

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 9956
November 21, 1985]

CAPITAL MAINTENANCE

Proposal on Treatment of Perpetual Debt as Primary Capital

*To All State Member Banks and Bank Holding Companies
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 published for comment a proposal that would define as primary capital perpetual debt securities issued by State member banks and bank holding companies.

Comment is requested by January 17, 1986.

To qualify as primary capital, such perpetual debt securities would be required to meet specific criteria that are intended to make perpetual debt the functional equivalent, for capital purposes, of perpetual preferred stock.

In addition, comment is requested on whether a limit should be imposed on the combined amount of mandatory convertible instruments, perpetual preferred stock, and perpetual debt that could qualify as primary capital. The Board proposed a limit of 33⅓ percent of primary capital, exclusive of such instruments, in order to ensure that common stockholders' equity remains the dominant component of primary capital.

Because the treatment of perpetual debt as primary capital would allow banking institutions to substitute another capital instrument for common stockholders' equity, the Board is seeking additional comment on whether the proposed treatment would, in fact, strengthen the capital positions of banking institutions.

Enclosed — for member banks and bank holding companies in this District — is a copy of the text of the Board's proposal. It will be published shortly in the *Federal Register*; copies will be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216). Comments on the proposal should be submitted by January 17, 1986 and may be sent to our Bank Analysis Department.

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

12 CFR Part 225, APPENDIX A

[Reg. Y Docket No. R-0557]

CAPITAL MAINTENANCE:

PERPETUAL DEBT AS PRIMARY CAPITAL

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed Rulemaking.

SUMMARY: Capital adequacy is one of the critical factors the Board of Governors of the Federal Reserve System is required to analyze in taking action on various types of applications, such as mergers and acquisitions by bank holding companies, and in the conduct of the Board's various supervisory activities related to the safety and soundness of individual banks and bank holding companies and the banking system. In April 1985, the Board announced revised Guidelines for required and appropriate levels of capital for bank holding companies and state chartered banks that are members of the Federal Reserve System. (50 Fed. Reg. 16057 (1985)) At that time the Board announced it would continue to study the issue of whether to consider treating "perpetual debt" as a form of primary capital. The Board has decided to seek public comment on this issue, and to that end has proposed to amend its Capital Adequacy Guidelines to include as primary capital perpetual debt securities issued by state member banks and bank holding companies, provided these perpetual debt securities meet

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certain criteria. The Board also proposes to limit the combined amount of mandatory convertible instruments, perpetual preferred stock and perpetual debt that could qualify as primary capital in order to ensure that common stock remains the dominant component of primary capital.

DATE: Comments must be received by January 17, 1986.

ADDRESS: All comments, which should refer to Docket No. R-0557, should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, N. W., Washington, D. C. 20551, or should be delivered to the Office of the Secretary, Room 2200, Eccles Building, 20th and Constitution Avenue, N. W., between the hours of 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room 1122, Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Anthony G. Cornyn, Assistant Director, Division of Banking Supervision and Regulation (202/452-3354), James E. Scott, Senior Attorney, Legal Division (202/452-3513), or Joy W. O'Connell, Telecommunication Device for the Deaf (202/452-3244), Board of Governors of the Federal Reserve System.

SUPPLEMENTARY INFORMATION: Background. In announcing its revised Capital Adequacy Guidelines, 50 Fed. Reg. 16057, 16064 (1984), the Board deferred for further study the issue of whether to treat perpetual debt securities as primary capital for purposes of the Guidelines. Since that time there has been

a continued interest in the issue. Beginning in May 1985, several banking organizations located in the United Kingdom issued perpetual debt notes that qualified as primary capital under guidelines adopted by the Bank of England. In June, the Canadian Inspector General of Banks issued a statement that would permit debentures with a minimum maturity of 99 years to qualify as "base" (primary) capital. At least one Canadian bank has issued qualifying perpetual debt. No United States banking institutions have issued perpetual debt securities. However, some such institutions have expressed interest in doing so pending a determination of the instrument's capital status.

Purpose of the Proposed Rulemaking. In November, 1983 Congress enacted the International Lending Supervision Act of 1983 (12 U.S.C. § 3901 et seq.) which directed that the federal banking agencies ". . . shall cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by such other methods as the appropriate Federal banking agency deems appropriate." (Section 908, 12 U.S.C. § 3907) Pursuant to this authority and the authority contained in the Bank Holding Company Act, the Federal Reserve Act, and the Financial Institutions Supervisory Act of 1966, the Board has adopted Capital Adequacy Guidelines that establish minimum and appropriate capital levels for state member banks and bank holding companies. These minimum and appropriate levels of capital are designed to protect the

banking institutions from unforeseen adversity, to provide additional loan loss absorption capability, to furnish additional protection to depositors and creditors, and to allow banking institutions to take advantage of opportunities for sound growth.

The Board is proposing this amendment to its Capital Adequacy Guidelines in an attempt to provide state member banks and bank holding companies the flexibility of an additional capital instrument to attain minimum and adequate levels of primary capital. It appears that perpetual debt, if properly structured, might provide some of the traditional protections for the issuing banking organizations provided by other capital instruments. At the same time, however, perpetual debt could not perform these functions to the same degree as common equity.

When compared with common equity, the limitations of perpetual debt as a capital instrument are limitations shared in varying degrees by mandatory convertible securities and perpetual preferred stock. Therefore, the Board proposes to limit the combined amount of mandatory convertible instruments, perpetual debt, and perpetual preferred stock that could qualify as primary capital to 33-1/3 percent of total primary capital excluding these three instruments. Thus, a banking institution with \$100 in total primary capital could have no more than \$25 in the form of mandatory convertible securities, perpetual preferred stock, and perpetual debt, since total

primary capital excluding these three types of instruments would be \$75.

Proposed Criteria For Perpetual Debt. Perpetual debt securities may qualify as primary capital to the extent that the securities possess the same characteristics and provide the same protections as equity. A perpetual debt instrument that is subject to acceleration in the event of nonpayment of interest would not provide the protections of equity. Such an instrument would lack permanence, would be unavailable to absorb losses of the issuer except in liquidation, and would increase financial risk. The Board, therefore, has proposed to consider perpetual debt securities as primary capital if those securities meet certain conditions that would address the shortcomings listed above.

The Board proposes that perpetual debt be treated as primary capital provided it meets the following criteria:

1. The instrument must be unsecured and, if issued by a state member bank, the instrument must also be subordinated to the claims of depositors.
2. The instrument may not provide the noteholder with any right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization.
3. The issue may be redeemed only with the approval of the Federal Reserve System.
4. The instrument must contain a provision that allows the issuer to reduce and defer interest payments on the perpetual debt in the event, and at the same time, that dividends on any common or preferred stock have been reduced, deferred or eliminated.

5. If issued by a bank holding company or a state member bank, the instrument must convert automatically to common or perpetual preferred stock of the issuer in the event that the issuer's retained earnings and surplus accounts become negative. If issued by a nonbank subsidiary of a bank holding company or a subsidiary of a state member bank, the instrument must convert automatically to common or preferred stock of the issuer's parent company in the event that the retained earnings and surplus accounts of the issuer's parent company become negative.

Treatment of Perpetual Preferred Stock. The Board believes that common equity should remain the dominant component of primary capital for all state member banks and bank holding companies. To that end, the Board proposes to limit the amount of primary capital that may be comprised of mandatory convertible securities, perpetual preferred stock, and perpetual debt. The Board has previously limited the amount of mandatory convertible securities that may be included in primary capital to 20 percent of total primary capital, exclusive of such securities. The Board now proposes to limit also the amount of perpetual debt securities and perpetual preferred stock that may be included in primary capital. A state member bank or bank holding company would be permitted to include a composite of mandatory convertible securities, perpetual preferred stock and perpetual debt as primary capital only in an amount equal to 33-1/3 percent of total primary capital excluding such instruments.

Since the proposed composite limitation could have the effect of limiting the amount of perpetual preferred stock that an issuing state member bank or bank holding company may

include as primary capital, the Board proposes that all perpetual preferred stock issued prior to the date of publication of this notice in the Federal Register that otherwise qualifies as primary capital would retain that primary capital status should this proposed rule be adopted. This "grandfather" provision would seek to avoid penalizing any institution that acted in good faith on the basis of the existing Guidelines.

The Board is attempting to set the proposed limit on the subject instruments low enough to ensure that common equity remains the dominant component of primary capital and yet high enough to enable banking organizations to use perpetual debt to satisfy a meaningful portion of their primary capital requirements. The Board recognizes that the limitation would have a greater impact on larger banking institutions than on smaller institutions, since the former tend to have more mandatory convertible and perpetual preferred securities. The Board is seeking comment on the appropriate limit.

Issues For Specific Comment. The Board requests comment on the following issues that it believes are raised by the proposed rulemaking.

1. Whether perpetual preferred debt instruments can be structured so as to provide the basic protections and safeguards that instruments of primary capital are designed to achieve, and thus whether perpetual debt should be given primary capital status.

2. Whether the specific conditions proposed by the Board provide an adequate basis for consideration of perpetual debt as akin to equity and whether they are sufficient to justify treatment of perpetual debt instruments as primary capital. Whether the individual conditions are necessary or could be modified while achieving the intended purposes and whether additional conditions should be imposed.
3. Whether the Board should limit the percentage of primary capital that may be composed of instruments other than common equity and whether the limit proposed is appropriate. Whether the grandfathering of perpetual preferred stock issued prior to publication for comment of this proposed rule is appropriate.
4. Whether there is sufficient interest in perpetual debt instruments structured to comply with the proposed conditions and limitations so as to justify, on a practical basis, issuing a final rule at this time.

Regulatory Flexibility Analysis Act. The Board certifies that the adoption of these proposals is not expected to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). The Board proposes to amend its Capital Adequacy Guidelines to provide more flexibility in meeting the previously required minimum capital standards through the use of an additional capital instrument. The Board has determined that the limits imposed on perpetual preferred stock will generally not affect smaller state member banks and bank holding companies, which have not historically issued significant amounts of such stock.

This proposal does not duplicate, overlap or conflict with any existing federal laws and regulations governing state member banks and bank holding companies.

List of Subjects in 12 C.F.R. Part 225. Banks, banking;
Federal Reserve System; Holding Companies, Capital Adequacy;
State Member Banks.

Pursuant to the Board's authority under the International Lending Supervision Act of 1983 (ILSA), 12 U.S.C. §§ 3907, 3909; section 5(b) of the Bank Holding Company Act (BHC Act), 12 U.S.C. § 1844(b); the Financial Institutions Supervisory Act of 1966 (FIS Act), 12 U.S.C. § 1818; and sections 9 and 11(a) of the Federal Reserve Act (12 U.S.C. §§ 248, 324, 329), the Board hereby proposes to amend its Capital Adequacy Guidelines for bank holding companies and state member banks, Appendix A of the Board's Regulation Y, 12 C.F.R. Part 225, as set forth below:

Part 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL
12 C.F.R. Part 225 is proposed to be amended, under authority cited in this part including 12 U.S.C. §§ 1844(b), 1817(j)(13), 1818(b), and Pub. L. No. 98-181, Title IX (12 U.S.C. §§ 3907 and 3909), by revising Appendix A to read as follows:

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

* * *

Definition of Capital to be Used in Determining Capital Adequacy of Bank Holding Companies and State Member Banks

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,
- allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves),
- minority interest in equity accounts of consolidated subsidiaries,
- perpetual debt instruments^{**/}

Criteria for determining the Capital Status of Perpetual Debt Instruments of Bank Holding Companies and State Member Banks.

1. The instrument must be unsecured and, if issued by a state member bank, the instrument must also be subordinated to the claims of depositors.

^{*/} The maximum composite amount of mandatory convertible securities, perpetual debt and perpetual preferred stock that may be counted as primary capital is limited to 33-1/3 percent of primary capital, exclusive of these types of instruments. No perpetual preferred stock issued prior to November __, 1985, [prior to the publication of the proposal to adopt this 33-1/3 percent limit] shall forfeit its status as primary capital as a result of adoption of this provision. (Amounts outstanding in excess of the 33-1/3 percent limitation may be counted as secondary capital provided they meet the requirements of secondary capital instruments.)

^{**/} See the definitional section below that lists the criteria for perpetual debt instruments to qualify as primary capital.

2. The instrument may not provide the noteholder with any right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization.
3. The issue may be redeemed only with the approval of the Federal Reserve System.
4. The instrument must contain a provision that allows the issuer to reduce and defer interest payments on the perpetual debt in the event, and at the same time, that dividends on any common or preferred stock have been reduced, deferred or eliminated.
5. If issued by a bank holding company or a state member bank, the instrument must convert automatically to common or perpetual preferred stock of the issuer in the event that the issuer's retained earnings and surplus accounts become negative. If issued by a nonbank subsidiary of a bank holding company or a subsidiary of a state member bank, the instrument must convert automatically to common or preferred stock of the issuer's parent company in the event that the retained earnings and surplus accounts of the issuer's parent company become negative.
6. The maximum amount of such perpetual debt, when considered together with mandatory convertible securities and perpetual preferred stock, that may be counted as primary capital is limited to 33-1/3 percent of such primary capital, exclusive of these three instruments. [Note that a similar 20 percent limit on mandatory convertible securities shall remain in effect.]

By order of the Board of Governors of the Federal Reserve System, November 14, 1985.

(signed)

William W. Wiles

William W. Wiles
Secretary of the Board