

**FEDERAL RESERVE BANK  
OF NEW YORK**

[ Circular No. **10512**  
January 23, 1992 ]

**CAPITAL ADEQUACY GUIDELINES**

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

*To All Bank Holding Companies 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 approved a proposal to lift the limit on the amount of noncumulative perpetual preferred stock that bank holding companies may include in Tier 1 capital for purposes of calculating their risk-based and leverage capital ratios.

There currently is no limit on the amount of noncumulative perpetual preferred stock that State member banks may include in Tier 1 capital.

Cumulative perpetual preferred stock will continue to be included in Tier 1 capital for bank holding companies, up to the current limit of 25 percent of Tier 1 capital.

Enclosed — for those maintaining sets of the Board's regulations — is the text of the current amendments to the Capital Adequacy Guidelines. Copies of the enclosure will be furnished to others upon request directed to our Circulars Division (Tel. No. 212-720-5215 or 5216); additionally, single copies may be obtained at this Bank (33 Liberty Street) from the Issues Division on the first floor.

Questions regarding on this matter may be directed to Anne Higgins, Financial Analyst, Bank Analysis Division (Tel. No. 212-720-6962).

E. GERALD CORRIGAN,  
*President.*

## Board of Governors of the Federal Reserve System

AMENDMENTS TO  
CAPITAL ADEQUACY GUIDELINES

(Effective January 17, 1992)

## 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:** Revisions to Capital Adequacy Guidelines.

**SUMMARY:** The Board is amending its risk-based and leverage capital guidelines 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 will continue to be included in Tier 1 capital for bank holding companies, up to a limit of 25 percent of Tier 1 capital. This change to the guidelines will afford banking organizations greater flexibility in raising capital.

**EFFECTIVE DATE:** The amendments to the capital adequacy guidelines are effective January 17, 1992.

**FOR FURTHER INFORMATION CONTACT:** Roger T. Cole, Assistant Director (202/452-2618), Roger 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 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 Basel framework, which by its terms applies only to internationally active banks, was adopted by the Federal Reserve for state member banks. In addition, the Board chose to apply a risk-based capital framework similar to the Basel 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

<sup>1</sup> The Basel Accord is a risk-based capital framework that was proposed by the Basel 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 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.

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 company Tier 1 capital is the fact that cumulative preferred, the type of perpetual preferred most prevalent in U.S. financial markets, normally involves preset dividends that can only be deferred, not cancelled. 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

<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.

For these Guidelines to be complete, retain:

- 1) Pamphlet dated March 1989.
- 2) Amendments effective September 10, 1990, and November 8, 1991
- 3) This slip sheet.

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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, on October 31, 1991, the Board proposed removing the limit on the amount of noncumulative preferred stock that bank holding companies may include in Tier 1 capital. This was 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.

By removing the limit for noncumulative perpetual preferred stock, the Board noted, the proposal would 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 would 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 proposal also would conform the treatment of noncumulative preferred for holding companies to the treatment for state member banks, which, consistent with the Basle Accord, may include noncumulative perpetual preferred stock in Tier 1 without any formal limit. The Board indicated that the additional flexibility provided by this proposal could assist bank holding companies to strengthen their capital positions and expand their lending capacity.

The Board noted that, although it was proposing to remove the limit on noncumulative perpetual preferred stock, it continued to believe that bank holding companies should avoid overreliance on preferred stock within Tier 1 capital. In this regard, the Board noted 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 Board further stated that 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, the Board concluded in its proposal that there are a number of mechanisms in place to monitor banking organizations' use of preferred stock and to discourage undue reliance on such instruments.

The comment period for this proposal ended on November 22, 1991. The Board received comments from twenty-one public respondents. None of the commenters opposed the proposal and fourteen commenters, or two-thirds of the total, supported it. Two of these commenters, however, questioned the language in the Board's proposal that overreliance by a banking organization on preferred stock and other nonvoting equity elements within Tier 1 could result in supervisory or enforcement actions. These commenters asked for specific guidance on the permissible upper limit within Tier 1 for such nonvoting instruments.

Seven commenters neither supported nor opposed the proposal but expressed the view that removal of the limitation on noncumulative preferred stock includable in Tier 1 capital would provide little or no benefit to bank holding companies' ability to raise capital because they view the market for noncumulative preferred as limited. Three of the commenters that explicitly supported the proposal expressed similar reservations on the benefits provided by the proposal. Five of the commenters that did not explicitly support the proposal put forth

alternative proposals to increase this ability. One of these suggestions was the removal of the limit on cumulative perpetual preferred stock bank holding companies may include in Tier 1. Another suggestion was to include in capital some amount of identifiable intangible assets such as purchased credit card intangibles and core deposit intangibles.<sup>5</sup>

Based on the comments received, the Board is now issuing in final form amendments to its risk-based and capital leverage guidelines to remove the limitation on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital. Bank holding companies will continue to be able to include cumulative perpetual preferred stock in Tier 1 capital, up to a limit of 25 percent of Tier 1. The Board believes that a limitation on cumulative perpetual preferred stock is appropriate because dividends on this type of instrument can only be deferred, not cancelled. Since the existence of large dividend arrearages could complicate an organization's ability to raise common equity in times of financial difficulty, the Board believes that the amount of cumulative preferred stock bank holding companies can include as Tier 1 capital should continue to be limited to 25 percent.

Although the Board is removing the limit on noncumulative preferred, it continues to believe that common equity should remain the dominant form of a banking organization's capital structure. Thus, the Board will retain the language in its risk-based capital guidelines stating that banking organizations should avoid overreliance on nonvoting equity instruments, including perpetual preferred stock, in their Tier 1 capital. Any determination of overreliance depends on a number of factors including the overall financial condition of the institution, the existence of multiple classes of common shareholders, the level and quality of minority interests in equity accounts of consolidated subsidiaries, and the level and quality of preferred stock. Since these factors can vary greatly among

<sup>5</sup> The Board is currently reviewing the capital treatment of intangible assets together with the other federal financial institutions regulatory agencies and will address this matter separately at a later date.



banking organizations, the Board will continue to make a final determination on overreliance on nonvoting equity elements on a case-by-case basis.

**II. Effective Date**

The amendments to the risk-based and leverage capital guidelines are effective upon publication. The provisions of 5 U.S.C. 553(d) generally prescribing 30 days' prior notice of the effective date of a rule have not been followed in connection with the adoption of this amendment. Section 553(d) also provides that such prior notice is not necessary whenever a rule reduces regulatory burdens or there is good cause for finding that such notice is contrary to the public interest. As noted above, by removing the limitation on the amount of noncumulative perpetual preferred stock bank holding companies may include in Tier 1 capital, this rule does reduce such a regulatory burden.

**II. Regulatory Flexibility Act Analysis**

The Federal Reserve Board does not believe that adoption of this proposal would have a significant economic impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In that regard, the proposed amendment would reduce certain regulatory burdens on bank holding companies. 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 by revising them 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, 78/(b), 78/(g), 78/(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. In Appendix A to part 208 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 to part 225 is amended by revising paragraphs (ii) and (iii) and adding paragraph (iv) in II.A.1., by revising the last three sentences of the third paragraph and the entire fourth paragraph in II.A.1.b., by revising the third entry under the heading and by adding a new entry directly after the newly revised third entry in Attachment II, and by revising footnote 1 in

Attachment VI, to read as follows:

- II. \* \* \*
- A. \* \* \*
- 1. \* \* \*
- (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.
- a. \* \* \*
- 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.

*Attachment II \* \* \**

Components	Minimum requirements after transition period
Qualifying noncumulative perpetual preferred stock.	No limit.
Qualifying cumulative perpetual preferred stock.	Limited to 25% of the sum of common stock, qualifying perpetual preferred stock, and minority interests.

*Attachment VI. \* \* \**

<sup>1</sup> Cumulative perpetual preferred stock is limited within tier 1 to 25% of the sum of

common stockholders' equity, qualifying perpetual preferred stock, and minority interests.

**Appendix D—[Amended]**

3. Appendix D to part 225 is amended by revising the first two sentences in footnote 3 to read as follows:

\* \* \* \* \*

3 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.)

\* \* \*

Board of Governors of the Federal Reserve System, January 13, 1992.

**William W. Wiles,**  
*Secretary of the Board.*

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