# FEDERAL RESERVE BANK
# OF NEW YORK

[ Circular No. 9374
October 7, 1982 ]

## Amended 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 reaffirmed, with one substantial change, its criteria adopted in May for determining whether debt securities with a mandatory requirement for future conversion to equity can qualify as part of the primary capital of State member banks and bank holding companies.

The Board began applying the criteria immediately after adoption, but invited comment from the public. The amendment of the criteria announced today was adopted after consideration of comment received. It applies only to securities issued after September 27, 1982. The Comptroller of the Currency is announcing similar amendment of these criteria, for national banks.

The amendment limits the issue of equity commitment notes to 10 percent of primary capital exclusive of mandatory convertible issues. The Board left unchanged the requirement that equity notes and equity commitment notes together may not make up more than 20 percent of such primary capital of a banking organization. Certain technical revisions were also made.

Equity commitment notes and equity notes are the two forms in which mandatory convertible debt has been issued recently by banking organizations.

The Board placed a cap on equity commitment notes to encourage banking institutions to rely more on equity notes in issuing mandatory convertible securities. It is the Board's view that there is greater assurance that equity notes will be transformed into equity by the time of maturity than is the case with equity commitment notes.

Equity commitment notes are issued with an undertaking by the issuer to sell sufficient equity during the life of the notes — up to 12 years — to build up a fund to liquidate the notes at maturity. Their transformation into stock may thus depend on circumstances over a considerable period of time.

In contrast, the contract attached to issues of equity notes obligates the holder of the notes to buy common or perpetual preferred stock of the issuer at a specified price at or before maturity of the notes, thus making conversion of the debt to equity almost certain.

In view of its desire to encourage the growth of equity in the primary capital of banking organizations, the Board views equity notes as a more desirable form of primary capital.

Printed on the following pages is the text of the policy statement on the revised criteria for determining the primary capital status of mandatory convertible securities. The amendment applies to securities issued after September 27, 1982. If you have any questions regarding mandatory convertible securities, please contact our Bank Analysis Department (Tel. No. 212-791-6710).

ANTHONY M. SOLOMON,
*President.*

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CRITERIA FOR DETERMINING THE PRIMARY CAPITAL STATUS OF MANDATORY CONVERTIBLE SECURITIES

The Federal Reserve Board has established the following criteria that mandatory convertible securities issued by state member banks and bank holding companies must meet in order to be counted as primary capital for purposes of capital adequacy analysis. These criteria will be applied to the two types of mandatory convertible securities that banking organizations have issued: (1) securities with mandatory stock purchase contracts; and (2) securities payable from the sale of common or perpetual preferred stock.

Provisions applicable to both types of mandatory convertible securities

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

b. The aggregate amount of mandatory convertible securities which will be included for regulatory purposes for evaluating capital adequacy cannot exceed 20 percent of primary capital other than mandatory convertible securities.[1/]

c. 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.

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

e. 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.

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1/ In addition, for regulatory analysis of capital adequacy the aggregate amount of securities payable from the sale of common or perpetual preferred stock cannot exceed 10 percent of primary capital other than mandatory convertible securities. See page 3, item d.

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Provisions applicable only to securities with mandatory stock purchase contracts

a. The 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.

b. The stock purchase contract must require the purchase of either common or perpetual preferred stock.

Provisions applicable only to securities payable from the sale of common or perpetual preferred stock

a. The securities indenture must contain the following two provisions:

1. The issuer will establish an identifiable and segregated fund solely from the sale of common or perpetual preferred stock, the proceeds of which will be the sole source of repayment for 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 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 an amount equal to two-thirds

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1/ Collateral is defined as:

a. cash or certificates of deposit;

b. U.S. government securities that will mature prior to or simultaneous with the 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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of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have paid into the fund an amount equal to the entire original principal of the securities. Payments into the fund must come only from the sale of common or perpetual preferred stock.1/

b. 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.

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

d. For regulatory analysis of capital adequacy, the aggregate amount of securities payable from the sale of common or perpetual preferred stock cannot exceed 10 percent of primary capital other than mandatory convertible securities.

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1/ The funded portions of the securities will be deducted from primary capital to avoid double counting.

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