American Bankers Association

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*By Electronic Submission to http://www.federalreserve.gov*

Mr. Robert de V. Frierson
Secretary, Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

**Re:** **Docket No. R-1533, RIN 7100- AE 47** – Interim Final Rule on Dividends on Federal Reserve Bank Stock (Interim Final Rule)[1]

Dear Members of the Board of Governors of the Federal Reserve System:

The American Bankers Association[2] is troubled by the recent legislation affecting the stock and capital of the Federal Reserve Banks and of the Federal Reserve System overall. We write in particular to express our deep concern about the flawed legal basis and damaging impact of the recent unilateral reduction in dividends payable on Reserve Bank stock held by member banks of the Federal Reserve System. This change to the statutory dividend rate upended Federal Reserve System policy on offsets and incentives for system membership, dating from the inception of the Federal Reserve System, in place for over 100 years. This action was taken explicitly to target a narrow set of financial institutions to fund a significant portion of the national transportation system. There is no special relationship between the banking industry and the nation's transportation infrastructure to justify the determination by Congress that payments otherwise due to Federal Reserve member banks should be taken and used to fund the projects envisioned in legislation. Member banks having more than $10 billion in assets will be materially damaged by the resulting dilemma: either accept a severely reduced return on a highly illiquid asset, or leave the Federal Reserve System altogether, together with the dislocations and consequences that would entail to the banks.

**Background**

As a condition of membership, Federal Reserve member banks are required to purchase stock in their district Reserve Bank equal to six percent of the member's capital and surplus, one-half of which is paid in, with the other half subject to call by the Board of Governors.[3] Increases in capital and surplus trigger mandatory proportionate subscriptions for additional Reserve Bank stock.[4] Though Federal Reserve membership is elective for state-chartered banks, national banks are required by law to be members and thus to subscribe for Reserve Bank stock.[5]

[1] https://www.federalregister.gov/articles/2016/02/24/2016-03747/federal-reserve-bank-capital-stock
[2] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.
[3] FRA Section 5, 12 USC §287.
[4] *Id.*
[5] FRA Section 2, 12 USC §282.

Section 32203 of the Fixing America's Surface Transportation Act (FAST Act)[6] amended the provisions of section 7(a)(1) of the Federal Reserve Act (FRA),[7] which governs dividend payments to Reserve Bank stockholders, as of January 1, 2016. Prior to the FAST Act amendments, all member banks were entitled to a six percent dividend on their paid-in capital stock. Though the amendment preserved the six percent dividend for member banks with $10 billion or less in total consolidated assets, member banks with more than $10 billion in total consolidated assets will now receive a dividend equal to the lesser of six percent and the rate equal to the high yield of the 10-year Treasury note auctioned at the last auction held prior to the payment of such dividend.[8] The Board issued the Interim Final Rule to implement the FAST Act's amendments to the FRA.

**Potential Damage to the Banking System**

As a paper published by the Federal Reserve Bank of Richmond has noted, dividend payments have been central to the relationship between the Federal Reserve System and commercial banks since the founding of the Federal Reserve in 1913. "The dividend was a key part of a bundle of benefits and costs that came with Fed membership."[9] This membership incentive was a Congressional decision in the original FRA.[10] The paper by the Richmond Federal Reserve Bank stresses that a careful consideration of the relationship between the Federal Reserve System and its members makes clear that the value of these dividends is greater—and more complicated—than just the dollar amount. These payments encourage banks to join and stay in the Federal Reserve System to reduce the risk of what is now known as "shadow banking."[11] A Congressional effort in 1964 to eliminate dividends of stock in Federal Reserve Banks and remit the funds to the Treasury was defeated, and then-Chairman Martin of the Board of Governors argued forcefully that Reserve Bank stock was important in integrating member banks into the System.[12] Changing the dividend rate, he continued, might be viewed, "as a step toward nationalization of the banking system" or as "significant portent of basic monetary changes."[13] In other words, it was understood by Federal Reserve officials and by member banks that stock ownership and the offsetting dividends were part and parcel of membership in the Federal Reserve System.

In addition to those long-standing policy concerns, ABA members are deeply concerned about both the immediate detriment and the dangerous precedent of funding general expenditures like highway construction by burdening specific segments of the business community. In this case, the burdened industry has no greater connection with or responsibility for Federal highway construction and maintenance obligations than does the American public at large. Beyond the potential damage to the Federal Reserve System described above, the government has now set a precedent for unfair treatment in meeting broad public obligations.

[6] Pub. L. No. 114-94, 129 Stat. 1312 (2015).
[7] 12 U.S.C. §289(a)(1).
[8] The FAST Act amendments to the FRA also provide that the Board must adjust the $10 billion threshold for total consolidated assets annually to reflect the change in the Gross Domestic Product Price Index.
[9] Federal Reserve Bank of Richmond, *Economic Brief* EB16-02) February 2016).
[10] *See id.* at 3.
[11] *Id.* at 1.
[12] *Id.* at 5.
[13] *Id.*

**Injury to Federal Reserve Member Banks**

Federal Reserve member banks that do remain in the system, required to hold illiquid capital stock investments to maintain system membership, will now be forced to accept a fluctuating dividend identified through processes established for very different purposes, in no way reflective of the costs to banks of holding statutorily illiquid stock in Federal Reserve Banks, i.e. return on a closely-held, non-tradable security priced by the broad national market for one of the most highly liquid and widely traded securities in the world. The Congressional Budget Office has estimated that, between 2016 and 2020, the cumulative cost to member banks will be $2.768 billion; over the period 2016-2025, the cumulative estimated cost is $6.904 billion.[14] This is not accidental, as Congress specifically intended this underpricing of Federal Reserve Bank stock dividends in order to steer that difference into national transportation funding. As explained in detail below, the action is unjust and violates several legal principles, as reflected in established legal precedents.

**Breach of Contract by the United States**

In *United States v. Winstar*,[15] the Supreme Court held that the government may be held liable for a breach of contract caused by a change in the law. In *Winstar*, three financial institutions brought claims for the enforcement of contracts with federal regulatory agencies. The claimants asserted that a new federal statute made it impossible for the agencies to carry out their promises and that the government was therefore liable for breach. The government responded that its obligations under the contracts "could change along with the relevant regulations."[16] The Supreme Court disagreed. The Court concluded that the government had made "express commitments,"[17] and that it therefore had assumed the risk of a future change in the law that might preclude it from carrying out those commitments.

Following *Winstar*, lower courts have held the government liable for breaching contracts caused by changes in the law. In *Centex Corp. v. United States*,[18] for example, the Court of Federal Claims held that the United States violated the implied covenant of good faith and fair dealing when Congress passed a law that eliminated certain tax benefits. The court explained that, "[i]n a government contract, the implied covenant of good faith and fair dealing requires that the Government not use its unique position as sovereign to target the legitimate expectations of its contracting partners."[19] The court rejected the government's argument that "no breach of the implied covenant of good faith could have occurred . . . because the benefits were derived from a tax deduction and plaintiffs understood that the tax laws could change,"[20] noting that the "[p]laintiffs . . . legitimately expected that the covered asset loss deduction would not be eliminated through retroactive legislation targeted specifically at assistance agreements entered into by the [federal agencies]."[21] Yet, as the court explained, "[t]he uncontroverted evidence here demonstrates that the . . legislation was specifically intended to strip those taxpayers who had entered into contracts with the

[14] Letter from Keith Hall, Director, Congressional Budget Office, to the Hon. Bill Shuster (December 2, 2015).
[15] 518 U.S. 839 (1996).
[16] *Id*. at 868.
[17] *Id*.
[18] 49 Fed. Cl. 691 (2001).
[19] *Id*. at 708.
[20] *Id*. at 709.
[21] *Id*. at 712.

[federal agencies] of the fruits of those contracts."[22] The Federal Circuit affirmed the decision of the Court of Federal Claims "in all respects."[23]

As noted above, prior to the amendments made by the FAST Act, the FRA established a 6 percent dividend rate payable to all member banks on their holdings of Reserve Bank stock. Reserve Bank stock certificates expressly state that their issuance is made "in pursuance of the provisions of the Act of Congress approved Dec. 23, 1913 known as the Federal Reserve Act." When the Board of Governors approved a bank's application for membership prior to the effective date of the FAST Act's amendments and issued Reserve Bank stock, the United States expressly promised to pay the 6 percent dividend rate codified in the FRA.[24]

**Taking of Property without Compensation**

The FAST Act's dividend rate change amounts to an unconstitutional taking of member banks' property without compensation. The Takings Clause of the Fifth Amendment provides that "private property" shall not "be taken for public use, without just compensation."[25] Courts apply a two-part test to determine whether a taking has occurred. "First, as a threshold matter, the court determines whether the claimant has identified a cognizable Fifth Amendment property interest that is asserted to be the subject of the taking. Second, if the court concludes that a cognizable property interest exists, it determines whether that property interest was 'taken.'"[26] If a taking has occurred, the owner is entitled to receive "just compensation."[27]

The right to receive dividends resulting from stock ownership is generally recognized as a property interest,[28] and was recognized as such at the time of the FRA.[29] This understanding of stock dividends as property appears to be implicit in the text of FRA, which declares that Reserve Bank shareholders are "*entitled* to receive an annual dividend of 6 percent,"[30] and provides that upon dissolution of any Reserve Bank, any surplus remaining "shall be paid to and *become* the property of the United States" only "after the payment of all debts, [and] dividend requirements."[31] Moreover, courts have "repeatedly found takings" in "confiscations of money" including "financial obligations" consisting of expected revenue streams.[32] For example, the Court of Federal Claims has recognized

[22] *Id.* at 709.
[23] *Centex Corp. v. United States*, 395 F.3d 1283, 1287 (Fed. Cir. 2005).
[24] See *Winstar*, 64 F.3d at 1537–42 (finding there was "manifest assent to the same bargain proposed by the offer" where the government's approval of a bank resolution demonstrated its acceptance of the terms therein).
[25] U.S. Const. amend. V.
[26] *Hearts Bluff Game Ranch, Inc. v. United States*, 669 F.3d 1326, 1329 (Fed. Cir. 2012) (citations omitted).
[27] *Id.*
[28] *See, e.g., Delaware v. New York*, 507 U.S. 490, 495-96 (1993) (holding State in which holder of funds is incorporated has right to escheat "property interest[s]" in "unclaimed dividends, interest, and other distributions made by issuers of securities"); *Cerajeski v. Zoeller*, 735 F.3d 577, 580 (7th Cir. 2013) (per Posner, J.) (holding confiscation of interest payments—"or, equivalently, dividends"—is a taking); *Canel v. Topinka*, 818 N.E.2d 311, 326 (Ill. 2004) (holding confiscation of certain stock dividends was a taking); Del. Code tit. 12, § 1170(a)(1) (defining "abandoned property" to include abandoned "interest or dividends").
[29] *See, e.g., N. Pac. R. Co. v. Boyd*, 228 U.S. 482, 508 (1913) ("If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. . . . [I]t was a right of property . . . .").
[30] 12 U.S.C. § 289(a)(1) (emphasis added).
[31] *Id.* § 290 (emphasis added).
[32] *Koontz v. St. Johns River Water Mgmt. Dist.*, 133 S. Ct. 2586, 2601 (2013) (collecting cases).

that member banks have a property interest cognizable under the Fifth Amendment in the arguably analogous situation of interest income on deposits held by a Reserve Bank.[33]

The government's actions under the FAST Act amount to a regulatory taking of member banks' property interest. Among the factors the Supreme Court has identified in deciding whether a taking has occurred is the extent to which government action interfered with "distinct investment-backed expectations."[34] Where the issue is not "imposition of a new 'regulatory regime,' but legislative abrogation of the key rule of a pre-existing regime," the "critical question is whether a reasonable [investor] confronted with the particular circumstances . . . would have expected the government to nullify" the rule.[35] A Federal Reserve member bank, as a reasonable investor, would not have expected Congress to unilaterally nullify the 6 percent dividend rate for banks with assets exceeding $10 billion. The dividend rate remained unchanged for over 100 years, and it has long been considered fundamental to the Federal Reserve's ability to attract member banks. If anything, the relatively low Federal Reserve membership figure, combined with increased concern on the part of regulators regarding "shadow banking," suggests that a reasonable investor would expect the dividend to increase, not decrease.

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ABA understands that the proposed interim final rule is in pursuance of a decision made by legislation, not in furtherance of a policy initiated by the Federal Reserve Board. Nevertheless, we believe that the policy implemented by the interim final rule is unfair and contrary to law. For that reason, ABA stands ready to assist the Board of Governors of the Federal Reserve with any appropriate measures that mitigate these concerns. Please do not hesitate to contact the undersigned if you have any questions.

Very truly yours,

Rob Nichols
President and CEO

[33] *Cmty. Bank & Trust v. United States*, 54 Fed. Cl. 352, 359 (2002) ("For the limited purpose of this motion to dismiss, the court finds that plaintiff has a property interest in the principal of its reserve accounts, cognizable under the Fifth Amendment.").

[34] *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

[35] *Cienega Gardens v. United States*, 331 F.3d 1319, 1342 (Fed. Cir. 2003) 331 F.3d at 1346 (citing Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1005 (1984)).