

# EXHIBIT G



12 C.F.R. § 250.166

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Effective:[See Text Amendments]

Code of Federal Regulations Currentness

Title 12. Banks and Banking

Chapter II. Federal Reserve System

Subchapter A. Board of Governors of the  
Federal Reserve System

▣ Part 250. Miscellaneous Interpretations  
(Refs & Annos)

▣ Interpretations

→ § 250.166 Treatment of mandatory convertible debt and subordinated notes of state member banks and bank holding companies as “capital”.

(a) General. Under the Board's risk-based capital guidelines, state member banks and bank holding companies may include in Tier 2 capital subordinated debt and mandatory convertible debt that meets certain criteria. The purpose of this interpretation is to clarify these criteria. This interpretation should be read with those guidelines, particularly with paragraphs II.c. through II.e. of appendix A of 12 CFR part 208 if the issuer is a state member bank and with paragraphs II.A.2.c. and II.A.2.d. of appendix A of 12 CFR part 225 if the issuer is a bank holding company.

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(b) Criteria for subordinated debt included in capital--

(1) Characteristics. To be included in Tier 2 capital under the Board's risk-based capital guidelines for state member banks and bank holding companies, subordinated debt must be subordinated in right of payment to the claims of the issuer's general creditors [FN1] and, for banks, to the claims of depositors as well; must be unsecured; must state clearly on its face that it is not a deposit and is not insured by a federal agency; must have a minimum average maturity of five years; [FN2] must not contain provisions that permit debtholders to accelerate payment of principal prior to maturity except in the event of bankruptcy of or the appointment of a receiver for the issuing organization; must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practice; and must not be credit sensitive.

<sup>1</sup> The risk-based capital guidelines for bank holding companies state that bank holding company debt must be subordinated to all senior indebtedness of the company. To meet this requirement, the debt should be subordinated to all general creditors.

<sup>2</sup> The “average maturity” of an obligation or issue repayable in scheduled periodic payments shall be the weighted average of the maturities of all such scheduled payments.

(2) Acceleration clauses--

(i) In order to be included in Tier 2 capital, the appendices provide that subordinated debt instruments must have an original weighted average maturity of

at least five years. For this purpose, maturity is defined as the earliest possible date on which the holder can put the instrument back to the issuing banking organization. Since acceleration clauses permit the holder to put the debt back upon the occurrence of certain events, which could happen at any time after the instrument is issued, subordinated debt that includes provisions permitting acceleration upon events other than bankruptcy or reorganization under Chapters 7 (Liquidation) and 11 (Reorganization) of the Bankruptcy Code, in the case of a bank holding company, or insolvency--i.e., the appointment of a receiver--in the case of a state member bank, does not qualify for inclusion in Tier 2 capital.

(i) In order to be included in Tier 2 capital, the appendices provide that subordinated debt instruments must have an original weighted average maturity of at least five years. For this purpose, maturity is defined as the earliest possible date on which the holder can put the instrument back to the issuing banking organization. Since acceleration clauses permit the holder to put the debt back upon the occurrence of certain events, which could happen at any time after the instrument is issued, subordinated debt that includes provisions permitting acceleration upon events other than bankruptcy or reorganization under Chapters 7 (Liquidation) and 11 (Reorganization) of the Bankruptcy Code, in the case of a bank holding company, or insolvency--i.e., the appointment of a receiver--in the case of a state member bank, does not qualify for inclusion in Tier 2 capital.

(ii) Further, subordinated debt whose terms provide for acceleration upon the occurrence of events other than bankruptcy or the appointment of a receiver does not qualify as Tier 2 capital. For example, the terms of some subordinated debt issues would permit debtholders to accelerate repayment if the issuer failed to pay principal or interest on the subordinated debt

issue when due (or within a certain timeframe after the due date), failed to make mandatory sinking fund deposits, defaulted on any other debt, failed to honor covenants, or if an institution affiliated with the issuer entered into bankruptcy or receivership. Some banking organizations have also issued, or proposed to issue, subordinated debt that would allow debtholders to accelerate repayment if, for example, the banking organization failed to maintain certain prescribed minimum capital ratios or rates of return, or if the amount of nonperforming assets or charge-offs of the banking organization exceeded a certain level.

(iii) These and other similar acceleration clauses raise significant supervisory concerns because repayment of the debt could be accelerated at a time when an organization may be experiencing financial difficulties. Acceleration of the debt could restrict the ability of the organization to resolve its problems in the normal course of business and could cause the organization involuntarily to enter into bankruptcy or receivership. Furthermore, since such acceleration clauses could allow the holders of subordinated debt to be paid ahead of general creditors or depositors, their inclusion in a debt issue throws into question whether the debt is, in fact, subordinated.

(iv) Subordinated debt issues whose terms state that the debtholders may accelerate the repayment of principal only in the event of bankruptcy or receivership of the issuer do not permit the holders of the debt to be paid before general creditors or depositors and do not raise supervisory concerns because the acceleration does not occur until the institution has failed. Accordingly, debt issues that permit acceleration of principal only in the event of bankruptcy (liquidation or reorganization) in the case of bank holding companies and receivership in the case of banks may generally be clas-

sified as capital.

(3) Provisions inconsistent with safe and sound banking practices--

(i) The risk-based capital guidelines state that instruments included in capital may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practice. As a general matter, capital instruments should not contain terms that could adversely affect liquidity or unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty, or that could limit the regulator's ability to resolve problem bank situations. For example, some subordinated debt includes covenants that would not allow the banking organization to make additional secured or senior borrowings. Other covenants would prohibit a banking organization from disposing of a major subsidiary or undergoing a change in control. Such covenants could restrict the banking organization's ability to raise funds to meet its liquidity needs. In addition, such terms or conditions limit the ability of bank supervisors to resolve problem bank situations through a change in control.

(ii) Certain other provisions found in subordinated debt may provide protection to investors in subordinated debt without adversely affecting the overall benefits of the instrument to the organization. For example, some instruments include covenants that may require the banking organization to:

(A) Maintain an office or agency where securities may be presented,

(B) Hold payments on the securities in trust,

(C) Preserve the rights and franchises of the company,

(D) Pay taxes and assessments before they become delinquent,

(E) Provide an annual statement of compliance on whether the company has observed all conditions of the debt agreement, or

(F) Maintain its properties in good condition. Such covenants, as long as they do not unduly restrict the activity of the banking organization, generally would be acceptable in qualifying subordinated debt, provided that failure to meet them does not give the holders of the debt the right to accelerate the debt. [FN3]

<sup>3</sup> This notice does not attempt to list or address all clauses included in subordinated debt; rather, it is intended to give general supervisory guidance regarding the types of clauses that could raise supervisory concerns. Issuers of subordinated debt may need to consult further with Federal Reserve staff about other subordinated debt provisions not specifically discussed above to determine whether such provisions are appropriate in a debt capital instrument.

(4) Credit sensitive features. Credit sensitive subordinated debt (including mandatory convertible securities) where payments are tied to the financial condition of the borrower generally do not qualify for inclusion in capital. Interest rate payments may be linked to the financial condition of an institution through various ways, such as through an auction rate mechanism, a preset schedule that either mandates interest rate increases as the credit rating of the institution declines or automatically increases them over the passage of time, [FN4] or that

raises the interest rate if payment is not made in a timely fashion. [FN5] As the financial condition of an organization declines, it is faced with higher and higher payments on its credit sensitive subordinated debt at a time when it most needs to conserve its resources. Thus, credit sensitive debt does not provide the support expected of a capital instrument to an institution whose financial condition is deteriorating; rather, the credit sensitive feature can accelerate depletion of the institution's resources and increase the likelihood of default on the debt.

<sup>4</sup> Although payments on debt whose interest rate increases over time on the surface may not appear to be directly linked to the financial condition of the issuing organization, such debt (sometimes referred to as expanding or exploding rate debt) has a strong potential to be credit sensitive in substance. Organizations whose financial condition has strengthened are more likely to be able to refinance the debt at a rate lower than that mandated by the preset increase, whereas institutions whose condition has deteriorated are less likely to be able to do so. Moreover, just when these latter institutions would be in the most need of conserving capital, they would be under strong pressure to redeem the debt as an alternative to paying higher rates and, thus, would accelerate depletion of their resources.

<sup>5</sup> While such terms may be acceptable in perpetual preferred stock qualifying as Tier 2 capital, it would be inconsistent with safe and sound banking practice to include debt with such terms in Tier 2 capital. The organization does not have the option, as it does with auction rate preferred stock issues, of eliminating the higher payments on the subordinated debt without going into default.

(c) Criteria for mandatory convertible debt included in capital. Mandatory convertible debt included in capital must meet all the criteria cited above for subordinated debt with the exception of the minimum maturity requirement. [FN6] Since mandatory convertible debt eventually converts to an equity instrument, it has no minimum maturity requirement. Such debt, however, is subject to a maximum maturity requirement of 12 years.

<sup>6</sup> Mandatory convertible debt is subordinated debt that contains provisions committing the issuing organization to repay the principal from the proceeds of future equity issues.

(d) Previously issued subordinated debt. Subordinated debt including mandatory convertible debt that has been issued prior to the date of this interpretation and that contains provisions permitting acceleration for reasons other than bankruptcy or receivership of the issuing institution; includes other questionable terms or conditions; or that is credit sensitive will not automatically be excluded from capital. Rather, such debt will be considered on a case-by-case basis to determine whether it qualifies as Tier 2 capital. As a general matter, subordinated debt issued prior to the release of this interpretation and containing such provisions or features may qualify as Tier 2 capital so long as these terms:

(1) have been commonly used by banking organizations,

(2) do not provide an unreasonably high degree of protection to the holder in cases not involving bankruptcy or receivership, and

(3) do not effectively allow the holder to stand ahead of the general creditors of the issuing institution in cases of bankruptcy or receivership.

Subordinated debt containing provisions that permit

the holders of the debt to accelerate payment of principal when the banking organization begins to experience difficulties, for example, when it fails to meet certain financial ratios, such as capital ratios or rates of return, does not meet these three criteria. Consequently, subordinated debt issued prior to the release of this interpretation containing such provisions may not be included within Tier 2 capital.

(e) Limitations on the amount of subordinated debt in capital--

(1) Basic limitation. The amount of subordinated debt an institution may include in Tier 2 capital is limited to 50 percent of the amount of the institution's Tier 1 capital. The amount of a subordinated debt issue that may be included in Tier 2 capital is discounted as it approaches maturity; one-fifth of the original amount of the instrument, less any redemptions, is excluded each year from Tier 2 capital during the last five years prior to maturity. If the instrument has a serial redemption feature such that, for example, half matures in seven years and half matures in ten years, the issuing organization should begin discounting the seven-year portion after two years and the ten-year portion after five years.

(2) Treatment of debt with dedicated proceeds. If a banking organization has issued common or preferred stock and dedicated the proceeds to the redemption of a mandatory convertible debt security, that portion of the security covered by the amount of the proceeds so dedicated is considered to be ordinary subordinated debt for capital purposes, provided the proceeds are not placed in a sinking fund, trust fund, or similar segregated account or are not used in the interim for some other purpose. Thus, dedicated portions of mandatory convertible debt securities are subject, like other subordinated debt, to the 50 percent sublimit with-

in Tier 2 capital, as well as to discounting in the last five years of life. Undedicated portions of mandatory convertible debt may be included in Tier 2 capital without any sublimit and are not subject to discounting.

(3) Treatment of debt with segregated funds. In some cases, the provisions in mandatory convertible debt issues may require the issuing banking organization to set up a sinking fund, trust fund, or similar segregated account to hold the proceeds from the sale of equity securities dedicated to pay off the principal of the mandatory convertible debt at maturity. The portion of mandatory convertibles covered by the amount of proceeds deposited in such a segregated fund is considered secured and, thus, may not be included in capital at all, let alone be treated as subordinated debt that is subject to the 50 percent sublimit within Tier 2 capital. The maintenance of such separate segregated funds for the redemption of mandatory convertible debt exceeds the requirements of appendix B to Regulation Y. Accordingly, if a banking organization, with the agreement of its debtholders, seeks Federal Reserve approval to eliminate such a fund, approval normally would be given unless supervisory concerns warrant otherwise.

(f) Redemption of subordinated debt prior to maturity--

(1) By state member banks. State member banks must obtain approval from the appropriate Reserve Bank prior to redeeming before maturity subordinated debt or mandatory convertible debt included in capital. [FN7] A Reserve Bank will not approve such early redemption unless it is satisfied that the capital position of the bank will be adequate after the proposed redemption.

<sup>7</sup> Some agreements governing mandatory convertible debt issued prior to the risk-based capital guidelines provide that the bank may redeem the notes if they no longer count as primary capital as defined in appendix B to Regulation Y. Such a provision does not obviate the requirement to receive Federal Reserve approval prior to redemption.

(2) By bank holding companies. While bank holding companies are not formally required to obtain approval prior to redeeming subordinated debt, the risk-based capital guidelines state that bank holding companies should consult with the Federal Reserve before redeeming any capital instruments prior to stated maturity. This also applies to any redemption of mandatory convertible debt with proceeds of an equity issuance that were dedicated to the redemption of that debt. Accordingly, a bank holding company should consult with its Reserve Bank prior to redeeming subordinated debt or dedicated portions of mandatory convertible debt included in capital. A Reserve Bank generally will not acquiesce to such a redemption unless it is satisfied that the capital position of the bank holding company would be adequate after the proposed redemption.

(3) Special concerns involving mandatory convertible debt. Consistent with appendix B to Regulation Y, bank holding companies wishing to redeem before maturity undedicated portions of mandatory convertible debt included in capital are required to receive prior Federal Reserve approval, unless the redemption is effected with the proceeds from the sale of common or perpetual preferred stock. An organization planning to effect such a redemption with the proceeds from the sale of common or perpetual preferred stock is advised to consult informally with its Reserve Bank in order to avoid the possibility of taking an action that could result in weakening its capital position.

A Reserve Bank will not approve the redemption of mandatory convertible securities, or acquiesce in such a redemption effected with the sale of common or perpetual preferred stock, unless it is satisfied that the capital position of the bank holding company will be satisfactory after the redemption. [FN8]

[FN8] The guidance contained in this paragraph applies to mandatory convertible debt issued prior to the risk-based capital guidelines that state that the banking organization may redeem the notes if they no longer count as primary capital as defined in Appendix B to Regulation Y. Such provisions do not obviate the need to consult with, or obtain approval from, the Federal Reserve prior to redemption of the debt.

[57 FR 40598, Sept. 4, 1992]  
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SOURCE: 33 FR 9866, July 10, 1968; 57 FR 41644, Sept. 11, 1992; 61 FR 57289, Nov. 6, 1996; 66 FR 24233, May 11, 2001, unless otherwise noted.  
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AUTHORITY: 12 U.S.C. 78, 248(i), 371c(f) and 371c-1(e).  
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