 4. Dividend Restrictions

The bank holding company is not expected to pay any corporate dividends on common stock until such time as its debt to equity ratio is below 30 percent. However, some dividends may be permitted provided all of the following conditions are met: a) the applicant has begun making scheduled repayments of principal on the acquisition debt; b) such scheduled repayments of principal are reasonable in amount, will be made at least annually, and will allow for the retirement of the acquisition debt over a period not to exceed 25 years; and c) the applicant can clearly demonstrate at the time the application is filed that such dividends will not jeopardize the ability of the holding company to reduce its debt to equity ratio to 30 percent within 12 years of consummation of the proposal or cause the gross capital to assets of the subsidiary bank to fall below 8 percent over the same period. Also, it is expected that dividends will be eliminated if the holding company is not meeting the projections made at the time the application was

filed regarding the ability of the holding company to reduce the debt to equity ratio to 30 percent within 12 years of consummation of the proposal.

Board of Governors of the Federal Reserve System, March 28, 1980.

(signed) Theodore E. Allison

---

Theodore E. Allison  
Secretary of the Board