



**BOARD OF GOVERNORS**  
OF THE  
**FEDERAL RESERVE SYSTEM**

WASHINGTON, D.C. 20551

DIVISION OF BANKING  
SUPERVISION AND REGULATION

**November 17, 2010**

**Revised Temporary Addendum to SR letter 09-4: Dividend Increases and Other Capital Distributions for the 19 Supervisory Capital Assessment Program Bank Holding Companies**

Bank holding companies should consult with Federal Reserve staff before taking any actions that could result in a diminished capital base, including actions such as increasing dividends, implementing common stock repurchase programs, or redeeming or repurchasing capital instruments more broadly (planned capital actions). This revised temporary addendum to SR letter 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," outlines specific criteria the Federal Reserve will consider when evaluating such proposed actions by the firms that participated in the Supervisory Capital Assessment Program (SCAP BHCs or BHCs). The status of this temporary addendum will be reviewed on or before December 31, 2011.<sup>1</sup>

The purpose of this supervisory letter is to re-emphasize the Federal Reserve's expectations concerning the processes SCAP BHCs should have in place to ensure that they hold adequate capital under adverse conditions to maintain ready access to funding, continue to serve as credit intermediaries, and continue operations.<sup>2</sup> This letter describes the process the Federal Reserve will follow in assessing those BHCs' capital plans and capital adequacy, including in the context of requests to undertake planned capital actions.<sup>3</sup> The Federal Reserve will consult with primary federal bank regulators when assessing the capital adequacy of the BHCs.

**Comprehensive Capital Plans**

Supervisory assessments of capital adequacy will be based on a review of a comprehensive capital plan submitted by SCAP BHCs to the Federal Reserve and the primary federal bank regulator. SCAP BHCs are encouraged to have their capital plans filed by January 7, 2011, irrespective of whether they intend to undertake any capital distributions. Senior management and the board of directors should review and approve the comprehensive capital plan prior to its submission to the Federal Reserve. A BHC should update and re-submit its plan to reflect any material change in the firm's risk profile, business strategy, or corporate structure. That is, the

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<sup>1</sup> This revised temporary addendum supersedes the December 21, 2009, temporary addendum to SR letter 09-4.

<sup>2</sup> The expectations in this letter refer to and clarify interagency and Federal Reserve supervisory guidance applicable to large and complex BHCs including, as appropriate, *Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Advanced Approaches Final Rule* (see July 15, 2008, Federal Reserve Board press release) and SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles."

<sup>3</sup> The Federal Reserve's review of a BHC's capital plan, and any related planned capital actions, is part of the ongoing supervisory process. The Federal Reserve is considering the appropriateness of developing a more standardized process for assessing capital adequacy that may require the annual submission of comprehensive capital plans to help guide such reviews.

responsibility resides with a BHC's management to identify the circumstances under which the existing comprehensive capital plan is no longer relevant and should be revised, approved by the board of directors and re-submitted to the Federal Reserve. The Federal Reserve will monitor a BHC's condition relative to its current capital plan, and, where the firm's condition proves to be significantly weaker than anticipated in the plan, will expect management to take additional action to strengthen the BHC's capital base.

In broad terms, a comprehensive capital plan should incorporate a stress testing framework that considers a range and variety of economic, financial market and operational events and outcomes, including very severe ones, to estimate potential capital needs. It should capture, among other elements, management's estimates of potential losses, revenues and the amount of capital needed to withstand these scenarios and be able to continue to operate in a safe and sound financial condition. Pro forma, post-stress estimates of capital should be inclusive of any planned capital actions that would impact capital levels and needs over the planning horizon.

More specifically, the comprehensive capital plan submitted in response to this request should:

- Assume a minimum planning horizon of 24 months, including loan loss reserves needed to support credit and other financial exposures in place at the end of the planning horizon;
- Specify assumptions comprising, at a minimum, both a firm-defined baseline scenario and a firm-defined adverse scenario appropriate to the BHC's business model and portfolios, including a probabilistic assessment of the likelihood of the scenarios;
- Include estimates of losses, revenue, and pro forma, post-stress capital levels based on the firm-defined scenarios, as well as on an adverse macroeconomic scenario that will be provided by the Federal Reserve;
- Provide a quarterly path of pro forma, post-stress estimates of potential losses and their impact on reserves and valuation adjustments, potential resources available to absorb losses (e.g., pre-provision net revenues and gains from sales), and the impact of those estimates on exposures subject to regulatory capital adjustment or deduction;
- Specify by quarter all planned capital actions, as well as expected changes in the firm's risk profile, business strategy, or corporate structure over the planning horizon;
- Provide quarterly, pro forma estimates under each macroeconomic scenario described above of the BHC's tier 1 and total risk-based capital ratios, tier 1 leverage ratio, as well as a tier 1 common risk-based ratio<sup>4</sup> to serve as an additional supervisory reference point;
- Describe the composition of the firm's regulatory capital base, including key contractual terms of the capital instruments and any management plans to retire, refinance, or replace the instruments over the planning horizon;

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<sup>4</sup> Tier 1 common is calculated as tier 1 capital less non-common elements, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities. Specifically, non-common elements must include the following items captured in Federal Reserve Reporting Form FR Y-9C, *Consolidated Financial Statements for Bank Holding Companies*: Schedule HC, line item 23 net of Schedule HC-R, line item 5; Schedule HC-R, line items 6a, 6b, and 6c; and Notes to the Balance Sheet - Other as captured in Schedule HC-R, line item 10.

- Describe the firm's dividend and common stock repurchase policies, with particular emphasis on how management decisions to declare such actions are informed by considerations of the future performance of the BHC;<sup>5</sup>
- Reflect management's plans for addressing proposed revisions to the regulatory capital framework agreed by the Basel Committee on Banking Supervision (Basel III). BHCs should provide a transition plan that includes pro forma estimates of regulatory capital ratios consistent with the recently proposed Basel III regulatory framework over the phase-in period, with supporting detail around actions and assumptions to be taken over the entire period necessary for the BHC to meet the fully phased in 7% tier 1 common equity target; and
- Incorporate in the plan any anticipated impact of requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)<sup>6</sup> that could affect the BHC's risk profile, business strategy, corporate structure, or capital adequacy over the 24-month planning horizon.

### Supervisory Assessment

In assessing capital adequacy, the Federal Reserve will consider the firm's risk profile, the content of the capital plan, and the strength of management's internal capital assessment process as informed by recent supervisory examinations and existing supervisory knowledge of risk management or other weaknesses that may compromise a BHC's ability to effectively assess its capital needs. Such supervisory assessments will implement, through a consistent supervisory process, the requirement of the Board's capital rules that institutions should hold capital commensurate with the level and nature of the risks to which they are exposed. The Federal Reserve will evaluate a SCAP BHC's comprehensive capital plan in the context of the firm's risk profile, the regulatory capital standards applicable today, and the reasonableness of the BHC's plans to address anticipated future standards, including Basel III and relevant aspects of the Dodd-Frank Act.

For SCAP BHCs that include a request to increase common stock dividends, reinstate or increase common stock repurchase programs, or make other capital distributions, the plans will be evaluated with particular emphasis on the following considerations.

**U.S. Government Investments:** the Federal Reserve expects SCAP BHCs to complete the repayment or replacement of any outstanding U.S. government investment in the form of common equity or preferred shares as well as satisfy any conditions related to Troubled Asset Relief Program repayment plans prior to taking any other capital actions.<sup>7</sup>

**Pro Forma, Post-Stress Estimates:** a BHC's pro forma, post-stress capital estimates (inclusive of any proposed capital distributions) will be evaluated relative to regulatory minimums and a

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<sup>5</sup> In general, the Federal Reserve expects that plans submitted in 2011 will reflect conservative dividend payout ratios and net share repurchase programs (i.e., requests that imply dividend payout ratios above 30% of after-tax net income will receive particularly close scrutiny). The Federal Reserve further expects that plans will allow for significant accretion of capital after taking consideration of all proposed capital actions.

<sup>6</sup> Pub. L. 111-203; 124 Stat. 1376 (July 21, 2010).

<sup>7</sup> Temporary Liquidity Guarantee Program (TLGP) debt would not be considered in this evaluation of U.S. government investments; however, BHCs' capital plans should be consistent with their liquidity plans to address repayment of debts scheduled to mature over the 24-month planning horizon. This should include TLGP debt that is maturing, or that management plans to redeem prior to maturity, over that horizon.

tier 1 common to risk-weighted assets supervisory reference level of 5 percent. That reference level reflects a supervisory assessment of the minimum capital needed to be a going concern on a post-stress basis, based on an analysis of the historical distribution of earnings by large U.S. banking organizations.<sup>8</sup> In evaluating a BHCs' pro forma, post-stress capital estimates:

- The Federal Reserve will review and assess the BHC's pro forma, post-stress estimates of losses, revenues, and resulting capital ratios based both on the firm-defined baseline and adverse scenarios appropriate for its business model and portfolios, as well as those based on a supervisory-defined adverse macroeconomic scenario;
- The Federal Reserve will evaluate the specific assumptions underlying the BHC's stressed loss and revenue estimates, as well as all supporting information submitted; and
- In assessing the reasonableness of the BHC's stressed loss and revenue estimates, the Federal Reserve will rely on observations from ongoing monitoring and analysis of the firm's operating performance and risk exposures and on supervisory loss and revenue modeling.

Based on an assessment of the comprehensive capital plan, including the loss and revenue estimates and resulting pro forma, post-stress capital levels submitted by the BHC, the Federal Reserve may advise the BHC to revise and resubmit its capital plan for evaluation during a subsequent calendar quarter.

**Management Actions in Anticipation of Basel III:** The Federal Reserve will evaluate whether the proposed capital action(s) are appropriate in light of management's plans to address the proposed Basel III reform measures. The Federal banking agencies have begun the process for adopting the Basel III framework agreed to by the Basel Committee. In line with this effort, the Federal Reserve expects that BHCs will demonstrate with great assurance that they could achieve the ratios required by the Basel III framework, inclusive of any proposed dividend increases or other capital distributions, as those ratios come into effect in the United States. Accordingly, as part of its comprehensive capital plan submission, management should provide a transition plan that includes pro forma estimates under the baseline scenario of the BHC's regulatory capital ratios in the recently proposed Basel III regulatory framework, with due regard to the possibility that earnings or losses may be less favorable than anticipated. As stated in the September 2010 Group of Governors and Heads of Supervision agreements, under the Basel III proposal BHCs that meet the minimum ratio requirement during the transition period but remain below the 7% tier 1 common equity target (minimum plus conservation buffer) would be expected to maintain prudent earnings retention policies with a view to meeting the conservation buffer as soon as reasonably possible.

In considering a proposed capital action, the Federal Reserve will also take into account the nature of the proposed capital action, such as whether a proposed redemption of regulatory capital instruments is funded by the issuance of instruments of equal or better quality in terms of loss-absorption capacity, or whether common share repurchases are designed to offset increases in share count related to employee share-based compensation awards. Moreover, notwithstanding the factors described above, the Federal Reserve may determine that a BHC's proposed capital actions are inappropriate in view of supervisory concerns such as unresolved risk management issues.

The Federal Reserve will contact each BHC when the supervisory review of its comprehensive

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<sup>8</sup> The 5% tier 1 common supervisory reference level was calculated using Basel I risk-weighted assets.

capital plan has been completed. Plans containing the elements specified above that are submitted by the first week of a calendar quarter will generally receive a supervisory response no later than 10 days prior to quarter end.

Questions about this addendum may be directed to Michael R. Foley, Senior Associate Director, at (202) 452-6430; Timothy Clark, Senior Advisor, at (202) 452-5264; or John Connolly, Manager, Capital and Regulatory Policy, at (202) 452-3621.