FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **9301**
May 27, 1982]

Criteria for Determining Primary Capital
Status of Mandatory Convertible Securities

To All State Member Banks and Bank Holding Companies
in the Second Federal Reserve District:

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

The Federal Reserve Board has made public criteria for determining whether debt securities issued by State member banks and bank holding companies with a mandatory requirement for future conversion to equity can qualify as primary capital in assessing capital adequacy.

The Board will begin immediately to apply these criteria — also adopted for national banks by the Office of the Comptroller of the Currency — to mandatory convertible issues of State member banks and bank holding companies. However, the Board asked for comment on the criteria, to be submitted to the Secretary of the Board by June 24, 1982. Any changes subsequently made in the criteria would apply to securities issued after the revision.

The Board, and the Comptroller, earlier adopted guidelines for assessing bank and bank holding company capital adequacy to be used by the two agencies in the examination and supervision of financial institutions they supervise. The guidelines recognized as primary capital common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves, the allowance for possible loan losses and mandatory convertible instruments. The criteria now issued are meant to clarify the characteristics mandatory convertible issues must have if they are to be included in primary capital.

The Board stressed that any organization that now has a capital deficiency should regard the sale of mandatory convertible securities as making up for the deficiency and not as the basis for additional leverage.

Enclosed is the text of the policy statement on the criteria for determining the primary capital status of mandatory convertible securities, which is effective immediately. If you have any questions regarding mandatory convertible securities, please contact our Bank Analysis Department (Tel. No. 212-791-6710).

Comments on the criteria should be submitted by June 24, 1982 and may be sent to that Department.

Anthony M. Solomon,
President.

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FEDERAL RESERVE BOARD
OFFICE OF THE COMPTROLLER OF THE CURRENCY

CRITERIA FOR DETERMINING PRIMARY CAPITAL STATUS OF
MANDATORY CONVERTIBLE SECURITIES

On December 17, 1981, the Federal Reserve and the Office of the Comptroller of the Currency issued capital adequacy guidelines that are now being used by these agencies in assessing the capital of well managed national banks, state member banks and bank holding companies. In implementing this capital program, the agencies are using two principal capital measurements: (1) primary capital, and (2) total capital. Primary capital consists of common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves, mandatory convertible instruments and the allowance for possible loan losses. Total capital includes the primary capital components plus limited life preferred stock and qualifying subordinated notes and debentures.

As indicated, one of the components of primary capital is mandatory convertible securities. Historically, banking organizations have issued mandatory convertible securities only on rare occasions. Recently, there has been a sizable amount of securities sold that were designed to qualify as mandatory convertible securities. A number of banking organizations have expressed interest in marketing similar securities and have inquired as to whether the terms and conditions of their proposals would qualify the issue for regulatory treatment as part of the institution's primary capital. In view of this interest, the Federal Reserve and the Office of the Comptroller of the Currency have developed a set of criteria that will be applied in determining whether a particular issue

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qualifies as primary capital. In developing the criteria, the Agencies wish to stress that the principal determinant is the permanence of the funds and the certainty with which the debt issue will be replaced by permanent equity. In this respect, there have thus far been two basic approaches to the concept of mandatory convertible securities. The first is a so-called "equity note" which obligates the holder of the note to purchase a like amount of stock in the issuing institution. The second involves a note which obligates the issuer to sell stock in sufficient amounts to replace the debt obligation. In determining whether securities qualify as primary capital, the following criteria will be applied.

Securities with mandatory stock purchase contracts

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

b. A stock purchase contract can be separated from a security and held separately only if the holder of the contract provides sufficient collateral[1/] to the issuer, or to an independent trustee for the benefit of the issuer, to assure performance under the contract.

1/ Collateral is defined as:

a. cash or certificates of deposit;

b. U.S. government securities that will mature prior to 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;

c. standby letters of credit issued by a U.S. bank that is not an affiliate of the issuer; or

d. other collateral as may be designated from time to time by the regulators.

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Securities payable from sale of common or perpetual preferred stock

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

b. The securities indenture must contain the following provisions:

1. The issuer of the securities will establish a fund (identifiable from the records of the bank or with a separate trustee) solely from the sale of common or perpetual preferred stock. This fund will be the sole source of repayment of the securities.

2. By the time that one-third of the life of the securities has run, the issuer must have paid into the fund from the sale of common or perpetual preferred stock 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 paid into the fund from the sale of common or perpetual preferred stock an amount equal to two-thirds of the original principal of the securities. The issuer must have paid into the fund from the sale of common or perpetual preferred stock an amount equal to the final one-third of principal of the securities at least 60 days prior to the maturity of the securities.

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

The funded portions of the securities will be deducted from primary capital to avoid double counting. If the issuer fails to meet any of these periodic funding requirements, its supervisor immediately will cease to treat the unfunded securities as primary capital.

General provisions applicable to any type of mandatory convertible issues

a. The aggregate amount of mandatory convertible securities must not exceed 20 percent of primary capital other than mandatory convertible securities.

b. The issuer may redeem securities prior to maturity only with the proceeds of the sale of common or perpetual preferred stock of the bank or bank holding company or with the approval of its primary supervisor.

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c. The holder of the security cannot accelerate the payment of principal except in the event of bankruptcy, insolvency or reorganization.

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

Any questions on the above criteria for determining the primary capital status of mandatory convertible securities should be directed to Samuel H. Talley (202-452-3354) or Anthony G. Cornyn (202-452-3450) of the Board's Division of Banking Supervision and Regulation.

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