

I. INTRODUCTION

Section 18(i)(1) of the Federal Deposit Insurance (FDI) Act requires an insured state nonmember bank to seek the prior consent of the FDIC before it reduces the amount or retires any part of its common or preferred capital stock, or retires any part of its capital notes or debentures.

Consistent with the statute, there are two major classes of applications, each of which is treated separately:

- Reduction in the amount of common or preferred stock; and,
- Retirement of capital notes and debentures.

In the case of retirement of capital notes and debentures, there are two main types:

- Prior consent to retire; and,
- Consent to prepay all or part of an existing note.

The FDIC has applied Section 18(i) to the following transactions, thus requiring an application to the FDIC:

- Repurchase and retention by a bank of its own common or preferred stock, even if the purchase is part of a stock option plan;
- Prepayment by a bank of all or part of an existing note;
- Final payment on an existing note that has reached the note's stated maturity, provided the bank has not received pre-approval from the FDIC when the note was issued;
- A dividend payment that exceeds a bank's retained earnings;
- A dividend payment that is paid from the surplus account of common or preferred stock;
- Retirement or a reduction in capital that is part of another proposal for which a current application has been filed for FDIC approval;
- Conversion of capital notes or debentures to an equivalent amount of common or preferred stock;
- Exchange of one class of common stock for another class with differing par values; or
- Conversion of preferred stock to an equivalent amount of common stock.

In some cases, a large dividend that has a liquidating or capital-reducing effect and results in a return of capital to the holding company or shareholders may also require the prior consent of the FDIC. In reviewing cases involving large dividends, Case Managers should consult with the Regional Accountant, Legal Division, and Washington Office in determining whether a capital retirement application is required.

Exceptions

When replacement of capital issuances does not effectively reduce the amount of the bank's capital, and there is no change to the governing terms and conditions of the instruments themselves, the replacement issuance is not subject to the provisions of Section 18(i)(1) and no filing is required.

Capital

If a bank reduces the amount or retires any part of its common or preferred capital stock or retires any part of its capital notes or debentures, the bank's capital ratios under Part 324 of the FDIC

Rules and Regulations may be impacted negatively. While any negative impact on regulatory capital should be closely analyzed, an application under Section 18(i)(1) may be required even if there is no impact on a bank's regulatory capital.

For an instrument to qualify as regulatory capital under Part 324 of the FDIC Rules and Regulations, it must receive the FDIC's prior approval before it is redeemed. See Section 324.20(b)(1)(iii) for Common Equity Tier 1 Capital, (c)(1)(v) and (vi) for additional Tier 1 Capital, and (d)(1)(v) and (x) for Tier 2 Capital. While these are separate requirements, an application under Section 18(i)(1) satisfies the bank's requirement for FDIC prior approval under Part 324.

State Savings Associations

According to Sections 390.342 through 390.348 of the FDIC Rules and Regulations, if a proposed capital distribution falls within certain described criteria, a state savings association may be required to file an application or notice with the FDIC. The filing must be made at least 30 days before the proposed declaration of dividend or approval of the proposed capital distribution by the state savings association's board of directors. Not all capital distributions by state savings associations require a filing to the FDIC. See Section 390.345 to determine whether an application or notice must be filed.

Section 390.343 generally defines a capital distribution as a distribution of cash or other property to the state savings association's owners made on account of their ownership other than a dividend payment consisting only of shares or rights to purchase shares of a state savings association or payments that a mutual state savings association is required to make under the terms of a deposit instrument and any other amount paid on deposits that the FDIC determines is not a distribution. Regulations applicable to state savings associations note that a capital distribution also includes:

- (1) any payment to acquire any of the state savings association's shares or other ownership interests through repurchase, redemption, or retirement;
- (2) any payment to acquire debt instruments included in the state savings association's total capital through repurchase, redemption, or retirement;
- (3) Any extension of credit to finance an affiliate's acquisition of the state savings association's shares or interests;
- (4) any direct or indirect payment of cash or other property to owners or affiliates made in connection with a corporate restructuring;
- (5) any other distribution charged against a state savings association's capital accounts, if the association would not be Well Capitalized following the distribution; and
- (6) any transaction that the FDIC determines, by order or regulation, to be in substance a distribution of capital.

A state savings association may combine a required notice or application relating to capital distributions with other required filings, if the capital distribution is a part of, or is related to the other filing. If the state savings association submits a combined filing, it must state that the related notice or application is intended to serve as a notice or application under Sections 390.342 through 390.348, and must submit the notice or application in a timely manner.

Case Managers must consult with the WO on any application or notice related to a state savings association to ensure that the appropriate procedures and timelines are followed. Refer to *Applications Overview*, Section 1.1 of these Procedures, for information regarding filings involving state savings associations.

II. ADVANCE APPROVALS

Although Section 18(i) of the FDI Act requires insured state nonmember banks to obtain the FDIC's prior approval to retire capital notes, there is no requirement to seek approval to issue capital notes. However, to facilitate the sale of capital notes, many institutions seek advance approval for the eventual retirement of the capital notes prior to issuance. Such filings may raise concern due to the potentially extended timeframe until the retirement of the capital notes. As such, filings requesting advance approval to retire capital notes must be closely reviewed, and approval letters must include the following conditions (in addition any other non-standard conditions deemed appropriate):

1. That the applicant has obtained all necessary and final approvals from the appropriate federal, state, or other authorities.
2. That if the transaction does not take effect [within a specified time period] and a request for an extension of time has not been approved by the FDIC, the consent granted shall expire [at the end of the specified time period].
3. That until the retirement of the capital notes has been completed, the FDIC retains the right to alter, suspend, or withdraw its commitment should any interim development be deemed to warrant such action.
4. That following retirement of the capital notes the institution shall meet all applicable capital requirements imposed by statute, regulation, agency action, or other means, and will satisfy all requirements to qualify as Well Capitalized pursuant to the applicable capital statutes and regulations.
5. That at the time of retirement of the capital notes the institution is not subject to any formal or informal actions addressing the institution's capital or overall safety and soundness, and has not been notified by any relevant regulatory agency of the agency's intent to issue a formal or informal action addressing the institution's capital or overall safety and soundness.
6. That the institution must submit no later than 60 days prior to retirement of the capital notes, a plan that includes:
 - (a) Details regarding the change to the institution's capital levels and structure as a result of the retirement of the capital notes;
 - (b) Details regarding any related or pending capital raise and the expected impact on the institution's capital levels and structure;
 - (c) If the proposal involves the repurchase of capital instruments, the repurchase price and the basis for establishing the fair market value of the repurchase price;
 - (d) A statement that the proposal will be available to all holders of a particular class of outstanding capital instruments on an equal basis, and if not, the details of any restrictions; and,
 - (e) The date that the applicant's board of directors approved the proposed retirement.

III. FORM OF APPLICATION

Pursuant to Section 303.241(c) of the FDIC Rules and Regulations, applicants are to submit either a letter application or an electronic application via the FDIC's secure, communication channel to the appropriate Regional Office (RO). Refer to *Applications Overview*, Section 1.1 of these

Procedures, for information regarding applications filed through the secure, internet-based communication channel. Under Section 303.241(c), the application should include the following information:

1. The type and amount of the proposed change to the capital structure and the reason for the change;
2. A schedule detailing the present and proposed capital structure;
3. The time period that the proposal will encompass;
4. If the proposal involves a series of transactions affecting Tier 1 capital components that will be consummated over a period of time not exceeding 12 months, the application must certify that the bank will maintain Well Capitalized status per Prompt Corrective Action (PCA) guidelines, as defined in Part 324, both before and after each of the proposed transactions;
5. If the proposal involves the repurchase of capital instruments, the repurchase price and the basis for establishing the fair market value of the repurchase price;
6. A statement that the proposal will be available to all holders of a particular class of outstanding capital instruments on an equal basis, and if not, the details of any restrictions; and
7. The date that the applicant's board of directors approved the proposal.

The FDIC may request additional information at any time while processing the application.

For state savings associations, the notice or application must:

1. Be in narrative form;
2. Include all relevant information concerning the proposed capital distribution, including the amount, timing, and type of distribution; and,
3. Demonstrate compliance with Section 390.348 of the FDIC Rules and Regulations.

The notice or application may include a schedule proposing the state savings association's capital distributions over a specified period, not to exceed 12 months.

Procedures regarding applications by an undercapitalized insured state nonmember bank and insured branch of a foreign bank to retire capital stock or capital debt instruments pursuant to Section 38 of the FDI Act are set forth in Section 303.203 of the FDIC Rules and Regulations. Applications pursuant to Section 38 and 18(i) may be filed concurrently or as a single application.

IV. ACCEPTING AND PROCESSING THE APPLICATION

Case Managers should review and process the application following the steps below and should refer to *Applications Overview*, Section 1.1 of these Procedures, for general information regarding

receipt and acceptance of applications.¹

1. These applications should be reviewed upon receipt, or soon thereafter, to determine if expedited processing is available, or if there are issues that would justify invoking removal of the application from expedited processing pursuant to Section 303.11(c)(2) of the FDIC Rules and Regulations.
2. An application filed under this section by an eligible depository institution, as defined in Section 303.2(r) of the FDIC Rules and Regulations, will be acknowledged in writing by the FDIC and will receive expedited processing, unless the applicant is notified in writing to the contrary and provided with the basis for that decision. Absent such removal, an application filed under this section by an eligible depository institution will be deemed approved 20 days after the FDIC's receipt of a substantially complete application, as described in *Time Frame for Processing*, Part VI of this Section. If the filing is removed from expedited processing, the RO must notify the bank of such decision prior to the deemed approved date. Refer to *Applications Overview*, Section 1.1 of these Procedures, for information regarding expedited processing.
3. All applications should be entered into the appropriate system of record within three business days of receipt. In all cases, dates and comments in the record should be updated regularly to reflect the current status of the application. When pre-approving retirement of capital in conjunction with its issuance, the Case Manager should maintain relevant, related information as a permanent record in the appropriate internal database.
4. Applications filed under this Section can be technical in nature. Therefore, Case Managers should consult with accounting specialists, capital markets specialists, and Legal, as appropriate, before determining completeness of the filing or developing a review strategy.
5. If the proposal involves the purchase of treasury stock, contact the Legal Division to ensure the purchase complies with Part 362 of the FDIC Rules and Regulations, particularly in the case of state savings associations. Part 362 implements the applicable provisions of Section 24 of the FDI Act. These provisions restrict and prohibit insured state banks and their subsidiaries from engaging in activities and investments that are not permissible for national banks and their subsidiaries. Consider the following when reviewing a proposal involving the purchase of treasury stock:
 - Generally, insured state banks may acquire or hold treasury stock without applying under Part 362, if the acquisition or holding of the stock is for a legitimate corporate purpose. The acquisition or holding of treasury stock for speculative purposes is prohibited under Part 362. (National banks may purchase treasury stock only to fulfill a legitimate corporate purpose. See OCC, *Activities Permissible for National Banks and Federal Savings Associations, Cumulative* (October 2017)).
 - Examples of legitimate corporate purposes include: holding shares in connection with an officer or employee stock option or bonus plan; holding shares to sell to a potential director, if directors are obligated to own qualifying shares; or purchasing a director's qualifying shares upon death or resignation,

¹ Case Managers should follow the general instruction and expectations for all applications regarding receipt and acceptance, recordkeeping responsibilities, DCP notifications, WO action or input, delegations, etc., in *Applications Overview*, Section 1.1 of these Procedures.

- if there is no ready market for the shares.
 - Transactions that involve an insured state bank acquiring its own stock and cancelling or restoring the shares to authorized but unissued status do not require consideration under Part 362 because these transactions are permitted for a national bank.
6. Contact the state authority to determine its opinion on the proposal. State authorities generally require prior approval for a retirement or reduction of capital.
 7. Complete the appropriate Summary of Investigation (SOI) form.² The narrative should include a discussion of the statutory factors set forth in Section 18(i)(4) of the FDI Act. Also, include in the SOI pro forma capital ratios for the Tier 1 Leverage, Common Equity Tier 1, and Total Capital subsequent to the capital distribution³. For state savings associations, the narrative should include a discussion of the factors required by Section 390.348 of the FDIC Rules and Regulations. Comments should also include the attitude of the state authority and the Board of Governors of the Federal Reserve Board System (FRB) regarding the application, where appropriate. Refer to the *Areas of Consideration*, Part V of this Section, for specific instructions in drafting the SOI. Retrieve the Application Summary Statement from the appropriate internal database and attach to the SOI.
 8. If the application is approved, an approval letter should be sent to the institution, with a copy sent to the state authority and to the FRB, if the bank is controlled by a holding company. The approval letter should set a timeframe consistent with the proposal during which the transaction must be completed; state that no other consent to retirement or reduction of capital is granted; state that changes to the terms disclosed in the application will require prior written consent by the FDIC; and, request notification of the consummation date. The letter should include all applicable standard conditions and any recommended non-standard conditions. The Case Manager should obtain the applicant's written commitment to adhere to any non-standard conditions prior to submitting the approval documents for signature. See *Standard and Non-standard Conditions*, Section 1.11 of these Procedures, for additional instructions regarding the imposition of conditions.
 9. If consideration of the statutory factors may result in a denial of the application, the RO should advise the applicant of the problem areas to ensure that all relevant facts are obtained prior to making a decision. Refer to *Denials and Disapprovals*, Section 1.3 of these Procedures, for further instruction.
 10. If the application is denied, a denial letter should be sent to the applicant, stating the reasons for the denial. A copy of the denial letter should be sent to the state authority and to the FRB, if the bank is controlled by a holding company.
 11. Update the appropriate internal database with the action date, expiration date, hours devoted to the application, and other required information.

V. AREAS OF CONSIDERATION

The adequacy of remaining capital is the chief statutory factor to consider for retirement or

² Case Managers should follow the general instructions and detailed discussion of SOI requirements for all types of applications located in Summary of Investigation, Section 1.2 of these Procedures, as well as the specific instructions in this Section.

³ Case Managers should include pro forma ratios of the Community Bank Leverage Ratio in the SOI once applicable to banks submitting applications to reduce or retire capital.

reduction of capital applications. However, the narrative portion of the SOI should include a discussion of all of the following statutory factors set forth in Section 18(i)(4) of the FDI Act.

- Financial History and Condition;
- Adequacy of Capital Structure;
- Future Earnings Prospects;
- General Character and Fitness of Management;
- Convenience and Needs of the Community to be Served; and,
- Consistency of Corporate Powers with the Purposes of the FDI Act.

The comments should assess the reasons for the proposed transaction, the effect on capital adequacy, and the overall effect on the safety and soundness of the bank, both immediately and on a prospective basis. The capital adequacy discussion must include the Basel III capital ratios. Expanded analysis and comments are required if CAMELS, SCOR, Compliance or CRA ratings are less than satisfactory. Comments should also include the attitude of the state authority and the FRB concerning the application, where appropriate.

Applications submitted by troubled, problem, or deteriorating institutions must be closely reviewed to assess the full impact of the proposed transaction(s), even if the proposed redemption is at less than the face value of the debt issued. Though redemptions may result in an increase in capital ratios, other impacts are distinctly negative, including with respect to the statutory factors pertaining to the adequacy of capital and the institution's financial condition as a result of the more limited resources available to absorb losses and possible strain on liquidity from the redemption, which may also lead to increased funding costs. In addition, depending on the facts and circumstances, the redemption may raise concerns regarding management to the extent that insiders or existing shareholders may benefit from the transaction, which may contribute to negative impacts on the ability to attract new investors to participate in a capital raise or the ability to market the institution to possible acquirers. Further, redemptions may also be viewed negatively by the courts in the event of a parent company bankruptcy. Most of these possible negative impacts may result regardless of whether the proposal involves a cash redemption or a transaction in which the existing debt is exchanged for newly issued debt. Negative impacts may also result regardless of whether the proposed transaction is a redemption of debt or a retirement of capital.

For filings by troubled, problem, or deteriorating institutions one must assess not only the immediate, direct impacts, but also the indirect impacts that may only be evident by assessing the longer-term consequences. This more comprehensive and prospective analysis has frequently resulted in unfavorable findings with respect to one or more of the applicable statutory factors, and applications overall.

Although an institution must have a Satisfactory or better CRA rating to qualify for expedited processing for any filing, the CRA performance of an institution does not serve as a basis for denial of this type of application. See Section 345.29 of the FDIC Rules and Regulations. While this type of application is not a "CRA-covered application," an unsatisfactory CRA or Compliance rating may reflect unfavorably on the general character and fitness of management.

For state savings associations, the FDIC may disapprove a notice or deny an application, in whole or in part, if the FDIC makes any of the following determinations pursuant to Section 390.348 of the FDIC Rules and Regulations:

- The state savings association will be Undercapitalized, Significantly Undercapitalized, or

Critically Undercapitalized following the capital distribution. If so, the FDIC will determine if the capital distribution is permitted under PCA;

- The proposed capital distribution raises safety or soundness concerns; or,
- The proposed capital distribution violates a prohibition contained in any statute, regulation, agreement between the state savings association and the FDIC, or a condition imposed on the state savings association in an FDIC-approved application or notice. If so, the FDIC will determine whether it may permit the capital distribution notwithstanding the prohibition or condition.

Depending on the institution's capital category for PCA purposes, an additional application may be necessary. PCA restricts capital distributions and payments on subordinated debt. Refer to *Prompt Corrective Action*, Section 12 of these Procedures, for further instruction.

Conversion terms or other financial arrangements in the proposal that involve the applicant's directors, officers, principal shareholders, affiliates, subsidiaries, or their interests should be fair and reasonable compared to conversion terms or other financial arrangements involving the applicant's minority shareholders.

VI. TIME FRAME FOR PROCESSING

Expedited Processing for Eligible Institutions:

An application processed under expedited processing will be deemed approved 20 days after the FDIC's receipt of a substantially complete application.

Standard Processing:

Statutory: None.

RO Processing Guideline: 30 days from receipt of a substantially complete application.

VII. PUBLICATION REQUIREMENT

None.

VIII. DELEGATED AUTHORITY

Delegations of authority regarding applications, notices and other filings are discussed in *Applications Overview*, Section 1.1 of these Procedures.

IX. REFERENCES

Sections 18(i), 24, 28, and 38 of the FDI Act

Parts 324 and 362 and Sections 303.241, 390.342-348 of the FDIC Rules and Regulations

Risk Management Manual of Examination Policies

OCC, Activities Permissible for National Banks and Federal Savings Associations, Cumulative (October 2017)