FEDERAL RESERVE BANK
OF DALLAS

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FIRST VICE PRESIDENT

DALLAS, TEXAS 75222

December 12, 1985

Circular 85-146

TO: The Chief Executive Officer at all
member banks, state member banks
and others concerned in the
Eleventh Federal Reserve District

SUBJECT

Policy statement on payment of cash dividends

DETAILS

The Board of Governors of the Federal Reserve System has issued a policy statement on the payment of cash dividends by state member banks and bank holding companies that are experiencing financial difficulties.

This policy is meant to reinforce prudential considerations and to encourage management to continually review dividend policies in light of an organization's financial condition, compliance with supervisory guidelines on capital adequacy, and future growth plans and prospects.

ATTACHMENTS

The Board's press release and policy statement are attached.

MORE INFORMATION

For further information, please contact David Dixon at (214) 651-6228 or the following Supervision and Regulation personnel:

State Member Banks: Marvin C. McCoy (214) 651-6657

Bank Holding Companies: Richard J. Burda (214) 651-6472

Sincerely yours,

William H Wallace

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

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FEDERAL RESERVE press release

For immediate release November 14, 1985

The Federal Reserve Board today issued a policy statement on the payment of cash dividends by state member banks and bank holding companies that are experiencing financial difficulties.

The policy statement, which is part of a program to strengthen supervision of banking operations, addresses the following practices of supervisory concern by institutions that are experiencing earnings weaknesses, other serious problems, or that have inadequate capital:

-- the payment of dividends not covered by earnings,

-- the payment of dividends from borrowed funds, and

-- the payment of dividends from unusual or nonrecurring gains, such as the sale of property or other assets.

It is the Federal Reserve's view that an organization experiencing earnings weaknesses or other financial pressures should not maintain a level of cash dividends that exceeds its net income, that is inconsistent with the organization's capital position, or that can only be funded in ways that may weaken the organization's financial health. In some instances, it may be appropriate to eliminate cash dividends altogether.

The policy statement reads in part:

"A fundamental principal underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as a source of managerial and financial strength to their subsidiary banks. The Board believes, therefore, that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of bank subsidiaries or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a

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source of strength. Thus, for example, if a major subsidiary bank is unable to pay dividends to its parent company--as a consequence of statutory limitations, intervention by the primary supervisor, or noncompliance with regulatory capital requirements--the bank holding company should give serious consideration to reducing or eliminating its dividends in order to conserve its capital base and provide capital assistance to the subsidiary bank".

The Federal Reserve recognizes that many organizations have decided on their own to reduce their dividends within the last several years, and others have done so in response to supervisory encouragement.

Thus, this policy is meant to reinforce prudential considerations and to encourage management to continually review dividend policies in light of an organization's financial condition, compliance with supervisory guidelines on capital adequacy, and future growth plans and prospects.

On October 7, the Board announced policies to increase the frequency of on-site examination and inspection of state member banks and bank holding companies and said it is considering possible other actions, including tightened prudential standards, improved coordination and cooperation with other federal and state banking departments, and strengthened examination staffs and improved examiner training programs.

Earlier this month, the Board approved revisions to the reporting requirements for bank holding companies and implementation of a new report on nonbanking subsidiaries. Most of these changes will take effect on March 31, 1986 and are designed to obtain new data to more fully assess operations and risks, to enhance off-premise surveillance programs, to obtain data on a more frequent basis and to conform the account categories and definitions, where appropriate, to those of the call report.

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In general, the revisions provide for the submission of basic financial statements prepared in accordance with generally accepted accounting principles, and for the collection of a limited amount of additional data which is to be used in the calculation of holding companies' capital ratios for the purpose of monitoring compliance with the Board's capital adequacy ratio guidelines.

Copies of the new reporting forms for bank holding companies (Y-6 and Y-9) may be obtained from the district Federal Reserve Banks.

The Board's policy statement on dividends is attached.

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Attachment

Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies

The Board of Governors of the Federal Reserve System considers adequate capital to be critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a bank's or bank holding company's capital adequacy is the strength of its earnings and the extent to which its earnings are retained and added to capital or paid out to shareholders in the form of cash dividends.

Normally, during profitable periods, dividends represent an appropriate return of a portion of a banking organization's net earnings to its shareholders. However, the payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, the Board believes that a bank or bank holding company generally should not maintain its existing rate of cash dividends on common stock unless 1) the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends and 2) the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition. Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious consideration to cutting or eliminating its dividends. Such an action will help to conserve the organization's capital base and assist it in weathering a period of adversity. Once earnings have begun to improve, capital can be strengthened by keeping dividends at a level that allows for an increase in the rate of earnings retention until an adequate capital position has been restored.

The Board also believes it is inappropriate for a banking organization that is experiencing serious financial problems or that has inadequate capital to borrow in order to pay dividends since this can result in increased leverage at the very time the organization needs to reduce its debt or increase its capital. Similarly, the payment of dividends based solely or largely

upon gains resulting from unusual or nonrecurring events, such as the sale of the organization's building or the disposition of other assets, may not be prudent or warranted, especially if the funds derived from such transactions could be better employed to strengthen the organization's financial resources.

A fundamental principle underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as a source of managerial and financial strength to their subsidiary banks. The Board believes, therefore, that a bank holding company should not maintain a level of cash dividends to its shareholders that places undue pressure on the capital of bank subsidiaries, or that can be funded only through additional borrowings or other arrangements that may undermine the bank holding company's ability to serve as a source of strength. Thus, for example, if a major subsidiary bank is unable to pay dividends to its parent company--as a consequence of statutory limitations, intervention by the primary supervisor, or noncompliance with regulatory capital requirements--the bank holding company should give serious consideration to reducing or eliminating its dividends in order to conserve its capital base and provide capital assistance to the subsidiary bank.

The Board's guidelines on capital adequacy define primary capital to include perpetual preferred stock, and the Board is aware that such instruments have become an increasingly significant element in the capital base of some banking organizations. As part of a balanced capital structure, this instrument can serve as a useful vehicle for supplementing common stockholders' equity, the most critical component of an organization's capital base, and for augmenting primary capital. However, in formulating capital plans and meeting regulatory capital requirements, banking organizations should avoid excessive reliance on preferred stock since this could limit an organization's financial flexibility in the event it encounters serious and protracted earnings weaknesses.

This statement of principles is not meant to establish new or rigid regulatory standards; rather, it reiterates what for most banks, and businsses in general, constitutes prudent financial practice. Boards of directors should continually review dividend policies in light of their organizations' financial condition and compliance with regulatory capital requirements, and should ensure that such policies are consistent with the principles outlined above.

Federal Reserve examiners will be guided by these principles in evaluating dividend policies and in formulating corrective action programs for banking organizations that are experiencing earnings weaknesses, asset quality problems, or that are otherwise subject to unusual financial pressures.