

March 16, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Eligible Retained Income

SUMMARY: In light of recent disruptions in economic conditions caused by the coronavirus disease (COVID-19) and current strains in U.S. financial markets, 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 interagency interim final rule (“interim final rule”), which would amend the definition of eligible retained income under the regulatory 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) for all depository institutions, bank holding companies, and savings and loan holding companies subject to the agencies’ capital rules (together, a banking organization or banking organizations). The interim final rule would make any automatic limitations on capital distributions that could apply under the agencies’ capital rule more gradual.

Recommendation: Staff requests that the FDIC Board approve this interim final rule and authorize its publication in the *Federal Register* with an effective date as of the date of publication in the *Federal Register* and with a comment period deadline of 45 days after the date of *Federal Register* publication.

Concur:

Nicholas J. Podsiadly
General Counsel

Discussion:

The capital rule requires a banking organization to maintain minimum risk-based capital and leverage ratios.¹ The capital rule also requires a banking organization to maintain certain buffers above its risk-based capital and leverage ratios, as applicable, to avoid increasingly stringent restrictions on capital distributions and discretionary bonus payments. All banking organizations are currently subject to a fixed capital conservation buffer equal to 2.5 percent of risk-weighted assets.² Banking organizations subject to Category I, II, and III standards also are subject to a countercyclical capital buffer requirement, and the largest and most systemically important banking organizations—global systemically important bank holding companies, or U.S. GSIBs—are subject to an additional capital buffer based on a measure of their systemic risk, the GSIB surcharge.³ In addition, a minimum supplementary leverage ratio of 3 percent applies to banking organizations subject to Category I, II, and III standards. U.S. GSIBs and their depository institution subsidiaries also are subject to enhanced supplementary leverage ratio standards, which require each U.S. GSIB and its depository institution subsidiaries to hold additional supplementary leverage capital to avoid limitations on the banking organization’s distributions and discretionary bonus payments.⁴ The depository institution subsidiaries of U.S. GSIB holding companies generally must maintain a similarly higher supplementary leverage

¹ 12 CFR 324.10.

² 12 CFR 324.11.

³ In October 2019, the agencies finalized the tailoring rule, which more closely matches the regulations applicable to large banking organizations with their risk profile. The tailoring rule groups large U.S. and foreign banking organizations into four categories of standards (Category I through IV), with the most stringent standards applying to firms subject to Category I standards. 84 FR 59230 (November 1, 2019).

⁴ Each GSIB must maintain a supplementary leverage ratio greater than 3 percent plus a leverage buffer of 2 percent to avoid limitations on distributions and certain discretionary bonus payments. In addition, each depository institution subsidiary of a GSIB must maintain a 6 percent supplementary leverage ratio to be considered “well-capitalized” under the prompt corrective action framework of each agency. See 12 CFR 324.403(b)(1) (FDIC).

ratio to be considered well capitalized under the agencies' respective prompt corrective action frameworks. On March 4, 2020, the FRB adopted a final rule that simplified the FRB's capital framework for large banking organizations with the introduction of a stress capital buffer requirement (SCB final rule).⁵ Under the SCB final rule, a banking organization will receive a new stress capital buffer requirement on an annual basis, which replaces the static 2.5 percent capital conservation buffer requirement.

Under the capital rule, if a banking organization's capital ratios fall within its buffer requirements, the maximum amount of capital distributions and discretionary bonus payments it can make is a function of its eligible retained income. For example, a banking organization in the bottom quartile of its capital conservation buffer may not make any capital distributions without prior approval from the FRB, OCC, or FDIC, as applicable. The countercyclical capital buffer, the GSIB surcharge, and enhanced supplementary leverage ratio standards use the same definition of eligible retained income. As adopted, eligible retained income is defined as four quarters of net income, *net* of distributions and associated tax effects.

Under a more benign business environment when banking organizations have significant capital cushions above their capital requirements, some banking organizations decide to distribute all or nearly all of their net income. Because the measure of eligible retained income subtracts capital distributions made during the previous year, a period of sudden stress following a period of relatively benign conditions could result in very low or zero eligible retained income.

Similarly, if a banking organization with eligible retained income that is very low or negative

⁵ Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, March 4, 2020, available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200304a2.pdf>. The SCB final rule applies to bank holding companies and U.S. intermediate holding companies of foreign banking organizations subject to the capital plan rule (covered holding company). 12 CFR 225.8.

experiences an increase in its stress capital buffer requirement, because, for example, the banking organization's risk profile changed, then the banking organization's capital levels might not be sufficient to meet the stress capital buffer requirement. In either scenario, the banking organization could face sudden and severe distribution limitations even if its capital ratios only marginally fall below applicable buffer requirements.

To address this concern, the SCB final rule revised the definition of eligible retained income for the stress loss portion of a covered holding company's capital conservation buffer requirement. Under the SCB final rule, if a covered holding company's capital ratios are above minimum requirements plus the fixed 2.5 percent portion of the capital conservation buffer plus any applicable GSIB surcharge and countercyclical capital buffer, the covered holding company's eligible retained income is defined as the average of its previous four quarters of net income. Under the SCB final rule, if a covered holding company's capital ratios are below this level, the covered holding company's eligible retained income is defined as net income for the four preceding calendar quarters, net of any distributions.

Recent events have suddenly and significantly impacted financial markets. The spread of COVID-19 has disrupted economic activity in many countries. In addition, financial markets have experienced significant volatility. The magnitude and persistence of the overall effects on the economy remain highly uncertain. In light of these developments, banking organizations may realize a sudden, unanticipated drop in capital ratios. This could create a strong incentive for these banking organizations to limit their lending and other financial intermediation activities in order to avoid facing abrupt limitations on capital distributions. Thus, the current definition of eligible retained income, particularly in light of present market uncertainty, could serve as a

deterrent for banking organizations to continue lending to creditworthy businesses and households.

The agencies established the buffer requirements to encourage better capital conservation by banking organizations and to enhance the resilience of the banking system during stress periods.⁶ In particular, the agencies intend for the buffer requirements to limit the ability of banking organizations to distribute capital in the form of dividends and discretionary bonus payments and therefore strengthen the ability of banking organizations to continue lending and conducting other financial intermediation activities during stress periods. Staff of the agencies are concerned, however, that the buffer requirements do not limit capital distributions in the gradual manner intended when the buffer requirements were developed. Rather, the limitations on capital distributions could be sudden and severe if such banking organizations were to experience even modest reductions in capital ratios undermining the ability of banking organizations to use their capital buffers.

To address these concerns and better allow a banking organization to continue lending during times of stress, staff of the agencies have developed the interim final rule to revise 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) average quarterly net income over the preceding four quarters. This definition would apply with respect to all of a banking organization's buffer requirements, including the fixed 2.5 percent capital conservation buffer, and, if applicable, the countercyclical capital buffer, the GSIB surcharge, and enhanced supplementary leverage ratio standards. Once the SCB final rule is effective, this definition would also apply to all parts of a

⁶ 78 FR 62018, 62034 (Oct. 11, 2013).

covered holding company's buffer requirements, including the stress loss portion of a covered holding company's capital conservation requirement. Staff of the agencies believe that having one definition for all banking organizations as part of this interim final rule would simplify the regulatory capital framework and ensure fairness across banking organizations of all sizes.

By modifying the definition of eligible retained income and thereby allowing banking organizations to more freely use their capital buffers, this interim final rule should help to promote lending activity and other financial intermediation activities by banking organizations and avoid compounding negative impacts on the financial markets.⁷ The interim final rule would encourage banking organizations to make prudent decisions regarding capital distributions. In addition, this interim final rule would not make changes to any other rule or regulation that may limit capital distributions or discretionary bonus payments. For instance, under the prompt corrective action framework, an insured depository institution that becomes less than adequately capitalized will continue to be subject to dividend restrictions.⁸

Conclusion:

Staff requests that the FDIC Board approve this interim final rule and authorize its publication in the *Federal Register* effective as of the date of publication in the *Federal Register* and with a comment period deadline of 45 days after the date of *Federal Register* publication.

⁷ The interim final rule also would apply to the U.S. intermediate holding companies of foreign banking organizations required to be established or designated under 12 CFR 252.153.

⁸ 12 CFR 324.405.

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