First Quarter 2011 / Volume 15 Issue 3

SRC Insights®

Federal Reserve Bank of Philadelphia

Balancing Shareholder Value with Regulation

by William Lenney, Regulatory Applications Specialist

Balance is often key to success. Thomas Merton, a 20th Century author, once said, "Happiness is not a matter of intensity but of balance and order and rhythm and harmony." During today's economic times, balancing regulation with an institution's objective of maximizing shareholder value can be extremely challenging, but it is a worthy effort that can benefit both management and shareholders.

An institution should act in the best interest of its shareholders while also making good decisions. From a supervisory perspective, a bank holding company (BHC) should act as a source of strength to its subsidiary bank(s), which can conflict with a BHC's desire to pay consistent dividends, buy back shares, and increase return on equity (ROE). A BHC acting as a source of strength does not have to be at odds with maximizing shareholder value, but rather it can be viewed as fostering shareholder value over the long-term. Supervisory guidance is one way to help management to make good long-term decisions; it should not be viewed as an impediment to success.

A company's dividend policy can be highly sensitive, since investors tend to reward companies that have a dependable dividend payment history, pay relatively high yields, and consistently increase their dividends through the years. Standard & Poor's (S&P's) even has an S&P 500 Dividend Aristocrats Index consisting of companies that have followed a policy of increasing dividends every year for at least 25 consecutive years.[1] Stock buybacks are also attractive to shareholders, since they help boost earnings per share (EPS) and ROE. However, assuaging shareholders who may have a short-term perspective can cause management to make bad decisions about dividends and leverage.

SR Letter 09-4, ***Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at BHCs***, was issued on February 24, 2009, and revised March 27, 2009.[2]

...continued on page 22

[1] Available online at www.standardandpoors.com/indices/sp-500-dividend-aristocrats/en/us/?indexId=spusa-500dusdff--p-us----.

[2] SR Letter 09-4, ***Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at BHCs***, is available online at www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm.

SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current and prior issues of ***SRC Insights*** are available at the Federal Reserve Bank of Philadelphia's website at www.philadelphiafed.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-6633), or by e-mail (katrina.johnston@phil.frb.org). Please address all correspondence to: Katrina Johnston, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

Editor .... Julie D'Aversa
Editor .... Katrina Johnston
Designer .... Dianne Hallowell

Supervision Spotlight

Supervision Spotlight: Enhancing Transparency in Bank Supervision

by Michael E. Collins, Executive Vice President

The financial crisis revealed a need for improved transparency in financial market operations and instruments and also brought heightened attention to the role that transparency plays in bank supervision. A clear strategy, dependable communication channels, and readily available access to timely and quality information can help alleviate uncertainty, improve efficiency, and contribute to restoring trust and confidence in the financial industry.

This article will discuss some recent efforts aimed at fostering greater transparency of Federal Reserve operations. In addition, it will reacquaint bankers with some of the well-established programs and publications that have effectively served the mission of the Supervision, Regulation, and Credit (SRC) department here at the Federal Reserve Bank of Philadelphia (FRBP) for many years.

Defining Transparency

It is perhaps best to start by defining transparency. The fundamental concept of transparency is closely aligned with the governance and regulatory principles of disclosure and accountability. However, expectations for transparency now appear to have expanded beyond traditional disclosure of required or agreed-upon information. As James Kelly, banking lawyer and consultant, writes, "With transparency, the emphasis shifted to embrace a broader and ongoing state of voluntary disclosure that includes characteristics such as simplicity and understandability, access and availability, and appropriateness, among others. While disclosure is in effect a regulated norm for communicating, transparency, at least at present, implies a more idealized, ongoing state of communicating."[1]

The Need for Greater Transparency

Transparency is critical to combating some of the negative effects of the recent crisis. The Financial Crisis Inquiry Commission found that "a combination of excessive borrowing, risky investments, and lack of ***transparency*** put the financial system on a collision course with

[1] Kelly, James, E., "Transparency and Bank Supervision," ***Albany Law Review,*** Vol. 73, Issue 2, available online at www.albanylawreview.org/articles/04%20KELLY.pdf.

crisis," and the group's final report notes that "the soundness and the sustained prosperity of the financial system and our economy rely on the notions of fair dealing, responsibility, and ***transparency***." [2]

Being opaque can not only lead to poor financial decisions, but it can also breed cynicism and stoke people's fear that they are being condescended to or manipulated. Being credible and withstanding the scrutiny is crucial to the process. Transparency helps to alleviate some of the uncertainty and instill public confidence by increasing understanding and reducing the fear of the unknown.

Transparency helps to alleviate some of the uncertainty and instill public confidence by increasing understanding and reducing the fear of the unknown.

Of course, one of the important roles of government and central banks during any crisis is stabilizing financial markets. Globally, all central banks intervened to respond to the crisis. Economist Petra Geraats explains that, "For independent central banks, the benefits of transparency include not only a reduction of private sector uncertainty, but also greater flexibility to stabilize economic disturbances, a reduction of output volatility and a closer alignment of central bankers' actions to socially optimal behavior."[3]

Transparent Supervision

A financial system works best when information flows freely and informs decisions. A recently-released working paper based on a survey among Dutch households by the De Nederlandsche Bank found that, "The public's knowledge about banking supervision is far from perfect. It revealed that respondents often expect more from supervisors than they can realistically achieve."[4] Moreover, the findings suggest that "better-informed people have more realistic views on banking supervision. Realistic views on banking supervision lead to more prudent financial behavior, which, in turn, contributes to financial stability. Therefore, the communication policies of banking supervisors should aim to improve the public's knowledge about banking supervision."

In addition to enhanced supervision and prudential standards, the Dodd-Frank Wall Street Reform and Consumer Protection Act sets in motion significant changes to Federal Reserve System supervision policy matters. As part of this change, a current Board of Governors member will be appointed to serve in the role of vice chair for Supervision. This individual will develop policy recommendations regarding supervision and regulation for the Board and will be required to report to Congress semiannually.

Balance with Confidential Supervisory Information

While the case for transparency is quite clear, the real question is: How open is open enough? Where the line gets drawn is a critical consideration. Committing to transparency should not be confused with sharing confidential information. ***Harvard Business Review*** blogger Dave Balter explains, "It means providing some insight into one's thinking and considerations, so that those around you can feel involved and empowered."[5]


Michael E. Collins,
Executive Vice President

[2] ***The Financial Crisis Inquiry Report***, U.S. Government Printing Office, January 2011, available online at c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf.

[3] Geraats, Petra, "The Benefits of Central Bank Transparency," ***The Economic Journal***, excerpt available online at www.res.org.uk/society/mediabriefings/pdfs/2002/November/geraats.pdf.

[4] van der Cruijsen, Carin; de Haan, Jakob; Jansen, David-Jan; and Mosch, Robert, "Knowledge and Opinions about Banking Supervision: Evidence from a Survey of Dutch Households," DNB Working Paper No. 275, December 2010, available online at http://www.dnb.nl/binaries/275%20-%20Knowledge%20and%20opinions_tcm46-245130.pdf.

[5] Balter, Dave, "The Strategic Benefits of Transparency," November 13, 2007, available online at blogs.hbr.org/cs/2007/11/the_strategic_benefits_of_tran.html#.

Community Reinvestment Act (CRA) ratings and performance evaluations are released externally so that the public can gain better insight into how well a federally-insured bank or thrift meets the credit needs of communities, including those of low or moderate income within its assessment area. However, because an announcement by a regulator that a bank has a high probability of failure could be extremely detrimental to the institution, individual bank CAMELS ratings are highly classified. Disclosure of confidential information may lead to bank runs or short sales of a bank's shares and make it harder to manage weakened banks. Keeping this information confidential is part of the FRBP's mission to promote financial stability and a safe and sound banking system.

Not only are these ratings not available to the public, they are also available only on a "need-to-know" basis within the Federal Reserve System. Bank examination staff, the Board of Governors, and the Presidents of Reserve Banks are aware of CAMELS ratings because of their work supervising examination staff, approving regulatory actions at troubled institutions, and considering safety and soundness issues as part of any bank acquisition or merger. In addition, people directly involved with systemic oversight and financial stability monitoring are provided needed access to ratings information. Staff whose work does not involve examinations do not have access to CAMELS ratings.

Even the courts recognize that the bank examination reports are protected by a qualified privilege, known as a bank examination privilege. In 1992, the Court of Appeals for the D.C. Circuit wrote extensively about the reasons underpinning the bank examination privilege:

> "Because bank supervision is relatively informal and more or less continuous, so too must be the flow of communication between the bank and the regulatory agency. Bank management must be open and forthcoming in response to the inquiries of bank examiners, and the examiners must in turn be frank in expressing their concerns about the bank. These conditions simply could not be met as well if communications between the bank and its regulators were not privileged."[6]

Making CAMELS ratings public would be bad both for banks and for regulators. As discussed in an article about the release of confidential Federal Reserve emails, such public disclosure would prohibit examiners' ability to effectively do their jobs. "Examiners need to be able to do their jobs and not worry about how the judgments that they are passing on the banks play out in the public light."[7]

The Supervisory Capital Assessment Program (SCAP)

In February 2009, the Treasury unveiled a multifaceted approach to addressing uncertainty, troubled assets, capital constraints of financial institutions, and the frozen secondary markets. The plan was intended to restart the flow of credit, clean up and strengthen banks, and provide critical financing for homeowners and small businesses. One key aspect of the plan involved the Federal Reserve's SCAP, or stress test, to review the country's 19 largest institutions. Although at times the media criticized the event and investors showed considerable apprehension, the process ultimately proved helpful in providing transparency and restoring confidence in the banking industry.

The Retail Risk Analysis Unit of SRC, a group that includes PhD economists and statisticians with retail credit expertise, played an important role in conducting the stress tests. Effective interaction among the regulatory agencies was also critical to the effort's success.

The exercise was designed to determine whether the largest U.S. banking organizations had sufficient capital buffer to withstand the impact of an economic environment that is more challenging than is currently anticipated. It does not represent a new capital standard, but the exercise will likely inform upcoming reviews of capital adequacy.

The interagency exercise was considered part of

[6] Available online at ftp.resource.org/courts.gov/c/F2/967/967.F2d.630.91-5428.91-5427.html.

[7] Lanman, Scott, and Chadbourn, Margaret, "Fed E-Mail Disclosure May Chill Confidential Bank Supervision," Bloomberg, July 1, 2009, available online at www.bloomberg.com/apps/news?pid=newsarchive&sid=abkxoZue_3uo.

traditional supervisory activity and normal dialogue with banks. Assessments of the 19 banks with assets above $100 billion were conducted. Institutions estimated potential losses under the loss range estimates provided. Supervisors determined what capital buffers are needed today to remain sufficiently capitalized under the adverse scenario. The baseline scenario reflected the consensus forecast of the depth and duration of the recession, while the adverse scenario accounted for a more severe or prolonged recession; the SCAP was a deliberately stringent test.

Regulators debated how much information should be made public about the SCAP. Some expressed concern about potential damage to weaker institutions. Ultimately, regulators announced that 10 of the 19 largest banks must raise $75 billion in additional capital. Capital raises were encouraging and paved the way for a group of large institutions to exit the TARP program far earlier than many had envisioned. In addition, all eight big banks that received money and passed the government's stress tests have also raised capital by voluntarily selling common stock to private investors, even though regulators did not require them to do so.

The results were promising, with the following comment being made in the final results: "The unprecedented nature of the SCAP, together with the extraordinary economic and financial conditions that precipitated it, has led supervisors to take the unusual step of publically reporting the findings of this supervisory exercise. The decision to depart from the standard practice of keeping examination information confidential stemmed from the belief that greater clarity around the SCAP process and findings will make the exercise more effective at reducing uncertainty and restoring confidence in our financial institutions."[8]

Federal Reserve Balance Sheet Transparency Initiatives

The government responded aggressively to the extraordinary stress in financial markets and the weakening economy. Several new lending programs were targeted at easing short-term funding pressures, promoting credit extensions, and containing systemic fallout. By lending to financial institutions, providing liquidity directly to key markets, and buying longer-term securities, the Federal Reserve can push down interest rates and ease credit conditions in a range of markets, despite the fact that the federal funds rate is close to its zero boundary. Throughout the financial crisis, the Federal Reserve strengthened its ongoing commitment to transparency. Good government requires transparency so that people can effectively judge whether their interests are being served.

The Fed's balance sheet eventually swelled above $2 trillion dollars, but has since contracted as the economy recovers and many liquidity programs and short-term assets naturally fall off the balance sheet. As market functioning improves, the facilities gradually become less attractive. General Counsel Scott Alvarez testified on increasing Federal Reserve transparency before the Committee on Financial Services, stating, "We recognize that these programs must be accompanied by additional transparency so that the Congress and the public can be assured that we are exercising the best possible stewardship of the resources and responsibilities that have been entrusted to us. For these reasons, we have substantially increased both the type and amount of information that we disclose concerning our liquidity and asset purchase programs."[9]

During the crisis, significant new information was added to the weekly H.4.1 balance sheet releases,

---

[8] ***The Supervisory Capital Assessment Program: Overview of Results***, Board of Governors of the Federal Reserve System, May 7, 2009, available online at www.federalreserve.gov/bankinforeg/bcreg20090507a1.pdf.

[9] Alvarez, Scott G., "Federal Reserve Transparency," Testimony Before the Committee on Financial Services, September 25, 2009, available online at www.federalreserve.gov/newsevents/testimony/alvarez20090925a.htm.

including data about the amount of credit outstanding under each credit facility. A portion of the Board's website was also devoted to providing detailed information about policy programs and financial activities.

The Dodd-Frank Act also confers on the GAO the authority to audit certain Federal Reserve System emergency credit facilities and creates a mechanism for greater transparency and public access to Federal Reserve System information about its credit facilities and financial statements. For example, on December 1, 2010, the Federal Reserve Board posted detailed information on its public website about more than 21,000 individual credit and other transactions conducted to stabilize markets during the recent financial crisis.[10] Additionally, certain discount window and open market operation transactions after July 21, 2010, will be posted with a two-year lag.

Federal Reserve Initiatives and Dodd-Frank

As reform legislation transitions to implementation, the need for transparency grows. Providing clarity around the defined rules and interpretations alleviates uncertainty. Markets and bankers are calmed when the rules and expectations are clearly articulated and can begin responding to the expectations accordingly.

The legislation represents a principled effort to strengthen financial regulation and supervision. It takes meaningful steps by providing the tools and authority needed to prevent or mitigate a future financial crisis. In addition, the bill promotes more transparency at the Federal Reserve and preserves political independence.

The sweeping reform also ushers in a transitional phase for the Federal Reserve and SRC. The overall role and responsibility of this agency has been expanded considerably, though most of SRC's core duties remain intact. In addition, SRC will be adding savings and loan holding companies to its supervision portfolio, and there has been growing demand for SRC staff expertise in systemic risk oversight efforts.

Implementation is occurring in stages, and rulemaking is at the forefront over the first 6 to 18 months following enactment. Given the dynamic nature of this process, the Board of Governors has provided resources designed for apprising banks of the key status of regulatory milestones and developments. There will also be opportunity for the industry to provide comment on the proposals. This process promotes reasonableness and fair and consistent application of the rules.

SRC Philadelphia's Longstanding Commitment to Outreach

The environment in which financial institutions operate is dynamic. In environments of rapid change, effective communication is a critical element to the continued success of all participants. Indeed, as change envelops the industry, financial institutions are increasingly turning to SRC for information and guidance outside the examination cycle.

A unique relationship exists between SRC and the institutions that it supervises. Due to the supervisory nature of SRC's responsibilities, it can be argued that a "provider-customer" relationship does not exist between SRC and financial institutions. Consequently, "customer service" generally is not one of SRC's objectives. Instead, its focus is on fair, prompt, and consistent supervision and on ensuring that institutions operate in a safe and sound manner. SRC's interest in safe and sound operations naturally leads to a need for proactive, preventative supervisory initiatives to supplement detective supervisory activities. SRC's outreach activities are significant preventative initiatives, since the more informed state member banks, bank holding companies, financial holding companies, Edge corporations, and foreign banking organizations become about the regulatory environment in which they operate, the greater the opportunity for them to operate in a safe and sound manner and achieve compliance on their own.

Fundamentally, outreach is about sharing knowledge, teaching, and learning. Therefore, the primary purposes of SRC's outreach initiatives are to disseminate and receive information, knowledge, and experiences to and from its supervised institutions in a non-examination setting.

---

[10] Board press release, December 1, 2010, available online at www.federalreserve.gov/newsevents/press/monetary/20101201a.htm.

Outreach takes a variety of forms and is undertaken using a variety of processes. Within SRC, outreach may involve written communication, traditional classroom instruction, or group roundtable discussion. By participating in outreach activities, SRC officers and staff not only extend knowledge to those who might benefit from it, but they often learn and grow professionally and personally from these experiences.

Useful sources of information on conditions are garnered from contact with bankers in the region. Federal Reserve Chairman Bernanke explained that "The insights provided by our role in supervising a range of banks, including community banks, significantly increase our effectiveness in making monetary policy and fostering financial stability."[11]

Conclusion

Transparency is a commendable principle that enhances central bank accountability and public access to information. However, transparency is also difficult to define and carries high expectations. Transparency is evolving in financial markets, as standards and governance change and access to data through improved technology becomes more prevalent. A key tenet relative to the efficacy of transparency is that recipients of information must be able to process information as it becomes accessible.

During this dynamic period in the banking industry, Third District bankers are strongly encouraged to remain abreast of the latest industry and regulatory developments and to express opinions openly. SRC will continue to do its best to promote transparency through various outreach forums and will continue to convey timely, relevant, and reliable information to Third District bankers. ☐

[11] Bernanke, Ben, "The Federal Reserve's Role in Bank Supervision," Testimony Before the Committee on Financial Services, March 17, 2010, available online at www.federalreserve.gov/newsevents/testimony/bernanke20100317a.htm.

Third District Outreach Programs

SRC staff members have a long tradition of presenting at financial trade group conferences, in academic settings, and at individual outreach engagements. In addition, SRC Philadelphia hosts periodic outreach events. Some of these programs are outlined here.

Bankers' Forums (for bankers only)

The forums were developed to convey key supervision and regulation issues relevant to community and regional bankers and to frame these issues within an open, information-sharing venue. The periodic events provide an opportunity to exchange insights on banking conditions, regulatory topics, and emerging issues; to gain perspective of local market conditions; and to address prominent concerns.

Directors' Workshops (for directors only)

These workshops are geared specifically toward bank board directors. They are designed to provide insight into current supervisory expectations, promote proper risk management practices and internal controls, and build core skills needed to fulfill the obligations of a bank director in a rapidly-changing industry.

CFO/CPA Roundtable

The roundtable fosters discussion between representatives of the Board of Governors, the Federal Reserve Bank of Philadelphia, and Third District bankers and accountants regarding accounting and specialized knowledge issues.

Partnership for Progress

Launched in June 2008, P4P is the Federal Reserve's outreach and technical assistance program for minority-owned and de novo banking institutions. This program helps these institutions confront their unique challenges, cultivate safe and sound practices, and compete more effectively in today's marketplace. It combines one-on-one guidance, workshops, and an extensive interactive web-based resource and information center at http://www.fedpartnership.gov/.

Publications

SRC Insights®

This quarterly newsletter for Third District institutions highlights current supervisory and regulatory topics and is available in print or online at http://www.philadelphiafed.org/bank-resources/publications/src-insights/.

Consumer Compliance Outlook®

This Federal Reserve System publication is dedicated to providing information and analysis of current consumer compliance issues and is available in print or online at http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/.

SPECIAL *SRC INSIGHTS* FEATURE

Navigating Dodd-Frank: An Implementation Update and Resource Guide

This special ***SRC Insights*** feature provides an update on events associated with the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or the act) and examines potential effects on Third District bankers and regulators. This is the first of a recurring segment that will be devoted to covering the transition of the Dodd-Frank Act from law to practice. This piece is intended to heighten awareness of and offer a basic perspective on the dynamic implementation and interpretation process currently underway.

Bankers should note that this is not meant to be a comprehensive or authoritative review of this historic legislation, but it is primarily intended to convey key information and suggest relevant resources that may assist Third District bankers in learning about and applying new rules and regulations. The Supervision, Regulation, and Credit (SRC) department of the Federal Reserve Bank of Philadelphia has a series of well-established outreach programs and publications to update bankers on the latest news pertaining to Dodd-Frank Act events. Third District bankers are encouraged to continue to participate and interact with SRC through this outreach.

The Dodd-Frank Act represents a principled effort to strengthen financial regulation and supervision and to create stronger protections for consumers of financial products and services.

Financial Crisis Spurs Reform

The past few years have been characterized by unprecedented events and disruption in the financial system. There are typically three phases in resolving significant financial crises. Initially, there is a containment phase designed to address and contain problems in the financial markets, such as central bank intervention to alleviate interbank liquidity strains. A second phase centers on loss recognition, restructuring, and recapitalization. A third phase seeks to implement fundamental reforms. This is a lengthy process, but it should ultimately strengthen the financial system and improve the way the system responds to future crises.

The recent financial disruption and economic recession have led to a period of profound transformation aimed at making the financial system more resilient. To accomplish this, risk management practices must be enhanced, and significant regulatory reform must occur. The objective is to lessen the industry's risk and impose a regulatory framework that monitors the stability of the whole sector more effectively and that allows it to react quickly to early warning signs of potential problems.

Regulatory Reform

The historic Dodd-Frank Act is a federal statute enacted by the 111th U.S. Congress and signed into law on July 21, 2010. The passage represents the most sweeping U.S. financial regulatory reform since the 1930s.

The Dodd-Frank Act represents a principled effort to strengthen financial regulation and supervision and to create stronger protections for consumers of financial products and services. It takes meaningful steps by providing the tools and authority needed to prevent or mitigate future financial crises. The intent described within the Dodd-Frank Act is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[1]

Federal Reserve Supervision and Regulation
The efficacy of the legislation depends in part on how the act is implemented by the regulatory agencies. Although the terms supervision and regulation are often used interchangeably, they are, in fact, two distinct, although complementary, functions. Bank regulation refers to the laws and rules that govern the industry, while bank supervision involves the monitoring, inspecting, and examining of banking organizations to assess their condition and compliance with relevant laws and regulations. Both are essential to a safe and sound financial system. Supervision should remain balanced and consider its effect on banks, nonbanks, capital markets, global supervision programs, and the broader economy.

Future financial stability success will depend on complementing micro-prudential supervision and regulation aimed toward improving the resilience of individual institutions with effective macro-prudential practices that focus on the financial system as a whole. The goal of an enhanced regulatory structure includes reinforcing the relationship between consumer protection and market stability while providing the regulatory incentives and infrastructure for robust financial markets in a global economy.

The supervision process continues to evolve through a process of learning and applying new rules and regulations. The largest, most interconnected, and highly-leveraged companies face stricter prudential regulation, including higher capital requirements and more robust consolidated supervision. In addition, there will be extensions of regulatory technique (e.g., stress testing), increased emphasis on data and analytics, more sharing of information between agencies, higher expectations for corporate governance, and a change in the approach to financial innovation.

The Federal Reserve has already begun to refine its supervisory approach. For example, the Large Institution Supervision Coordinating Committee (LISCC), a multi-disciplinary committee, was formed to coordinate the FRS large bank supervision framework. The LISCC incorporates systemic risk considerations and provides strategic and policy direction for supervisory activities across the Federal Reserve System.

In November 2010, the Federal Reserve Board established an internal Office of Financial Stability Policy and Research and appointed Board Economist J. Nellie Liang as its director. The office will bring together economists, banking supervisors, market experts, and others in the Federal Reserve who will be dedicated to supporting the Board's financial stability responsibilities. The office will develop and coordinate staff efforts to identify and analyze potential risks to the financial system and the broader economy by monitoring asset prices, leverage, financial flows, and other market risk indicators; following developments at key institutions; and analyzing policies to promote financial stability. It will also support the supervision of large financial institutions and the participation of the Board of Governors on the Financial Stability Oversight Council (FSOC).[2]

The Dodd-Frank Act also makes changes to Federal Reserve System governance and supervision policy matters. Greater transparency around the supervision process will result. One example is that a current Board of Governors member will be appointed to serve in the role as vice chair for Supervision. This individual will develop policy recommendations regarding supervision and regulation for the Board and will be required to report to Congress semiannually.

Writing Rules: The Next Step
Reform involves a dynamic, ongoing process. The act is categorized into 16 titles and requires regulators to create rules, conduct studies, and issue periodic reports. Implementation will occur in stages, with much of the rulemaking at the forefront over the first 6 to 18 months following the passage. The rulemaking phase began shortly after enactment, and widespread and complex changes are expected.

[1] ***Dodd-Frank Wall Street Reform and Consumer Protection Act***, Public Law 111-203, July 21, 2010, available online at www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[2] Board press release, November 4, 2010, available online at www.federalreserve.gov/newsevents/press/other/20101104a.htm.

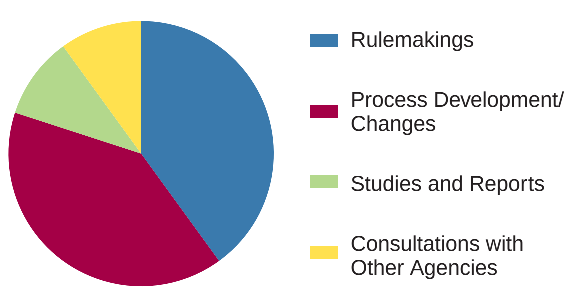
The Dodd-Frank Act contains more than 300 provisions that expressly indicate that rulemaking is either required or permitted. However, it is unclear how many rules will ultimately be issued pursuant to the act because, among other things: 1) many of the provisions appear to be discretionary (e.g., stating that an agency "may" issue a rule); 2) individual provisions may result in multiple rules; 3) some provisions appear to provide rulemaking authorities to agencies that the agencies already possess; and 4) rules may be issued to implement provisions that do not specifically require rulemaking. Nearly 80 percent of the relevant provisions in the Dodd-Frank Act assign rulemaking responsibilities or authorities to four agencies: the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission (CFTC), and the Consumer Financial Protection Bureau (CFPB).[3]

The Federal Reserve's Role in Implementation

The Federal Reserve System is involved in implementing over 250 Dodd-Frank Act initiatives, three-quarters of which are mandated by the legislation. The Federal Reserve is the lead agency responsible for implementing two-thirds of these initiatives.

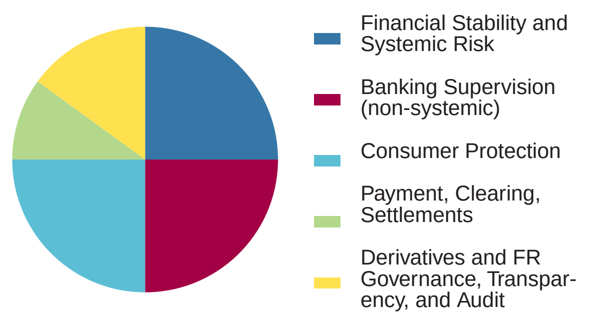
Current Fed initiatives vary in type: about 40 percent are rulemakings; 40 percent are process development/changes; 10 percent are studies and reports; and the remainder of these consist of consultations with other agencies on rulemakings, studies, and reports.

Current Federal Reserve Initiatives



The Federal Reserve, however, groups its Dodd-Frank Act initiatives into several significant work streams. About one-quarter are related to financial stability and systemic risk; another quarter to banking supervision (non-systemic); another quarter to consumer protection; and one-tenth to payment, clearing, and settlements. The remainder of these are being devoted to derivatives and Federal Reserve governance, transparency, and audit.

Federal Reserve Initiatives Under Dodd-Frank



Impact on FRB Philadelphia

The sweeping reform also ushers in a transitional phase for the Federal Reserve and SRC. The overall role and responsibility of the Third District SRC department will grow considerably; however, most of SRC's existing core examination responsibilities will remain largely intact.

Thrift holding companies will be added to SRC's supervision portfolio. The Dodd-Frank Act transfers authority for consolidated supervision of savings and loan holding companies (SLHCs) and their nondepository subsidiaries from the Office of Thrift Supervision (OTS) to the FRB effective July 21, 2011. As of September 30, 2010, 34 SLHCs in the Third District had individual savings institutions under them, ranging in size from $30 million to $88 billion.

The FRB is currently engaged in a range of activities to implement this transfer; a status report on the implementation plan was made available in January.[4] For example, the federal bank and thrift regula-

[3] Copeland, Curtis W., "Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act," CRS Report for Congress, November 3, 2010, available online at www.llsdc.org/attachments/files/255/CRS-R41472.pdf.

[4] Joint Implementation Plan, 301-326 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, January 2011, available online at www.federalreserve.gov/boarddocs/rptcongress/regreform/joint_implementation_20110125.pdf.

tory agencies recently released a notice of intention to require SLHCs to submit the same reports as BHCs, beginning with the March 31, 2012, reporting period.[5] In addition, staffing and training preparations are well underway to facilitate the process. Considerable effort will be devoted to ensuring that this transition is carried out smoothly and effectively.

The Dodd-Frank Act also expands the Fed's authority to examine and regulate nonbank subsidiaries of bank holding companies. It modifies Gramm-Leach-Bliley Act restrictions and requires the Fed to examine bank-permissible activities of nonbank subsidiaries not functionally regulated. This authority becomes effective on the transfer date of July 21, 2011, unless extended.

Demand for SRC's Retail Risk Analysis Unit, a group that includes PhD economists and statisticians with retail credit expertise, has grown significantly since the crisis began. The unit played an integral role in the Supervisory Capital Assessment Program (i.e., stress test) and continues to contribute greatly to macroprudential supervision.

One critical area of reform to emerge from the financial crisis has been the recognition that researchers and examiners within the Federal Reserve need access to more granular and timely data on mortgage performance, credit markets, and securities instruments. SRC staff led an initiative to acquire, centralize, and make available large databases for such purposes. The RADAR (Risk Assessment, Data Analysis, and Research) project consists of a data warehouse featuring a wide array of key U.S. consumer credit datasets with powerful analytical tools for querying, mapping, reporting, and charting data. RADAR also has a separate securities evaluation service that provides the capability to conduct surveillance on all parts of ABS/MBS markets and evaluate securities in investment portfolios at banks and other systemically-important institutions. The Mortgage Outreach and Research Efforts (MORE) Initiative, based at the Chicago Fed, notes RADAR's contributions to System efforts, stating, "The launch of RADAR in 2010 has greatly increased the ability of Fed staff to produce timely reports and research papers that can inform monetary policy, bank supervision and regulation and community development, as well as assist in macroprudential supervision as part of regulatory reform."[6]

Efforts to enhance transparency may also affect Third District institutions. The Federal Reserve Board's public website has detailed information about more than 21,000 individual credit and other transactions conducted to stabilize markets during the recent financial crisis. As outlined in the Dodd-Frank Act, the first release occurred on December 1, 2010, and included transaction-level details for select programs. Additionally, discount window and open market operation transactions after July 21, 2010, will be posted with a two-year lag.[7]

Considerable effort will be devoted to ensuring that this transition is carried out smoothly and effectively.

The Dodd-Frank Act mandated that an Office of Minority and Women Inclusion be established by January 21, 2011, at the Federal Reserve Board, Reserve Banks, and certain other federal agencies. Headed by a director, the office will be responsible for the agency's "diversity in management, employment, and business activities." The office will also assess the diversity policies and practices of entities regulated by the particular agency and of contractors providing services to the agency. In addition to promoting diversity at the Board and throughout the System, as required by the Dodd-Frank Act, the Board's Office of Diversity and Inclusion will play an integral role in developing standards to assess the diversity practices at entities regulated by the Federal Reserve. Senior Vice President Mary

[5] Joint press release, February 3, 2011, available online at www.federalreserve.gov/newsevents/press/bcreg/20110203a.htm.

[6] ***Addressing the Impact of the Foreclosure Crisis Federal Reserve Mortgage Outreach and Research Efforts***, available online at www.chicagofed.org/digital_assets/others/in_focus/foreclosure_resource_center/more_report_final.pdf.

[7] Board press release, December 1, 2010, available online at http://www.federalreserve.gov/newsevents/press/monetary/20101201a.htm.

Ann Hood was selected to head the office at the Federal Reserve Bank of Philadelphia.[8]

Impact on Third District Institutions
In recent testimony, Federal Reserve Chairman Bernanke reiterated the importance of not overburdening community bankers. "We want to make sure we do all we can not to increase the regulatory burden that small banks face," Bernanke said. "Small banks have been playing just an incredibly important role, particularly as large banks have cut back on their lending to small business, and in other contexts they have in many cases stepped up and proven their worth to the U.S. economy."[9]

Some Dodd-Frank Act provisions are geared toward larger institutions and exempt smaller institutions based on asset size. For example, all financial companies with more than $10 billion in assets must conduct annual internal stress tests. Publicly-traded bank holding companies (BHCs) with assets of $10 billion or more and nonbank financial holding companies supervised by the Fed are required to establish a board-level risk committee. There are also carve-outs from the CFPB regarding enforcement and examination for banks and credit unions with $10 billion or less in assets. Smaller institutions will be examined for consumer protection compliance by their primary regulator instead of the CFPB, but still must comply with the regulations issued by the bureau and may be required to file reports with the CFPB.

The majority of institutions and holding companies in the Third District are considered to be community banks that would fall below these threshold levels. To put this into perspective, consider the following tables using data as of September 30, 2010:

Third District Bank Holding Companies

Size	Number	Assets (billions)
Greater than $10 billion	4	$216
Between $1 billion and $10 billion	15	$33
Between $500 million and $1 billion	34	$24
Less than $500 million	53	$13

Third District Commercial Banks (excluding credit card banks)

Size	Number	Assets (billions)
Greater than $10 billion	2	$182
Between $1 billion and $10 billion	20	$55
Between $500 million and $1 billion	31	$22
Less than $500 million	94	$22

In some instances, assessing the impact of Dodd-Frank Act provisions can be further quantified, given that a limited number of institutions participate in certain products or securities. For example, the practical effect of the Collins Amendment is that securities known as trust-preferred securities (TPS) will no longer qualify as tier 1 capital for BHCs. Current TPS issuances by BHCs with assets greater than $15 billion as of December 31, 2009, will be phased out between 2013 and 2016, allowing those BHCs time to raise replacement capital. TPS at BHCs with less than $15 billion in assets are grandfathered, and this amendment does not apply at all to the smallest BHCs—those with less than $500 million in assets. Because of the exclusions, this will affect a limited number of BHCs. In the Third District, 28 BHCs have issued $1 billion in TPS. Only one entity is over $15 billion in assets and will be required to exclude the TPS from capital on a phase-out basis. Four are less than $500 million and will not be affected. The remaining 23 will not be required to phase out their TPS, but any additional TPS issued will not qualify for tier 1 capital treatment.

Dodd-Frank Act changes for community banks are meaningful, but are typically less onerous. Third District community bankers should benefit from the Dodd-Frank Act provision allowing banks to pay interest on demand deposit accounts (effective July 21, 2011), the retroactive increase in FDIC deposit

---

[8] Board press release, January 18, 2011, available online at www.federalreserve.gov/newsevents/press/other/20110118a.htm.

[9] Borak, Donna, "Bernanke Backs Small Banks," ***American Banker***, January 10, 2011, available online at www.bankinvestmentconsultant.com/news/bernanke-small-banks-2670833-1.html.

insurance coverage to $250,000, and favorable changes in the calculations of FDIC premiums that redefine the assessment base.

Conversely, some Dodd-Frank Act provisions that were intended to address larger bank issues may still have a great bearing on a wider segment of the industry. One example is the Durbin Amendment, a provision that addresses interchange transactions. While this provision exempts debit card issuers that, together with their affiliates, have less than $10 billion in assets, community bankers perceive it as having a broader influence on their fee generation strategy. In these instances, therefore, it is important that bankers voice their opinions during the implementation phase. In the case of the Durbin Amendment, a formal comment period on the Federal Reserve's proposal was offered through February 22, 2011.[10]

Financial Regulatory Structure: New Agencies

The Dodd-Frank Act focuses on closing gaps in oversight that became apparent during the financial crisis. One criticism of the previous regulatory structure was the perception that it allowed banks to "shop" for the most favorable regulator. The Dodd-Frank Act attempts to minimize shopping by troubled banks. Title III, cited as the "Enhancing Financial Institution Safety and Soundness Act of 2010," is intended to streamline banking regulation and reduce competition and overlaps among different regulators. Overall, the regulatory structure was strengthened, but not necessarily simplified.

The Dodd-Frank Act focuses on closing gaps in oversight that became apparent during the financial crisis.

One agency, the OTS, was abolished, but the formation of several important new agencies was mandated. The following sections provide basic background information and a status update on the newly-created agencies.

Bureau of Consumer Financial Protection (CFPB)

Led by an independent director appointed by the President and confirmed by the Senate, with a dedicated budget in the Federal Reserve, the bureau will be able to autonomously write rules for consumer protections covering all financial institutions—banks and nonbanks—offering consumer financial services or products. The CFPB will also oversee the enforcement of federal laws intended to ensure fair, equitable, and nondiscriminatory access to credit for individuals and communities.

The CFPB will oversee consumer borrowing and the use of other financial services by:

- Implementing and enforcing federal consumer financial laws
- Reviewing business practices to ensure that financial services providers are following the law
- Monitoring the marketplace and taking appropriate action to better ensure that markets work as transparently as they can for consumers
- Establishing a toll-free consumer hotline and website for complaints and questions about consumer financial products and services

Under the Dodd-Frank Act, the Secretary of the Treasury is responsible for standing up the CFPB until a bureau director is confirmed by the Senate.

On September 17, 2010, President Obama announced the appointment of Elizabeth Warren to serve as assistant to the President and special advisor to the Secretary of the Treasury on the CFPB. On January 5, 2011, the CFPB's implementation team signed a "memorandum of understanding" with the Conference of State Bank Supervisors to coordinate and share supervision information on consumer financial products and services providers. Additional information is available at www.consumerfinance.gov.

Financial Stability Oversight Council (FSOC)

The FSOC has a clear statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability. It is a collaborative body chaired by the Secretary of the Treasury that brings together

[10] Board press release, December 16, 2010, available online at www.federalreserve.gov/newsevents/press/bcreg/20101216a.htm.

the expertise of the federal financial regulators, an insurance expert appointed by the President, and state regulators. The FSOC has important new authorities to constrain excessive risk in the financial system.

- The FSOC held its inaugural meeting on October 1, 2010.
- On January 18, 2011, the FSOC issued a notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.
- On January 18, 2011, the FSOC released a study and recommendations regarding the implementation of the Volcker Rule. On the same day, it also released a report on the concentration limit of large financial companies.
- Additional information is available at www.treasury.gov/initiatives/Pages/FSOC-index.aspx.

Office of Financial Research (OFR)

The Dodd-Frank Act establishes the OFR within the Treasury Department to improve the quality of financial data available to policymakers and facilitate more robust and sophisticated analysis of the financial system. The OFR is tasked with providing administrative, technical, budget analysis, and other support services to the FSOC and its affiliated agencies. The OFR has broad latitude in performing support services for both the FSOC and other member agencies, including collecting data, performing applied research and essential long-term research, and developing tools for monitoring risk.

- The OFR will be headed by a director who is to be appointed by the President with the advice and consent of the Senate for a six-year term. The director will be required to testify annually before Congress regarding the activities of the OFR and its assessment of systemic risk. During the first two years following the date of enactment, the Federal Reserve shall fund the office.
- Additional information is available at www.treasury.gov/initiatives/Pages/ofr.aspx.

Federal Insurance Office

The Dodd-Frank Act establishes within the Department of the Treasury the Federal Insurance Office. This office is tasked with monitoring all aspects of the insurance industry (except health insurance, some long-term care insurance, and crop insurance), including the identification of gaps in regulating insurers that could contribute to financial crises.

Keeping Track of the Implementation Process

As mentioned earlier, this special report of SRC Insights will be the first of a recurring series of articles providing updates on Dodd-Frank Act milestones and pending initiatives that are particularly relevant to Third District bankers. Given the dynamic pace of change surrounding the act's implementation, bankers are also encouraged to keep abreast of the latest events through other reliable websites.

In the interest of transparency and accountability, and in order to facilitate the tracking process, the Board of Governors of the Federal Reserve has devoted a portion of its website to tracking regulatory reform initiatives. Sections for initiatives, both completed and planned in the near-term, are available. The site is available at www.federalreserve.gov/newsevents/reform_milestones201101.htm.

The Federal Reserve Bank of St. Louis has also provided an excellent roadmap for tracking the Dodd-Frank Act Regulatory Reform Rules from start to finish. E-mail notification service alerts are available that provide a brief description and a link to a recent posting. The site is available at www.stlouisfed.org/regreformrules/.

Finally, the American Bankers Association (ABA) provides a useful and comprehensive rulemaking date chart and a Dodd-Frank Tracker Calendar on its website at http://regreformtracker.aba.com/p/dodd-frank-calendar.html?

Future Regulatory Improvement

"Improving Regulation and Regulatory Review," an Executive Order signed January 18, 2011, outlines the following guiding principles for government agencies when crafting regulation:[11]

[11] ***Improving Regulation and Regulatory Review***, White House Executive Order, January 18, 2011, available online at www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order.

- Consistent with law, agencies must consider costs and benefits and choose the least burdensome alternative.
- The regulatory process must encourage public participation and an open exchange of views, with an opportunity for the public to comment.
- Agencies must attempt to coordinate, simplify, and harmonize regulations to reduce costs and promote certainty for businesses and the public.
- Agencies must consider low-cost approaches that reduce burden and maintain flexibility.
- Regulations must be guided by objective scientific evidence.
- Existing regulations must be reviewed to determine that they are still necessary and crafted effectively; if not, they must be modified, streamlined, or repealed.

Together, these principles will create a more effective and cost-efficient regulatory framework.

The ABA reports that, "As of January 3, 2011, less than six months after the Dodd-Frank Act was signed into law, regulators have issued over 1,000 pages of regulatory proposals and over 360 pages of final rules. Many more pages of regulations, upwards of 5,000, are expected."[12]

The intent is not to craft ***more*** regulation, but to introduce better regulation. The interpretation and implementation process remains critical to that objective. To this end, the Federal Reserve Bank of Philadelphia reinforces its commitment to outreach during this dynamic period of sweeping reform. Regulators recognize that community and regional banks serve an important role in the economy. Ultimately, all parties are working to repair the damages from the crisis, restore public confidence, mitigate future risks, and emerge with a more robust and resilient banking system.

If you have any questions regarding this article, please contact Senior Specialist Bob Rell (bob.rell@phil.frb.org) at (215) 574-4382. □

[12] "Dodd-Frank Proposal Burden Exceeds 1,000 Pages in Less than 6 Months Since Passage," ABA Dodd-Frank Tracker, January 14, 2011, available online at regreformtracker.aba.com/2011/01/dodd-frank-proposal-burden-exceeds-1000.html.

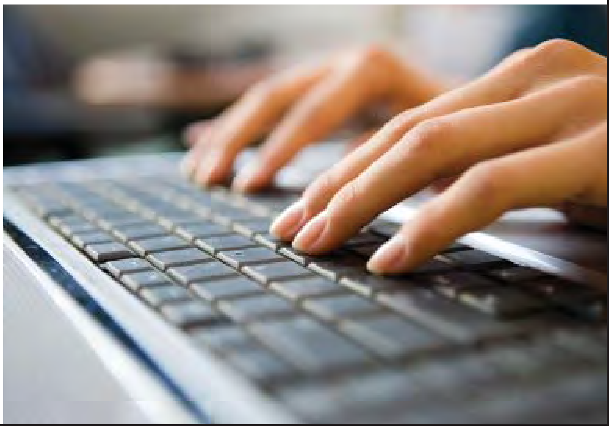
To obtain more comprehensive information about the legislative history and to access select reports, summaries, and commentaries of the act, the following resources are available to the public:

Library of Congress (THOMAS)
thomas.loc.gov/cgi-bin/query/z?c111:H.R.4173

U.S. Government Printing Office (PUBLIC LAW 111–203—JULY 21, 2010)
www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

Law Librarians' Society of Washington, D.C.
www.llsdc.org/Dodd-Frank-Act-Leg-Hist/

FEDERAL RESERVE BANK OF PHILADELPHIA



Overview of 2010 *Bank Secrecy Act/Anti-Money Laundering Examination Manual* Revisions

by Amy Sill, Project Manager, and Michelle Owens, Assistant Examiner

The Federal Financial Institutions Examination Council's (FFIEC's) ***Bank Secrecy Act/ Anti-Money Laundering Examination Manual*** (manual) is an important tool for banking organizations to use to ensure compliance with the BSA and safeguard operations against money laundering and terrorist financing.[1] Banking organizations have now had close to one year of experience operating under the most extensively revised version of the manual issued to date. The revised manual, effective May 2010, clarifies supervisory expectations of BSA/AML compliance and incorporates regulatory changes implemented since the last update in 2007. As with previous versions of the manual, the 2010 version of the manual includes input from the industry, the FFIEC, examiners, and consultation with FinCEN and OFAC.

Institutions should note that the revised manual does not set new standards for banking organizations. First issued by the FFIEC in collaboration with FINCEN in 2005, the manual is intended to provide a consistent approach to compliance with the BSA and related AML regulations. The 2010 manual consolidates all BSA/AML regulatory requirements in one handbook and communicates regulatory expectations for compliance with the BSA.

This overview provides highlights of the more significant revisions so that Third District financial institutions can verify that they are in compliance with the updates.

BSA/AML Compliance Program

As part of BSA/AML compliance program procedures, the Independent Testing section provides additional guidance for evaluating the auditor's reports and workpapers on the adequacy and effectiveness of the bank's BSA/AML compliance program. At a minimum, the auditor should provide sufficient information for the reviewer to reach a conclusion about the overall quality of the program. Typically, the auditor should include an explicit statement about the overall adequacy and effectiveness of the program. The workpapers should support this conclusion and include the tracking of previously identified issues and deficiencies, as well as verification that such issues have been corrected by management.

In addition, the Transaction Testing section outlines considerations for conducting transaction testing, with special consideration given to handling any new products, services, or customers since the previous BSA/AML examination.

Developing Conclusions and Finalizing the Examination

To ensure accurate analysis of compliance with the core structure of the BSA, this section of the manual has been expanded significantly. The expanded portion includes a discussion on how to differentiate between systemic or recurring violations, as opposed to isolated or technical violations.

The Systemic or Recurring Violations section provides guidance to evaluate whether violations represent a pattern or practice of noncompliance with the BSA. The manual notes that systemic or recurring violations involve either a substantial number of deficiencies or a repeated failure to effectively and accurately report information required under the BSA.

Systemic or recurring violations can also be seen if the errors or incompleteness impair the integrity of the report, fail to adequately represent the transactions to be reported, or impact the effectiveness of the bank's suspicious activity monitoring and reporting processes. On the other hand, isolated or technical violations are limited instances of noncompliance with the BSA occurring within an otherwise adequate compliance structure. While these violations generally do not prompt serious concern, multiple isolated violations occurring throughout the

[1] The manual is available at www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2010.pdf.

organization can be indicative of systemic or recurring weaknesses or violations.

Suspicious Activity Reporting
The Suspicious Activity Reporting (SAR) section has been significantly expanded to discuss the four key components of an effective monitoring and reporting system, which include identification or alert of unusual activity, managing alerts, SAR decision-making, and SAR completion and filing. The revisions include methods a bank may use to identify suspicious activity. These methods include activities identified by employees during day-to-day operations, results of law enforcement inquiries, reviews of the output of the transaction and surveillance monitoring system, or any combination of these.

BSA/AML Compliance Program Structures
The section, formerly known as Enterprise-Wide BSA/AML Compliance Program, was significantly revised and renamed. This revised section specifically references assessing the structure and management of the organization's BSA/AML compliance program and, if applicable, the organization's consolidated or partially consolidated approach to BSA/AML compliance. This section also elaborates on the concept of a consolidated approach toward BSA/AML compliance, replacing references to an enterprisewide program for BSA/AML compliance.

Various sections of the manual have also been updated to reflect the changes in other reference documents.

Bulk Shipments of Currency
In recent years, smuggling of bulk currency has become a preferred method for moving illicit funds across borders. Therefore, this new section has been added to the manual to address the increasing risk associated with a bank receiving bulk shipments of currency.

A bank may receive bulk shipments of currency both directly (when it takes possession of a shipment) and indirectly (when it takes possession of the economic equivalent of a currency shipment, such as through a cash letter notification). This section outlines the bank's reporting requirements for bulk shipments of

currency, the risk factors associated with these shipments, and risk mitigation expectations.

Electronic Banking
This section has been expanded to reflect the new risk management obligations of financial institutions regarding prepaid cards/stored value cards. This includes considerations for contractual agreements for these products and their various risk factors, such as money laundering, terrorist financing, and other criminal activity.

Other Updates
Various sections of the manual have also been updated to reflect the changes in other reference documents, such as:

- Currency Transaction Reporting Exceptions section updated with new regulations and FinCEN guidance
- Foreign Bank and Financial Accounts Reporting section updated with new requirements associated with the IRS's revised Report of Foreign Bank and Financial Accounts (FBAR) form
- Office of Foreign Assets Control (OFAC) section updated with OFAC's final rule entitled, "Economic Sanctions Enforcement Guidelines"
- Electronic Banking section updated with FFIEC guidance regarding Remote Deposit Capture
- Automated Clearing House Transactions section updated with new rules issued by Electronic Payments Association
- Third Party Payment Processors section updated with guidance issued by the FDIC and OCC □

Balancing Shareholder Value with Regulation *...continued from page 1*

This letter provides guidance for management to follow when dividends could have a negative impact on the financial condition of the institution. It heightens expectations that a BHC will inform and consult with Federal Reserve supervisory staff in advance of (i) declaring and paying a dividend that could raise safety and soundness concerns (e.g., declaring and paying a dividend that exceeds earnings for the period for which the dividend is being paid); (ii) redeeming or repurchasing regulatory capital instruments when the BHC is experiencing financial weakness; or (iii) redeeming or repurchasing common stock or perpetual preferred stock that would result in a net reduction as of the end of a quarter in the amount of such equity instruments outstanding compared with the beginning of the quarter in which the redemption or repurchase occurred. While the principles addressed in this letter apply to all BHCs, they are especially pertinent for BHCs that have financial difficulties and/or that receive public funds.

Although risk-based ratios provide a foundation for assessing capital, they do not take into explicit account the quality of individual asset portfolios or other risk factors, such as interest rate, liquidity, market, and operational risks; therefore, a banking organization is expected to operate with capital positions well above minimum ratios, and capital levels should be increased in accordance with increases in broad risk exposure.

The banking organization needs to understand its risks and create an internal process for assessing capital adequacy and planning for capital needs. This process should include:

1. Assessing both the risks to which the institution is exposed and the processes for managing and mitigating those risks
2. Evaluating the institution's capital adequacy relative to its risks
3. Considering the potential impact on the institution's earnings and capital based on current and prospective economic conditions

Additionally, the quality of capital and trends in its composition are important. For example, voting common stockholder's equity, which has been known to be the most desirable capital element from a supervisory standpoint, is usually heavily relied upon, followed by perpetual preferred stock. In turn, the BHC should avoid overreliance on its non-common-equity capital components.

Capital Planning Process

A BHC's capital planning process should be commensurate with its size, complexity, and risk profile. The SR Letter focuses on the following factors, which a BHC's board of directors should bear in mind when considering the payment of dividends:

- Overall asset quality, potential need to increase reserves and write down assets, and concentrations of credit
- Potential for unanticipated losses and declines in asset values
- Implicit and explicit liquidity and credit commitments
- Quality and level of current and prospective earnings
- Current and prospective cash flow and liquidity
- Ability to serve as an ongoing source of financial and managerial strength to its depository subsidiaries
- Level, composition, and quality of capital
- Ability to raise additional capital in the prevailing market and economic conditions

Dividends in Cash or Other Value

A banking organization should have a comprehensive policy on dividend payments that takes into account the potential decline on a BHC's resources caused by the payment of not just cash dividends, but also of noncash dividends (i.e., assets, guarantee of shareholders' liabilities, etc). The BHC's board of directors should ensure that the dividend level is prudent in relation to the organization's financial position and based on realistic earnings scenarios. Although many organizations emphasize the importance of consistently paying dividends, as SR Letter 09-4 states, the board of directors of a BHC should inform the Federal Reserve and should eliminate, defer, or significantly reduce the BHC's dividends if:

- The BHC's net income for the past four quarters, net of dividends previously paid during that pe-

riod, is not sufficient to fully fund the dividends.
- The BHC's prospective earnings retention for the past four quarters is not consistent with the BHC's capital needs and overall current and prospective financial condition.
- The BHC will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

In addition, the BHC should inform the Federal Reserve reasonably in advance of declaring or paying a dividend that exceeds earnings for the period for which the dividend is being paid or that could adversely impact the organization's capital structure. Likewise, notification to the Federal Reserve is required if the institution is increasing its common stock dividend by a material amount. Failure to do so could result in a supervisory finding that the organization is operating in an unsafe and unsound manner.

Stock Redemptions and Repurchases

A banking organization's redemption of instruments included in regulatory capital and repurchases of common stock, preferred stock, and other regulatory capital instruments from investors must be consistent with the organization's current and prospective capital needs. In addition to explicit regulations that require a BHC to provide the Federal Reserve advance notice to review transactions under Section 225.4 (b) (1) of Regulation Y and 12 CFR, part 225, Appendix A, section II (iii) in the Board's Small Bank Holding Company Policy Statement, the Federal Reserve has general supervisory and enforcement authority to prevent a BHC from repurchasing its common stock, preferred stock, trust-preferred securities, and other regulatory capital instruments in the market, if such action would be inconsistent with the BHC's prospective capital needs and continued safe and sound operation.

Under the Board's risk-based capital rule for BHCs, most instruments included in tier 1 capital with features permitting redemption at the option of the issuing BHC (e.g., perpetual preferred stock and trust-preferred securities) may qualify as regulatory capital only if redemption is subject to prior Federal Reserve approval. The risk-based capital rule directs BHCs to consult with the Federal Reserve before redeeming any equity or other capital instrument included in tier 1 or tier 2 capital prior to stated maturity, if such redemption could have a material effect on the level or composition of the organization's capital base.

The Federal Reserve will consider the following:

- The potential losses that a BHC may suffer from the prospective need to increase reserves and write down assets from continued asset deterioration
- The BHC's ability to raise additional common stock and other tier 1 capital to replace capital instruments that are redeemed or repurchased

Capital Purchase Plan (CPP) or Other Capital Program Participants

CPP and other government capital program participants must comply with the capital and other requirements of the Treasury in addition to the general guidance set forth in the SR Letter. BHCs in these programs should consider and communicate in a timely manner to Federal Reserve supervisory staff how the BHC's proposed dividends, capital redemptions, and capital repurchases are consistent with the requirements applicable to its receipt of capital under the program and related Federal Reserve supervisory policy, as well as how it is able to redeem securities issued to the government prior to any contractual increase in the dividend rate without affecting its safety and soundness. A BHC that wants to redeem instruments issued under the CPP or other programs related to the Treasury must first consult with the Federal Reserve before notifying the Treasury of its intent.

Conclusion

William Arthur Ward once said, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." Good management decisions are based on realistic expectations, and when the facts change, management needs to proactively make adjustments. Although an institution may feel pressures to pay dividends and increase ROE, it may be more prudent to adjust its dividend policy and maintain a capital level based on realities. SR Letter 09-4 provides management with guidance for dividend and capital policies, which will increase the likelihood of good management decisions that lead to maximizing shareholder value.
If you have any question about this article, please contact William Lenney (william.lenney@phil.frb.org) at (215) 574-6074. ☐

FEDERAL RESERVE BANK
OF PHILADELPHIA

Supervision, Regulation and Credit Department
Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

Scan with your smartphone to access ***SRC Insights*** online

E-Mail Notification Service

Would you like to read ***SRC Insights*** on our website up to three weeks before it is mailed? Sign up for our e-mail notification service today at <http://www.srcinsights.org/>.