FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 9201
December 17, 1981]

Definition of Bank Capital For Determining Capital Adequacy

To All State Member Banks in the Second Federal Reserve District:

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

The Federal Reserve Board has adopted a broadened definition of bank capital for its use in determining the adequacy of capital in State member banks.

The definition was recommended to the Federal Reserve and to the other Federal bank regulators by the Federal Financial Institutions Examination Council in the interests of promoting uniformity among Federal bank regulators.

In adopting the Council's recommended definition of capital — set forth below — the Board made it clear that the definition applies only to bank capital and does not apply to the definition of capital for bank holding companies. The Board did indicate that in the application of the definition, it would take into account the level of bank equity represented by the proceeds of debt issued by the parent holding company. The Board expressed concern about the possibility of undue bank purchases of the subordinated debt of other banks and indicated that the level of such activity would be monitored through the examination process.

The Council's recommendations to the Federal regulators on bank capital made it clear that the regulators would have flexibility to depart from the recommended guidelines when warranted by the circumstances of particular cases.

Under the new definition, bank capital would consist of two main elements:

— *Primary capital* consisting of common and perpetual preferred stock, surplus and undivided profits, contingency and other capital reserves, mandatory convertible instruments and 100 percent of funds set aside as reserves for possible loan losses.

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

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

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

Limited-life preferred stock and subordinated notes and debentures would be considered eligible for consideration as secondary capital only if:

1. These instruments have an original weighted average maturity of at least 7 years;
2. Any serial or installment repayments, once begun, are made at least annually, with each payment no less than the previous one;
3. Together, such financing equals no more than half the amount of a bank's primary capital; and,
4. The percent of such issues considered as capital declines by a fifth each year when their maturity is less than five years distant. This would mean that such instruments would have no capital value when they have a maturity of less than a year.

With respect to any existing secondary capital, the Board will give consideration to supervisory standards relating to bank capital that were in effect at the time of the issue.

Printed on the following pages is the full text of the new definition. Questions thereon may be directed to our Bank Analysis Department (Tel. No. 212-791-6710).

Anthony M. Solomon,
President.

DEFINITION OF BANK CAPITAL
TO BE USED IN DETERMINING CAPITAL
ADEQUACY OF STATE MEMBER BANKS

Primary Components of Bank Capital

The primary components of bank capital are considered to be:

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

Secondary Components of Bank Capital

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

- -- Limited-life preferred stock
- -- Subordinated notes and debentures

Restrictions Relating to Secondary Components

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

- -- The issue must have an original weighted average maturity of at least seven years.

-- If the issue has a serial or 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--will be amortized in accordance with the following schedule:

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

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

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