FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10106**
November 18, 1986]

CAPITAL ADEQUACY

Revised Guidelines on the Treatment of Perpetual Debt as Primary Capital

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

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

The Federal Reserve Board has issued revisions to its capital adequacy guidelines for bank holding companies that treat perpetual debt as primary capital, and place limits on the amount of perpetual debt, perpetual preferred stock, and mandatory convertible securities that may qualify as primary capital. The guidelines are effective immediately.

Capital adequacy is one of the critical factors the Board 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 the banking system.

Before perpetual debt can be treated as primary capital, it must meet the following criteria:

- the debt issue must be unsecured. If it is issued by a bank, it must be subordinated to claims of depositors.
- repayment of the principal of the debt instrument will be limited to those situations involving the issuer's insolvency, bankruptcy, or reorganization.
- any voluntary redemption of the perpetual debt securities must be approved by the Board.
- the debt instrument contract must give the issuer the authority to choose to defer interest payments if all dividends on common and preferred stock have been eliminated.
- perpetual debt issued must convert to equity when the issuer's retained earnings and surplus become negative (or in the case of a guarantee when the guarantor's earnings and surplus become negative).

The amount of perpetual debt, perpetual preferred stock, and mandatory convertible securities that will qualify as primary capital has been limited to 33-1/3 percent of all primary capital (stated on a gross rather than a net basis) — an increase from the proposed 25 percent limit. In addition, the Board has imposed a limit of 20 percent of all primary capital on mandatory convertible securities and perpetual debt.

All securities exceeding the limits and issued, or in the process of being issued, prior to November 20, 1985, will be grandfathered and given primary capital treatment.

Enclosed — for member banks and bank holding companies in this District — is the typewritten copy of the text of the revision, which amends Appendix A, "Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks," of the Board's Regulation Y. The complete text will also be published shortly in the *Federal Register*, and will be furnished upon request directed to the Circulars Division of this Bank (Tel. No. 212-791-5216). Questions regarding the Board's capital adequacy guidelines may be directed to Donald E. Schmid, Manager, Bank Analysis Department (Tel. No. 212-720-6611).

E. Gerald Corrigan,
President.

FEDERAL RESERVE SYSTEM

12 CFR Part 225, APPENDIX A

[Regulation Y Docket No. R-0557]

Capital Guidelines:
Perpetual Debt as Primary Capital
and
Limits on Perpetual Debt, Preferred Stock and Mandatory Convertible Securities

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final 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, bank holding companies and the banking system. To provide additional flexibility in the capital structure of the financial institutions it regulates, the Board proposed in November 1985 (50 Fed. Reg. 47754) to treat "perpetual debt" as a form of primary capital. The Board has decided to amend its Capital Adequacy Guidelines ("Guidelines") (12 CFR Part 225 Appendix A) to treat perpetual debt securities that meet certain criteria as primary capital for bank holding companies (but not state member banks). The Board also has decided to adopt, with modifications, its proposal to limit the combined amount of mandatory convertible instruments, perpetual preferred stock and perpetual debt that may qualify as primary capital.

[Enc. Cir. No. 10106]

EFFECTIVE DATE: These amendments to the Capital Guidelines are effective immediately. The Board has chosen to state its capital policies in the form of guidelines rather than as a formal regulation. Consequently, a delayed effective date is not required.

FOR FURTHER INFORMATION CONTACT: Anthony G. Cornyn, Assistant Director (202/452-3354), or Robert Marshak, Financial Analyst (202/452-3450), Division of Banking Supervision and Regulation, or James E. Scott, Senior Counsel (202/452-3513), or Conrad Bahlke, Attorney (202/452-3707), Legal Division, or for users of Telecommunications Device for the Deaf, Earnestine Hill or Dorothea Thompson (202/452-3244), Board of Governors of the Federal Reserve System, Washington, D.C.

SUPPLEMENTARY INFORMATION:

1. BACKGROUND

Reasons for Revision of the Guidelines

Perpetual Debt. In announcing its revised Capital Adequacy Guidelines in April 1985, 50 Fed. Reg. 16057, 16064 (1985), the Board deferred for further study the issue of whether to treat perpetual debt securities as primary capital. Since that time there has been a continued interest in the issue. Banking organizations located in the United Kingdom have issued several billion dollars in perpetual debt notes that have qualified as primary capital under guidelines originally adopted by the Bank of England in 1985 and revised and formalized in March 1986. In addition, in June 1985, 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. Several Canadian banks have since issued qualifying perpetual debt. While no United States banking organizations have issued perpetual debt securities, several have expressed an interest in issuing such securities, particularly through subsidiaries located in those countries in which tax treatment is more certain.

The Board has decided to adopt, with some modifications, its proposal to permit perpetual debt securities issued by a bank holding company or its banking or nonbanking subsidiaries to qualify as primary capital on a consolidated basis for the bank holding company. The Board has concluded that perpetual debt securities, as defined in the revised Guidelines, can serve the purposes or perform the functions of primary capital.

In addition, perpetual debt provides bank holding companies with added flexibility in maintaining minimum and adequate levels of capital. Perpetual debt may also provide certain bank holding companies with a comparatively inexpensive alternative form of capital on a limited basis. Finally, primary capital treatment of perpetual debt will permit domestic bank holding companies and their overseas subsidiaries to compete more effectively with banking institutions domiciled or operating in those countries that treat perpetual debt as a form of capital.

While the advantages of primary capital treatment for perpetual debt would also apply to the capital structure of state member banks, the Board, in the interest of uniform treatment of all federally supervised banks, has declined to consider perpetual debt as primary capital for an issuing state chartered bank that is a member of the Federal Reserve System. Banks may issue perpetual debt securities, however; and the parent holding company of a member bank that issues such securities to a third party may treat such securities as primary capital on a consolidated basis within the limits of the Guidelines.

Limits on Perpetual Preferred Stock. The Board has adopted, with increased limits, its proposal to limit the amount of perpetual preferred stock, mandatory convertible notes and perpetual debt that may be counted as primary capital by a bank holding company. The Board continues to believe that excessive reliance on these types of capital exposes a bank holding company to potential financial problems. For example, these types of instruments require predetermined, preferential, and often cumulative payments that could limit an organization's financial flexibility in the event it encounters serious and protracted weaknesses in earnings. In addition, excessive use of such instruments could place control of an organization in the hands of individuals with an extremely limited financial stake in that organization. These concerns, together with a belief that common equity should remain the dominant form of any banking organization's capital, have

prompted the Board to limit reliance by bank holding companies on non-common-equity forms of primary capital. While the Board believes the same limits should be applied to state member banks, the Board is also concerned about maintaining uniform capital requirements for all federally regulated banks. Thus, the Board will continue to assess the level of the limited forms of primary capital -- perpetual preferred stock, mandatory convertible securities, and perpetual debt -- on a case-by-case basis for state member banks.

Summary of the Amendments to the Capital Guidelines

Perpetual Debt. The Board has revised its Capital Adequacy Guidelines to permit perpetual debt instruments to qualify as primary capital, subject to the following conditions and limitations:

1. The instrument must be unsecured and, if issued by a 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 the principal (even if non-payment of interest occurs) except in the event of bankruptcy, insolvency, or reorganization.

3. The issuer shall not voluntarily redeem the securities without the approval of the Federal Reserve, except that the issuer may redeem the securities if the securities are simultaneously replaced by a like amount of common or perpetual preferred stock of the issuer or the issuer's parent company.

4. The instrument must contain a provision that allows the issuer to defer (it may also allow the issuer to eliminate or reduce) interest payments on perpetual debt in the event, and at the same

time, that dividends on all outstanding common and preferred stock of the issuer (or in the case of a guarantee by the parent company, the dividends of the parent company's common and preferred stock) have been eliminated.

5. If the instrument is issued by a bank holding company or subsidiary with substantial operations, then 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. (In the case in which the perpetual debt issued by a bank or a subsidiary with substantial operations is guaranteed by a parent, conversion may be deferred until a guarantor's retained earnings and surplus accounts become negative.) If issued by a company without substantial operations that is a subsidiary of a bank holding company or bank, then the instrument must convert automatically to common or preferred stock of the issuer's parent in the event that the retained earnings and surplus accounts of the issuer's parent become negative.

6. The amount of perpetual debt that may qualify as primary capital is limited to a maximum of 20 percent of primary capital, depending on other limited forms of primary capital as set forth below.

<u>Limits on Perpetual Preferred Stock, Perpetual Debt and Mandatory Convertible Securities</u>. In consideration of the arguments advanced by many commenters, the Board has increased the proposed limits on the amount of perpetual preferred stock, perpetual debt and mandatory convertible securities that may be included as primary capital for bank holding companies. The combined amount of these three instruments that may qualify as primary capital is 33 1/3 percent of the total amount of all forms of primary capital (including these instruments). This figure, which equals 50 percent of primary capital on a net

basis (i.e. total primary capital excluding these three forms of capital), represents an increase from the proposal, which would have permitted 33 1/3 percent of primary capital on a net basis, or 25 percent of all forms of primary capital on a gross basis.

In addition, the revised Guidelines will limit, for bank holding companies, perpetual debt and mandatory convertible securities to 20 percent of the total amount of all forms of primary capital (including such instruments). This figure, which equals 25 percent of primary capital on a net basis (excluding such instruments), represents an increase from the existing limit for bank holding companies on mandatory convertible securities of 20 percent of net primary capital. The Guidelines will retain, however, the requirement that equity commitment notes, a type of mandatory convertible security treated as primary capital for bank holding companies only, be permitted to qualify as primary capital in an amount not to exceed one-half of the amount of mandatory convertible securities that would qualify as primary capital under the revised Guidelines -- that is in an amount not to exceed 10 percent of all forms of primary capital, including mandatory convertible securities.

No qualifying perpetual preferred stock issued, or in the process of being issued, on or before November 20, 1985, shall be ineligible for primary capital status solely by reason of the fact that, on the effective date of this amendment to

the Guidelines, the amount of any of such preferred stock exceeds the limits imposed in the revised Guidelines.

2. COMMENTS RECEIVED

The Board's proposal to allow perpetual debt to qualify as primary capital and to limit certain non-common equity forms of primary capital was announced on November 14, 1985. During the comment period, which ended January 17, 1986, the proposal drew comments from thirty-two commercial banking organizations, three bank trade associations, and the state banking departments of Pennsylvania and New Jersey. Eight of the regional Federal Reserve Banks also commented on the proposal.

The commenters generally limited their remarks to three specific questions: (1) whether to afford primary capital treatment to perpetual debt; (2) whether the proposed conditions or criteria to ensure that perpetual debt securities meet the objectives of primary capital will serve that purpose without unduly restricting the marketability or increasing the cost to the issuer of the securities; and (3) whether the proposed limitations on the amount of preferred stock, perpetual debt and mandatory convertible securities that could qualify as primary capital are necessary and reasonable. Some commenters also addressed the issue whether there is sufficient interest in issuing perpetual debt.

Perpetual Debt

Virtually all commenters supported the treatment of perpetual debt as primary capital, noting that the proposed instrument contains key features of primary capital -- subordination, permanence, and loss absorption capability -- and that it permits banking organizations additional flexibility in their efforts to achieve and maintain adequate levels of capital. The two commenters opposing the treatment of perpetual debt as primary capital did so on the basis that the instruments would be more akin to debt than equity.

There were substantive comments on each of the proposed conditions or criteria to ensure that perpetual debt would retain the characteristics of primary capital. While the commenters generally supported the need for such conditions or constraints on perpetual debt securities, there was significant opposition to several of the criteria viewed as having a materially adverse impact on the marketability of perpetual debt.

The first of the criteria that received significant adverse comment was the proposed requirement for Federal Reserve approval prior to redemption of perpetual debt securities. Several commenters pointed out that a bank holding company can redeem up to ten percent of its equity securities in a given year without prior regulatory approval and that such prior approval for redemption of debt securities would impair the speed and timing necessary for an effective redemption.

Some commenters also objected to the requirement that bank holding companies that issue perpetual debt must reserve the right to reduce, defer or eliminate interest on perpetual debt if common or preferred stock dividends are reduced or eliminated. (The issuing bank holding company would not be required to take such action, but only to reserve the right to take such action if it chose). Some commenters thought this condition would severely restrict the marketability of a perpetual debt instrument, while others maintained that it would encourage tax authorities to view perpetual debt as a form of equity and to treat the interest payments associated with these securities as nondeductible expenses.

The Board also received negative comments on the proposed requirement for actual conversion of perpetual debt to equity in the event that the retained earnings and surplus of the issuer or the issuer's parent become negative. Commenters suggested such conversion is a lengthy proceeding requiring adjustment of authorized shares to reflect fluctuations in value. They pointed out that the Bank of England does not require actual conversion in the case of insolvency, but, more simply, the treatment of perpetual debt noteholders as equity holders.

Limit on Perpetual Preferred Stock

The strongest opposition to the proposed amendments to the Guidelines was directed at the proposal to limit the combined amount of mandatory convertible securities, perpetual

debt and perpetual preferred stock that may qualify as primary capital. Commenters focused on the proposal to include perpetual preferred stock within the blanket limit on non-common-equity capital, since perpetual preferred stock is the only one of the three instruments to have been previously treated as primary capital without limit as to amount. Commenters argued that perpetual preferred stock possesses the basic characteristics of equity capital, including permanence, subordination and an ability to eliminate or defer dividends. Commenters suggested that, in many cases, fixed dividend schedules make preferred stock a cheaper form of capital than common stock with its fluctuating dividends. Commenters further suggested that neither state corporate law nor the accounting profession distinguishes between common and preferred stock as forms of equity.

Some commenters suggested that preferred stock provides a meaningful financing alternative for smaller institutions that lack access to the public equity market. Others suggested that preferred stock is a valuable estate planning tool for smaller institutions.

Some commenters suggested that the Board should address the issue of financial flexibility directly rather than by limiting preferred stock, and they suggested an absence of abuses to justify the restriction. Finally, many commenters suggested that the Board raise the blanket limit above the proposed level of 33 percent of primary capital net of these

instruments or, in the alternative, that the Board remove the blanket limit and impose a limit on preferred stock apart from those limits on perpetual debt or mandatory convertible securities.

3. RESOLUTION OF MAJOR ISSUES

Treatment of Perpetual Debt as Primary Capital

The Board has adopted the proposed amendment to its Capital Guidelines that would treat as primary capital for a bank holding company perpetual debt securities issued by the holding company or an affiliate in accordance with certain specific conditions or criteria. The Board believes that, with the limitations and conditions imposed in the amended Guidelines, perpetual debt can meet the underlying objectives of primary capital, *i.e.*, to serve as a buffer for individual banking organizations in times of poor performance, to promote the safety of depositors' funds, and to support the reasonable growth of banking organizations.

The Board finds merit in the comments that suggest that perpetual debt possesses many of the characteristics of primary capital. Perpetual debt is permanent in that it cannot be redeemed by noteholders except in the extraordinary event of insolvency, bankruptcy or reorganization. It may not be retired by the issuer without the prior approval of the Federal Reserve, except if converted to, exchanged for, or simultaneously replaced by common or perpetual preferred stock. It has the ability to absorb losses, since interest on

the debt issue may be deferred and the holders of the debt treated as equity shareholders when serious difficulties arise. Finally, if issued by a bank, the claims of perpetual debt noteholders must be subordinated to the rights of depositors. Thus, the Board concludes that perpetual debt serves the basic purpose of capital by adding a measure of safety to an issuing institution.

While this reasoning is equally applicable to the treatment of perpetual debt as primary capital for banks, and while the Board proposed to permit both bank holding companies and state chartered banks that are members of the Federal Reserve System to treat perpetual debt as primary capital, the Board has decided to afford such treatment only to bank holding companies in order to preserve uniform capital treatment for all federally supervised banks, a primary goal of the 1985 revisions to the Guidelines. The Board will study the experience of bank holding companies in issuing perpetual debt, and it will defer any decision on the treatment of perpetual debt as capital for state member banks in an effort to coordinate its position with that of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

It should be noted that although perpetual debt issued by a state member bank will not count as primary capital of the bank, it will be considered on a consolidated basis as primary capital of the holding company if such debt is held by an unaffiliated third party. In other words, a state member bank

subsidiary or a foreign bank subsidiary of a bank holding company located in the United States may issue perpetual debt that will be treated as capital of the holding company.

Since the primary capital status of perpetual debt is predicated upon these instruments providing the basic safety features of equity, the Board has adopted certain criteria to ensure that a perpetual debt issue achieves these benefits. A perpetual debt issue must meet these criteria in order to qualify as primary capital.

Criterion 1 - Unsecured and Subordinated. To qualify as primary capital, perpetual debt instruments must be unsecured, and, if issued by a bank, the instrument must also be subordinated to the claims of depositors. This requirement is designed to be, at a minimum, as stringent as the requirements for long-term, subordinated debt that may qualify as secondary capital. In order to provide the maximum protection for depositors and secured creditors, the holders of perpetual debt should not be permitted to encumber the assets of the issuer or its affiliates and should rank as general creditors of the issuer. The perpetual debt instrument should not create any priority or accelerated payment of interest or principal in the event that the issuer encounters financial difficulties. It should not place or attempt to place perpetual debt holders ahead of other general or subordinated creditors. This criterion, however, would not prohibit a parent company of the issuer from guaranteeing the debt, provided the debt remained subordinated.

Criterion 2 - Right to Repayment of Principal Limited to Bankruptcy, Insolvency or Reorganization. To qualify as primary capital, the perpetual debt instrument must limit the right of the holder to repayment of the principal only in the case of insolvency, bankruptcy or a financial reorganization that would impair the rights of noteholders. In the case of the nonpayment of interest, the instrument should limit the noteholder's rights to repayment of the interest accrued and owing rather than acceleration of interest payments or repayment of the principal amount of the debt. Moreover, while a noteholder may also have recourse to the bankruptcy courts, the perpetual debt instrument must provide that failure to pay interest on the note shall not in and of itself trigger bankruptcy. Finally, the debt instrument may not contain cross-default clauses that provide that other obligations of the issuer become immediately due and owing in the event of any default in the payment of interest on the perpetual debt.

These provisions are designed to ensure that the proceeds of the perpetual debt issue remain available to the issuer while that entity remains a viable concern. In the event the issuer encounters financial difficulties short of insolvency that impair interest payments, the noteholders may not exacerbate those difficulties by accelerating repayment of the debt.

Moreover, the noteholders should not be permitted to gain a determination of bankruptcy or insolvency prematurely solely on the basis of a failure to pay interest on the perpetual debt in a timely fashion. The Board is concerned with the suggestion of certain commenters that restrictions on the repayment of the debt principal would encourage noteholders to seek a determination of bankruptcy as a means of forcing repayment of the debt before it is converted to equity (criterion 5). The Board recognizes this problem, but it believes that the bankruptcy laws provide adequate protection from an unwarranted or premature finding of insolvency.

Criterion 3 -- Voluntary Redemption Only With Federal Reserve Approval. In order to ensure that the funds raised by a perpetual debt issue remain with the issuer to fulfill the purposes of capital, the debt instrument must require any voluntary redemption of the debt issue to be subject to prior approval by the Federal Reserve. The revised Guidelines provide for an exception to this prior approval requirement in the case in which the debt is converted to, exchanged for, or simultaneously replaced by perpetual preferred or common stock. The pledge of proceeds over time to redeem perpetual debt, as in the case of mandatory convertible securities, will not be an acceptable means of avoiding the requirement of prior Board approval. Nothing contained in this criterion shall preclude the debt instrument from providing for redemption of

the debt in exchange for the common stock or perpetual preferred stock of the issuer at the option of the holder of the debt--even in the case in which such redemption is not accompanied by a general redemption of all such debt.

Several commenters argued that Federal Reserve approval should not be required because timing is critical in a redemption decision and delay for the purpose of regulatory approval could increase the cost of redemption or even eliminate the viability of the redemption. The Board considered this point, but decided to retain the prior approval requirement because the need to maintain the permanence of perpetual debt in order to serve the purposes of capital outweighs the concern for some additional flexibility for the issuer. In addition, the Board notes that prior approval is required for redemption of all mandatory convertible securities as well as for all capital instruments issued by state member banks. There is no strong evidence that the prior approval process in those cases has proved burdensome.

<u>Criterion 4 -- Deferred Interest Payments</u>. The revised Guidelines provide that an issuer of perpetual debt must reserve the right, at a minimum, to defer interest payments on perpetual debt in the event that dividend payments on all outstanding common and preferred stock of the issuer are eliminated. In the case in which the issuing entity is a bank or other subsidiary with substantial operations (as opposed to

a nonoperating subsidiary established for purposes of raising funds or issuing collateralized securities) and the perpetual debt issue is guaranteed by a parent of the issuer, the Guidelines permit deferral of interest to be triggered by elimination of stock dividends by the guarantor. In the case in which the issuing entity is a nonoperating company, the deferral of interest is always triggered by the elimination of stock dividends by the parent organization.

These requirements differ from the proposal that was put out for comment in two respects. First, the issuer must only reserve the right in the debt instrument to defer interest rather than to reduce or eliminate such interest altogether. (The debt agreement, of course, may impose such measures, although they are not required in order to gain primary capital treatment.) This modification will make perpetual debt more closely approximate cumulative preferred stock, more closely parallel the requirements of the Bank of England in its guidelines involving perpetual débt, and contribute to the marketability and reduce the cost to the issuer of the debt.

Deferral of interest payments provides the issuer with the ability to limit cash outflows related to perpetual debt in times of severe financial problems. The more severe measures of reduction or elimination of interest payments do not appear to be necessary to preserve perpetual debt as an instrument that provides the protection of capital at a time when the issuer is experiencing severe financial difficulties.

A second change from the proposed regulation involves the conditions under which the deferral of interest may be invoked by the issuer. The Board first proposed that the debt instrument permit the issuer to limit interest payments whenever dividends on common and preferred stock were reduced or eliminated. The revised Guidelines now require that the debt instrument provide the issuer with the right to <u>defer</u> dividends only when all common and preferred stock dividends are <u>eliminated</u>. The Board adopted this position in response to comments suggesting that perpetual debt would be more marketable and less costly if the contingencies that could trigger deferral of interest were more limited and less likely to occur. At the same time, retention of the deferral feature would help to ensure that perpetual debt would remain available in time of serious difficulty.

Several commenters argued that the Board should go even further and not require any type of contingency clause for deferral of interest. These commenters argued that such a clause would cause certain foreign tax authorities to treat interest payments as a nondeductible dividend distribution, thereby making these instruments less marketable overseas, where initially such debt is most likely to be issued. While the Board is interested in providing added flexibility in achieving and maintaining adequate primary capital by permitting bank holding companies to issue perpetual debt at a reasonable cost, the Board cannot permit primary capital

treatment for instruments that do not provide a substantial measure of safety and soundness for the issuer. While limiting the scope of the interest payment remedies to deferral rather than elimination and also limiting the contingencies that trigger this remedy, the Board continues to believe that perpetual debt must offer equity-like safety features. One key feature is the ability of the issuer, in extreme circumstances, to reduce cash outflows related to perpetual debt. Thus, the Board rejected arguments for recision of the interest deferral contingency clause.

Criterion 5 -- Conversion to Equity. The revised Guidelines require that a perpetual debt instrument must provide for automatic conversion of the debt to equity of the issuer or the issuer's parent in the event that the retained earnings and surplus of the issuer or the bank holding company parent become negative. Specifically, if the perpetual debt is issued directly by a bank holding company or by its subsidiary bank or other subsidiary with substantial operations, the perpetual debt must convert to common or perpetual preferred stock of the issuing entity when the surplus and retained earnings of the issuing entity become negative. If the parent of the issuer guarantees the perpetual debt of an operating subsidiary, the perpetual debt must convert to common or perpetual preferred stock of the operating subsidiary or of the parent as provided in the debt instrument. Moreover, such conversion must be triggered when the surplus and retained

earnings of the issuing entity become negative or, if specifically provided in the perpetual debt instrument, conversion may instead be triggered when the surplus and retained earnings of the parent guarantor become negative.

If the perpetual debt is issued by a nonoperating subsidiary of a bank holding company or bank (that is, a funding subsidiary or one formed to issue securities), the perpetual debt must convert to common or perpetual preferred stock of the nonoperating subsidiary's parent when the surplus and retained earnings of the parent become negative, regardless of whether the parent guarantees the issue.

In effect, these provisions broaden the equity base of an issuing entity and reduce financial risk to that entity, as they permit the issuing entity to absorb losses and to possibily remain a viable concern at a time when it faces severe financial problems. Concerns about the continued viability of an entity may be lessened when a parent has guaranteed the perpetual debt of a nonoperating subsidiary; thus, the revised Guidelines do not require that the perpetual debt of an operating subsidiary immediately convert to the equity of the issuing subsidiary at the time the subsidiary experiences difficulties. At that time, the parent may take action to assume the obligations of the issuing subsidiary and it is then the parent's condition that would trigger conversion.

Several commenters urged the Board not to require actual conversion of perpetual debt to equity, but merely to require, as does the Bank of England, that the debt instrument treat noteholders as shareholders in cases in which an issuer's or parent's surplus and earnings become negative. These commenters noted that the Board's proposed requirement of actual conversion was more stringent that the standard of the Bank of England, and that actual conversion may trigger additional expenses and raise additional issues such as the need for regulatory filings due to a change in control and the need to authorize and adjust shares for conversion.

The Board acknowledges the practical difficulties involved in the actual conversion of perpetual debt to equity. However, the Board believes that actual conversion is necessary because it enables an organization to absorb losses, on a going concern basis, for the issuer (or parent) prior to actual bankruptcy.

Limits on Perpetual Preferred Stock, Mandatory Convertible Securities and Perpetual Debt

Limits Imposed. In response to a substantial number of adverse comments, the Board has eased the limits contained in its proposal. The revised Guidelines limit the combined amount of perpetual preferred stock, mandatory convertible securities and perpetual debt that may qualify as primary capital to 33-1/3 percent of the gross amount of all forms of primary capital, including these three types of

instruments.[1] This limit is an increase over the November 1985 proposal of 25 percent of gross primary capital.[2]

In addition, the revised Guidelines also limit the amount of mandatory convertible securities and perpetual debt that may qualify as primary capital to 20 percent of the gross amount of all forms of primary capital, including these instruments. This amount represents an increase over the limit in the current Guidelines of 16-2/3 percent of gross primary capital which is for mandatory convertible securities alone (stated as 20 percent of primary capital excluding mandatory convertible securities). This increase will permit even those bank holding companies that are at the present limit of qualifying mandatory convertible securities to have the opportunity to issue perpetual debt.

Finally, the Board has decided to retain the limit on equity commitment notes, a type of mandatory convertible security, that may be included as primary capital for bank

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1/ In its proposal the Board stated the proposed limits in net form--i.e., excluding the instruments being limited. This became confusing as the Board proposed limits on different combinations of instruments, thereby requiring a different means of computing the net percentage in each case. Accordingly, the limits in the revised Guidelines are defined more simply in gross terms.

2/ Stated in net terms, the revised Guidelines would allow 50 percent of net primary capital, excluding these three instruments, to be treated as primary capital, an increase over the 33-1/3 percent of net primary capital that the Board proposed to permit.

holding companies. The Guidelines previously stated that limit as 10 percent of primary capital exclusive of mandatory convertible securities or one-half of the amount of all mandatory convertible notes that may be treated as primary capital. The revised Guidelines, for the purposes of clarity and consistency, continue to limit the amount of equity commitment notes to one-half of all types of mandatory convertible securities that may be treated as primary capital. The revised Guidelines, therefore, permit capital treatment for equity commitment notes up to 10 percent of the gross amount of all forms of primary capital of the bank holding company, including mandatory convertible securities.

Reasons for the Limits. The Board believes that common equity should remain the dominant form of capital because it provides the greatest measure of safety to the issuing institution. That safety is found in a number of factors. First, as a general rule common equity offers greater financial flexibility. The dividends on common equity generally are voted by the directors who can assess the financial condition of the bank holding company--and are not predetermined by contract as are the interest and dividends on the three instruments subject to the limitation. Generally, therefore, the dividends on common stock may be eliminated more easily. In addition, dividends on common equity are not cumulative as the interest or dividends on the limited capital instruments are likely to be. Dividends on common stock are

generally payable after the interest and dividends on the limited debt instruments and preferred stock are paid. In short, the Board continues to believe, as it stated in its Policy Statement on Payment of Cash Dividends, 72 Federal Reserve Bulletin 26 (1986): "Excessive reliance on preferred stock should be avoided, since reliance could limit an organization's flexibility in the event it encounters serious and protracted earnings weaknesses."

An additional safety feature is that reliance on common equity as the dominant form of capital will generally help to insure that the ownership of the bank holding company remains with those with the most significant investment in the company. The Board has had a longstanding policy with respect to applications under the Bank Holding Company Act of requiring those in control of a corporation to have a substantial investment so as to guard against absentee ownership or lack of prompt attention to the problems a company may encounter. Under the Board's Policy Statement on the Formation of Small One-Bank Holding Companies, Appendix B to Regulation Y, 12 C.F.R. Part 225, for example, the Board has interpreted the minimum down payment requirement of 25 percent so that controlling shareholders rather than minority shareholders must meet the down payment. The limits on non-common-equity forms of primary capital are designed to address the same types of concerns.

The treatment of perpetual debt and mandatory convertible securities as primary capital, together with additional reliance in some cases on preferred stock, means there is a greater potential for placing voting control of an organization in the hands of individuals with a very limited financial stake in the organization. The Board has decided to formalize the procedure it has applied on a case-by-case basis of limiting reliance on preferred stock or other non-common-equity forms of capital. See Croesus Partners I, Inc., 72 Federal Reserve Bulletin 45 (1986). While the Board acknowledges that in a given case any limit may appear arbitrary, the Board emphasizes that the limits are being placed in Capital Guidelines rather than in regulations so that bank holding companies may rely upon objective standards while permitting individual companies to demonstrate the need in a particular case for the Board to apply a more flexible measure.

This concern for added flexibility has prompted the Board to raise the proposed limits on the non-common-equity forms of capital. The Board has also applied different limits for perpetual preferred stock and the debt forms of primary capital in recognition of the arguments of some commenters that preferred stock ought to be distinguished from the debt instruments since it possesses more of the characteristics of common equity capital and provides a greater measure of safety to the issuer than debt.

<u>Grandfathering Status of Previously-Issued Perpetual Preferred Securities</u>. The Board has adopted the grandfathering treatment of perpetual preferred securities embodied in the November proposal. Under this grandfathering clause, all qualifying perpetual preferred stock issued as of November 20, 1985, the date of the proposal's publication in the <u>Federal Register</u>, will count as primary capital, even if such action would place the bank holding company above the limit in the amended Guidelines. Moreover, to the extent that a bank holding company issued perpetual preferred stock after the grandfathering date, but had taken meaningful steps to issue those securities before such date, including filing with an appropriate government agency or signing binding contracts, the Board will give consideration to conferring grandfather status upon those securities.

Several commenters urged the Board to move the grandfather date forward, either to the date of publication of the final rule or beyond. To do otherwise, they argued, would be unfair and would disrupt the capital planning process. The Board believes that the increase in the combined limits from 25 percent to 33 percent of primary capital on a gross basis together with the clear notice of the grandfather date in the proposal provides enough leeway to avoid any difficulties in the capital planning process. Moreover, to avoid disruption, the Board will consider grandfathering any issue in which meaningful steps to issue such securities had occurred before the cutoff date.

It should be noted that grandfathering merely means that, to the extent that previously issued perpetual preferred stock, when considered together with properly issued mandatory convertible securities, exceeds the newly imposed limit on non-common-equity instruments, such preferred stock will continue to be treated as primary capital. Such preferred stock is not excluded, however, in computing the limits.

The Board believes that the revisions to the Capital Guidelines relating to limits on non-common-equity forms of capital in general, and preferred stock in particular, should be equally applicable to bank holding companies and banks. Nevertheless, the Board has not applied these changes to state member banks absent a parallel action by the Comptroller of the Currency and Federal Deposit Insurance Corporation with respect to other federally regulated banks. The Board will monitor the effects of these revisions on bank holding companies and, based on that experience, it will continue to discuss with the other federal banking agencies application of these revisions to banks on a uniform basis.

It should also be noted that the Board will carefully scrutinize the use of preferred stock by state member banks on a case-by-case basis. The Board also notes that the 20 percent limit on the treatment of mandatory convertible securities (on a net basis exclusive of such securities) by state member banks remains in the Guidelines.

<u>Regulatory Flexibility Analysis Act</u>. 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 amendment to the Capital Adequacy Guidelines will provide more flexibility in meeting the previously required minimum capital standards through the use of an additional capital instrument. The Board has grandfathered, for capital purposes, that perpetual preferred stock issued or in the process of being issued prior to the announcement of this proposal, and thus it has precluded any adverse impact on the capital position of small bank holding companies as a result of the limits imposed on the amount of perpetual preferred stock that may be considered primary capital. In addition, the Board has raised the limit on preferred stock over that proposed in November 1985, and it has declined to apply the limit through its Capital Guidelines to state member banks.

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

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

Part 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority for Part 225 continues to read as follows:

AUTHORITY: 12 U.S.C. 1817(j)(13), 1818, 1843(c)(8), 1844(b), 3106, 3108, 3907, 3909.

2. The portion of Appendix A of Part 225 entitled "Definition of Capital to be Used in Determining Capital Adequacy of Bank Holding Companies and State Member Banks" is amended by adding perpetual debt to the list of primary capital components, by deleting footnote 3, and by adding a new subsection entitled "Limits on Non-Common-Equity Forms of Primary Capital." That portion of Appendix A now reads 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 (for bank holding companies but not for state member banks).

Limits on Certain Forms of Primary Capital

Bank Holding Companies. The maximum composite amount of mandatory convertible securities, perpetual debt, and perpetual preferred stock that may be counted as primary capital for bank holding companies is limited to 33.3 percent of all primary capital, including these instruments. Perpetual preferred stock issued prior to November 20, 1985 (or determined by the Federal Reserve to be in the process of being issued prior to that date), shall continue to be included as primary capital.

The maximum composite amount of mandatory convertible securities and perpetual debt that may be counted as primary capital for bank holding companies is limited to 20 percent of all primary capital, including these instruments. The maximum amount of equity commitment notes (a form of mandatory convertible securities) that may be counted as primary capital for a bank holding company is limited to 10 percent of all primary capital, includng mandatory convertible securities. Amounts outstanding in excess of these limitations may be counted as secondary capital provided they meet the requirements of secondary capital instruments.

State Member Banks. The composite limitations on the amount of mandatory convertible securities and perpetual preferred stock (perpetual debt is not primary capital for state member banks) that may serve as primary capital for bank holding companies shall not be applied formally to state member banks, although the Board shall determine appropriate limits for these forms of primary capital on a case-by-case basis.

The maximum amount of mandatory convertible securities that may be counted as primary capital for state member banks is limited to 16-2/3 percent of all primary capital, including mandatory convertible securities. Equity commitment notes, one form of mandatory convertible securities, shall not be included as primary capital for state member banks, except that notes issued by state member banks prior to May 15, 1985 will continue to be included in primary capital. Amounts of mandatory convertible securities in excess of these limitations may be counted as secondary capital if they meet the requirements of secondary capital instruments.

3. That portion of Appendix A entitled "Criteria Applicable to Both Types of Mandatory Convertible Securities" is amended by deleting paragraph (b) and footnote 4 and relettering paragraphs (c) through (f) as paragraphs (b) through (e). Footnotes 5 and 6 will be renumbered as footnotes 3 and 4.

4. That portion of Appendix A entitled "Additional Criteria Applicable to Equity Commitment Notes" is amended by deleting paragraph (d) and by renumbering footnotes 7 and 8 as footnotes 5 and 6.

5. Appendix A of Part 225 is amended by adding the following paragraphs at the end of the Appendix.

<u>Criteria for Determining the Primary Capital Status of Perpetual Debt Instruments of Bank Holding Companies</u>

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

2. The instrument may not provide the noteholder with the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.

3. The issuer shall not voluntarily redeem the debt issue without prior approval of the Federal Reserve, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.

4. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as the elimination of dividends on all outstanding common or preferred stock of the issuer (or in the case of a guarantee by a parent company at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.

5. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or

perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed by its parent, the debt may convert to the shares of the issuer or guarantor and such conversion may be triggered when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert automatically to common or preferred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

By order of the Board of Governors of the Federal Reserve System, November 3, 1986.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board