FEDERAL DEPOSIT INSURANCE CORPORATION

STATEMENT OF POLICY ON CAPITAL

AGENCY: Federal Deposit Insurance Corporation

ACTION: Statement of Policy on Capital

SUMMARY: On February 11, 1985 the Board of Directors of the Federal Deposit Insurance Corporation ("Board") adopted a final rule concerning Capital Maintenance. That final rule, Part 325 of the FDIC's rules and regulations (12 C.F.R. Part 325) is published at ___ Fed. Reg. ___(1985). This statement of policy was adopted by the Board concurrent with that final rule. It is intended that this statement of policy explain various portions of that final rule and give some guidance on the manner in which the FDIC intends to apply the rule.

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

FOR FURTHER INFORMATION: Contact Robert F. Storch, Planning and Program Development Specialist, Division of Bank Supervision, Federal Deposit Insurance Corporation, 550-17th Street, N.W., Washington, D.C. 20429, (202) 389-4761.

SUPPLEMENTARY INFORMATION:

Background

A proposed regulation on capital maintenance was published for comment in the Federal Register on July 20, 1984. 49 Fed. Reg. 29399 (1984). On February 11, 1985, the Board of Directors of the FDIC ("Board") adopted a final rule on Capital Maintenance. This rule, Part 325 of the FDIC's Rules and Regulations (12 C.F.R. Part 325) becomes effective on ________, 1985.

The FDIC is required to analyze capital adequacy in taking action on various types of applications such as mergers and the establishment or relocation of branches and in the conduct of its 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, which includes maintaining adequate capital. The final rule: (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. This statement of policy was adopted by the Board concurrent with the adoption of the final rule in order to explain certain aspects of that rule and to give banks guidance as to the manner in which the FDIC will apply the rule.

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 the final rule on capital maintenance and this statement of policy on capital, the Board has revoked the 1981 statement of policy.

Statement of Policy

In considering the comments received in response to the proposed regulation on capital maintenance, the Board of Directors decided that the adoption of a statement of policy would be an effective way of addressing some of those comments as well as providing guidance to the public and the industry as to how the FDIC would implement and enforce the regulation. Accordingly, a statement of policy on capital containing such explanatory information has been adopted by the Board concurrent with the adoption of the final rule. A full discussion of the content of the statement of policy is contained in the Federal Register notice announcing adoption of the final rule.

In consideration of the foregoing the FDIC hereby adopts a Statement of Policy as follows:

STATEMENT OF POLICY ON CAPITAL

Part 325 (12 C.F.R. Part 325) of the Federal Deposit Insurance Corporation rules and regulations sets forth minimum capital requirements for fundamentally sound, well-managed banks having no material or significant financial weaknesses. It also defines capital and sets forth sanctions which will be used against banks which are in violation of the regulation. This statement of policy on capital provides some interpretational and definitional guidance as to how this regulation will be administered and enforced by the FDIC.

ENFORCEMENT OF MINIMUM CAPITAL REQUIREMENTS

Section 325.3(b) specifies that all FDIC-insured, state-chartered nonmember commercial and savings banks (or other insured banks making applications to the FDIC) must maintain a minimum ratio of primary capital to adjusted total assets of 5.5 percent and a minimum ratio of total capital to total assets of 6.0 percent. Banks operating with ratios under the minimums will be deemed to have inadequate capital and, subject to certain exceptions specified in the regulation, will be in violation of the regulation. Furthermore, such banks will have any application submitted to the FDIC denied and will be subject to the use of capital directives or other formal enforcement action by the FDIC to increase capital.

Capital adequacy in banks which have capital ratios at or above the minimums will be assessed and enforced based on the following factors:

Banks Which are Fundamentally Sound and Well Managed

Section 325.3(a) of the regulation specifies that the capital standards set forth therein 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. While the FDIC will make this determination in each bank based on its own condition and specific circumstances, this definition will generally apply to those banks evidencing a level of risk which is no greater than that normally associated with a Composite rating of 1 or 2 under the Uniform Financial Institutions Rating System. Banks meeting this definition which are in compliance with the minimum capital requirements will not generally be required by the FDIC to raise new capital from external sources. The FDIC does, however, encourage such banks to maintain capital above the minimums and will carefully evaluate their earnings and growth trends, dividend policies, capital planning procedures and other factors important to the continuous maintenance of adequate capital. Adverse trends or deficiencies in these areas will be subject to criticism at regular examinations and may be an important factor in the FDIC's action on applications submitted by such banks. In addition, the FDIC's consideration of capital adequacy in banks making applications to the FDIC will also fully examine the expected impact of those applications on the banks' ability to maintain its capital adequacy.

Other Banks

Banks not meeting the definition set forth above, that is, banks evidencing a level of risk which is at least as great as that normally associated with a Composite rating of 3, 4 or 5 under the Uniform Financial Institution Rating System, will be required to maintain capital higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels will normally be addressed through Memorandums of Understanding between the FDIC and the bank or, in cases of more pronounced risk, through the use of formal enforcement actions under section 8 of the Federal Deposit Insurance Act.

Capital Requirements of Primary Regulator

Notwithstanding the above, all banks will be expected to meet any capital requirements established by its primary state or federal regulator which exceed the minimum capital requirement set forth in the regulation. In addition, the FDIC will, when establishing capital requirements higher than the minimum set forth in the regulation, consult with the bank's primary state or federal regulator.

CAPITAL PLANS

Section 325.4(b) specifies that any bank which has less than its minimum capital requirement is deemed to be engaging in an unsafe and unsound banking practice unless it has submitted to, 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. (This section specifies that written

agreements may also be used for this purpose but these will be subject to different requirements which are discussed in the next section.) The general criteria which will be used by the FDIC in its review and approval of such plans will depend upon several factors which are set forth below:

Stock Institutions Which are Fundamentally Sound and Well Managed

Banks which have less than the minimum capital requirement are required to submit a reasonable plan to the FDIC within 60 days of the effective date of the regulation (section 325.3(c)(3)). As a matter of general policy, the FDIC will require plans submitted by stock owned banks which are fundamentally sound and well managed to provide for attainment of the minimum capital ratios within 12 months after approval of the plan by the FDIC. Exceptions will be permitted only when there is a showing of good cause why, for reasons outside the control of the bank, this is unattainable and there is a reasonable prospect that the minimum will be reached in a reasonable amount of time.

Fundamentally sound banks which have their capital ratios fall below the minimum requirements subsequent to the effective date of the regulation will be expected to take steps to correct the situation immediately or be subject to a capital directive or other enforcement proceeding.

Other Banks With a Stock Form of Ownership

As noted above, banks evidencing more than normal levels of risk will normally have their minimum capital requirements established in a formal or informal enforcement proceeding. The time frames for meeting these requirements will be set forth in such actions and will generally require some immediate action on the bank's part to meet its minimum capital requirement.

Savings Banks With a Mutual Form of Ownership

Based upon recent adverse conditions in the thrift industry and the special problems in raising capital for institutions with a mutual form of ownership, mutual savings banks will, subject to the exceptions specified below, be permitted to achieve their minimum capital requirements in accordance with the following schedule:

Primary Capital Ratio as of Effective Date of Regulation	Time to Achieve Minimum Capital Requirement *
5.0% or more	One Year
4.5% to 4.99%	Two Years
4.0% to 4.49%	Three Years
3.5% to 3.99%	Four Years
3.0% to 3.49%	Five Years

* From date of approval of initial plan.

The extended times for achieving the minimum capital requirement shall apply to only those mutual savings banks which exhibit no more than normal risk

characteristics and which can continuously demonstrate a realistic ability to achieve their minimum capital requirement within the time period specified through retained earnings. Plans must be submitted and approved on an annual basis as a means of demonstrating this continuous ability. Mutual savings banks evidencing more than normal risk or mutual savings banks which cannot demonstrate an ability to achieve their minimum capital requirement through earnings will be expected to incorporate in their plans alternative means of achieving their minimum capital requirements (conversion to stock form of ownership, elimination of excessive risk, merger, or other appropriate means) and begin to pursue those alternatives immediately.

Mutual savings banks whose capital ratios drop below the minimum requirements subsequent to the effective date of the regulation will be expected to take steps to correct the situation immediately except in those instances where the capital reduction arises as a part of a balance sheet restructuring plan, approved by the FDIC and designed to improve the bank's exposure to fluctuations in interest rates. In approving such plans the FDIC will require that the bank achieve its minimum capital requirement in a reasonable time, not to exceed that set forth in the above schedule for those banks which are below their minimum capital requirement as of the effective date of the regulation.

Plans Submitted in Connection with Applications

The above provisions do not apply to capital plans submitted in connection with applications as provided for in section 325.3(d)(2) of the regulation. The reasonableness of such plans will be determined in conjunction with the FDIC's consideration of the application.

WRITTEN AGREEMENTS

Section 325.4(c)(1) requires that any insured bank with a primary capital ratio of less than 3 percent must enter into and be in compliance with a written agreement with the FDIC (or with its other primary federal regulator with FDIC as a party to the agreement) to increase its primary capital ratio to such level as the FDIC deems appropriate or be subject to a termination of insurance action by the FDIC. Except in the very rarest of circumstances, the FDIC will require that such agreements contemplate immediate efforts by the bank to acquire the required capital.

A bank which has received net worth certificates from the FDIC will be considered to be in compliance with this requirement for so long as it is in compliance with the FDIC requirements set forth in the net worth certificate program, provided that both its board and the FDIC Board of Directors agree that the net worth certificate agreements they enter into or have entered into are written agreements as defined in the regulation.

CAPITAL COMPONENTS

Section 325.2 sets forth the definitions of primary and secondary capital as well as some of the various instruments and accounts which are included

therein. The following provides some additional guidance with respect to some of these items.

Intangible Assets

With the adoption of Part 325, the FDIC is now permitting state nonmember banks to record intangible assets on their books and to report the value of such assets in Consolidated Reports of Condition. As noted in the instructions for preparation of Consolidated Reports of Condition and Income (published by the Federal Financial Institutions Examination Council), intangible assets may arise from business combinations accounted for under the purchase method in accordance with Accounting Principles Board Opinion No. 16, as amended, and acquisitions of portions or segments of another institution's business, such as branch offices, mortgage servicing portfolios, and credit card portfolios.

Intangible assets created from such transactions may be booked in accordance with generally accepted accounting principles with one exception. For the purpose of reporting such assets on Call Reports, banks reporting to the FDIC shall amortize such assets over their estimated useful lives or a period not in excess of 15 years, whichever is shorter.

Notwithstanding the authority to report all intangible assets in Consolidated Reports of Condition, Section 325.2(h) of the regulation specifies that mortgage servicing rights are the only intangible assets which will be allowed as primary capital. The portion of equity capital represented by other types of intangible assets will be excluded from the computation of a bank's primary and total capital ratios. Certain pre-existing intangible assets will, however, be grandfathered in accordance with conditions which are set forth below under "Grandfathered Instruments or Transactions."

In certain instances banks may have investments in unconsolidated subsidiaries or joint ventures that have large volumes of intangible assets. In such instances the bank's consolidated statements will reflect an investment in a tangible asset even though such investment will, in fact, be represented by a large volume of intangible assets. In any such situation where this is material and, consistent with the treatment of mortgage servicing rights set forth above, the bank's investment in the unconsolidated subsidiary will be divided into a tangible and an intangible portion based on the percentage of intangible assets to total assets in the subsidiary. The intangible portion of the investment will be treated as if it were an intangible asset on the bank's books in the calculation of primary and secondary capital.

Perpetual Preferred Stock

Perpetual preferred stock is defined as preferred stock that does not have a stated maturity date or that cannot be redeemed at the option of the holder. It is possible for banks to issue preferred stock with a dividend rate which escalates to such a high rate that the terms become so onerous as to effectively force the bank to call the issue (for example, an issue with an initial rate of 12 percent which escalates to 18 percent in the tenth year).

Preferred stock issues with such onerous terms have much the same characteristics as limited life preferred stock in that the bank would be effectively forced to redeem the issue to avoid performance of the onerous terms. Such instruments may be disallowed as primary capital and banks which are contemplating issues bearing terms which may be so characterized are encouraged to submit them for FDIC review prior to issuance. Nothing herein shall prohibit banks from issuing floating rate preferred stock issues where the rate is constant in relation to some base rate.

The FDIC will also require that issues of perpetual preferred stock be consistent with safe and sound banking practices. Issues which would unduly enrich insiders or which contain dividend rates or other terms which are inconsistent with safe and sound banking practices will likely be the subject of an appropriate supervisory response from the FDIC. Banks contemplating preferred stock issues which may pose safety and soundness concerns are encouraged to submit such issues to the FDIC for review prior to sale.

Other Instruments or Transactions Which Fail to Provide Capital Support

Section 325.5(c) specifies that 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 bank by providing a cushion to absorb losses shall be deducted from capital. An example involves certain types of minority interests in consolidated subsidiaries. Minority interests in consolidated subsidiaries have been included in primary capital based on the fact that they provide capital support to the risk in the consolidated subsidiaries. Certain transactions have been structured where a bank forms a subsidiary by transferring essentially risk free assets to the subsidiary in exchange for common stock of the subsidiary. The subsidiary then sells preferred stock to third parties. The preferred stock becomes a minority interest in a consolidated subsidiary but, in effect, fails to provide any meaningful capital support to the consolidated entity inasmuch as it has a preferred claim on the essentially risk free assets. Capital instruments or transactions of this nature which fail to absorb losses or provide meaningful capital support will be deducted from primary capital.

Mandatory Convertible Debt

Section 325.2(e) of the regulation defines mandatory convertible debt as a subordinated debt instrument which requires the issuer to convert such instrument into either 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. So-called "equity commitment notes," which merely require a bank to sell common or perpetual preferred stock during the life of the subordinated debt obligation, are specifically excluded from this definition.

GRANDFATHERED INSTRUMENTS OR TRANSACTIONS

The FDIC has previously approved for specific banks certain mandatory convertible debt instruments or subordinated notes and debentures as equity

capital and has allowed certain banks to make investments in intangible assets that would also count as equity capital as that term was defined in previous guidelines. Any such instruments or transactions which have previously been explicitly approved by FDIC as equity capital will be counted as primary capital subject to the original terms or, in the case of intangible assets, subject to the requirement that they be amortized over a period not to exceed 15 years or their estimated useful lives, whichever is shorter.

ANALYSIS OF CONSOLIDATED COMPANIES

In determining a bank's compliance with its minimum capital requirements the FDIC will, with two exceptions, utilize the bank's consolidated statements as defined in the instructions for the preparation of Consolidated Reports of Condition and Income.

The first exception relates to securities subsidiaries of state nonmember banks which are subject to section 337.4 of the FDIC's rules and regulations. Any subsidiary established pursuant to this section must be a bona fide subsidiary which is adequately capitalized. In addition, section 337.4(b)(3) requires that any insured nonmember bank's investment in such a subsidiary shall not be counted toward the bank's capital. In those instances where the securities subsidiary is consolidated in the 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 in the securities subsidiary on the equity method. In this case, and in those cases where the securities 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 the bank's primary and total capital ratios.

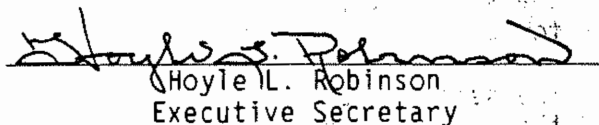
The second exception relates to the treatment of subsidiaries of insured banks that are domestic depository institutions such as commercial banks, savings banks, or savings and loan associations. These subsidiaries are not consolidated on a line-by-line basis with the insured bank parent in the bank 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. Since the FDIC believes that the minimum capital requirements should apply to a bank's depository institution activities in their entirety, regardless of the form that the organization's corporate structure takes, it will be necessary, for the purpose of calculating the bank's primary and total capital ratios, to adjust a bank parent's Consolidated Report of Condition to consolidate its domestic depository institution subsidiaries on a line-by-line basis. The financial statements of the subsidiary that are used for this consolidation must be prepared in the same manner as the Consolidated Report of Condition.

The FDIC will, in determining the capital adequacy of a bank which is a member of a bank holding company or chain banking group, consider the degree of leverage and risks undertaken by the parent company or other affiliates. Where the level of risk in a holding company system is no more than normal and

the consolidated company meets 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 for the subsidiary bank on its own merit. In cases where a holding company or other affiliated banks (or other companies) evidence more than a normal degree of risk (either by virtue of the quality of their assets, the nature of the activities conducted, or other factors) or have capital ratios below the Federal Reserve guidelines (as would frequently be the case in small, highly leveraged one-bank holding companies), the FDIC will consider the potential impact of the additional risk or excess leverage upon an individual bank to determine if such factors will likely result in excessive requirements for dividends, management fees, or other support to the holding company or affiliated organizations which would be detrimental to the bank. Where the excessive risk or leverage in such organizations is determined to be potentially detrimental to the bank's condition or its ability to maintain adequate capital, the FDIC may initiate appropriate supervisory action to limit the bank's ability to support its weaker affiliates and/or require higher than minimum capital ratios in the bank.

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

FEDERAL DEPOSIT INSURANCE CORPORATION



Hoyle L. Robinson
Executive Secretary

(SEAL)