

August 13, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Eligible Retained Income

SUMMARY: Staff is presenting for approval of the Federal Deposit Insurance Corporation (FDIC) Board of Directors (FDIC Board) a request to adopt, issue, and publish the attached final rule (final rule), which would adopt as final the revisions to the definition of eligible retained income made under the interim final rule issued in the *Federal Register* on March 20, 2020 (capital rule IFR) for all depository institutions, bank holding companies, and savings and loan holding companies subject to the regulatory capital rules (capital rule) of the FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of the Comptroller of the Currency (OCC) (together, the agencies). The final rule would revise the definition of eligible retained income to make more gradual any automatic limitations on capital distributions that could apply under the capital rule. Separately, in this final rule, the FRB also is adopting as final the definition of eligible retained income made in the interim final rule published in the *Federal Register* on March 26, 2020, for purposes of the FRB's total loss-absorbing capacity (TLAC) rule (TLAC IFR). The final rule would adopt the capital rule IFR and the TLAC IFR with no changes.

Recommendation: Staff requests that the FDIC Board approve this final rule and authorize its publication in the *Federal Register* with an effective date of January 1, 2021.

Concur:

Nicholas J. Podsiadly
General Counsel

Discussion:

I. Background

Under the capital rule, a banking organization must maintain minimum risk-based capital and leverage ratios.¹ In addition, a banking organization under the capital rule must maintain a buffer of regulatory capital above its applicable minimum risk-based capital and leverage ratio requirements, as applicable, to avoid restrictions on capital distributions including in the form of dividends and share buybacks and discretionary bonus payments.²

All banking organizations under the capital rule are generally subject to a fixed capital conservation buffer requirement, composed solely of common equity 1 capital, of greater than 2.5 percent of risk-weighted assets. Moreover, banking organizations subject to Category I, II, and III standards also are subject to a countercyclical capital buffer requirement³ and a minimum supplementary leverage ratio of 3 percent. The largest and most systematically important bank holding companies (U.S. GSIBs) are subject to the GSIB surcharge, an additional capital buffer based on a measure of their systemic risk. Further, U.S. GSIBs are subject to enhanced supplementary leverage ratio standards, and must hold an additional leverage capital buffer of tier 1 capital to avoid limitations on capital distributions. The insured depository institution subsidiaries of U.S. GSIBs must maintain a similarly higher supplementary leverage ratio to be considered well capitalized under the agencies' respective prompt corrective action frameworks.⁴ On March 4, 2020, the FRB adopted a final rule that simplified the FRB's regulatory capital

¹ 12 CFR 3.10 (OCC); 12 CFR 217.10 (FRB); and 12 CFR 324.10 (FDIC). An additional minimum supplementary leverage ratio of 3 percent applies to banking organizations subject to Category I, II, and III standards.

² See 12 CFR 3.11 (OCC); 12 CFR 217.11 (FRB); and 12 CFR 324.11 (FDIC).

³ Currently, the countercyclical capital buffer is set at 0 percent.

⁴ See 12 CFR 6.4(b)(1)(i) (OCC); 12 CFR 217.11(b)(1)(i) (Board); 12 CFR 324.403(b)(1)(ii) (FDIC).

framework for large bank holding companies with the introduction of a stress capital buffer requirement (SCB final rule). Under the SCB final rule, an applicable bank holding company will receive a new stress capital buffer requirement on an annual basis, which replaces the static greater than 2.5 percent capital conservation buffer requirement.

Under the capital rule, if a banking organization's capital ratios fall within its minimum-plus-buffer requirements, the maximum amount of capital distributions it can make is a function of its eligible retained income, as defined in the capital rule.⁵ All of the buffer requirements in the capital rule use the same definition of eligible retained income and the same definition of eligible retained income applies to depository institutions and holding companies. Prior to the capital rule IFR, the capital rule generally defined eligible retained income as four quarters of net income, net of distributions and associated tax effects not already reflected in net income.⁶

II. Overview of the Capital Rule IFR

In March 2020, the agencies issued the capital rule IFR, which revised the definition of eligible retained income to the greater of (1) a banking organization's net income for the four preceding calendar quarters, net of any distributions and associated tax effects not already reflected in net income, and (2) the average of a banking organization's net income over the preceding four quarters.⁷ This revision reduces the likelihood that a banking organization is

⁵ A banking organization in or below the bottom quartile of its capital conservation buffer may not make any capital distributions without prior approval from the Board, OCC, or FDIC, as applicable.

⁶ For purposes of the stress capital buffer, the definition of eligible retained income used to determine restrictions on capital distributions by an applicable banking organization depended on the banking organization's capital buffer amount compared to its stress capital buffer requirement.

⁷ The capital IFR also applies to the U.S. intermediate holding companies of foreign banking organizations required to be established or designated under 12 CFR 252.153. The FRB's TLAC IFR includes the same definition of eligible retained income.

suddenly subject to abrupt and restrictive distribution limitations in a scenario where its ratios fall within its applicable minimum-plus-buffer requirements.

The revised definition of eligible retained income under the capital rule IFR applies to all of a banking organization's buffer requirements, including the fixed greater than 2.5 percent capital conservation buffer and, if applicable, the countercyclical capital buffer, as well as, for global systemically important bank holding companies, the GSIB surcharge, and enhanced supplementary leverage ratio buffer. Once the stress capital buffer requirements under the SCB final rule apply, the revised definition would also apply to all parts of a covered holding company's buffer requirements.

In addition, the revised definition of eligible retained income under the capital rule IFR assists in the ability of S-corporation banking organizations to provide dividends to shareholders in order to meet their pass-through tax liabilities. When an otherwise adequately capitalized S-corporation banking organization is restricted from making dividends because one or more of its capital ratios breach its buffer requirements, a situation can arise in which the banking organization's dividends to its shareholders would be insufficient to pay their share of taxes on the banking organization's income.⁸

C. Public Comments

Some commenters on the capital rule IFR supported the change to the definition of eligible retained income in the capital rule, indicating that flexibility provided by the change will help banking organizations continue to lend through the COVID-19 crisis. One commenter believed that the capital rule IFR would assist community banking organizations organized as S-

⁸ FDIC, FIL-40-2014 (July 21, 2014).

corporations to meet tax obligations and still raise capital as needed. Another commenter was supportive of the capital rule IFR's application of a consistent definition of eligible retained income across banking organizations of all sizes and suggested that the new definition will add consistency to the capital rule while balancing the need for banking organizations to lend to borrowers affected by COVID-19 and still maintain general safety and soundness.

Other commenters opposed the change to the definition of eligible retained income in the capital rule IFR, and requested that the agencies not adopt the revisions or place additional restrictions on banking organizations as applicable. One commenter to the capital rule IFR was not supportive of the timing of the proposal. The commenter stated that the present extraordinary economic circumstances of a severe economic downturn marked by uncertainty is the wrong time to give banking organizations more flexibility to make capital distributions.

The revised definition of eligible retained income under the capital rule IFR facilitates banking organizations' use of their buffers as intended by ensuring that the limits on capital distributions apply gradually. The revised definition reduces the incentive for banking organizations to limit their lending and other financial intermediation activities in order to avoid facing abrupt limitations on capital distributions.

III. Summary of the Final Rule

For the reasons described above, the final rule would adopt as final the definition of eligible retained income unchanged from the capital rule IFR. Accordingly, under the final rule, eligible retained income for purposes of the capital rule would be defined as the greater of (1) a company's net income for the four preceding calendar quarters, net of any distributions and

associated tax effects not already reflected in net income, and (2) the average of a company's net income over the preceding four quarters.

Separately, in this final rule, the FRB is adopting as final the same definition of eligible retained income for purposes of the FRB's TLAC rule.

Conclusion:

Staff requests that the FDIC Board approve this final rule and authorize its publication in the *Federal Register* with an effective date of January 1, 2021.

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