FED NOTES: Originally published in the Autumn 2013 edition of *Bank Owner* magazine.

Several factors guide Fed's analysis of capital distributions

By Stephanie Weber

Federal Reserve Bank of Minneapolis staff frequently receives questions regarding factors we consider when analyzing a holding company's request to make a capital distribution, including paying a dividend (including subchapter S distributions), redeeming stock (including Trust Preferred Securities or TPS), or making interest payments on TPS. This article discusses what Federal Reserve Bank staff review in their analysis of capital distributions.

When is consultation or approval required?

Depending on the circumstances, a holding company may need to consult, provide notice, or seek approval from the Federal Reserve System or the Reserve Bank for a capital distribution. Holding companies should consider the requirements of SR 09-4: Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies. SR letter 09-4 generally requires consultation when a weak firm makes a distribution or any firm makes a large distribution relative to its financial resources (e.g., declaring or paying a dividend that exceeds earnings for the period or purchasing stock equal to or greater than 10 percent of net worth).

In addition, prior approval to redeem TPS or securities issued under the Troubled Asset Relief Program is required by the terms of the instruments. Finally, supervisory actions, both formal and informal, usually require prior approval of capital distributions.

What factors does the Federal Reserve consider?

In addition to providing guidance to bankers, SR letter 09-4 is used by Reserve Bank staff for guidance in our analysis of dividends, stock redemptions, or stock repurchases. We are more likely to require firms to eliminate, defer or reduce dividends if these payments are not fully covered by the net income available to shareholders for the past four quarters, earnings retention is not consistent with capital needs or the holding company is in danger of not meeting minimum regulatory capital adequacy ratios. For stock redemption proposals, we consider the negative effects on capital if voting common stock is replaced with lower forms of capital, such as non-voting stock, cumulative preferred stock, or subordinated debt, or if the funds would better serve the capital base or financial needs of the organization. We also assess the company's ability to service any debt incurred in a redemption without unduly burdening the subsidiary bank.

Staff also considers the rating of the holding company and subsidiary bank and related enforcement actions. For firms in good condition, the primary focus of reviews is earnings relative to the dividend or redemption. For firms in weaker condition or under an action, the areas of focus include maintenance of capital ratios above targeted amounts, strength of earnings, and current and trend of overall condition. Problem BHCs are not allowed, as a general rule, to make a distribution. It is important to note that the small BHC policy statement prevents a dividend payment when the debt-to-equity ratio is greater than 1:1.

For holding companies in satisfactory financial condition we review the organization's earnings to ensure the dividend or redemption is covered by earnings. For larger holding companies reporting on a consolidated basis, the proposed dividend or redemption should not cause the holding company to report ratios below the well-capitalized levels. If the holding company is in less-than-satisfactory condition and subject to enforcement action or the subsidiary bank's enforcement action includes minimum capital ratio requirements, we ensure the subsidiary bank exceeds its minimum capital ratio requirements, the organization has positive earnings, and consider the trend in the subsidiary banks' condition. Finally, if a dividend is required from the subsidiary bank, we consider the views of the primary bank regulator.

We encourage firms to contact Applications, or Safety and Soundness staff at your local Federal Reserve Bank for additional information if you have questions on any capital distribution.

Stephanie Weber is an examiner with the Federal Reserve Bank of Minneapolis. A nine-year Federal Reserve Bank employee, she has responsibility for oversight of enforcement actions.

Fed Notes is provided through a partnership the Bank Holding Company Association shares with the Federal Reserve Bank of Minneapolis.