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LEGAL UPDATES AND NEWS

Federal Reserve Board Clarifies Policies/Timing on Review of Dividends

Background

In 2009, the Federal Reserve Board ("FRB") issued its Supervision and Regulation Bulletin 09-4 ("SR 09-4"), "Applying Supervisory Guidance and Regulation on the Payment of Dividends, Stock Redemptions and Stock Repurchases at Bank Holding Companies." SR 09-4 (available at https://www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm) provides guidance to supervisory staff at the Federal Reserve Banks, as well as bank and savings and loan holding companies, on the FRB's expectations with respect to the declaration of dividends and adoption of stock repurchase programs by all holding companies and, in particular, those companies that may be experiencing financial difficulties.

In addition to setting forth relevant supervisory principles for assessing a holding company's capital adequacy, capital planning and risk management, SR 09-4 specifies factors that the FRB considers appropriate for a holding company's board of directors in assessing declaration of a dividend. The guidance urges boards of directors to "strongly consider" reducing, deferring or eliminating dividends "when the quantity and quality of earnings have declined or the [holding company] is experiencing other financial problems", or when the "macroeconomic outlook" for the company's "primary profit centers have deteriorated." Further, SR 09-4 states that a holding company should "inform the Federal Reserve" and "eliminate, defer or significantly reduce" dividends if:

(1) The holding company's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund dividends;

(2) The holding company's prospective rate of earnings retention is not consistent with the BHC's capital needs and overall current and prospective financial condition; or

(3) The holding company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

SR 09-4 notes that failure to do so could result in a supervisory finding that the company is operating in an unsafe and unsound manner.

SR 09-4 also indicates that a holding company should consult with the Reserve Bank "reasonably in advance" of declaring or paying a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the organization's capital structure. SR 09-4 reflects the FRB's view that declaring or paying a dividend in either circumstance could raise supervisory concerns. According to SR 09-4, a holding company should also apprise the Federal Reserve reasonably in advance of declaring any material increase in its common stock dividend to similarly ensure that it does not raise safety and soundness concerns.

New Guidance

On July 24, 2020, the FRB posted on its website "Attachment C" to SR 09-4. According to the FRB, Attachment C is intended to "clarify the process" that the FRB uses when consulting with holding companies on proposed dividends under SR 09-4. In particular, Attachment C addresses timing considerations for holding companies when consulting with Reserve Bank supervisory staff under SR 09-4 on paying a dividend that exceeds earnings for the period for which the dividend is being paid. That has become a source of concern to many holding companies given difficult economic conditions primarily related to COVID-19.

Essentially, Attachment C creates two tiers of holding companies for this purpose. The first tier receives what Attachment C calls "expedited consultation" with the Reserve Bank; such companies may generally expect a response from the relevant Reserve Bank supervisory staff within two business days from submission of notice of the proposed dividend. A holding company is in the first tier if it:

(1) has net income available to common shareholders over the past year sufficient to fully fund the dividend (and previous dividends over the past four quarters); and

(2) is not considering making stock repurchases/redemptions in the current quarter; and

(3) does not have concentrations in commercial real estate lending that exceed the thresholds described in FRB Supervision and Regulation Bulletin 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate" (i.e., reported loans for construction, land development and other land do not exceed 100% of total capital and total commercial real estate loans do not exceed 300% of total capital and the CRE portfolio has not increased 50% or more in the prior 36 months); and

(4) is in good supervisory condition, as generally indicated by:

    a. overall condition: current capital and asset quality subcomponent ratings under the RFI rating system of 1 or 2 (or capital and asset quality ratings of 1 or 2 for the lead bank of noncomplex holding companies with total assets less than $3 billion); and

    b. asset quality risk: a ratio of (restructured loans + noncurrent loans + other real estate owned) / (tier 1 capital + reserves) < 25% for the current reporting period.

A holding company that does not meet the above criteria is in the second tier. Attachment C indicates that, "in most cases," Reserve Bank supervisory staff will provide a response to the holding company's consultation within five business days of the company providing its internal analysis supporting its decision to pay the proposed dividend. Attachment C indicates that a banking organization considering paying dividends that exceed earnings for the period for which the dividend is being paid will "typically" assess the level and trend of noncurrent assets; criticized and classified assets; the adequacy of its allowance for loan and lease losses; potential risk resulting from asset concentrations and prospective earnings relative to its capital position, including in consideration of current economic conditions, to ensure an appropriate capital position can be maintained.

To our experience, the various Reserve Bank supervisory staffs have differed in the degree of scrutiny given proposed dividends where consultation is expected under SR 09-4 due to a proposed quarterly dividend exceeding quarterly earnings. Given recent economic conditions, Attachment C reflects a recognition by the FRB that more holding companies will need to consult with the Reserve Bank supervisory staff than in the recent past and that timing considerations related to such consultation are highly significant, particularly to publicly-traded holding companies. Factors recited in Attachment C as "typically" considered by a banking organization evaluating a prospective quarterly dividend that exceeds quarterly earnings are usually incorporated within an effective holding company dividend policy. However, Attachment C suggests that the Reserve Bank's supervisory staff may want to review, and question, the holding company's internal analysis of the relevant factors. Holding companies that are expected to consult on a prospective dividend under SR 09-4 should communicate with their primary Reserve Bank supervisory contact to discuss exactly what type of submission will be required with respect to the proposed dividend.

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