FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR PART 325
Capital Maintenance

AGENCY: Federal Deposit Insurance Corporation

ACTION: Final Rule

SUMMARY: The Federal Deposit Insurance Corporation ("FDIC") has adopted a final regulation concerning capital maintenance. The FDIC is required to analyze capital adequacy in taking action on various types of applications, such as mergers and branches, and in the conduct of its various supervisory activities related to the safety and soundness of individual banks and the banking system. Additionally, as a condition of federal deposit insurance all insured banks must remain in a safe and sound condition, including maintaining adequate capital. This regulation: (a) defines capital; (b) establishes minimum standards for adequate capital; (c) establishes standards to determine when an insured bank is operating in an unsafe and unsound condition by reason of the amount of its capital; and (d) establishes procedures for issuing a directive to require an insured state nonmember bank to achieve and maintain a minimum capital ratio.

EFFECTIVE DATE: (30 days from date of publication in the Federal Register.)

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SUPPLEMENTARY INFORMATION:

Background

On July 20, 1984 the FDIC issued a proposed regulation concerning capital maintenance. 49 Fed. Reg. 29399 (1984). Comments had to be received by the FDIC by September 18, 1984.

Capital performs several very important functions in banking institutions. It absorbs fluctuations in income so that banking institutions can continue to operate in periods when losses are being sustained. It also provides a measure of assurance to the public that an institution will continue to provide financial services thereby helping to maintain confidence in individual entities and the banking system as a whole. It serves to support growth yet restrains unjustified or imprudent expansion of assets. Capital also provides protection to depositors in the event of a threatened insolvency.

The Federal Deposit Insurance Corporation, as a regulator and insurer, has always had a critical interest in the maintenance of adequate capital in

individual banking institutions and in the banking system. The protection of depositors and maintenance of stability in the financial system are critical to the mission of the FDIC and capital adequacy plays a key role in the policies and programs used in performing its supervisory functions. A determination of capital adequacy is one of the major objectives of an examination and is one of the five components which form the basis of the Uniform Financial Institution Rating System used by the FDIC in determining the condition of individual banking institutions. Additionally, through passage of the International Lending Supervision Act of 1983 (12 U.S.C. 3901 et seq) ("ILSA") and by requiring the FDIC to consider the adequacy of capital in connection with various applications, the Congress has given explicit statutory recognition to the importance this factor assumes in the safe and sound operation of the Nation's banking system.

Capital of any given bank should be sufficient to maintain public confidence in the institution, support the volume, type and character of the business conducted, provide for the possibilities of loss inherent therein, and permit the bank to continue to meet the reasonable credit requirements of the area served.

The following chart depicts the ratio of equity capital to total assets in the total U.S. commercial banking system since 1960.

Year	Equity Capital/Total Assets
1960	8.1
1970	6.6
1980	5.8
1981	5.8
1982	5.8
1983	6.0

While the vast majority of individual banks have equity capital ratios above six percent, the systemwide ratio has varied over time but, until recently, has clearly demonstrated a declining trend. The Federal bank regulators adopted capital guidelines in 1981 which, together with the efforts of banks to achieve them, have been at least partially responsible for arresting the declining trend.

Several factors have, however, emerged over the past few years which are accentuating the potential demands on bank capital. The deregulation of interest rates on bank liabilities together with a weakening of loan portfolios brought about by shocks in the domestic and world economy have caused a decline in bank profitability and increased levels of risk within the system. The competition for financial services has intensified on both an intra-industry and inter-industry basis, placing additional pressures on bank profitability. Further, because of the growing interdependency within the system, problems in one institution can have repercussions on other institutions arguing for stronger capital levels in both individual banks and the system as a whole. Increasing levels of off-balance sheet risks are also a factor in the need for higher capital.

Section 908 of ILSA (12 U.S.C. 3907) prescribes 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." Pursuant to this authority and the authorities contained in the Federal Deposit Insurance Act, the FDIC is adopting a capital regulation. This regulation will implement the provisions of the ILSA, will foster further improvement in bank capital ratios, and, when combined with similar efforts expected to be taken by the other federal bank regulators, will eliminate the disparities in treatment of the banks supervised by the agencies with respect to capital adequacy. The regulation also sets the procedures, pursuant to the authority contained in ILSA and consistent with due process considerations, for implementing a directive to require banks to maintain adequate capital.

The FDIC has also decided to concurrently adopt a statement of policy on capital which will provide additional guidance on how the Agency intends to implement and enforce the rule.

The regulation applies to insured nonmember commercial and savings banks. State member banks, national banks, and FDIC insured federal savings banks will also be affected by the provisions dealing with termination of deposit insurance and with respect to any application which requires the approval of the FDIC such as a merger with an uninsured institution. The regulations do not apply directly to bank holding companies; however, the statement of policy does provide guidance as to how the FDIC will evaluate holding companies and other bank affiliates in its analysis of capital in individual banks.

On December 17, 1981, the FDIC Board of Directors adopted a policy statement to inform banks and the public of its views concerning capital and capital adequacy [FDIC Statement of Policy on Capital Adequacy, 46 Fed. Reg. 62694 (1981)]. Because of the adoption of this final rule on capital maintenance and the related statement of policy on capital, the Board has revoked the 1981 statement of policy.

Comments

The FDIC's proposed regulation was published for a sixty-day comment period which ended on September 18, 1984. The Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System also published proposed regulations or guidelines shortly thereafter which were very similar to the FDIC's proposal. The comment period for the last of these proposals expired on November 5, 1984. In view of the similarity of the proposals of the FDIC and the other two federal bank regulators and the fact that several commenters were writing to all of the agencies, the FDIC gave consideration to all comments received through November 5, 1984. The FDIC received 136 written comments. Of these comments, 37 were from mutual savings banks, 43 were from smaller commercial banks (under $1 billion in total assets), 30 were from larger commercial banks, and 26 were from other than banks (principally state banking departments, bankers associations, law firms, members of Congress and others).

Of the 136 comments received, 42 were supportive of the regulation largely as proposed and 60 could be characterized as generally opposed to its issuance. The remainder of the comments tended to deal with specific issues rather than an expression of support or opposition for the general thrust of the regulation. Many of these were supportive of the need to increase or halt the decline in bank capital ratios and largely offered alternative suggestions as to how this might be best accomplished or commented on the proposed treatment of certain capital components.

Those expressing support for the proposal were mostly small commercial banks. They tended to favor it largely because capital requirements would be uniform for all banks. Five commenters felt the minimum requirements should be established at a higher level or raised again in the future and several others felt that capital requirements for savings and loan associations, credit unions, and other institutions competing with banks should be comparable to those for banks.

Those expressing opposition to the proposal were mostly mutual savings banks and savings bank associations. Their primary reasons for opposing the regulation were as follows: 1) the proposal will hinder a restructuring of assets or will hinder the growth necessary to develop a sound earnings base; 2) the proposal will require mutual savings banks to raise too much capital too soon or is simply unachievable for mutual savings banks; 3) the proposal will result in inequitable treatment for mutual savings banks in relation to some of their competition, such as savings and loan associations and credit unions; 4) the proposed regulation exceeds the statutory mandate of the ILSA which dealt largely with the international lending problem and is not applicable to mutual savings banks; 5) the proposal will force mutual savings banks to convert to stock form; and 6) the proposal will discourage voluntary mergers of mutual savings banks.

Comments in opposition to the proposal from commercial banks and others echoed the concerns of mutual savings banks about inequities relative to other types of competitors (including foreign banks). The other reasons were different, however, with the major ones being: 1) higher capital requirements will result in banks taking on greater risks to earn the income necessary to pay for the increased cost of capital; 2) banks will reduce liquidity by reducing high quality-low spread assets; 3) capital standards based on total assets fail to recognize different risk profiles in individual banks; and 4) the proposal will place great stress on the money markets. Other objections were: 1) the establishment of minimum capital requirements will have the effect of lowering capital in the industry as the minimum will tend to become the maximum; 2) the proposal does not cite a role for state regulators who are in a better position to determine capital requirements based on community needs and other factors; and 3) higher capital requirements will tend to curtail lending by banks and will result in higher borrowing costs for consumers.

After due consideration to the comments received, the FDIC has decided to proceed with implementation of the regulation. As was noted at the time the proposal was issued for public comment, the regulation is designed to strengthen the capital base in the banking system, eliminate disparities in

capital minimums required of banks of different sizes, and provide direction to banks for capital and strategic planning purposes. The majority of the comments received were generally supportive of these objectives although many of these were concerned with specific aspects of the proposal. The FDIC has duly considered these comments and suggestions and has made some modifications to the original proposal to address them as will be set forth below. The FDIC has, however, decided that the stated objectives can be best accomplished through the issuance of a regulation setting forth the minimum capital requirements for insured banks accompanied by a statement of policy on capital addressing how the regulation will be implemented and enforced by the FDIC. In reaching this decision the FDIC considered and resolved those comments expressing opposition to the proposal as follows.

The FDIC has addressed many of the concerns of mutual savings banks in the statement of policy which sets forth guidelines the FDIC will use in evaluating capital plans for meeting minimum capital requirements submitted by such banks. The comments noted that existing conditions in this industry and the existing capital levels in many mutual savings banks pose a special problem for such banks in complying with the regulation. The idea of establishing lower minimum capital requirements for mutual savings banks was considered and rejected as the FDIC is convinced that the minimum capital requirements set forth in the regulation are just as appropriate for mutual savings banks as they are for commercial banks. The events of the past few years have certainly proven that mutual savings banks are not riskless and many continue to be subject to risks which, although different, are just as devastating as those which exist in some commercial banks. In addition, the minimum capital ratios would apply only to banks with moderate levels of risk whether they be commercial or mutual savings banks. In view of this the FDIC has decided to establish the same minimum capital requirements but permit more time for mutual savings banks to achieve them.

The statement of policy specifies that mutual savings banks with primary capital ratios of 3 percent or above as of the effective date of the regulation will be allowed one year to achieve their minimum capital requirement for each 0.5 percent that their primary capital ratio is below 5.5 percent, up to a maximum of five years. To qualify, however, a mutual savings bank must be able to submit a plan which shows a reasonable ability to achieve its minimum capital requirement within this period from earnings or it must pursue other alternatives such as conversion to stock form or merger. In addition, mutual savings banks which have their capital ratios fall below the minimum as a result of balance sheet restructuring to reduce risk will be accorded largely comparable treatment. The FDIC believes this is an equitable way of dealing with this issue in that it will permit those mutual savings banks capable of restoring themselves to health in a mutual form of ownership an ample opportunity to do so while requiring those which cannot do so to immediately seek other alternatives.

The FDIC is sympathetic to the comments of mutual savings banks and others concerning the unfairness of requiring insured banks to compete with other types of organizations which have lower capital requirements. Notwithstanding, it would be both inappropriate and dangerous for the FDIC to permit capital

ratios in insured banks to fall to the lowest common denominator. Rather, FDIC is and will be an advocate for increased levels of capital in those institutions competing with insured banks, both in Congress and when the opportunity arises in the course of its normal regulatory and supervisory responsibilities.

Insofar as the comments regarding the intent of the ILSA are concerned, the FDIC notes that the legislative history shows that the provision for establishing minimum capital levels in banks was not solely related to the international debt problem. It was a specific legislative response to a court decision (First National Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674 (5th Cir. 1983)) which challenged the authority of a federal bank regulator to establish a minimum capital requirement for a bank. Moreover, the FDIC has the authority to issue this regulation in accordance with its stated mandate of promoting safety and soundness in insured banks irrespective of the ILSA.

Several comments opposed the regulation on the basis of its potential alteration of risk profiles in banks or its failure to appropriately consider risk characteristics in individual banks. The FDIC does not believe these comments fully consider the overall thrust of the regulation. The regulation specifies minimum capital ratios which are applicable only to banks whose overall financial condition is fundamentally sound, which are well-managed and have no material or significant financial weaknesses. The minimum capital requirements of banks which assume inordinate risks, either on or off their balance sheets, will be established at a higher level consistent with the level of risk in each institution. Banks which assume inordinate levels of risk as a means of increasing internal capital generation through earnings will find that the minimum capital requirements set forth in the regulation no longer apply and they will be required to generate additional capital to support the increased risk. Assuming an inordinate level of risk would therefore be counterproductive and it is not something that the FDIC expects well-managed banks to do. There may well be some movement of risk off of bank balance sheets; however, as the level of such risk increases, a commensurate increase in capital to support this higher risk will be necessary.

The FDIC does not view this regulation as a substitute for effective risk management and will not relax its traditional insistence on soundness in all financial and managerial aspects of a bank's operations, of which adequate capital is but one. The regulation does nothing more than establish minimum capital requirements and impose certain sanctions on banks which fail to meet the minimums. It does not inhibit the FDIC from making an independent evaluation of capital adequacy in any bank nor from taking appropriate supervisory action in connection with any deficiency in a bank's operations. Moreover, the statement of policy specifies that the FDIC will encourage even fundamentally sound, well-managed banks to maintain capital above the minimums and will carefully evaluate (and criticize where appropriate) earnings and growth trends, dividend policies, capital planning procedures and other factors important to the continuous maintenance of adequate capital.

Some commenters also felt that the regulation will place great stress on the money markets and will have adverse effects on consumers through curtailed lending and higher borrowing costs. The FDIC does not believe that the facts fully justify these concerns; however, certain provisions have been incorporated into the statement of policy which address them to a limited extent. As of September 30, 1984, less than four percent of the Nation's commercial and mutual savings banks had capital ratios less than the minimums set forth in this regulation. It is estimated that these banks would have needed approximately $6.3 billion to achieve the minimum requirements at that time. Of this total, about $4 billion would be required in commercial banks and the balance in mutual savings banks. It is estimated that, in 1983, the commercial banking industry raised about $4 billion in total capital from external sources, about 33% of which was equity capital.

In the statement of policy the FDIC has provided that sound, well managed commercial banks which are below the minimums as of the effective date of the regulation will be given up to 12 months from the date FDIC approves the bank's plan to raise the required capital. This, together with the 60 days provided in the regulation for the submission of plans, will provide up to 14 months from the effective date of the regulation for banks to achieve compliance. As was noted earlier, mutual savings banks will be given more time because of the special problems which exist for these banks. The FDIC believes this is a sufficient time for both commercial and mutual savings banks to generate the required capital through earnings or acquisition of external funding, as the case may be. It should be noted, however, that banks with excessive risks or banks whose capital ratios fall below the required minimums will be required to immediately take the necessary steps to achieve their minimum capital requirements. With respect to banks having excessive risks, both their level of required capital and the time frame for achieving it will generally have already been addressed in a formal or informal administrative action.

With almost 96% of the banks in the nation not being impacted by this regulation and with the time permitted for other institutions to achieve compliance, it is not expected that there would be any meaningful adverse impact on bank consumers in terms of either the availability or the cost of credit. It is recognized that increased capital does impose some additional costs on banks and can serve to impede growth; however, the need for those banks which are impacted to remain competitive with those which are not mitigates any serious concerns about adverse effects on consumers.

With respect to the one comment about the failure of the proposal to cite a role for state regulators, the FDIC would point out that it has traditionally consulted with state regulators in establishing bank capital requirements and will continue to do so. The statement of policy does, however, specify that banks will be expected to meet any capital requirements established by its primary state or federal regulator which exceed the minimums set forth in the regulation. It additionally specifies that the FDIC will consult with such primary regulators when establishing capital requirements which are higher than the minimums.

The provisions of the final regulation and a summary of the comments received on specific issues associated with these provisions are detailed below.

Minimum Capital Requirements

The final regulation requires that all FDIC-insured state nonmember banks will be required to maintain a ratio of total capital to total assets of not less than 6 percent and a ratio of primary capital to total assets of not less than 5.5 percent. Other insured banks submitting applications to the FDIC will be subject to the same requirements. The regulation further specifies that this is the minimum capital requirement for fundamentally sound, well-managed banks which have no material or significant financial weaknesses. Where the FDIC determines that a bank does not meet this definition it may determine that a higher minimum primary and/or total capital ratio is required.

There were very few comments concerning the level of the minimum requirements. This segment of the regulation is unchanged from the original proposal except for the specific addition of "off balance sheet risk" as one of the factors which may cause FDIC to find that a bank is not fundamentally sound and well managed. This was clearly defined as one of the criteria in the discussion of the proposal which was published for public comment and is simply being added to the language in section 325.3(a).

In the statement of policy on capital the FDIC provides a general definition of a fundamentally sound, well-managed bank as one which evidences a level of risk which is no greater than that normally associated with a Composite rating of 1 or 2 under the Uniform Financial Institution Rating System. The statement of policy makes it clear, however, that this is a determination which will be made by the FDIC in each individual bank based upon the condition and circumstances in that bank. This definition was included to assist banks in determining what the FDIC's capital expectations for them will likely be on a continuous basis between examinations. The FDIC currently advises banks of their Composite rating and, from this reference point, banks will have some ability to continually assess what FDIC's future capital expectations will be based on changing circumstances within the institution.

Definition of Primary Capital

Section 325.2(h) of the regulation defines primary capital as the sum of common stock, perpetual preferred stock, capital surplus, undivided profits, capital reserves, mandatory convertible debt (to the extent of 20 percent of primary capital exclusive of such debt), minority interests in consolidated subsidiaries, net worth certificates issued pursuant to 12 U.S.C. 1823(i) and the allowance for loan and lease losses and minus intangible assets other than mortgage servicing rights and assets classified loss. This definition differs from the one that appeared in the proposal which was published for comment with respect to the treatment of the mortgage servicing rights component of intangible assets. A definition of perpetual preferred stock has also been added to the regulation.

There were numerous comments on several issues associated with the definition of primary capital. The most extensive comments related to the exclusion of intangible assets from primary capital. Twenty-nine comments were received on this issue. One suggested that intangible assets should not be counted as either primary or secondary capital. Another suggested allowing intangible assets as primary capital in bank holding companies but not in banks. The remaining comments recommended the inclusion of intangible assets in primary capital in some form. Eleven recommended the inclusion of either core deposit intangibles, mortgage servicing rights, or only those intangible assets with identifiable values. Sixteen comments recommended that all intangible assets be counted as primary capital although seven of these recommended some limit on the amount which could be included. Many of these comments contained lengthy discussions as to why certain classes of intangible assets were appropriate as primary capital.

The FDIC has long been opposed to the inclusion of intangible values in its determination of a bank's equity capital as a matter of general policy. The FDIC Statement of Policy on Capital Adequacy which was adopted by the Board of Directors on December 17, 1981 continued a long-standing practice of excluding intangible assets as a component of equity capital. Prior to the adoption of this statement of policy, and for a short time thereafter, the FDIC generally even required that intangible assets held by banks be charged off and not be reflected on the bank's books. The FDIC later permitted banks to record intangible assets on their books; however, it has continued to deduct such assets from equity capital when assessing capital adequacy. At the same time, it is fully recognized that substantial differences exist among the various classes of intangible assets in terms of the quality and marketability of the rights or values which they represent and the FDIC has in specific circumstances permitted some banks to count certain intangible assets as equity capital.

Therefore, the FDIC has carefully considered the intangible asset issue and the comments thereon and has concluded that it would be more appropriate to evaluate each class of intangible assets that might appear on a bank's balance sheet on the basis of its own nature and characteristics rather than to approach intangibles as a single homogeneous asset category. If an individual class of intangible assets were found to be of sufficient quality, it would treated in the same manner as all other asset categories on the balance sheet for purposes of capital adequacy. Otherwise, that particular class of intangible assets would continue to deducted from the components of primary capital as was originally proposed.

Intangible assets may be characterized according to the manner in which they are acquired, their separability from an entire banking organization, their marketability, and the certainty of the future cash flows or income stream they represent. The intangibles encountered in banks are typically acquired in a purchase of all or part of another business enterprise although mortgage servicing rights can also be acquired by themselves as a single asset. Along a similar vein, intangibles such as goodwill and core deposit intangibles cannot be separated from the remainder of a bank's assets and sold or otherwise disposed of apart from the bank as a whole or a substantial part of

it whereas such a separation is possible with mortgage servicing rights. Due in part to this separability, there is a fairly active market for these servicing rights which in turn adds a degree of liquidity to this class of intangibles.

The estimated future cash flows or income streams associated with the rights or values underlying intangible assets vary considerably with respect to their certainty and predictability. Interest rate deregulation has been undermining the concept of the low cost core deposit base and assumptions about the average remaining lives of such deposits when acquired and the interest rate spreads projected over these lives have made the valuation of purchased core deposit intangibles increasingly subjective. As for goodwill, the future income stream it purports to represent is even less quantifiable and the value assigned to this intangible may be associated more with what a bank is willing to pay to expand into new markets or to increase market penetration. On the other hand, mortgage servicing rights are derived from known servicing fee rates on a specified group of mortgages with contractual repayment terms and reasonably predictable prepayment characteristics.

When judged in terms of the framework described above, mortgage servicing rights are the only class of intangible assets whose attributes can be favorably resolved for capital adequacy purposes from the FDIC's perspective. Accordingly, the FDIC concurs with those commenters who recommended that purchased mortgage servicing rights as a class of asset should be counted in full in the measurement of a bank's primary capital. A definition of mortgage servicing rights has been added in section 325.2(f). Nonetheless, FDIC examiners will assess the quality of such intangibles on a bank-by-bank basis during examinations in the same manner that they evaluate tangible assets. Where the carrying value of mortgage servicing rights at an individual bank cannot be properly supported, an adverse classification would be accorded. Should a loss classification be assigned, the amount classified would be deducted from capital as prescribed in the regulation.

One further reason why the FDIC has rejected the use of intangible assets other than mortgage servicing rights as primary capital arises from systemic concerns. When banks purchase other business enterprises in a manner which gives rise to the creation of intangible assets, the equity capital which supported the risk in the purchased bank or business is extinguished. This reduces capital in the banking industry unless the former stockholders reinvest in new equity issues in other banks or the purchasing bank issues equity to the former stockholders or replaces the equity from new sources. While the FDIC cannot control the investment choices of the stockholders of the acquired bank or business, it can, through the nonrecognition of intangible assets other than purchased mortgage servicing rights as primary capital, encourage the replacement of that portion of the lost equity which is required to support the risk assumed in the purchasing bank. The FDIC feels strongly that this issue is a significant safety and soundness concern in terms of capital adequacy in both individual banks and the banking system. It is recognized that the exclusion of intangible assets other than mortgage servicing rights from primary capital will place some restraints on banks purchasing other banks and businesses including those failed banks which the FDIC seeks to

handle through purchase and assumption transactions; however, it is believed to be the best solution in terms of the future soundness of the banking system.

As a final note on the issue of intangibles, section 325.5(b) has been added to grant specific authority for banks which have had intangible assets specifically approved as equity capital prior to the effective date of this regulation to continue to count such assets as primary capital subject to the amortization of such assets over their estimated useful lives or a period not in excess of 15 years, whichever is shorter.

Another issue extensively commented upon was the use of equity commitment notes as primary capital. These are subordinated debt obligations which are expected to be repaid in cash but relative to which the issuing bank commits to their replacement with equity capital prior to the maturity of the debt. The proposal which was issued for comment stated that the definition of mandatory convertible debt specifically excluded such notes. Twelve comments were received on this issue. Two felt equity commitment notes should not be permitted as primary capital and ten felt they should be included.

After carefully considering the comments and the nature of these instruments, the FDIC decided to retain the definition of mandatory convertible debt (section 325.2(e)) as originally proposed. Under the FDIC Statement of Policy on Capital Adequacy adopted in 1981, mandatory convertible debt has included only those subordinated debt instruments that are required to be converted into the issuing bank's common or perpetual preferred stock. While the issuer of equity commitment notes agrees in advance to sell stock in sufficient amounts to replace the debt obligation, there is no assurance that the bank in spite of its best efforts will in fact be able to do so. Once such a situation becomes evident, the amount of the equity commitment notes would no longer be eligible to be treated as primary capital components. However, between the issue date of the notes and the date when their replacement failed to occur, the bank's primary capital ratio would have in effect been overstated. As a consequence, the FDIC's supervisory response to conditions and practices within the institution during this period may have been less than what would otherwise have been appropriate.

The FDIC also left unchanged the proposed requirement that mandatory convertible debt have a maturity of not more than 12 years and the provision that mandatory convertible debt may comprise no more than 20 percent of a bank's primary capital exclusive of such debt. There were very few comments concerning these issues.

Prior to the adoption of this regulation the FDIC permitted 100 percent of a mandatory convertible debt issue to be counted as equity capital where the bank's primary regulatory authority includes such debt in a determination of the solvency of the bank. The FDIC has added section 325.5(a) to the regulation to permit banks which have had such instruments approved by the FDIC as equity capital prior to the effective date of this regulation to continue to include such instruments in equity capital. This action was suggested by several of the commenters.

The FDIC has also added two other sections to the regulation which relate to the definition of primary capital. The first is a definition of perpetual preferred stock in section 325.2(g). This provision incorporates the definition of perpetual preferred stock which is contained in the instructions for the preparation of Consolidated Reports of Condition and Income but specifically excludes any issue which contains an escalation of the dividend rate to such a high level as to effectively require the issuer to redeem the issue. During the comment period it came to the FDIC's attention that banks could issue perpetual preferred stock which complies with the Report of Condition instructions but which incorporates a substantial increase in the dividend rate at some point during the life of the instrument. Where such increases are particularly excessive they effectively force the bank to redeem the issue much as if it were a limited life preferred stock issue. The FDIC has not established specific requirements as to how much of a rate escalation would be permitted; however, in the statement of policy banks are cautioned that such instruments may be disallowed as primary capital and are encouraged to submit them for FDIC review before issuing perpetual preferred stock with such rate increases.

The second change is the addition of section 325.5(c) which specifies that any transaction or balance sheet entry which would increase an insured bank's primary capital but which does not provide support to the insured bank by providing a cushion to absorb losses shall be deducted from primary capital. The statement of policy provides an example of such a transaction involving minority interests in consolidated subsidiaries which creates merely an illusion of capital support. The FDIC is vitally interested in maintaining the integrity of primary capital as a permanent capital base for a bank and feels the inclusion of this provision will help assure that result.

Definition of Secondary Capital

In the proposal issued for public comment the FDIC specifically asked for comment on two issues associated with secondary capital.

1. Should limits be placed on the amount of subordinated notes and debentures and limited life preferred stock that is included in secondary capital?

2. Should limits be placed on the amount of secondary capital that can be included in total capital?

Twelve comments were received on the first issue with all but one feeling that it was appropriate to place some maturity limitation on subordinated debt that could be counted as secondary capital. Most of these recommended the discounting of such debt for secondary capital purposes by 20% annually over the last five years of the life of such instruments.

Despite these comments the FDIC has decided to place no maturity requirements on subordinated debt over and above those which were already imposed in section 329.10 of the FDIC's rules and regulations. It was reasoned that,

with the severe sanctions for noncompliance with primary and secondary capital requirements now being imposed through regulation, there was little need to place additional discounting restrictions on subordinated debt. Discounting restrictions effectively impose higher capital requirements by forcing replacement debt to be issued prior to the actual maturity of the issues they replace. The FDIC felt that, with the incentive of regulatory compliance which is now being imposed, it was unnecessary to impose requirements which would discount subordinated debt for capital adequacy purposes prior to its maturity.

As a matter of clarification the FDIC has incorporated relevant portions of the definition of subordinated notes and debentures from section 329.10 of the FDIC's rules and regulations into the regulation in section 325.2(j).

Nineteen comments were received on the second issue. Two suggested that secondary capital should not be recognized at all, eight recommended that no limits be placed on secondary capital, and nine recommended that secondary capital be limited to some specified percentage of primary capital.

The FDIC has decided to impose a provision in the regulation whereby secondary capital components can comprise no more than 50 percent of a bank's primary capital for the purpose of calculating the total capital ratio. This was the limit suggested by most of the commenters who felt that some limit should be imposed. This action was also believed justified to prohibit banks from reporting to the public total capital ratios which are comprised of inordinate amounts of secondary capital components.

The FDIC took one further action which impacts the definition of secondary capital. The original proposal permitted intangible assets as well as limited life preferred stock, subordinated notes and debentures, and the portion of mandatory convertible debt which is not counted as primary capital to be used as secondary capital. That proposal did not place a limit on the amount of intangible assets eligible for inclusion in secondary capital after excluding all intangibles from primary capital. However, because of the decision that the purchased mortgage servicing rights class of intangibles should not be deducted from the sum of the primary capital components, the FDIC also reconsidered its proposed treatment of intangible assets in secondary capital. Hence, the FDIC has concluded that the definition of secondary capital in the final regulation (section 325.2(i)) should not include any intangibles. As was noted earlier, the FDIC has historically not permitted the use of intangible assets in its analysis of capital adequacy and it was therefore felt that the Agency should not proceed beyond its acceptance of purchased mortgage servicing rights in primary capital.

Effect on Banks Which are Not in Compliance

The regulation imposes several sanctions on banks which are not in compliance with the minimum capital requirements:

1. Banks in noncompliance will not have applications approved (Section 325.3(c)) with two exceptions: a) the FDIC retains the authority to approve applications involving failed or failing banks; and b) the FDIC may approve applications for banks which have committed to and are in compliance with an acceptable plan. These requirements are unchanged from the original proposal submitted for public comment.

2. Section 325.4(b) specifies that a bank having less than its minimum capital requirement will be deemed to be engaging in an unsafe and unsound banking practice unless it has entered into and is in compliance with a written agreement or an acceptable plan to increase its capital to such levels as FDIC deems appropriate. Such banks will be subject to the issuance of directives or cease and desist actions under sections 8(b)(1) and/or 8(c) of the FDI Act. This provision is largely unchanged from the original proposal except to make it clear that a bank which has complied with the requirement for a written agreement or a plan will not be deemed to be engaging in an unsafe and unsound banking practice solely on account of its capital ratios.

3. Section 325.4(c) specifies that any insured bank with a primary capital ratio of less than 3 percent will be deemed to be operating in an unsafe and unsound condition unless it has entered into a written agreement with the FDIC (or its other primary federal regulator with FDIC a party to the agreement) to increase its capital to such level as the FDIC deems appropriate. A written agreement is defined in section 325.2(m) as an agreement which is enforceable under section 8(a) and/or section 8(b) of the FDI Act. These provisions are essentially unchanged from the original proposal submitted for public comment.

Comments on these provisions of the regulation were directed for the most part at the form in which it should be issued (regulation or guidelines) and the section dealing with the sanctions on banks which had primary capital ratios under 3 percent. Twenty comments were received on the form in which the proposal should be issued with two favoring a regulation and 18 favoring guidelines. Those preferring guidelines generally mentioned the need to maintain flexibility in the enforcement of the requirement with respect to individual banks and felt that guidelines better served this purpose. Notwithstanding these comments, the FDIC has decided to impose the requirements in the form of a regulation because of substantive advantages that a regulation provides in enforcing the requirements. By adopting a regulation employing the statutory language incorporated into the FDIC's enforcement authorities, the Agency will be able to more quickly and effectively use its enforcement tools to insure compliance in those situations where this is necessary. The FDIC believes that sufficient flexibility has been built into the regulation and it has also decided to issue an accompanying statement of policy on capital which sets forth how the FDIC will interpret and enforce the regulation.

The comments concerning the requirements placed on banks which have primary capital ratios under 3 percent were received primarily from mutual savings banks. Eleven comments were received including nine which felt this language was dangerous, could cause runs, would make it difficult to raise capital, or was not consistent with either the Net Worth Certificate Program or the capital requirements imposed on savings and loan associations. Two commercial banks felt that the language should be changed to require the FDIC to institute a termination of insurance action when a bank's primary capital was below 3 percent. As was noted in the previous paragraph the FDIC has purposely structured a regulation which will permit the Agency to use its various enforcement tools quickly and effectively when the need arises. The Agency's experience has shown that banks whose capital ratios decline to a very low level are usually beset with problems which have caused this decline and they frequently have substantial difficulty in attracting new capital. Banks of this nature pose a substantial risk to the deposit insurance fund and are normally deserving of the Agency's most aggressive supervisory attention. The FDIC fully recognizes the severe implications of an action to remove deposit insurance and has never taken its responsibilities lightly in the use of this authority; however, the initiation of an action to terminate deposit insurance has proven to be an effective means of encouraging banks to new heights of effort in resolving their problems or, if all fails, of hastening the inevitable failure of the institution at a sometimes significant cost savings to the FDIC. Although the FDIC fully intends to use its insurance termination authority in cases of this nature, it is not required to do so under the regulation and will continue to review the merits of each individual case. Further, the definition of a written agreement as being enforceable as an action under section 8(a) (and/or section 8(b) for a state nonmember bank) will enable the Agency to move more quickly in those cases where such agreements are violated.

In response to the comment concerning the consistency with the Net Worth Certificate Program, the FDIC has made it clear in the statement of policy that banks which are participating in the Net Worth Certificate Program and are in compliance with the requirements of that program will not be determined to be in an unsafe and unsound condition solely on the basis of their capital ratios. However, the boards of such banks and the FDIC Board of Directors must also agree that the net worth certificate agreements they enter into are enforceable under sections 8(a) and 8(b) of the FDI Act.

There were no comments relating to the application of the exception to section 325.3(c)(2) contained in section 325.3(d)(2). However, the FDIC believes that it is appropriate to explain the application of that exception to an application for a merger or other type of business combination. In this type of application, the plan of merger, acquisition or etc. will be considered a reasonable plan where the resulting entity, whether or not it is insured by the FDIC, will have adequate capital pursuant to this regulation. Thus, the FDIC may, in its discretion, approve such a transaction pursuant to section 325.3(d)(2) where the applicant does not meet the minimum capital requirement.

Other Comments and Changes

Nine comments were received specifically suggesting that average total assets should be used as the denominator in calculating capital ratios rather than total assets on a specific date. The FDIC agrees with these suggestions and has appropriately amended the definition of total assets in section 325.2(k).

Eight comments were received suggesting that the FDIC adopt specific zones of capital adequacy similar to what the Board of Governors of the Federal Reserve System included in its proposed guidelines which were issued for public comment on July 26, 1984. The thrust of this proposal was to establish three zones of total capital (below 6 percent - between 6 and 7 percent - and above 7 percent) and specify what the Board of Governors' supervisory response would be for banks falling within those zones. The supervisory response indicated in the Federal Reserve proposal for banks with total capital ratios below 6 percent is largely comparable to that set forth in the FDIC's regulation. The supervisory response indicated for banks with total capital ratios between 6 and 7 percent would be largely comprised of an intense of analysis of related financial factors. If these are not found to be satisfactory, appropriate action would be taken. The FDIC has indicated in its statement of policy on capital an intent to do this same type of analysis (and to take comparable action) in all banks, including those which have capital ratios above the minimums. The FDIC does not believe that there are significant differences between the two proposals in terms of the supervisory response of the two agencies and has chosen not to specifically identify zones of capital adequacy.

The final regulation and the statement of policy indicate that the FDIC will be calculating primary and total capital ratios based on consolidated statements prepared in accordance with the instructions for the preparation of Consolidated Reports of Condition and Income with two exceptions. Certain other exceptions may also be necessary at a later date.

On November 23, 1984 the FDIC adopted a final regulation (12 C.F.R. Part 337) setting forth standards governing the securities activities of state nonmember banks. That regulation required that certain securities activities be conducted in separate bona-fide subsidiaries of the bank and specified that a bank's investment in such subsidiaries would not be counted toward the bank's capital. In those instances where such a securities subsidiary is consolidated in a bank's Consolidated Report of Condition, it will be necessary, for the purpose of calculating the bank's primary and total capital ratios, to adjust the Consolidated Report of Condition in such a manner as to reflect the bank's investment therein on an unconsolidated basis in accordance with the equity method. In this case, and in those cases where the subsidiary has not been consolidated, the investment in the subsidiary will then be deducted from the bank's capital and assets prior to calculation of its primary and total capital ratios (section 325.5(d)).

In addition, on December 13, 1984, the FDIC published for comment a proposed revision to 12 C.F.R. Part 332. 49 Fed. Reg. 48552 (1984). This proposal would relate to the conduct of certain real estate and insurance activities of insured banks that are otherwise authorized by law. Among other things, the

proposal would require these activities to be conducted in a bona-fide subsidiary as defined in the regulation. If this proposal is adopted in its current form or with a provision of similar effect, Part 325 will be amended at the same time to conform to its provisions. Specifically, for capital adequacy purposes, the accounting treatment of such subsidiaries will be made the same as the treatment of securities subsidiaries pursuant to section 325.5(d) (see also 12 C.F.R. Part 337).

The second exception to the use of consolidated statements prepared in accordance with the instructions for the preparation of Consolidated Reports of Condition and Income relates to the treatment of bank subsidiaries that are domestic depository institutions such as commercial banks, savings banks, or savings and loan associations. These subsidiaries are not consolidated on a line-by-line basis with the bank parent in the bank parent's Consolidated Reports of Condition and Income. Rather, the instructions for these reports provide that bank investments in such subsidiaries are to be reported on an unconsolidated basis in accordance with the equity method so that aggregate data for depository institutions and the deposit insurance assessment base for individual banks are not overstated. Were it not for these concerns, depository institution subsidiaries would be consolidated in the Reports of Condition and Income consistent with generally accepted accounting principles. Moreover, the FDIC believes that the minimum capital requirements prescribed in this regulation should apply to a bank's depository institution activities in their entirety, regardless of the form that the organization's corporate structure takes. The FDIC currently follows this approach for assessing capital adequacy in cases where depository institution subsidiaries are present in banks. Accordingly, section 325.5(e) has been added to specify that domestic depository institution subsidiaries of banks that are not consolidated for purposes of the Consolidated Reports of Condition and Income are to be consolidated for purposes of capital adequacy calculations.

In the statement of policy the FDIC has also specified how it will analyze capital adequacy in banks which are members of bank holding companies or chain banking groups. Where bank holding companies are deemed to be sound and are in compliance with the minimum capital ratios specified by the Board of Governors of the Federal Reserve System, the FDIC will not generally require additional capital in subsidiary banks under its supervision over and above that which would be required by the subsidiary bank on its own merit. The FDIC will, however, consider the potential impact of excessive leverage or risk in bank holding companies or chain banking groups in its analysis of capital in specific banks which are members of such systems.

A new section 325.3(c)(4) has been added to clarify the situation where there is a merger, acquisition or other type of business combination requiring FDIC approval. It follows the requirement in 12 U.S.C. 1828(c)(5) that the FDIC shall take into consideration the financial resources of the existing and proposed institutions.

Directives

Section 908 of ILSA authorizes the FDIC to issue a directive to an insured nonmember bank that fails to maintain the minimum capital requirement. A directive may require a bank to submit and adhere to a plan for achieving such requirement. A directive, including a capital adequacy plan submitted thereunder, is a final order enforceable in the appropriate United States district court in the same manner and to the same extent as a final cease-and-desist order issued under 12 U.S.C. 1818(b). The issuance of a directive is discretionary, and a directive may be issued in lieu of, in conjunction with, or in addition to existing enforcement tools available to the FDIC. Procedures leading to the issuance of a directive have been established which are designed to provide banks with due process.

No comments were received concerning the issuance of directives (section 325.6). However, various changes have been made. A sentence was added at the end of section 325.6(c)(1). This allows the FDIC to include specific requirements for meeting the minimum capital requirement in the notice of intent to issue a directive.

Section 325.6(c)(3) deletes the 14-day period in which the FDIC must respond to the bank's response to the proposed issuance of a directive. This change is necessary to allow time for the processing of the bank's response and reaching a determination on it. In addition, a sentence has been added which clarifies the fact that, after consideration of the bank's response, the original proposed directive or a modified version, if warranted by evidence presented to the Board of Directors of the FDIC, may be issued.

A new section 325.6(c)(4) has been added which permits a bank to ask for reconsideration of or changes in its capital plan upon a showing of changed circumstances. This additional language clarifies the intent of the original regulation. Former sections 325.6(c)(4) and (5) have been renumbered 325.6(c)(5) and (6).

Regulatory Flexibility Analysis -- Paperwork Reduction Act

In accordance with the FDIC's policy statement entitled "Development and Review of FDIC Rules and Regulations" and the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), the FDIC conducted an analysis of the impact of the proposed regulation prior to publication of the proposed rule. The result of that analysis follows:

The regulation is not expected to have any significant economic impact on banks, including small banks. The FDIC is currently required by statute to consider bank capital in a number of situations. These include applications for deposit insurance, branching, mergers and relocations of offices. In addition, under sections 8(a) and (b) of the Federal Deposit Insurance Act (12 U.S.C. 8(a) and (b)) the FDIC is charged with the responsibility of requiring a bank to take corrective action or revoking federal deposit insurance when the bank is in an unsafe or unsound condition or is operating in an unsafe or unsound manner. In addition, 12 U.S.C. 3907(a)(1) requires

the FDIC to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the appropriate federal banking agency deems appropriate."

In carrying out its responsibilities the FDIC has always considered the capital adequacy of banks. It was only recently that the FDIC promulgated a written policy to inform banks and the public of its beliefs concerning capital and capital adequacy [FDIC Statement of Policy on Capital Adequacy, 46 Fed. Reg. 62694, December 28, 1981, effective December 17, 1981]. The FDIC now believes that because of the importance of capital and the requirements contained in 12 U.S.C. 3907(a)(1) it would better serve insured banks' and the public's interest if capital were defined in a regulation, thereby insuring that there will be no confusion regarding the components and level of adequate capital. Furthermore, the FDIC wants to make it clear to the banking industry and the public exactly what standards are used in assessing capital adequacy and how the FDIC exercises its statutory duties with regard to the safety and soundness of banks in its consideration of capital adequacy.

Historically there have been higher capital ratios in smaller banks. To the extent that this regulation equalizes those requirements it will lessen the burden on small banks.

The information collection requirements contained in this rule pertaining to the preparation of a written plan by a bank to raise its capital ratio have been approved by the Office of Management and Budget pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3504(h)) and assigned control number 3064-0075.

List of Subjects in 12 C.F.R. Part 325. Bank deposit insurance; Banks, banking; Federal Deposit Insurance Corporation; Capital adequacy; State nonmember banks.

In consideration of the foregoing, the FDIC hereby adopts a new Part 325 of title 12 of the Code of Federal Regulations as follows:

PART 325 - CAPITAL MAINTENANCE

Sec.

AUTHORITY: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1819 (Tenth), 1828(c), 1828(d), 1828(i), 3907, 3909.

§ 325.1 Scope.

The provisions of this part apply to those circumstances for which the Federal Deposit Insurance Act or this chapter requires an evaluation of the adequacy of a bank's capital structure. The FDIC is required to evaluate capital before approving various applications by banks. The FDIC also must evaluate capital, as an essential component, in determining the safety and soundness of banks it insures and supervises. This part establishes the criteria and standards FDIC will use in determining capital adequacy for banks.

§ 325.2 Definitions.

In this part:

(a) Assets classified loss. The term "assets classified loss" means assets that have not been charged-off from the bank's books or collected and that have been determined by an evaluation made by a state or federal bank examiner at the immediately preceding examination of the bank to be a loss.

(b) Bank. The term "bank" means an FDIC insured, state-chartered commercial or savings bank that is not a member of the Federal Reserve System.

(c) Insured bank. The term "insured bank" means any bank (except for a foreign bank having an insured branch) the deposits of which are insured in accordance with the provisions of the Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.).

(d) Intangible assets. The term "intangible assets" means those assets that are required to be reported in the item for intangible assets in a banking institution's "Reports of Condition and Income" (Call Report).

(e) Mandatory convertible debt. The term "mandatory convertible debt" means a subordinated debt instrument which requires the issuer to convert such instrument into common or perpetual preferred stock by a date at or before the maturity of the debt instrument. The maturity of these instruments must be 12 years or less.

(f) Mortgage servicing rights. The term "mortgage servicing rights" means the purchased rights to perform the servicing function for a specific group of mortgage loans that are owned by others. Mortgage servicing rights must be amortized over a period not to exceed 15 years or their estimated useful life, whichever is shorter.

(g) Perpetual preferred stock. The term "perpetual preferred stock" means a preferred stock that does not have a stated maturity date or that cannot be redeemed at the option of the holder. It includes those issues of preferred stock that automatically convert into common stock at a stated

date. It excludes those issues, the rate on which increases, or can increase, in such a manner that would effectively require the issuer to redeem the issue.

(h) Primary capital. The term "primary capital" means the sum of common stock, perpetual preferred stock, capital surplus, undivided profits, capital reserves, mandatory convertible debt (to the extent of 20 percent of primary capital exclusive of such debt), minority interests in consolidated subsidiaries, net worth certificates issued pursuant to 12 U.S.C. 1823(i) and the allowance for loan and lease losses and minus intangible assets other than mortgage servicing rights and assets classified loss.

(i) Secondary capital. The term "secondary capital" means the sum of mandatory convertible debt that is not included in primary capital, limited life preferred stock and subordinated notes and debentures, in an amount up to 50 percent of primary capital.

(j) Subordinated note and debenture. The term "subordinated note and debenture" means an obligation other than a deposit obligation that:

(1) Bears on its face, in boldface type, the following: This obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation;
(2) Has a maturity of (i) at least seven years, or (ii) in the case of an obligation or issue that provides for scheduled repayments of principal, has an average maturity of at least seven years; provided that the FDIC may permit the issuance of an obligation or issue with a shorter maturity or average maturity if the FDIC has determined that exigent circumstances require the issuance of such obligation or issue; provided further that the provisions of this paragraph (2) shall not apply to mandatory convertible debt obligations or issues;
(3) States expressly that it is subordinated to the claims of depositors and is ineligible as collateral for a loan by the issuing bank; and
(4) Is unsecured.

(k) Total assets. The term "total assets" means the average of total assets required to be included in a banking institution's "Reports of Condition and Income" (Call Reports), as these reports may from time to time be changed, as of the most recent report date plus the allowance for loan and lease losses and minus assets classified loss and intangible assets other than mortgage servicing rights. In the case of commercial banks, the average of total assets is found in the schedule of quarterly averages. In the case of savings banks, the average of total assets is found in the memoranda to the balance sheet.

(l) Total capital. The term "total capital" means the sum of primary capital and secondary capital.

(m) Written agreement. The term "written agreement" means an agreement in writing executed by authorized representatives entered into with the FDIC

by an insured bank which is enforceable by an action under section 8(a) (and/or section 8(b) for a state nonmember bank) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a), (b)).

§ 325.3 Minimum capital requirement.

(a) General. Banks must maintain at least the minimum capital requirement set forth in this section. The capital standards in this part are the minimum acceptable for banks whose overall financial condition is fundamentally sound, which are well-managed and which have no material or significant financial weaknesses. Where the FDIC determines that the financial history or condition, including off-balance sheet risk, managerial resources and/or the future earnings prospects of a bank are not adequate and/or a bank has a significant volume of assets classified substandard, doubtful or loss or otherwise criticized, the FDIC may determine that the minimum adequate amount of total capital and/or primary capital for that bank is greater than the minimum standards stated in this section. These same criteria will apply to any insured bank making an application to the FDIC for purposes of the FDIC's consideration of that application.

(b) Calculation of minimum capital requirement. The minimum capital requirement for a bank (or an insured bank making an application to the FDIC) shall consist of a ratio of total capital to total assets of not less than 6 percent and a ratio of primary capital to total assets of not less than 5.5 percent.

(c) Insured banks with less than minimum capital requirement.

(1) A bank (or an insured bank making an application to the FDIC) operating with less than the minimum capital requirement does not have adequate capital and therefore has inadequate financial resources.

(2) Any insured bank operating with an inadequate capital structure, and therefore inadequate financial resources, will not receive approval for an application requiring the FDIC to consider the adequacy of its capital structure or its financial resources.

(3) A bank having less than the minimum capital requirement shall, within 60 days of the effective date of this regulation, submit to its FDIC regional director for review and approval a reasonable plan describing the means and timing by which the bank shall achieve its minimum capital requirement.

(4) In any merger, acquisition or other type of business combination where the FDIC must give its approval and where it is required to consider the adequacy of the financial resources of the existing and proposed institutions, approval will not be granted when the resulting entity, whether or not insured by the FDIC, does not meet the minimum capital requirement.

(d) Exceptions. Notwithstanding the provisions of paragraphs (a), (b) and (c) of this section:

(1) The FDIC, in its discretion, may approve an application pursuant to the Federal Deposit Insurance Act where it is required to consider the adequacy of capital if it finds that such approval must be taken to prevent the closing of a financial institution or to facilitate the acquisition of a closed financial institution, or, when severe financial conditions exist which threaten the stability of an insured financial institution or of a significant number of financial institutions insured by the FDIC or the Federal Savings and Loan Insurance Corporation (FSLIC) or of insured institutions possessing significant financial resources, such action is taken to lessen the risk to the FDIC or the FSLIC posed by an insured institution under such threat of instability.

(2) The FDIC, in its discretion, may approve an application pursuant to the Federal Deposit Insurance Act where it is required to consider the adequacy of capital or the financial resources of the insured bank where it finds that the applicant has committed to and is in compliance with a reasonable plan to meet its minimum capital requirement within a reasonable period of time.

(Approved by the Office of Management and Budget under control number 3064-0075.)

§ 325.4 Inadequate capital as an unsafe or unsound practice or condition.

(a) General. As a condition of federal deposit insurance, all insured banks must remain in a safe and sound condition.

(b) Unsafe or unsound practice. Any bank which has less than its minimum capital requirement is deemed to be engaged in an unsafe or unsound practice pursuant to section 8(b)(1) and/or 8(c) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)(1) and/or 1818(c)). Except that such a bank which has entered into and is in compliance with a written agreement with the FDIC or has submitted to the FDIC and is in compliance with a plan approved by the FDIC to increase its primary and total capital ratios to such levels as the FDIC deems appropriate and to take such other action as may be necessary for the bank to be operated so as not to be engaged in such an unsafe or unsound practice will not be deemed to be engaged in an unsafe or unsound practice pursuant to section 8(b)(1) and/or 8(c) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)(1) and/or 1818(c)) on account of its capital ratios.

(c) Unsafe or unsound condition. Any insured bank with a ratio of primary capital to adjusted total assets that is less than three percent is deemed to be operating in an unsafe or unsound condition pursuant to section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a)).

(1) A bank with a ratio of primary capital to adjusted total assets of less than three percent which has entered into and is in compliance with a

written agreement with the FDIC (or any other insured bank with a ratio of primary capital to adjusted total assets of less than three percent which has entered into and is in compliance with a written agreement with its primary federal regulator and to which agreement the FDIC is a party) to increase its primary capital ratio to such level as the FDIC deems appropriate and to take such other action as may be necessary for the insured bank to be operated in a safe and sound manner, will not be subject to a proceeding by the FDIC pursuant to 12 U.S.C. 1818(a) on account of its primary capital ratio.

(2) An insured bank with a ratio of primary capital to adjusted total assets that is equal to or greater than three percent may be operating in an unsafe or unsound condition. The FDIC is not precluded from bringing an action pursuant to 12 U.S.C. 1818(a) where an insured bank has a ratio of primary capital to adjusted total assets that is equal to or greater than three percent.

§ 325.5 Miscellaneous.

(a) Pre-existing instruments. Any instrument not counted as primary capital pursuant to this part which was approved by the FDIC for use as equity capital under pre-existing guidelines shall be added as a component of primary capital.

(b) Intangible assets approved prior to effective date. Any intangible asset which was booked in accordance with generally accepted accounting principles when acquired and which was approved by the FDIC for inclusion in equity capital prior to the effective date of this regulation shall be counted in full as a component of primary capital and shall not be deducted from total assets if it is being amortized over a period not to exceed 15 years or its estimated useful life, whichever is shorter.

(c) Transactions not providing capital support. Any capital instrument, transaction or balance sheet entry which would increase an insured bank's primary capital but which does not provide support to the insured bank by providing a cushion to absorb losses shall be deducted from primary capital.

(d) Securities subsidiary. For purposes of this part, any securities subsidiary subject to 12 C.F.R. § 337.4 shall not be consolidated with its bank parent and any investment therein shall be deducted from the bank parent's primary capital and total assets.

(e) Depository institution subsidiary. Any domestic depository institution subsidiary that is not consolidated in the "Reports of Condition and Income" (Call Reports) of its insured bank parent shall be consolidated with the insured bank parent for purposes of this part. The financial statements of the subsidiary that are to be used for this consolidation must be prepared in the same manner as the "Reports of Condition and Income" (Call Reports).

§ 325.6 Issuance of directives.

(a) General. A directive is a final order issued to a bank that fails to maintain capital at or above the minimum capital requirement as set forth in sections 325.3 and 325.4. A directive issued pursuant to this section, including a plan submitted under a directive, is enforceable in the same manner and to the same extent as a final cease-and-desist order issued under 12 U.S.C. 1818(b).

(b) Issuance of directives. If a bank is operating with less than the minimum capital requirement established by this regulation, the Board of Directors, or its designee(s), may issue and serve upon any insured state nonmember bank a directive requiring the bank to restore its capital to the minimum capital requirement within a specified time period. The directive may require the bank to submit to the appropriate FDIC regional director, or other specified official, for review and approval, a plan describing the means and timing by which the bank shall achieve the minimum capital requirement. After the FDIC has approved the plan, the bank may be required under the terms of the directive to adhere to the plan. The directive may be issued during the course of an examination of the bank, if the bank is found to be operating with less than the minimum capital requirement.

(c) Notice and opportunity to respond to issuance of a directive.

(1) If the FDIC makes an initial determination that a directive should be issued to a bank pursuant to paragraph (b), the FDIC through the appropriate designated official(s) shall serve written notification upon the bank of its intent to issue a directive. The notice shall include the current total capital ratio, the basis upon which said ratio was calculated, the proposed capital injection, the proposed date for achieving the minimum capital requirement and any other relevant information concerning the decision to issue a directive. When deemed appropriate, specific requirements of a proposed plan for meeting the minimum capital requirement may be included in the notice.

(2) Within 14 days of receipt of notification, the bank may file with the appropriate designated FDIC official(s) a written response, explaining why the directive should not be issued, seeking modification of its terms, or other appropriate relief. The bank's response shall include any information, mitigating circumstances, documentation or other relevant evidence which supports its position, and may include a plan for attaining the minimum capital requirement.

(3) After considering the bank's response, the appropriate designated FDIC official(s) shall serve upon the bank a written determination addressing the bank's response and setting forth the FDIC's findings and conclusions in support of any decision to issue or not to issue a directive. The directive may be issued as originally proposed or in modified form. The directive may order the bank to (i) achieve the minimum capital requirement established by this regulation by a certain date; (ii) submit for approval and adhere to a plan for achieving the minimum capital requirement; (iii) take

other action as is necessary to achieve the minimum capital requirement; or (iv) a combination of the above actions. If a directive is to be issued, it may be served upon the bank along with the final determination.

(4) Any bank, upon a change in circumstances, may request the FDIC to reconsider the terms of a directive and may propose changes in the plan under which it is operating to meet the minimum capital requirement. The directive and plan continue in effect while such request is pending before the FDIC.

(5) All papers filed with the FDIC must be postmarked or received by the appropriate designated FDIC official(s) within the prescribed time limit for filing.

(6) Failure by the bank to file a written response to notification of intent to issue a directive within the specified time period shall constitute a waiver of the opportunity to respond and shall constitute consent to the issuance of such directive.

(d) Enforcement of a directive.

(1) Whenever a bank fails to follow the directive or to submit or adhere to its capital adequacy plan, the FDIC may seek enforcement of the directive in the appropriate United States district court, pursuant to 12 U.S.C. 3907(b)(2)(B)(ii), in the same manner and to the same extent as if the directive were a final cease-and-desist order. In addition to enforcement of the directive, the FDIC may seek assessment of civil money penalties for violation of the directive against any bank, any officer, director, employee, agent, or other person participating in the conduct of the affairs of the bank, pursuant to 12 U.S.C. 3909(d).

(2) The directive may be issued separately, in conjunction with, or in addition to, any other enforcement mechanisms available to the FDIC, including cease-and-desist orders, orders of correction, the approval or denial of applications, or any other actions authorized by law.

By order of the Board of Directors this 11th day of February, 1985.

FEDERAL DEPOSIT INSURANCE CORPORATION

Hoyle L. Robinson
Executive Secretary

(SEAL)