FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 9100
July 3, 1981]

Proposed Definition of Bank Capital For Determining Capital Adequacy

*To All Banking Institutions
in the Second Federal Reserve District:*

Following is the text of a statement issued by the Federal Financial Institutions Examination Council:

The Federal Financial Institutions Examination Council proposed a broadened definition of bank capital for the use of the three Federal bank regulatory agencies[1] in determining the adequacy of capital in the banks they supervise.

The Council requested comment by August 31, 1981. The Council made its proposal to promote uniformity among the Federal bank regulators.

The Council proposed that bank capital should be defined as consisting of two elements – primary and secondary capital.

Under the Council's proposal, primary capital would consist of common and perpetual preferred stock, surplus and undivided profits, contingency and other capital reserves, mandatory convertible instruments and 100 percent of the allowances for possible loan losses.

The Council proposed that secondary capital consist of limited-life preferred stock and subordinated notes and debentures. As proposed, secondary capital would:

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

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

The Council noted that the agencies would continue to stress the importance of an adequate level of primary capital for the safe and sound operation of banks.

Limited-life preferred stock and subordinated notes and debentures were viewed by the Council as having some, but not all, of the characteristics of capital and thus would be considered eligible for consideration as [*secondary capital if certain conditions delineated in the text of the proposal are met*].

The Council made clear that although its proposal was aimed at promoting uniformity among the Federal bank regulators, the individual agencies have the flexibility to depart from the guidelines when the circumstances of a particular case warrant it.

The Council's views are set forth in more detail in the attached notice. The Council welcomes comment on all aspects of its proposal, but would particularly like to receive comment on the specific questions noted in the text of the proposal.

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

Printed on the following pages is the text of the Council's proposal, which has been reprinted from the *Federal Register*. Comments thereon should be submitted by August 31, 1981, and may be sent to our Banking Studies Department.

ANTHONY M. SOLOMON,
President.

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FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Proposed Definition of Bank Capital To Be Used in Determining Capital Adequacy; Request for Comments

AGENCY: Federal Financial Institutions Examination Council.

ACTION: Notice.

SUMMARY: The Federal Financial Institutions Examination Council is proposing to recommend a uniform definition of capital for use by the three federal bank supervisory agencies (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency) for purposes of determining the adequacy of bank capital for supervisory purposes. The Examination Council is taking this action in order to promote uniformity in supervisory policies among the bank regulatory agencies.

Extensive analysis of the proper role of bank capital and the appropriate components of bank capital has been carried out by the Examination Council and its interagency Staff Task Force on Supervision. This analysis placed special emphasis on the types of financial instruments that should be considered components of bank capital as well as appropriate restrictions to be applied to the use of particular types of financial instruments. A major conclusion of this analysis is that bank capital should be divided into two components, primary and secondary, for purposes of defining bank capital for making supervisory determinations regarding capital adequacy. The primary components are characterized principally by their permanence and include common and perpetual preferred stock, surplus, undivided profits, contingency and other capital reserves, mandatory convertible instruments, and 100 percent of the allowance for possible loan losses. The secondary components of capital include limited-life preferred stock and subordinated notes and debentures. These financial instruments posses certain features of capital, but they lack permanence because they have maturity or redemption dates. Furthermore, in the case of subordinated debt instruments, any default on required interest payments could result in accelerating the maturity date. It is recognized that preferred stock carries a contractual obligation to pay dividends; but so long as omission of such payments does not mandate retirement of the issue in the case of perpetual preferred, or acceleration of the redemption date in the case of limited-life preferred, such contractual obligations should not be considered in making the distinction between primary and secondary components of capital.

The Examination Council seeks public comment on the proposed definition of bank capital to be used in determining capital adequacy and on the various issues related to this definition and the implementation of the proposed definition by the federal bank supervisory agencies.

EFFECTIVE DATE: Comments on the proposed definition of bank capital must be received on or before August 31, 1981.

ADDRESS: Comments should be sent to Executive Secretary, Federal Financial Institutions Examination Council, 490 L'Enfant Plaza, SW, Washington, DC 20219, (202) 447–0939. Comments will be available for public inspection and photocopying.

FOR FURTHER INFORMATION CONTACT: David K. Schweitzer, Deputy Executive Secretary, Federal Financial Institutions Examination Council, 490 L'Enfant Plaza, SW, Washington, D.C. 20219, (202) 287–4206.

SUPPLEMENTARY INFORMATION: The principal drafter of this document was Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council. The Federal Financial Institutions Examination Council proposes to recommend a definition of bank capital for use by the three federal bank regulatory agencies in determining the adequacy of bank capital for supervisory purposes.

Functions of Bank Capital

The primary functions of bank capital are to: (1) help ensure that the bank can continue its operations during the periods when it experiences low earnings or losses; (2) provide protection for uninsured depositors and unsecured creditors of a bank; (3) help ensure that the inherent risks in banking are appropriately distributed between the public and private sectors; (4) help maintain public confidence in individual banks and in the banking system; and (5) provide a source of funds for banking operations.

The principal features of bank capital that enable it to serve these functions are: its permanence; the absence of contractual payments that, if omitted, could accelerate the maturity date of an issue; and the status of its holders as residual claimants to the assets of the bank. Financial instruments that have envolved in financial markets have these three features in widely varying degrees. Consequently, delineating all financial instruments as either capital or non-capital instruments would be overly arbitrary because it would fail to provide for some gradation in the capital-like qualities found among the myriad financial instruments available in the markets. The Examination Council believes, therefore, it is desirable to allow for two categories of capital in banks; these are referred to in the proposed definition as the primary components and secondary components of bank capital.

Primary Components of Capital

The components that the Council regards as being in the primary category are those having all or virtually all of the three features of capital. Clearly, common and perpetual preferred stock, surplus, and undivided profits possess these features. Mandatory convertible instruments, i.e., those with convenants mandating conversion into common or perpetual preferred stock, ultimately will possess them, though for an interim period there may be some required contractual payments which make them slightly less perfect as capital instruments than, say, common stock. With the capital reserves (other than contingency reserves) and allowances for possible loan losses, there is some lack of permanence because the reserves or allowance are established with the expectation that there will be some drawings on them in the normal course of a bank's operations. Generally, however, the loan loss and other capital reserves are quickly rebuilt because of the close scrutiny paid to such matters in financial markets and by the supervisory agencies. Thus, such reserves and allowances tend in reality to have a high degree of permanence, which justifies their inclusion as a primary component of capital. In the case of contingency reserves, they are established out of undivided profits for possible liabilities. Generally, the probability that such reserves will be drawn down is not known; hence, their inclusion in primary capital is warranted.

Secondary Components of Capital

The secondary components of capital included in the proposed definition, i.e., limited-life preferred stock and subordinated notes and debentures, possess some of the features of bank capital, but in one or more respects fall below those encompassed in the primary components. Both subordinated debt and limited-life preferred stock lack permanence and subordinated debt involves required interest payments as well. On the other hand, they possess to

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a considerable degree some of the important attributes of capital. Although they stand ahead of common stock holders in their claim on the bank's assets, their subordinate position to depositors and other creditors of a bank provides important protection to those parties. Also, while the two secondary components are not permanent, they provide relatively long-term protection to depositors and other creditors if the maturity, redemption or payment dates are several years or more in the future.

Because the secondary components do not have the features of bank capital to the degree that the primary components do, the Examination Council believes that four restrictions should be placed upon the use of such financial instruments in order for them to be counted as capital in determining capital adquacy. First, to provide a sufficient degree of continuance to a secondary capital instrument, any issuance must have an original final maturity of at least ten years and an original, weighted average maturity of at least seven years. Second, to help ensure that the desired continuance is achieved, the Council proposes to require—in the case of an obligation or issue that provides for any type of scheduled repayments of principal—that once repayment begins, all repayments shall be made at least annually and the amount repaid each year shall be no less than in the previous year. Third, the Council believes there should be an upper limit on the amount of secondary components that can be counted as capital and is proposing a limit equal to 50 percent of the amount of primary capital. Fourth, the Council believes that as the secondary components approach maturity, or interim payments become due, there must be clear recognition of the progressive loss of the "permanence" aspect of the instrument. The Council proposes to take this factor into account by amortizing secondary components with a remaining life of less than 5 years. Specifically, the Council proposes to count fully the secondary components as capital as long as their maturity, redemption or payment dates are 5 years or more away. Below 5 years, the qualifying balance of secondary capital instruments approaching maturity, redemption or payment would be reduced by 20 percentage points per year; for example, only 80 percent of the amount of the secondary components maturing or due for payment between 4 and 5 years would be counted as capital, 60 percent between years 3 and 4, and so forth, with those maturing or due in less than one year not counted as capital at all.

Supervisory Agency Flexibility

The definition being proposed by the Examination Council has, as one of its purposes, promoting uniformity in supervisory policies among the federal banking agencies represented on the Council. The individual supervisory agencies, however, may approve issuances that do not fully conform to the definition or may insist on more stringent conditions than those proposed if the circumstances of a particular case warrant such action. In particular, because the secondary capital components do not possess the characteristics of capital to the extent that the primary components do, the agencies will continue to stress the importance of an adequate level of primary capital for the safe and sound operation of banks.

In reviewing applications by banks to issue secondary captial instruments, the three federal bank supervisory agencies will continue to take into account, among other things, the following factors: (1) the overall condition of the bank, including trends in that condition, with particular scrutiny accorded to problem banks; (2) the ability of the bank to meet all principal and interest payments on the financial instrument; (3) if an applicant bank is a subsidiary of a holding company, the overall condition of the consolidated organization, especially its consolidated level of debt and capital; and (4) any provision of the financial instrument, such as the imposition of operating restraints on the bank, that would impair the bank's or the supervisory agency's flexibility to deal with changed circumstances.

It should be noted that, in the event of liquidation of a bank, the claims of the holders of secondary capital instruments are subordinated to any claims of the Federal Deposit Insurance Corporation arising out of the depositors' subrogation of their claims to the FDIC, or are subordinated to claims of the FDIC against any of the assets of the bank associated with a merger or purchase and assumption transaction pursuant to Section 13(e) of the Federal Deposit Insurance Act.

Specific Requests for Public Comment

The Examination Council welcomes comment on any aspect of its proposal. The Council would, however, appreciate specific comments on the following questions and issues.

(1) Should limited-life preferred stock be regarded as primary rather than secondary capital? In the proposed definition, both limited-life preferred stock and subordinated noted and debentures are regarded as secondary capital components. Both types of financial instruments lack permanence, and, therefore, would in any event be amortized as they approach their redemption or maturity dates in accordance with the amortization schedule for the secondary capital components. There is a difference, however, in that subordinated debt is a liability and preferred stock is an equity instrument. Also, subordinated debt involves interest payments, while preferred stock does not; and any default on required interest payments could result in accelerating the maturity date of the subordinated debt instruments. Are the differences in the two types of instruments of sufficient importance to warrant counting the eligible amount of limited-life preferred stock as "primary" capital; or, as the Examination Council is proposing, should the lack of permanence be the controlling factor in the decision on whether a financial instrument is considered a primary or secondary component of bank capital?

(2) Should securities that are convertible, but do not have a mandatory convertible feature, be treated differently from non-convertible securities? The proposed definition draws no distinction, but the fact that a debt instrument might be converted to common stock could make such an instrument move akin to capital than a debt instrument without a provision for convertibility. The Examination Council requests comment on the factors that should be taken into account, other than simply the convertibility feature, if such a distinction were to be made.

(3) Federal reserve Regulations D and Q and FDIC Regulation 329.10 currently impose a minimum size of $500 on subordinated debt issues if they are to be exempt from reserve requirements and interest rate limitations. Should there be a higher, more restrictive, minimum size, for example $25,000? A higher minimum size would help ensure that such issues are not confused by their purchasers with insured deposit instruments.

(4) Should there be a limit placed on the amount of subordinated debt that a bank can sell to other banks, such as $5 million? When one bank sells its subordinated debt to other banks, the increase in capital of the issuing bank does not result in any real increase in capital for the banking system. It may be desirable, therefore, to impose some type of limit on the amount an individual bank can sell to other banks.

The Council's proposed definition of bank capital, issued pursuant to the

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authority of section 1006 of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (12 U.S.C. section 3305), follows.

Primary Components of Bank Capital

The federal bank regulatory agencies consider the primary components of bank capital to be:

- Common stock
- Perpetual preferred stock
- Surplus
- Undivided profits
- Contingency and other capital reserves
- Mandatory convertible instruments (capital instruments with covenants mandating conversion into common or perpetual preferred stock.)
- Allowance for possible loan losses

Secondary Components of Bank Capital

That agencies recognize that other financial instruments can, with certain restrictions, be considered as part of bank capital because they posses some, though not all, of the features of capital. These instruments are:

- Limited-life preferred stock
- Subordinated notes and debenture

Restrictions Relating to Secondary Components

The agencies will consider the secondary components as bank capital under the conditions listed below.

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

Years to maturity	Percent of issue consid-ered capital
Greater than or equal to 5	100
Less than 5 but greater than or equal to 4	80
Less than 4 but greater than or equal to 3	60
Less than 3 but greater than or equal to 2	40
Less than 2 but greater than or equal to 1	20
Less tha 1	

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

Dated June 17, 1981.

Robert J. Lawrence,

Executive Secretary/FFIEC.

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