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OF THE
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DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 09-4

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**Revised December 21,
2015**

In March 2009, this letter was revised to provide greater clarity regarding priority of payment of dividends on tier 1 capital instruments and the redemption of capital instruments issued by bank holding companies under government investment programs. This revised letter also includes an attached list of frequently asked questions.

In December 2015, this letter has been superseded for U.S. bank holding companies or intermediate holding companies of foreign banking organizations with \$50 billion or more in total consolidated assets. See SR letter 15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms" and SR letter 15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms" for more information.

**TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH
FEDERAL RESERVE BANK AND EACH BANK HOLDING COMPANY
SUPERVISED BY THE FEDERAL RESERVE**

**SUBJECT: Applying Supervisory Guidance and Regulations on the Payment of
Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies**

This letter is intended to provide direction to supervisory staff and bank holding companies (BHCs) on the declaration and payment of dividends,¹ capital redemptions, and capital repurchases by BHCs in the context of their capital planning processes. Although the letter largely reiterates longstanding Federal Reserve supervisory policies and guidance, it also heightens expectations that a BHC will inform and consult with Federal Reserve supervisory staff sufficiently in advance of (i) 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); (ii) redeeming or repurchasing regulatory capital

¹ The term "dividends" as used in this letter refers to dividends on common stock and preferred stock, as well as dividends or interest on the subordinated notes underlying trust preferred securities and other tier 1 capital instruments, in cash or other value (collectively, "dividends"). Stock dividends (i.e., dividends in the form of common stock) are excluded. The priority of payment of dividends is based on the level of seniority of the instrument, which is established by contract between an issuer and its investors.

instruments when the BHC is experiencing financial weaknesses; or (iii) 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.

While the principles discussed in this letter are applicable to all BHCs, they are especially relevant for BHCs that are experiencing financial difficulties and/or receiving public funds. In response to economic strains on bank earnings and capital, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted, one component of which is the U.S. Department of Treasury (Treasury) Capital Purchase Program (CPP).² The Federal Reserve is working with the other federal banking agencies to assist the Treasury in monitoring compliance efforts of banking organizations participating in the CPP, and will continue to do so as additional programs entailing government investments in banking organizations (e.g., the Capital Assistance Program announced by the Treasury on February 10, 2009) are implemented going forward. This letter, therefore, also discusses special considerations for the supervisory review of dividend payments, capital redemptions, and capital repurchases by BHCs that are CPP participants or that have otherwise received public funds.

Supervisory staff should document their analyses of the issues discussed below and include such documentation in workpapers related to supervisory activities.³ Such documentation not only provides a basis for constructive dialogue with an organization's management, but also supports current and future supervisory actions or initiatives. Reserve Bank and Board staff will develop a supervisory response in all instances where concerns regarding depletion of capital arise for a BHC that is experiencing financial difficulty or that has received public funds.⁴

Review of Capital Adequacy Management

A fundamental principle underlying the Federal Reserve's supervision and regulation of BHCs is that a BHC should serve as a source of managerial and financial strength to its subsidiary banks. Consistent with this premise, the Federal Reserve expects an organization to hold capital commensurate with its overall risk profile. The risk-based capital rules state that the capital requirements are minimum standards based primarily on broad credit-risk considerations. The risk-based ratios do not take explicit account of the quality of individual asset portfolios or the range of other types of risk to which banking organizations may be exposed (e.g., interest-rate, liquidity, market, and operational risks). For this reason, banking organizations are generally

² In this regard, the federal bank regulatory agencies issued an interagency statement and accompanying press release, "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," on November 12, 2008. The interagency press release and statement are available on the Federal Reserve Board's public website at <http://www.federalreserve.gov/default.htm>. Interagency efforts continue to focus on effectively addressing the broad objectives identified in the statement.

³ As discussed in SR letter 02-1, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less," risk-focused supervision of certain noncomplex BHCs with consolidated assets of less than \$1 billion relies extensively on off-site monitoring, surveillance, and the assessments of primary banking supervisors of BHC subsidiaries. For such BHCs, supervisory staff generally will be able to rely to a large extent on offsite surveillance and monitoring activities to identify potential supervisory issues related to capital adequacy as discussed in this letter. Expectations for related documentation are likewise commensurate with the size and complexity of the BHC.

⁴ Notwithstanding the general guidance in this letter, the Federal Reserve may establish more stringent institution-specific requirements under its supervisory or enforcement authority. To the extent those requirements are more stringent than this guidance, those requirements supersede this guidance.

expected to operate with capital positions well above the minimum ratios, with the amount of capital held by a banking organization corresponding to its broad risk exposure. Because an overall assessment of capital adequacy must take into account factors beyond those reflected in the minimum regulatory capital ratios, supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization's risk-based capital ratio.

Consequently, an organization's internal process for assessing capital adequacy should reflect a full understanding of its risks and ensure that it holds capital corresponding to those risks to maintain overall capital adequacy. Key among these risks is the risk of illiquidity, particularly that a perceived lack of financial strength (e.g., a capital shortfall relative to potential losses in a stress scenario) may lead investors and counterparties to withhold funds or otherwise cease engaging in business with the organization. This is particularly important for a banking organization that is a core clearing and settlement organization or that has a significant presence in critical financial markets; such an organization is expected to have especially rigorous and effective internal processes for assessing capital adequacy.⁵

In addition to evaluating the appropriateness of a BHC's capital level given its overall risk profile, supervisory staff should focus on the quality of a BHC's capital and trends in its capital composition. In this regard, the Board's risk-based capital rules state that voting common stockholders' equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within tier 1 capital, and that banking organizations should avoid overreliance on non-common-equity capital elements.⁶ Accordingly, a BHC should place primary reliance on its common equity, followed by perpetual preferred stock, which is included in equity under generally accepted accounting principles (GAAP) and absorbs losses on a going-concern basis (i.e., helps a BHC avoid insolvency despite losses on its assets). Tax-deductible hybrid capital instruments, such as trust preferred securities, provide a limited supplement within tier 1 capital to a BHC's common stock and preferred stock.

In assessing a BHC's capital adequacy, supervisory staff should evaluate the comprehensiveness and effectiveness of management's capital planning. An effective capital planning process requires a banking organization to assess the risks to which it is exposed and its processes for managing and mitigating those risks, evaluate its capital adequacy relative to its risks, and consider the potential impact on its earnings and capital base from current and prospective economic conditions. A BHC's capital planning process should be commensurate with the BHC's size, complexity, and risk profile,⁷ and should entail consideration of a variety of factors. This letter is not intended to describe comprehensively all elements of a BHC's capital planning

⁵ As discussed in SR letter 03-9, "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System," core clearing and settlement organizations are defined as large-value payment system operators and market utilities that provide critical clearing and settlement services for critical financial markets. The term also includes firms that provide clearing and settlement services that are integral to a critical financial market (i.e., their market share is significant enough to present systemic risk in the event of their sudden failure to carry on those activities because there are no immediately viable alternatives). Firms that play significant roles in critical financial markets are those that consistently clear or settle at least five percent of the value of transactions in a critical market.

⁶ See 12 CFR part 225, Appendix A, section II.A.1.c.(3).

⁷ Large BHCs and others with complex risk profiles should have in place robust internal capital adequacy assessment processes, as noted in SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles." BHCs that use the advanced approaches in the risk-based capital adequacy framework based on Basel II may be subject to further requirements in this regard.

process, but rather to focus on those factors that a BHC's board of directors should take into account when considering the payment of dividends, stock redemptions, or stock repurchases. Among these factors are the BHC's:

- 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 Federal Deposit Insurance Corporation, including the extent of double leverage⁸ 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.

Supervisory findings in the areas discussed in this letter should be incorporated into the assessment of the "Capital" subcomponent for the BHC's "Financial Condition" rating component in the RFI (Risk Management, Financial Condition, and Impact) rating⁹ assigned to a BHC. See attachment A for information that supervisory staff should seek from BHCs in developing this assessment.

Dividends in Cash or Other Value

Crucial to any capital plan are the effects on a BHC's financial condition of the payment of dividends on common stock¹⁰ and other tier 1 capital instruments, as described in footnote 1. Consistent with the Board's November 14, 1985, Policy Statement on the Payment of Cash Dividends (see attachment B),¹¹ the principles of which generally are incorporated by reference into this guidance, a banking organization should have comprehensive policies on dividend payments that clearly articulate the organization's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. These policies should take into account the potential drain on a BHC's resources posed by the payment not just

⁸ Double leverage refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity. In this regard, supervisory staff should also consider the impact of any potential overreliance a BHC may have on dividends received from subsidiaries as a source of payment for its liabilities.

⁹ See SR letter 04-18, "Bank Holding Company Rating System."

¹⁰ This includes dividends paid on common stock by BHCs qualifying under Subchapter S of Chapter 1 of the Internal Revenue Code. For regulatory and supervisory purposes, such dividends are treated the same as those paid by other BHCs.

¹¹ While this SR letter applies to BHCs, the 1985 policy statement applies to state member banks as well. The principles set forth in this letter also are broadly relevant to state member banks.

of cash dividends, but also of non-cash dividends, which can take many different forms (e.g., the distribution of assets to shareholders, particularly insiders, or the assumption or guarantee of certain shareholders' liabilities), other than those in the form of common stock, which generally do not raise supervisory concerns.

When a BHC's board of directors is deciding on the level of dividends to declare,¹² it should consider, among other things, the factors discussed above under "Review of Capital Adequacy Management." It is particularly important for a banking organization's board of directors to ensure that the dividend level is prudent relative to the organization's financial position and is not based on overly optimistic earnings scenarios. Supervisory staff should engage in discussions with a BHC on the BHC's overall dividend policies and practices as part of the ongoing supervisory assessment of capital adequacy. Moreover, because the period between declaration of a dividend and the payment date may be as much as 60 days, in making a declaration, the board of directors should consider any potential events that may occur before the payment date that could affect its ability to pay while still maintaining a strong financial position.¹³

While many organizations place great importance on consistently paying dividends, a board of directors should strongly consider, after careful analysis of the factors described above under "Review of Capital Adequacy Management," 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.¹⁴ As a general matter, the board of directors of a BHC should inform the Federal Reserve and should eliminate, defer, or significantly reduce the BHC's 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.

Failure to do so could result in a supervisory finding that the organization is operating in an unsafe and unsound manner.

Moreover, a BHC should inform the Federal Reserve 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. Declaring or paying a dividend in either circumstance could raise supervisory concerns. Likewise, a BHC should apprise the Federal Reserve reasonably in advance of declaring any

¹² As a general matter, the declaration of a dividend to shareholders establishes a legal obligation to pay that dividend and is recorded as a liability on the balance sheet.

¹³ Payments on trust preferred securities are not declared. Rather, the BHC must make a decision not to make a payment; typically, this decision must be made 15 days before payment is due.

¹⁴ Contractual arrangements typically dictate that a banking organization may not defer dividends on senior instruments (e.g., preferred stock) unless dividends have been fully deferred on more junior instruments (e.g., common stock).

material increase in its common stock dividend to ensure that it does not raise safety and soundness concerns.

Stock Redemptions and Repurchases

It is an essential principle of safety and soundness that a banking organization's redemption of instruments included in regulatory capital and repurchases of common stock, preferred stock, and other regulatory capital instruments from investors be consistent with the organization's current and prospective capital needs. In assessing such needs, the board of directors and management of a BHC should consider the factors discussed above under "Review of Capital Adequacy Management."

Federal Reserve supervisory staff should continue exercising their supervisory oversight and regulatory authority in evaluating BHCs' capital planning processes, as discussed above, and consulting with BHCs regarding their proposed redemptions and repurchases of common stock, preferred stock, and other regulatory capital instruments. There are explicit regulatory requirements for Federal Reserve review of such transactions in several situations:

- Certain non-exempted BHCs are required under section 225.4(b)(1) of Regulation Y to notify the Federal Reserve of actions that would reduce a BHC's consolidated net worth by 10 percent or more.¹⁵
- Under the Board's risk-based capital rule for BHCs, most instruments included in tier 1 capital¹⁶ with features permitting redemption at the option of the issuing BHC (e.g., perpetual preferred stock and trust preferred securities) may qualify as regulatory capital only if redemption is subject to prior Federal Reserve approval.¹⁷
- The risk-based capital rule directs BHCs to consult with the Federal Reserve before redeeming any equity or other capital instrument included in tier 1 or tier 2 capital prior to stated maturity, if such redemption could have a material effect on the level or composition of the organization's capital base.¹⁸

¹⁵ Section 225.4(b)(1) of Regulation Y requires that a BHC that is not well capitalized or well managed, or that is subject to any unresolved supervisory issues, provide prior notice to the Federal Reserve for any repurchase or redemption of its equity securities for cash or other value that would reduce by 10 percent or more the BHC's consolidated net worth aggregated over the preceding 12-month period. Note that all repurchases and redemptions within a 12-month period are aggregated for application of this rule, regardless of any other approval or supervisory consultation process that was followed by the BHC with regard to its repurchases and redemptions of equity securities.

¹⁶ As discussed in SR letter 01-27, "The Use of Forward Equity Transactions by Banking Organizations," common shares covered by forward equity arrangements are excluded from tier 1 capital of a BHC. Such an arrangement is defined as an agreement by a banking organization to sell equity to a counterparty and purchase it back at a later date.

¹⁷ Unlike the process noted above for transactions requiring notification of the Federal Reserve under Regulation Y, such approvals and the consultative process for other repurchases and redemptions are part of the Federal Reserve's general supervisory processes and do not, therefore, require formal applications.

¹⁸ See 12 CFR part 225, Appendix A, section II.(iii). Such consultation by small BHCs subject to the Board's Small Bank Holding Company Policy Statement (small BHC policy statement; see Regulation Y: 12 CFR part 225, Appendix C), however, is only required for the redemption of instruments included in equity as defined under GAAP -- such as common and perpetual preferred stock -- and not for other instruments included in regulatory capital solely under the risk-based capital rule.

In addition, Federal Reserve supervisory staff should exercise the above regulatory authorities, as well as the Federal Reserve's general supervisory and enforcement authority, to prevent a BHC from repurchasing its common stock, preferred stock, trust preferred securities, and other regulatory capital instruments in the market if such action would be inconsistent with the BHC's prospective capital needs and continued safe and sound operation. BHCs experiencing financial weaknesses, or that are at significant risk of developing financial weaknesses, should consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration. Similarly, any BHC considering expansion, either through acquisitions or through new activities, also generally should consult with the appropriate Federal Reserve supervisory staff before redeeming or repurchasing common stock or other regulatory capital instruments for cash or other valuable consideration.

In evaluating the appropriateness of a BHC's proposed redemption or repurchase of capital instruments, Federal Reserve supervisory staff are directed to consider:

- The potential losses that a BHC may suffer from the prospective need to increase reserves and write down assets from continued asset deterioration; and
- The BHC's ability to raise additional common stock and other tier 1 capital to replace capital instruments that are redeemed or repurchased.

In addition, supervisory staff should consider the potential negative effects on capital of a BHC:

- Replacing common stock with lower-quality forms of regulatory capital (e.g., hybrids or subordinated debt); or
- Redeeming or repurchasing equity and other capital instruments from investors, including selective repurchases or redemptions from insiders, with cash or other value that could be better used to strengthen the BHC's regulatory capital base or its overall financial condition.

Furthermore, to facilitate such supervisory oversight, a BHC should inform Federal Reserve supervisory staff of a redemption or repurchase¹⁹ 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. It is not necessary to inform supervisory staff pursuant to this letter when reductions in a BHC's tier 1 capital during a quarter will result from other causes, such as a reduction of the BHC's retained earnings due to negative earnings.

BHCs should advise Federal Reserve supervisory staff sufficiently in advance of such redemptions and repurchases to provide reasonable opportunity for supervisory review and possible objection should Federal Reserve supervisory staff determine a transaction raises safety and soundness concerns. When informing Federal Reserve supervisory staff of redemptions and repurchases, including requests for approval of redemptions under the risk-based capital rule as

¹⁹ Redemptions of most instruments (e.g., preferred stock or trust preferred securities) included in regulatory capital require Federal Reserve approval under the risk-based capital rule, but such redemptions by small BHCs are not required under the small BHC policy statement.

discussed above, a BHC may provide information either for a proposed transaction or for a number of transactions within given a given quarter on its tier 1 capital composition. Most usefully, such information would include the dollar amount and percentage breakdown of the BHC's tier 1 capital components (i.e., common equity, perpetual preferred stock, and other tier 1 capital instruments), as well as its regulatory capital ratios, at the beginning of the previous quarter and most recent four-quarter period, as well as pro forma changes to its capital composition and ratios resulting from its proposed redemptions or repurchases.

Considerations for CPP and Other Capital Program Participants

In addition to the general guidance set forth in this letter, BHCs participating in the CPP and other government capital programs must comply on an ongoing basis with the pertinent capital and other requirements established by the Treasury (including those explicitly set forth in EESA²⁰) and related Federal Reserve supervisory policy. Moreover, a recipient of taxpayer funds through such capital programs should consider and communicate reasonably in advance to Federal Reserve supervisory staff how the BHC's proposed dividends, capital redemptions, and capital repurchases are consistent with the requirements applicable to its receipt of capital under the program and related Federal Reserve supervisory policy, as well as its ability to redeem securities issued to the government prior to any contractual increase in the dividend rate without affecting safety and soundness.

To ensure that any redemption of capital instruments issued to the Treasury (or other government agencies, if applicable) is consistent with current procedures for approving significant capital redemptions and does not raise safety and soundness concerns, BHCs that wish to redeem such instruments issued under the CPP or other programs should—consistent with the Federal Reserve's working relationship with Treasury in this regard—consult with Federal Reserve supervisory staff prior to notifying Treasury of their intent. As a general matter, the Treasury has indicated that it will consult with the Federal Reserve prior to approving redemptions of capital instruments issued by BHCs under the CPP. When considering the appropriateness of such a redemption, the Federal Reserve will consult closely with federal or state supervisors of any depository institution subsidiaries. The review of such proposals will include an assessment of the BHC's capital planning process, its current and prospective capital position, and its ability to serve as a continued source of strength to depository institution subsidiaries during stressed market conditions.

Conclusion

Reserve Banks are asked to distribute this revised SR letter to all BHCs. Questions regarding this letter may be directed to T. Kirk Odegard, Manager, Supervisory Guidance & Procedures, at (202) 530-6225; John F. Connolly, Senior Project Manager, Supervisory Policy & Guidance, at (202) 452-3621; Juan C. Climent, Senior Supervisory Financial Analyst, Supervisory Policy & Guidance, at (202) 872-7526; or William Tiernay, Senior Supervisory Financial Analyst, Supervisory Policy & Guidance, at (202) 872-7579. Questions related specifically to BHCs'

²⁰ These requirements can be found in the text of the EESA, which is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_public_laws&docid=f:publ343.110.pdf. Further information is available on the Treasury's public website at: <http://www.treas.gov/initiatives/eesa/>. The requirements include mandatory Treasury approval of common stock dividends and share repurchases as specified in the term sheets and legal documentation on the Treasury website relating to CPP issuances.

CPP redemptions may be directed to the Board's CPP Call Center at (202) 872-7557. In addition, questions may be sent via the Board's public website.²¹

Roger T. Cole
Director

Attachments:

- Attachment A
- Attachment B
- Frequently Asked Questions re: SR letter 09-4

Cross References:

- SR letter 04-18, "Bank Holding Company Rating System"
- SR letter 03-9, "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System"
- SR letter 02-1, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less,"
- SR letter 01-27, "The Use of Forward Equity Transactions by Banking Organizations"
- SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles"

²¹ See <http://www.federalreserve.gov/feedback.cfm>.