Featured Professionals

Karen L. Grandstrand

Capital Planning and Heightened Expectations – SR 09-4

Legal Update
12.02.2015

By Karen L. Grandstrand

During the financial crisis, many banking organizations became subject to enforcement actions that required banks and bank holding companies (BHCs) to obtain approval from their regulators to pay dividends and redeem stock. At the same time, the Federal Reserve issued Supervision and Regulation Letter SR 09-4 (February 24, 2009, as revised March 27, 2009). This SR letter places ongoing restrictions on the payment of BHC dividends and the redemption of BHC stock even after enforcement actions are lifted.

According to the letter's introductory paragraph, the letter is intended to provide direction to supervisory staff and BHCs on the declaration and payment of dividends, capital redemptions, and capital repurchases by BHCs in the context of their capital planning processes. The letter goes on to state that it largely reiterates longstanding Fed policy and guidance but heightens expectations that a BHC will inform and consult with the Federal Reserve in advance of the following:

- declaring and paying a dividend that could raise safety and soundness concerns (e.g., declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid);
- redeeming or repurchasing regulatory capital instruments when the BHC is experiencing financial weaknesses; or
- redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction as of the end of a quarter in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred.

CAPITAL PLANNING PROCESS

The SR letter directs supervisory staff to evaluate the comprehensiveness and effectiveness of management's capital planning and states that a BHC board should take into account a number of factors when considering dividends and redemptions:

- Overall asset quality, potential need to increase reserves and write down assets, and concentrations of credit;
- Potential for unanticipated losses and declines in asset values;
- Implicit and explicit liquidity and credit commitments, including off-balance sheet and contingent liabilities;
- Quality and level of current and prospective earnings, including earnings capacity under a number of plausible economic scenarios; • Current and prospective cash flow and liquidity;
- Ability to serve as an ongoing source of financial and managerial strength to depository institution subsidiaries insured by the FDIC, including the extent of double leverage and the condition of subsidiary depository institutions;
- Other risks that affect the BHC's financial condition and are not fully captured in regulatory capital calculations;
- Level, composition, and quality of capital; and
- Ability to raise additional equity capital in prevailing market and economic conditions.

DIVIDENDS

With respect to dividends, the letter states that the BHC board should strongly consider, after careful analysis of the above factors, reducing, deferring, or eliminating dividends when the quantity and quality of the BHC's earnings have declined or the BHC is experiencing other financial problems or when the macroeconomic outlook for the BHC's primary profit centers has deteriorated. Further, and significantly, the board should inform the Federal Reserve and should eliminate, defer, or significantly reduce dividends if:

1. The BHC'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 the dividends;
2. The BHC'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 BHC will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

In addition, the letter provides that a BHC should inform the Fed prior to declaring or paying a dividend that exceeds earnings for a period for which the dividend is being paid or that could result in a material adverse change to the capital structure.

STOCK REDEMPTIONS

The SR letter acknowledges that there are express regulatory requirements governing stock redemptions contained in Regulation Y. However, in addition, BHCs experiencing financial weaknesses or that are at significant risk of developing financial weaknesses, as well as BHCs considering expansion through acquisitions or through new activities, generally should consult with the Fed before redeeming stock. Further, a BHC should inform the Fed of a redemption of common stock or perpetual preferred stock for cash or other value resulting in a net reduction of a BHC's outstanding amount of common stock or perpetual preferred stock below the amount of such capital instrument outstanding at the beginning of the quarter in which the redemption or repurchase occurs.

TAKEAWAYS AND OBSERVATIONS

In my experience, this SR letter has become one of the key tools used by the Fed in its supervision and regulation of BHCs, particularly community banking organizations. Accordingly, while you may have reviewed SR 09-4 back in 2009 when it was issued, go back and read it carefully in its entirety. This article covers only the high points.

Second, while the language of the letter suggests that no Fed approvals are required, bankers should note that compliance with SR 09-4 is reviewed by the Fed and bankers are cited for failure to consult, inform and refrain from taking certain actions. Indeed, the letter provides that failure to follow the letter "could result in a supervisory finding that the organization is operating in an unsafe and unsound manner."

Third, while the focus is often on whether a bank can pay dividends, there is another hurdle in cases where the bank is owned by a BHC. Once the money is in the BHC, banking organizations cannot assume they can automatically use it.

Finally, this letter is a good example of the regulatory world post-crises. The letter speaks of heightened expectations, is in the form of guidance as opposed to new regulations, and is directed toward the board and management.