

*At-Lin. No. 9892*

July 8, 1985

To All Depository Institutions in the Second  
Federal Reserve District, and Others Maintaining  
Sets of Board Regulations:

Enclosed are copies of an amendment to Regulation H, "Membership of State Banking Institutions in the Federal Reserve System," and an amendment to Regulation Y, "Bank Holding Companies and Change in Bank Control," both effective May 15, 1985, issued by the Board of Governors of the Federal Reserve System in connection with its recently revised guidelines regarding capital adequacy for State member banks and bank holding companies. The amendment to Regulation H incorporates by reference the capital adequacy guidelines set forth in the amendment to Regulation Y. These guidelines were announced in our Circular No. 9846, dated April 29, 1985.

Questions regarding these capital adequacy guidelines may be directed to our Bank Analysis Department (Tel. No. 212-791-6611).

Circulars Division  
FEDERAL RESERVE BANK OF NEW YORK

## Amendment to Regulation H Membership of State Banking Institutions in the Federal Reserve System May 1985\*

---

*Effective May 15, 1985, section 208.13 is added to read as follows:*

### SECTION 208.13—Capital Adequacy

The standards and guidelines by which the capital adequacy of state member banks will be evaluated by the Board are set forth in appendix A to the Board's Regulation Y, 12 CFR 225.

---

\* The complete regulation, as amended effective May 15, 1985, consists of—

- the regulation pamphlet dated May 1982 (see inside cover) and
- this slip sheet.



## Amendment to Regulation Y Bank Holding Companies and Change in Bank Control May 1985\*

*Effective May 15, 1985, appendix A is amended to read as follows:*

### APPENDIX A—Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks

The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively "banking organizations"). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustments commensurate with changes in the economy, financial markets, and banking practices.

Two principal measurements of capital are used—the primary capital ratio and the total capital ratio. The definitions of primary and total capital for banks and bank holding companies and formulas for calculating the capital ratios are set forth below in the definitional sections of these guidelines.

### Capital Guidelines

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally, banking organizations are expected to operate above the minimum primary and total capital levels.

Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

	<i>Total Capital Ratio</i>
Zone 1	Above 7.0%
Zone 2	6.0% to 7.0%
Zone 3	Below 6.0%

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance-sheet activities. The Board is concerned that some banking organizations may attempt to comply with the guidelines in ways that reduce their liquidity or increase risk. Banking organizations should avoid the practice of attempting to meet the guidelines by decreasing the level of liquid assets in relation to total assets. In assessing compliance with the guidelines, the Federal Reserve will take into account liquidity and the overall degree of risk associated with an organization's operations, including the volume of assets exposed to risk.

The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance-sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint-venture activities. The Federal Reserve will review the relationship of all on- and off-balance-sheet risks to capital and will require those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance-sheet risks into the assessment of capital adequacy.

The capital guidelines apply to both banks and bank holding companies on a consolidated

\* The complete regulation, as amended effective May 15, 1985, consists of—

- the pamphlet dated February 1984 (see inside cover) and
- this slip sheet.



ed basis.<sup>1</sup> Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Consequently, in evaluating the consolidated capital positions of banking organizations, the Board is placing greater weight on the building-block approach for assessing capital requirements. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by federal or state regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

### Supervisory Action

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating cir-

cumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions.

The zone into which an organization's total capital ratio falls will normally trigger the following supervisory responses, subject to qualitative analysis:

- For institutions operating in zone 1, the Federal Reserve will consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.
- For institutions operating in zone 2, the Federal Reserve will pay particular attention to financial factors, such as asset quality, liquidity, off-balance-sheet risk, and interest rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.
- For institutions operating in zone 3, the Federal Reserve will—
  - consider that the institution is undercapitalized, absent clear extenuating circumstances;
  - require the institution to submit a comprehensive capital plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and
  - institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.

### Treatment of Intangible Assets for Purpose of Assessing Capital Adequacy

In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that

<sup>1</sup> The guidelines will apply to bank holding companies with less than \$150 million in consolidated assets on a bank-only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and principal shareholders of the banking organization or their related interests.



the determination of the future benefits and useful lives of certain intangible assets may involve a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve will carefully review the level and specific character of intangible assets in evaluating the capital adequacy of state member banks and bank holding companies.

The Federal Reserve recognizes that intangible assets may differ with respect to predictability of any income stream directly associated with a particular asset, the existence of a market for the asset, the ability to sell the asset, or the reliability of any estimate of the asset's useful life. Certain intangible assets have predictable income streams and objectively verifiable values and may contribute to an organization's profitability and overall financial strength. The value of other intangibles, such as goodwill, may involve a number of assumptions and may be more subject to changes in general economic circumstances or to changes in an individual institution's future prospects. Consequently, the value of such intangible assets may be difficult to ascertain. Consistent with prudent banking practices and the principle of the diversification of risks, banking organizations should avoid excessive balance sheet concentration in any category or related categories of intangible assets.

#### *Bank Holding Companies*

While the Federal Reserve will consider the amount and nature of all intangible assets, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital (i.e., stated primary capital less all intangible assets) or those institutions with lesser, although still significant, amounts of goodwill will be subject to close scrutiny. For the purpose of assessing capital adequacy, the Federal Reserve may, on a case-by-case basis, make adjustments to an organization's capital ratios based upon the amount of intangible assets in excess of the 25

percent threshold level or upon the specific character of the organization's intangible assets in relation to its overall financial condition. Such adjustments may require some organizations to raise additional capital.

The Board expects banking organizations (including state member banks) contemplating expansion proposals to ensure that pro forma capital ratios exceed the minimum capital levels without significant reliance on intangibles, particularly goodwill. Consequently, in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles. In acting on applications, the Board will take into account the nature and amount of intangible assets and will, as appropriate, adjust capital ratios to include certain intangible assets on a case-by-case basis.

#### *State Member Banks*

State member banks with intangible assets in excess of 25 percent of tangible primary capital will be subject to close scrutiny. In addition, for the purpose of calculating capital ratios of state member banks, the Federal Reserve will deduct goodwill from primary capital and total capital. The Federal Reserve may, on a case-by-case basis, make further adjustments to a bank's capital ratios based on the amount of intangible assets (aside from goodwill) in excess of the 25 percent threshold level or on the specific character of the bank's intangible assets in relation to its overall financial condition. Such adjustments may require some banks to raise additional capital.

In addition, state member banks and bank holding companies are expected to review periodically the value at which intangible assets are carried on their balance sheets to determine whether there has been any impairment of value or whether changing circumstances warrant a shortening of amortization periods. Institutions should make appropriate reductions in carrying values and amortization periods in light of this review, and examiners will evaluate the treatment of intangible assets during on-site examinations.



## Definition of Capital to Be Used in Determining Capital Adequacy

### Primary Capital Components

The components of primary capital are—

- common stock,
- perpetual preferred stock (preferred stock that does not have a stated maturity date and that may not be redeemed at the option of the holder),
- surplus (excluding surplus relating to limited-life preferred stock),
- undivided profits,
- contingency and other capital reserves,
- mandatory convertible instruments,<sup>2</sup>
- allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves), and
- minority interest in equity accounts of consolidated subsidiaries.

### Secondary Capital Components

The components of secondary capital are—

- limited-life preferred stock (including related surplus) and
- bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

### Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

The secondary components must meet the following conditions to qualify as capital:

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

<sup>2</sup> See the definitional section below that lists the criteria for mandatory convertible instruments to qualify as primary capital.

- The instrument must be unsecured.
- The instrument must clearly state on its face that it is not a deposit and is not insured by a federal agency.
- Bank debt instruments must be subordinated to claims of depositors.
- For banks only, the aggregate amount of limited-life preferred stock and subordinate debt qualifying as capital may not exceed 50 percent of the amount of the bank's primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

## Capital Ratios

The primary and total capital ratios for bank holding companies are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components}}{\text{Total assets} + \text{Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

Total capital ratio:

$$\frac{\text{Primary capital components} + \text{Secondary capital components}}{\text{Total assets} + \text{Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

The primary and total capital ratios for state member banks are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components} - \text{Goodwill}}{\text{Average total assets} + \text{Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)} - \text{Goodwill}}$$

Total capital ratio:

$$\frac{\text{Primary capital components} + \text{Secondary capital components} - \text{Goodwill}}{\text{Average total assets} + \text{Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)} - \text{Goodwill}}$$



Generally, period-end amounts will be used to calculate bank holding company ratios. However, the Federal Reserve will discourage temporary balance-sheet adjustments or any other "window dressing" practices designed to achieve transitory compliance with the guidelines. Banking organizations are expected to maintain adequate capital positions at all times. Thus, the Federal Reserve will, on a case-by-case basis, use average total assets in the calculation of bank holding company capital ratios whenever this approach provides a more meaningful indication of an individual holding company's capital position.

For the calculation of bank capital ratios, "average total assets" will generally be defined as the quarterly average total assets figure reported on the bank's Report of Condition. If warranted, however, the Federal Reserve may calculate bank capital ratios based upon total assets as of period-end. All other components of the bank's capital ratios will be based upon period-end balances.

### Criteria for Determining Primary Capital Status of Mandatory Convertible Securities

Mandatory convertible securities are subordinated debt instruments that are eventually transformed into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as primary capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: equity contract notes (securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal) and equity commitment notes (securities that are redeemable only with the proceeds from the sale of common or perpetual preferred stock). Both equity commitment notes and equity contract notes qualify as primary capital for bank holding companies, but only equity contract notes qualify as primary capital for banks.<sup>3</sup>

### Criteria Applicable to Both Types of Mandatory Convertible Securities

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

b. The maximum amount of mandatory convertible securities that may be counted as primary capital is limited to 20 percent of primary capital, exclusive of mandatory convertible securities.<sup>4</sup> (Amounts outstanding in excess of the 20 percent limitation may be counted as secondary capital provided they meet the requirements of secondary capital instruments.)

c. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank or bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities. Nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.

d. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

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

f. An issuer that intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (i.e. the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock) generally must make such a dedication during the quarter in which the new common or preferred stock is issued.<sup>5</sup> As a general

<sup>3</sup> Equity commitment notes that were issued by state member banks prior to May 15, 1985, will continue to be included in primary capital.

<sup>4</sup> The maximum amount of equity commitment notes that may be counted as primary capital is limited to 10 percent of primary capital exclusive of mandatory convertible securities.

<sup>5</sup> Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and

Continued



rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.<sup>6</sup>

#### *Additional Criteria Applicable to Equity Contract Notes*

a. The note must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The obligation of the holder to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.

b. A stock purchase contract may be separated from a security only if (1) the holder of the contract provides sufficient collateral<sup>7</sup> to the issuer, or to an independent trustee for the benefit of the issuer, to ensure performance under the contract and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

#### *Additional Criteria Applicable to Equity Commitment Notes*

a. The indenture or note agreement must contain the following two provisions:

1. The proceeds of the sale of common or perpetual preferred stock will be the sole

source of repayment for the notes, and the issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation certified by an authorized agent of the issuer showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)

2. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated 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 raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.<sup>8</sup>

b. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve immediately will cease to treat the unfunded securities as primary capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment and will be taken into consideration by the Board in acting on statutory applications.

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 repay-

#### *Continued*

amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

<sup>6</sup> The dedication procedure is necessary to ensure that the primary capital of the issuer is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as primary capital. De minimis amounts (in relation to primary capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year-end.

<sup>7</sup> Collateral is defined as (1) cash or certificates of deposit; (2) 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; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; or (4) other collateral as may be designated from time to time by the Federal Reserve.

<sup>8</sup> The funded portions of the securities will be deducted from primary capital to avoid double counting.



ment of the principal amount of the security at its final maturity.

d. The maximum amount of equity commitment notes that may be counted as primary capital for a bank holding company is limited

to 10 percent of primary capital exclusive of mandatory convertible securities. Amounts outstanding in excess of the 10 percent limitation may be counted as secondary capital provided they meet the requirements of secondary capital instruments.