

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. **10490**  
November 6, 1991 ]

**RISK-BASED CAPITAL GUIDELINES**

**Proposal to Permit Bank Holding Companies to Raise  
Additional Capital Through the Sale of Perpetual Preferred Stock**

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

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has requested public comment on a proposal to permit bank holding companies to raise additional tier one risk-based capital through the sale of perpetual preferred stock.

Comment should be received by the Board by November 22.

Under present risk-based capital guidelines, bank holding companies are permitted to count perpetual preferred stock up to 25 percent of their tier one capital. The proposal would remove the limitation for noncumulative perpetual preferred stock but continue to limit cumulative perpetual preferred stock to 25 percent of tier one capital.

Enclosed — for member banks, bank holding companies, and branches and agencies of foreign banks in this District — is the text of the Board's proposal. Comments thereon should be submitted by November 22, and may be sent to the Board of Governors, as set forth in the notice, or to our Bank Analysis Department. Copies of the enclosure will be furnished to others upon request directed to the Circulars Division of this Bank (Tel. No. 212-720-5215 or 5216).

E. GERALD CORRIGAN,  
*President.*

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. R-0740]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of Proposed Revisions to Capital Adequacy Guidelines.

SUMMARY: The Board is proposing to remove the limit on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital. Cumulative perpetual preferred stock would continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital.

DATE: Comments on the proposed revisions to the Federal Reserve Board's risk-based capital guidelines and leverage capital guidelines should be submitted on or before November 22, 1991.

ADDRESS: Comments, which should refer to docket No. R-0740, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, N.W., Washington, D.C. 20551; or delivered to Room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in section 2612.8

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of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Roger T. Cole, Assistant Director (202/452-2618), Rhoger H Pugh, Manager (202/728-5883), Norah M. Barger, Supervisory Financial Analyst (202/452-2402), Robert E. Motyka, Senior Financial Analyst (202/452-3621), Division of Banking Supervision and Regulation; and Michael J. O'Rourke, Senior Attorney (202/452-3288), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

#### SUPPLEMENTARY INFORMATION

##### I. BACKGROUND

The international bank capital standards (Basle Accord)<sup>1</sup> allow banks to include noncumulative perpetual preferred stock place in Tier 1 capital and place no formal limit on the amount of such instruments that may be included in Tier 1.<sup>2</sup> The Basle framework, which by its terms applies only to

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<sup>1</sup> The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

<sup>2</sup> Noncumulative perpetual preferred stock is perpetual preferred stock whose dividends, if missed, do not accrue and will never be paid. Cumulative perpetual preferred stock is preferred stock whose dividends, if missed because of insufficient earnings

internationally active banks, was adopted by the Federal Reserve for state nonmember banks. In addition, the Board chose to apply a risk-based capital framework similar to the Basle Accord to U.S. bank holding companies generally on a consolidated basis.<sup>3</sup> Under the Federal Reserve's bank holding company capital guidelines, holding companies are allowed to include both noncumulative and cumulative perpetual preferred stock in Tier 1 capital, but the total of all perpetual preferred stock includable in Tier 1 capital is limited to 25 percent of Tier 1.<sup>4</sup> Amounts of such stock in excess of the limitation may be included in Tier 2 capital. The limit on preferred stock is consistent with the Board's long-standing view that common equity should remain the dominant form of a banking organization's capital structure.

A principal reason for the Board's decision to limit the amount of perpetual preferred stock in bank holding Tier 1 capital is the fact that cumulative preferred, the type of perpetual preferred most prevalent in U.S. financial markets,

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or any other reason, accumulate until all arrearages are paid out. Cumulative preferred dividends have preference over common dividends, which cannot be paid out as long as any cumulative preferred dividends remain unpaid.

<sup>3</sup> For bank holding companies with consolidated assets of less than \$150 million in assets, the risk-based capital guidelines generally are applied on a bank-only basis.

<sup>4</sup> Under the risk-based capital guidelines, certain types of perpetual preferred stock do not qualify for inclusion in Tier 1 capital. For example, perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the banking organization's credit standing is excluded from Tier 1 capital, but may be included in Tier 2 capital.

normally involves preset dividends that cannot be cancelled, but only deferred. An institution that passes dividends on cumulative preferred stock must pay off any accumulated arrearages before it can resume payment of its common stock dividends. Thus, undue reliance on cumulative perpetual preferred stock and the related possibility of large dividend arrearages could complicate an organization's ability to raise new common equity in times of financial difficulty. On the other hand, dividends on noncumulative preferred, like dividends on common stock, may be cancelled. Thus, with respect to dividends, noncumulative preferred stock has characteristics that are consistent with common stock, the principal component of Tier 1 capital.

Conditions in the banking industry underscore the desirability of affording banking organizations greater flexibility in raising capital. This can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers. In view of these considerations, the Board is proposing to lift the limit on the amount of noncumulative preferred stock that bank holding companies may include in Tier 1 capital. This proposal is consistent with other steps initiated by the Federal bank regulatory agencies, in conjunction with the Treasury Department, to address concerns relating to the availability of credit to sound borrowers.

## II. Proposal

The Board is proposing to remove the limit on the amount of noncumulative perpetual preferred stock a bank holding company may include in its Tier 1 capital. Cumulative perpetual preferred stock would continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital.

By removing the limit for noncumulative perpetual preferred stock, this proposal will achieve parity with regard to the treatment of noncumulative perpetual preferred stock between the U.S. risk-based capital guidelines for bank holding companies and the Basle framework for banks. Thus, the proposal will place U.S. bank holding companies on a more equal footing with foreign banks subject to the Basle Accord with regard to their ability to augment Tier 1 capital through the issuance of noncumulative perpetual preferred stock. The additional flexibility provided by this step may assist bank holding companies to strengthen their capital positions and expand their lending capacity.

Although the Board is proposing to lift the limit on noncumulative perpetual preferred stock, it continues to believe that bank holding companies should avoid overreliance on preferred stock within Tier 1 capital. In proposing this step, the Board notes that the capital structure of a bank holding company is subject to quarterly review (through the analysis of financial reports filed with the Federal Reserve), and the composition of an organization's capital base and its capital

plans are subject to in-depth assessment during annual inspections and as part of the Federal Reserve's consideration of applications. The language of the Federal Reserve's risk-based capital guidelines makes clear the Board's long-standing belief that banking organizations should avoid overreliance on nonvoting equity instruments, including preferred stock, in Tier 1 capital. Capital structures that are inconsistent with this principle may result in supervisory or enforcement actions, including possible denial of applications filed with the Federal Reserve. In addition, rating agencies take the amount of common equity and preferred stock an organization has, as well as the overall composition of the organization's core capital, into account in determining the organization's financial ratings. Thus, there are a number of mechanisms in place to monitor banking organizations' use of preferred stock and to discourage undue reliance on such instruments.

### **III. Regulatory Flexibility Act Analysis**

The Federal Reserve Board does not believe adoption of this proposal would have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, this proposal will

not affect such companies.

#### List of Subjects

##### 12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

##### 12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, Banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board is amending 12 CFR Parts 208 and 225 to read as follows:



PART 208 - MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE  
FEDERAL RESERVE SYSTEM

1. The authority citation for Part 208 continues to read as follows:

AUTHORITY: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); sections 907-910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906-3909); sections 2, 12(b), 12(g), 12(i), 15B(c) (5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c) (5), 78q, 78q-1, and 78w, respectively); section 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and sections 1101-1122 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. 3310 and 3331-3351).

Appendix A - [Amended]

2. The footnote designator in the text is removed and footnote 6 is removed and reserved.

## PART 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

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

AUTHORITY: 12 U.S.C. 1817(j) (13), 1818, 1831i, 1843(c) (8), 1844(b), 3106, 3108, 3907, 3909, 3310, and 3331-3351.

## Appendix A - [Amended]

2. Appendix A is amended by revising paragraphs (ii) and (iii) and adding paragraph (iv) in II.A.1., and by removing the last three sentences in the third paragraph and the entire fourth paragraph in II.A.1.b. and replacing them, to read as follows:

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## II. \*\*\*

## A. \*\*\*

(i) \*\*\*

(ii) qualifying noncumulative perpetual preferred stock (including related surplus).

(iii) qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below.

(iv) minority interest in the equity accounts of consolidated subsidiaries.

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b. \*\*\* However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the cumulative perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred stock (that is, items, i, ii, iii, and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.\*\*\*\*\*

#### Appendix D - [Amended]

3. Appendix D is amended by removing the first two sentences in footnote 3 and replacing them, to read as follows:

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II. \*\*\*

<sup>3</sup> At the end of 1992, Tier 1 capital for bank holding companies includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.)\*\*\*

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Board of Governors of the Federal Reserve System,  
October 31, 1991.

(signed) William W. Wiles

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William W. Wiles  
Secretary of the Board