APPENDIX B TO PART 325—STATEMENT OF POLICY ON CAPITAL ADEQUACY

Part 325 of the Federal Deposit Insurance Corporation rules and regulations (12 CFR part 325) sets forth minimum leverage 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 part 325 regulation. This statement of policy on capital adequacy provides some interpretational and definitional guidance as to how this part 325 regulation will be administered and enforced by the FDIC. This statement of policy also addresses certain aspects of the FDIC’s minimum risk-based capital guidelines that are set forth in appendix A to part 325. This statement of policy does not address the prompt corrective action provisions mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991. However, section 38 of the Federal Deposit Insurance Act and subpart B of part 325 provide guidance on the prompt corrective action provisions, which generally apply to institutions with inadequate levels of capital.

I. ENFORCEMENT OF MINIMUM CAPITAL REQUIREMENTS

Section 325.3(b)(1) specifies that FDIC-supervised, state-chartered nonmember commercial and savings banks (or other insured depository institutions making applications to the FDIC that require the FDIC to consider the adequacy of the institutions’ capital structure) must maintain a minimum leverage ratio of Tier 1 (or core) capital to total assets of at least 3 percent; however, this minimum only applies to the most highly-rated banks (i.e., those with a composite CAMELS rating of 1 under the Uniform Financial Institutions Rating System established by the Federal Financial Institutions Examination Council) that are not anticipating or experiencing any significant growth. All other state nonmember banks would need to meet a minimum leverage ratio that is at least 100 to 200 basis points above this minimum. That is, in accordance with §325.3(b)(2), an absolute minimum leverage ratio of not less than 4 percent must be maintained by those banks that are not highly-rated or that are anticipating or experiencing significant growth.

In addition to the minimum leverage capital standards, section III of appendix A to part 325 indicates that state nonmember banks generally are expected to maintain a minimum risk-based capital ratio of qualifying total capital to risk-weighted assets of 8 percent, with at least one-half of that total capital amount consisting of Tier 1 capital. State nonmember banks (hereinafter referred to as “banks”) operating with leverage capital ratios below the minimums set forth in part 325 will be deemed to have inadequate capital and will be in violation of the part 325 regulation. Furthermore, banks operating with risk-based capital ratios below the minimums set forth in appendix A to part 325 generally will be deemed to have inadequate capital. Banks failing to meet the minimum leverage and/or risk-based capital ratios normally can expect to have any application submitted to the FDIC denied (if such application requires the FDIC to evaluate the adequacy of the institution’s capital structure) and also can expect to be subject to administrative and enforcement sanctions as to how this part 325 regulation will be administered and enforced by the FDIC. These sanctions are set forth in part 325 of the Federal Deposit Insurance Corporation rules and regulations (12 CFR part 325) and extend the authority of the FDIC to take any action as may be necessary to ensure the financial soundness and safe and sound operation of insured banks.

Editorial Note: For Federal Register citations affecting Appendix A of part 325, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.
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 (these same criteria will apply to any insured depository institutions making applications to the FDIC and to any other circumstances in which the FDIC is requested or required to evaluate the adequacy of a depository institution’s capital structure):

A. Banks Which Are Fundamentally Sound and Well-Managed

The minimum leverage capital ratios set forth in §325.3(b)(2) and the minimum risk-based capital ratios set forth in section III of appendix A to part 325 generally will be viewed as the minimum acceptable capital standards 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 case, the FDIC 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 leverage and risk-based capital ratio standards 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 well above the minimums, particularly those institutions that are anticipating or experiencing significant growth, 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 bank’s ability to maintain its capital adequacy. In all cases, banks should maintain capital commensurate with the level and nature of risks, including the volume and severity of adversely classified assets, to which they are exposed.

B. All Other Banks

Banks not meeting the definition set forth in I.A. of this appendix, 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 Institutions 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 bank and the FDIC, or in cases of more pronounced risk, through the use of formal enforcement actions under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818).

C. Capital Requirements of Primary Regulator

Notwithstanding I.A. and B. of this appendix, all banks (or other depository institutions making applications to the FDIC that require the FDIC to consider the adequacy of the institutions’ capital structure) will be expected to meet any capital requirements established by the primary state or federal regulator which exceed the minimum capital requirement set forth in the FDIC’s part 325 regulation. In addition, the FDIC will, when setting capital requirements higher than the minimum set forth in the regulation, consult with an institution’s primary state or federal regulator.

II. CAPITAL PLANS

Section 325.4(b) specifies that any bank which has less than its minimum leverage capital requirement is deemed to be engaging in an unsafe or unsound banking practice unless it has submitted, and is in compliance with, a plan approved by the FDIC to increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate.

As required under §325.104(a)(1) of this part, a bank must file a written capital restoration plan with the appropriate FDIC regional director within 45 days of the date the bank receives notice or is deemed to have notice that the bank is undercapitalized, significantly undercapitalized or critically undercapitalized, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period. The amount of time allowed to achieve the minimum leverage capital requirement will be evaluated by the FDIC on a case-by-case basis and will depend on a number of factors, including the viability of the bank and whether it is fundamentally sound and well-managed.

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. The reasonableness of capital plans submitted by depository institutions in connection with applications as provided...
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for in §325.3(d)(2) will be determined in conjunction with the FDIC’s consideration of the application.

III. WRITTEN AGREEMENTS

Section 325.4(c) provides that any insured depository institution with a Tier 1 capital to total assets (leverage) ratio of less than 2 percent must enter into and be in compliance with a written agreement with the FDIC (or with its primary federal regulator with FDIC as a party to the agreement) to increase its Tier 1 leverage capital ratio to such level as the FDIC deems appropriate or may be subject to a section 8(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 depository institution to acquire the required capital.

The guidance in this section III is not intended to preclude the FDIC from taking section 8(a) or other enforcement action against any institution, regardless of its capital level, if the specific circumstances deem such action to be appropriate.

IV. CAPITAL COMPONENTS

Section 325.2 sets forth the definition of Tier 1 capital for the leverage standard as well as the definitions for the various instruments and accounts which are included therein. Although nonvoting common stock, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders’ equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

The following provides some additional guidance with respect to some of the items that affect the calculation of Tier 1 capital.

A. Intangible Assets

The FDIC permits state nonmember banks to record intangible assets on their books and to report the value of such assets in the Consolidated Reports of Condition and Income (“Call Report”). As noted in the instructions for preparation of the 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 and acquisitions of portions or segments of another institution’s business, such as branch offices, mortgage servicing portfolios, and credit card portfolios.

Notwithstanding the authority to report all intangible assets in the Consolidated Reports of Condition and Income, §325.2(v) of the regulation specifies that mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are the only intangible assets which will be allowed as Tier 1 capital.1 The portion of equity capital represented by other types of intangible assets will be deducted from equity capital and assets in the computation of a bank’s Tier 1 capital. Certain of these intangible assets may, however, be recognized for regulatory capital purposes if explicitly approved by the Director of the Division of Supervision and Consumer Protection (DSO) as part of the bank’s regulatory capital on a specific case basis. These intangibles will be included in regulatory capital under the terms and conditions that are specifically approved by the FDIC.2

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,

1 Although intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are generally recognized for regulatory capital purposes, the deduction of part or all of the mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these assets are excessive in relation to their market value or the level of the bank’s capital accounts. In such cases, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships will be recognized for regulatory capital purposes only to the extent the rights meet the conditions, limitations and restrictions described in §325.5(f).

2 This specific approval must be received in accordance with §325.5(b). In evaluating whether other types of intangibles should be recognized for regulatory capital purposes, the FDIC will accord special attention to the general characteristics of the intangibles, including: (1) The separability of the intangible asset and the ability to sell it separate and apart from the bank or the bulk of the bank’s assets, (2) the certainty that a readily identifiable stream of cash flows associated with the intangible asset can hold its value notwithstanding the future prospects of the bank, and (3) the existence of a market of sufficient depth to provide liquidity for the intangible asset. However, pursuant to section 18(n) of the Federal Deposit Insurance Act (12 U.S.C. 1828(n)), specific approval cannot be given for an unidentified intangible asset, such as goodwill, if acquired after April 12, 1989.
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 Tier 1 capital. However, intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships, including servicing intangibles held by mortgage banking subsidiaries, are subject to the specific criteria set forth in §325.5(e).

B. Perpetual Preferred Stock

Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Also, pursuant to section 18(i)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1828(i)(1)), a state nonmember bank cannot, without the prior consent of the FDIC, reduce the amount or retire any part of its preferred stock. (This prior consent is also required for the reduction or retirement of any part of a state nonmember bank’s common stock or capital notes and debentures.)

Noncumulative perpetual preferred stock is generally included in Tier 1 capital. Nonetheless, 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 a low initial rate that is scheduled to escalate to much higher rates in subsequent periods). 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 Tier 1 capital and, for risk-based capital purposes, would be included in Tier 2 capital only to the extent that the instruments fall within the limitations applicable to intermediate-term preferred stock. Banks which are contemplating issues bearing terms which may be so characterized are encouraged to submit them to the appropriate FDIC regional office for 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 outside market or index rate. However, noncumulative floating rate instruments where the rate paid is based in some part on the current credit standing of the bank, and all cumulative preferred stock instruments, are excluded from Tier 1 capital. These instruments are included in Tier 2 capital for risk-based capital purposes in accordance with the limitations set forth in appendix A to part 325.

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 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 appropriate FDIC regional office for review prior to sale. Pursuant to §325.5(e), capital instruments that contain or that are subject to any conditions, covenants, terms, restrictions or provisions that are inconsistent with safe and sound banking practices will not qualify as capital under part 325.

C. Other Instruments or Transactions Which Fail To Provide Capital Support

Section 325.5(b) specifies that any capital component or balance sheet entry or account which has characteristics or terms that diminish its contribution to an insured depository institution’s ability 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 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 or low-risk 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, represents an essentially risk-free or low-risk investment for the preferred stockholders. This type of minority interest fails to provide any meaningful capital support to the consolidated entity inasmuch as it has a preferred claim on the essentially risk-free or low-risk assets of the subsidiary. In addition, certain minority interests are not substantially equivalent to permanent equity in that the interests must be paid off on specified future dates, or at the option of the holders of the minority interests, or contain other provisions or features that limit the ability of the minority interests to effectively absorb losses. Capital instruments or transactions of this nature which fail to absorb losses or provide meaningful capital support will be deducted from Tier 1 capital.

D. Mandatory Convertible Debt

Mandatory convertible debt securities are subordinated debt instruments that require
the issuer to convert such instruments into common or perpetual preferred stock by a
date at or before the maturity of the debt in-
struments. The maturity of these instru-
ments must be 12 years or less and the in-
struments must also meet the other criteria
set forth in appendix A to part 325. Manda-
tory convertible debt is excluded from Tier 1
capital but, for risk-based capital purposes,
is included in Tier 2 capital as a “hybrid cap-
tal instrument.”
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 spe-
cifically excluded from the definition of
mandatory convertible debt securities and
are only included in Tier 2 capital under the
risk-based capital framework to the extent
that they satisfy the requirements and limi-
tations for “term subordinated debt” set
forth in appendix A to part 325.

V. ANALYSIS OF CONSOLIDATED COMPANIES
In determining a bank’s compliance with
its minimum capital requirements the FDIC
will, with two exceptions, generally utilize
the bank’s consolidated statements as de-
defined in the instructions for the preparation
of Consolidated Reports of Condition and In-
come.
The first exception relates to securities
subsidiaries of state nonmember banks
which are subject to §337.4 of the FDIC’s
rules and regulations (12 CFR 337.4). Any sub-
sidiary subject to this section must be a
bona fide subsidiary which is adequately cap-
talized. In addition, §337.4(b)(3) requires
that any insured state nonmember bank’s in-
vestment in such a subsidiary shall not be
counted towards the bank’s capital. In those
instances where the securities subsidiary is
consolidated in the bank’s Consolidated Re-
port of Condition it will be necessary, for the
purpose of calculating the bank’s Tier 1 cap-
tal, to adjust the Consolidated Report of
Condition in such a manner as to reflect the
bank’s investment in the securities sub-
sidiary on the equity method. In this case,
and in those cases where the securities sub-
sidiary has not been consolidated, the invest-
ment in the subsidiary will then be deducted
from the bank’s capital and assets prior to
calculation of the bank’s Tier 1 capital ratio.
(Where deemed appropriate, the FDIC may
also consider deducting investments in other
subsidiaries, either on a case-by-case basis
or, as with securities subsidiaries, based on
the general characteristics or functional na-
ture of the subsidiaries.)
The second exception relates to the treat-
ment of subsidiaries of insured banks that
are domestic depository institutions such as
commercial banks, savings banks, or savings
associations. These subsidiaries are not con-
solidated on a line-by-line basis with the in-
sured bank parent in the bank parent’s Con-
solidated Reports of Condition and Income.
Rather, the instructions for these reports
provide that bank investments in such de-
pository institution subsidiaries are to be re-
ported on an unconsolidated basis in accord-
ance with the equity method. Since the FDIC
believes that the minimum capital require-
ments should apply to a bank’s depository
activities in their entirety, regardless of the
form that the organization’s corporate struc-
ture takes, it will be necessary, for the pur-
pose of calculating the bank’s Tier 1 leverage
and total risk-based capital ratios, to adjust
a bank parent’s Consolidated Report of Con-
dition to consolidate its domestic depository
institutions subsidiaries on a line-by-line
basis. The financial statements of the sub-
sidiary 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 ade-
quacy 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 is ade-
quately capitalized at all appropriate levels,
the FDIC generally will not require addi-
tional 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 com-
pany or other affiliated banks (or other com-
panies) evidence more than a normal degree
of risk (either by virtue of the quality of
their assets, the nature of the activities con-
ducted, or other factors) or where the affili-
ated organizations are inadequately capital-
ized, the FDIC will consider the potential
impact of the additional risk or excess lever-
age 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 com-
pany or affiliated organizations which would
be detrimental to the bank. Where the exces-
sive risk or leverage in such organizations is
determined to be potentially detrimental to
the bank’s condition or its ability to main-
tain adequate capital, the FDIC may initiate
appropriate supervisory action to limit the
bank’s ability to support its weaker affili-
ates and/or require higher than minimum
capital ratios in the bank.

VI. APPLICABILITY OF PART 325 TO SAVINGS
ASSOCIATIONS
Section 325.3(c) indicates that, where the
FDIC is required to evaluate the adequacy of
any depository institution’s (including any
savings association’s) capital structure in
conjunction with an application filed by the
institution, the FDIC will not approve the
application if the depository institution does

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not meet the minimum leverage capital requirement set forth in §325.3(b).

Also, §325.4(b) states that, under certain conditions specified in section 8(a) of the Federal Deposit Insurance Act, the FDIC may take section 8(b)(1) and/or 8(c) enforcement action against a savings association that is deemed to be engaged in an unsafe or unsound practice on account of its inadequate capital structure. Section 325.4(c) further specifies that any insured depository institution with a Tier 1 leverage ratio (as defined in part 325) of less than 2 percent is deemed to be operating in an unsafe or unsound condition pursuant to section 8(a) of the Federal Deposit Insurance Act.

In addition, the Office of Thrift Supervision (OTS), as the primary federal regulator of savings associations, has established minimum core capital leverage, tangible capital and risk-based capital requirements for savings associations (12 CFR part 567). In this regard, certain differences exist between the methods used by the OTS to calculate a savings association’s capital and the methods set forth by the FDIC in part 325. These differences include, among others, the core capital treatment for investments in subsidiaries and for certain intangible assets.

In determining whether a savings association’s application should be approved pursuant to §325.3(c), or whether an unsafe or unsound practice or condition exists pursuant to §§325.4(b) and 325.4(c), the FDIC will consider the extent of the savings association’s capital as determined in accordance with part 325. However, the FDIC will also consider the extent to which a savings association is in compliance with (a) the minimum capital requirements set forth by the OTS, (b) any related capital plans for meeting the minimum capital requirements approved by the OTS, and/or (c) any other criteria deemed by the FDIC as appropriate based on the association’s specific circumstances.

APPENDIX C TO PART 325—RISK-BASED CAPITAL FOR STATE NON-MEMBER BANKS: MARKET RISK

Section 1. Purpose, Applicability, Scope, and Effective Date

(a) Purpose. The purpose of this appendix is to ensure that banks with significant exposure to market risk maintain adequate capital to support that exposure. This appendix

1 This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled “Amendment to the Capital Accord to Incorporate Market Risks,” January 1996. Also see modifications issued in September 1997.

2 Trading activity means the gross sum of trading assets and liabilities as reported in the bank’s most recent quarterly Consolidated Report of Condition and Income (Call Report).

3 Total assets means quarter-end total assets as reported in the bank’s most recent Call Report.

4 A bank that voluntarily complies with the final rule prior to January 1, 1998, must comply with all of its provisions.

5 Subject to FDIC review, a bank may exclude structural positions in foreign currencies from its covered positions.

6 The term trading account is defined in the instructions to the Call Report.

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