Simpson Thacher

Memorandum

Federal Reserve Updates Supervisory Guidance on Payment of Dividends

July 29, 2020

In the most recent Comprehensive Capital Analysis and Review (CCAR) cycle completed in June 2020, the Federal Reserve imposed share buyback and dividend restrictions on the CCAR banks, including a requirement that quarterly dividends not exceed the lesser of the prior quarter dividend and the banking organization's average earnings over the prior four quarters, to preserve capital during the current period of economic uncertainty. The Federal Reserve has now issued updated supervisory guidance regarding dividend payments by non-CCAR banking organizations. This updated guidance does not impose the CCAR restrictions on non-CCAR banking organizations, but reiterates the long-standing guidance that banking organizations should consult with their local Reserve Bank before declaring dividends in excess of earnings for the corresponding quarter. The updated guidance now indicates, however, that banking organizations meeting certain earnings, capital and asset quality criteria may expect an expedited response to the consultation (within two business days). Banking organizations not meeting these criteria should expect a lengthier and more burdensome consultation process requiring more submissions to the Federal Reserve, and potentially a greater challenge to receive non-objection from the Federal Reserve.

Background on Federal Reserve Dividend Guidance

During the peak of the financial crisis in 2009, the Federal Reserve released Supervision and Regulation Letter 09-4 ("SR 09-4") to provide direction to bank holding companies ("BHCs") on the declaration of dividends, capital redemptions and capital repurchases in the context of their capital planning processes. Although the letter largely reiterated longstanding Federal Reserve supervisory policies and guidance, it also heightened expectations that a BHC will consult with Federal Reserve supervisory staff in advance of certain capital distributions, including declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid.

SR 09-4 provides that the board of directors of a BHC should, as a general matter, inform the Federal Reserve and should eliminate, defer or significantly reduce the BHC's dividends if:

- 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;
- 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

- the BHC will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

In addition, SR 09-4 provides that a BHC should inform the Federal Reserve reasonably in advance of declaring or paying a dividend that exceeds earnings for the quarter for which the dividend is being paid or that could result in a material adverse change to the organization's capital structure, due to the risks that the declaration of a dividend in either circumstance could raise supervisory concerns.

Overview of New Guidance

On July 24, 2020, the Federal Reserve updated SR 09-4 to provide greater clarity regarding the situations in which BHCs may expect an expedited consultation in connection with the declaration of dividends that exceed quarterly earnings. As clarified by the July 24, 2020 update to SR 09-4, a BHC dividend payment that exceeds quarterly earnings may receive an expedited response from Federal Reserve Bank supervisory staff if the BHC satisfies certain criteria, including that the BHC:

- 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);
- is not considering making stock repurchases/redemptions in the current quarter;
- does not have concentrations in commercial real estate lending that exceed the thresholds described in Supervision and Regulation Letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate"[1]; and
- is in good supervisory condition (*i.e.*, has current capital and asset quality subcomponent ratings under the RFI rating system of 1 or 2, and has restructured loans, noncurrent loans and other real estate owned that constitute less than 25% of its tier 1 capital and reserves).

The July 24, 2020 update to SR 09-4 indicates that a BHC that does not meet the criteria above should expect to be subject to a lengthier and possibly more burdensome review process by Federal Reserve supervisory staff when considering paying dividends that exceed quarterly earnings. In particular, the recent update to SR 09-4 indicates that such a BHC will generally need to provide internal analysis supporting its capital decision, which should 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. After providing its supporting internal analysis, the BHC should generally expect a response from Federal Reserve Bank supervisory staff regarding its dividend declaration within five business days.

[1] Supervision and Regulation Letter 07-1 specifies the following commercial real estate lending concentration thresholds for a banking institution: (ii) total reported loans for construction, land development and other land represent 100% or more of an institution's total capital; or (ii) total commercial real estate loans represent 300% or more of the institutions total capital and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50% or more during the prior 36 months.

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