FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
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Regulatory Capital Rules

Requests from S-Corporation Banks for Dividend Exceptions to the Capital Conservation Buffer

Summary: This Financial Institution Letter (FIL) describes how the FDIC will consider requests from S-corporation banks or savings associations (henceforth, "banks") to pay dividends to shareholders to cover taxes on their pass-through share of the bank's earnings, when these dividends would otherwise not be permitted under the capital conservation buffer requirements in the Basel III rule. As described in more detail in this FIL, absent significant safety-and-soundness concerns about the requesting bank, the FDIC generally would expect to approve exception requests by well-rated S-corporation banks that are limited to the payment of dividends to cover shareholders' taxes on their portion of an S-corporation's earnings.

Statement of Applicability to Institutions with Total Assets Under $1 Billion: This FIL is applicable to all FDIC-supervised S-corporation banks.

Distribution:
FDIC-Supervised Banks and Savings Associations

Suggested Routing:
Chief Executive Officer
Chief Financial Officer
Chief Risk Officer

Related Topics:
Risk-Based Capital Rules, 12 CFR Part 324

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Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule

Contact:
Bobby Bean, Associate Director, Capital Markets Branch, at bbean@fdic.gov

Ryan Billingsley, Chief, Capital Policy, at rbillingsley@fdic.gov

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Highlights

- This FIL applies to requests for exceptions from the capital conservation buffer limitations for dividends used by a subchapter S bank's shareholders to pay taxes on income attributed to the bank.
- The FDIC will consider all requests on a case-by-case basis.
- This letter describes the factors the FDIC will consider in evaluating certain requests for dividend exceptions under Section 324.11(a)(4)(iv) of the FDIC's risk-based capital rules.
- Nothing in this FIL alters or supersedes the Basel III capital rules or any other applicable regulation, policy, guidance, or procedure.
- Informational videos and other written reference materials designed to facilitate banks' understanding of the new Basel III capital rules can be found on the FDIC's Web site at www.fdic.gov/regulations/capital.
- The Basel III capital rules are effective January 1, 2014, with mandatory compliance beginning January 1, 2014, for FDIC-supervised institutions that are subject to the advanced internal ratings-based approaches (advanced approaches), and mandatory compliance scheduled to begin January 1, 2015, for all other FDIC-supervised institutions.

Requests from S-Corporation Banks for Dividend Exceptions to the Capital Conservation Buffer

This Financial Institution Letter (FIL) describes how the FDIC will consider requests from S-corporation banks[1] to pay dividends to shareholders to cover taxes on their pass-through share of the bank's earnings, when these dividends would otherwise not be permitted under the capital conservation buffer contained in the new Basel III capital rules. As described in more detail in this letter, absent significant safety-and-soundness concerns about the requesting bank, the FDIC generally would expect to approve exception requests by well-rated S-corporation banks that are limited to the payment of dividends to cover shareholders' taxes on their share of an S-corporation's earnings.

Because of the extended phase-in of the capital conservation buffer, this issue is unlikely to present itself in specific cases for a number of years. Moreover, historical experience with bank capital ratios suggests that few S-corporation banks likely would be affected by this pass-through tax issue solely because of the operation of the capital conservation buffer. Nevertheless, since the capital conservation buffer has been a source of concern for many S-corporation banks, the FDIC is issuing this FIL to clarify the application of the capital conservation buffer, including how it will consider exception requests.

Dividends and the Basel III Capital Conservation Buffer

FDIC-supervised depository institutions generally are free to pay dividends to their shareholders except in limited specific situations. By statute, 12 U.S.C. § 1831o(d)(1)(A), an insured depository institution may not pay a dividend if, after the payment of the dividend, the institution would be undercapitalized pursuant to the agencies' prompt corrective action (PCA) regulations. Moreover, institutions that are poorly rated or subject to written supervisory actions often are specifically directed not to pay dividends in order to ensure adequate capital exists to support their risk profile.

On April 8, 2014, the FDIC approved new Basel III capital rules.[2] These rules include a capital conservation buffer that limits the amount of dividends a bank can pay when the bank's capital ratios are below the threshold levels of the buffer.[3] The new Basel III capital rules place additional regulatory limits on the distributions and discretionary bonus payments that an adequately capitalized bank, or a bank whose capital ratios exceed by less than 0.5 percentage points any of its well-capitalized risk-based capital ratio thresholds, may potentially pay.[4] The capital conservation buffer is designed to encourage banks to maintain capital ratios well above regulatory minimums and to remain well-capitalized.

The appendix to this FIL summarizes the restrictions imposed by the capital conservation buffer. These restrictions are not fully effective until January 1, 2019. An institution whose risk-based capital ratios each exceed the minimum levels required under Section 324.10 by more than 2.5 percentage points is not subject to dividend restrictions under the capital conservation buffer. Otherwise, and provided the risk-based capital ratios all remain more than 1.875 percentage points[5] above the minimum required levels, a bank may distribute up to 60 percent of its eligible retained income. Thus, for example, even if its capital ratios fell below the 2.5 percentage point buffer, any bank meeting the PCA well-capitalized standard could still distribute 60 percent of its eligible retained income, an amount that should be more than sufficient to meet shareholders' tax obligations

[1] Throughout this letter, the term "S-corporation bank" is used as a short-hand for "S-corporation bank or S-corporation savings association."
[2] 79 FR 20754 (April 14, 2014).
[3] See appendix for a chart displaying the operation of the capital conservation buffer.
[4] 12 CFR 324.11(a).
[5] The 2.5 percentage point buffer which takes effect in 2019 is divided into four zones of 0.625 percentage points each; thus, the most favorable dividend treatment is for risk-based capital ratios ranging from 1.875 to 2.5 percentage points above the minimums. There is a three-year phase-in before 2019, during which the buffer amounts are 0.625 percent in 2016, 1.25 percent in 2017 and 1.875 percent in 2018.

on their share of pass-through income. As risk-based capital ratios deteriorate further, the limit on capital distributions under the capital conservation buffer becomes, respectively, 40 percent and 20 percent of eligible retained income, and finally zero if any risk-based capital ratio is equal to or less than 0.625 percentage points above the minimum required levels.

The new Basel III capital rules set out the general application of the capital conservation buffer, but also provide the ability for banks to request exceptions to the buffer restrictions.[6] Thus, FDIC-supervised institutions may request, and the FDIC may approve, dividend payments despite the restrictions imposed by the capital conservation buffer if the FDIC determines that the circumstances warrant the payment of dividends, that the payment is not contrary to the purposes of the buffer, and that the payment of dividends would not be detrimental to the safety and soundness of the bank. Specifically, Section 324.11(a)(4)(iv) provides that, notwithstanding the limitations of the capital conservation buffer,

> … the FDIC may permit an FDIC-supervised institution to make a distribution or discretionary bonus payment upon a request of the FDIC-supervised institution, if the FDIC determines that the distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the FDIC-supervised institution. In making such a determination, the FDIC will consider the nature and extent of the request and the particular circumstances giving rise to the request.

S-Corporation Banks and the Buffer

S-corporation banks do not pay federal income taxes. Income and losses are attributed to shareholders, potentially increasing their personal tax liability when the S-corporation has income and potentially reducing their personal tax liability if the S-corporation has losses. In a situation where the S-corporation has income but does not pay dividends, its shareholders are responsible for meeting the increased tax liability from their own resources.

A situation in which S-corporation shareholders' dividends would be insufficient to pay their share of taxes on the banks' income because of the capital conservation buffer is most likely to occur when the bank's risk-based capital ratios place it in the "0" or "20 percent" rows of the appendix table—that is, when the bank is adequately capitalized but one or more of its risk-based capital ratios are equal to or less than 1.25 percentage points above the minimum.

One scenario in which this may occur is when the bank's capital ratios are declining as a result of losses. In these situations, S-corporation shareholders may be in a position of using their pass-through share of losses to offset other income and reduce their personal tax liability. Another situation when a bank's capital ratios may be in this range is when its capital ratios are improving after being severely depleted. A third scenario involves a temporary deposit inflow that reduces a bank's capital ratio. If the bank invests such temporary deposit inflows in lower-risk liquid assets, as often happens, its risk-based capital ratios, which determine the application of the capital conservation buffer, may not be reduced significantly.

Based on historical experience with capital ratios, it appears that there have been relatively few S-corporation banks with capital ratios falling within the ranges corresponding to the zero and 20 percent rows of the appendix table that were in an income-earning status where the shareholders would have had pass-through income.

S-Corporation Requests for Dividend Exceptions to Cover Taxes on Pass-Through Income

As noted above, dividend restrictions have long been a part of the regulatory and supervisory process. Especially during periods of economic stress, a number of insured institutions, including S-corporation banks, have operated under dividend restrictions. The FDIC's basic supervisory approach to dividend restrictions applied to troubled banks is focused on the protection of the insurance fund and will remain unchanged. Nevertheless, the FDIC understands the concern that the new capital conservation buffer could increase the frequency with which S-corporation shareholders face a tax liability without having received dividends, and the concern that investors' fear of this scenario could make it more difficult for S-corporation banks to attract capital.

[6] See 12 CFR 324.11(a)(4)(iv).

Accordingly, the FDIC is clarifying the factors it will consider in response to requests under Section 324.11(a)(4)(iv) for exceptions to capital conservation buffer dividend limits specifically to cover the payment of taxes by S-corporation shareholders. In evaluating such requests, the FDIC would consider each of the following factors based on the specific facts and circumstances of the requesting bank:

- Is the S-corporation requesting a dividend of no more than 40 percent of net income?
- Does the requesting S-corporation believe the dividend payment is necessary to allow the shareholders of the bank to pay income taxes associated with their pass-through share of the institution’s earnings?
- Is the requesting S-corporation bank rated 1 or 2 under the Uniform Financial Institutions Rating System and not subject to a written supervisory directive?
- Is the requesting S-corporation bank at least adequately capitalized, and would it remain adequately capitalized after the requested dividend? (If not, the dividend is not permitted pursuant to statutory PCA, 12 U.S.C. § 1831o(d)(1)(A).)

If the FDIC determines that the S-corporation satisfies each of these factors, the requested dividend generally would be approved absent significant safety-and-soundness concerns, such as an ongoing examination with adverse trends identified, a pending written directive or downgrade to a less than satisfactory status, or a case where the buffer is triggered by an aggressive growth strategy. Since evaluating these factors should be relatively straightforward, the FDIC anticipates it would be able to respond affirmatively and in a timely manner to requests where the factors are satisfied. The FDIC will provide instructions on how to request an exception pursuant to this streamlined review process well in advance of when the buffer comes into effect.

With regard to the second factor, it is noted that S-corporation banks may not know the exact amount of dividends that would cover the marginal tax liability associated with the share of the banks’ income attributed to each of its shareholders, given that individual shareholders may have unique tax situations. The FDIC does not intend to review such information and generally would rely upon the requesting bank’s statement that it believes that this factor is satisfied.

This FIL only applies to requests for exceptions from the capital conservation buffer limitations for dividends used by an S-corporation bank’s shareholders to pay taxes on income attributed to the bank. The factors described are not meant to limit any bank’s ability to request dividend exceptions, including, for example, banks that had experienced difficulties but are returning to health. The FDIC will consider all requests on a case-by-case basis. Finally, this letter only describes the factors the FDIC will consider in evaluating certain requests for dividend exceptions under Section 324.11(a)(4)(iv) of the FDIC’s new Basel III capital rules. Nothing in this letter alters or supersedes the Basel III capital rules or any other applicable regulation, policy, guidance, or procedure.

Doreen R. Eberley
Director
Division of Risk Management Supervision

Appendix

Capital Conservation Buffer and Maximum Payout Ratio

Capital conservation buffer (as a percentage of standardized or advanced total risk-weighted assets, as applicable)	**Maximum payout ratio (as a percentage of eligible retained income)**
Greater than 2.5 percent	No payout ratio limitation applies
Less than or equal to 2.5 percent, and greater than 1.875 percent	60 percent
Less than or equal to 1.875 percent, and greater than 1.25 percent	40 percent
Less than or equal to 1.25 percent, and greater than 0.625 percent	20 percent
Less than or equal to 0.625 percent	0 percent

The size of the buffer is in reference to the minimum capital requirements for the common equity tier 1, tier 1 and total risk based capital ratios. For example, a bank with common equity tier 1 of 6 percent, tier 1 capital of 8 percent and total capital of 10, would have a capital conservation buffer of 1.5 percent. This is calculated as the lowest of :

- 6% CET1 – 4.5% CET1 minimum requirement (1.5%)
- 8% Tier 1 – 6.0% Tier 1 minimum requirement (2%)
- 10% Total Capital – 8% Total Capital minimum requirement (2%)