



FEDERAL RESERVE BANK
OF DALLAS

ROBERT H. BOYKIN
PRESIDENT

January 10, 1991

DALLAS, TEXAS 75222

Notice 91-03

TO: The Chief Executive Officer of each
member bank and others concerned in
the Eleventh Federal Reserve District

SUBJECT

Amendments to Regulation H

DETAILS

The Federal Reserve Board has announced amendments to Regulation H (Membership of State Banking Institutions in the Federal Reserve System) concerning the payment of dividends by state member banks.

The rule revises the way in which state member banks calculate their dividend payment capacity and brings the treatment of loan-loss reserves for dividend payment purposes into line with current regulatory reporting standards and generally accepted accounting principles (GAAP). Portions of the rule have been made effective immediately.

The provisions of the Board's rule are consistent with a similar rule published for national banks by the Office of the Comptroller of the Currency on December 13, 1990.

ATTACHMENT

A copy of the Board's notice as it appears on pages 52982-87, Vol. 55, No. 248, of the Federal Register dated Wednesday, December 26, 1990, is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis at (214) 744-7420. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

Robert H. Boykin

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 250

[Docket No. R-0696]

Regulation H—Payment of Dividends by State Bank Members of the Federal Reserve System; Miscellaneous Interpretations

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System is adding a new section to its Regulation H, Membership in the Federal Reserve System, that will clarify the circumstances under which state member banks may pay dividends and will bring calculation of dividend payment capacity more closely into line with current regulatory reporting standards and generally accepted accounting principles (GAAP). The rule defines the terms used in two statutory provisions that impose capital and current earnings restrictions on the payment of dividends by national banks. These provisions, 12 U.S.C. 56 and 60, are made applicable to state member banks by section 9 of the Federal Reserve Act.

DATES: Section 208.19(a) of this regulation will be effective January 25, 1991. Section 208.19(b) will be effective December 20, 1990, although a state member bank may choose to apply the paragraph retroactively (see transition provisions in § 208.19(b)(5)).

FOR FURTHER INFORMATION CONTACT: Oliver Ireland, Associate General Counsel (202/452-3625), or Lawranne Stewart, Attorney (202/452-3513), Legal Division; or Rhoger Pugh, Manager, Policy Development (202/728-5883), or Charles Holm, Senior Accountant (202/452-3502), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, DC 20551. For the hearing impaired only, Telecommunications Device for the Deaf ("TDD"), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: On June 13, 1990, the Board published for comment a notice of proposed rulemaking concerning the payment of dividends by state member banks. 55 FR 23941. The proposed rule, which would add a new section to the Board's Regulation H, interprets and clarifies two statutory provisions that restrict the payment of dividends by state member banks. These statutory provisions, 12

U.S.C. 56 and 60, are designed to protect and stabilize the capital support of a bank's operations. The purpose of the rule is to interpret these provisions to provide definitive guidelines for state member banks to use in calculating their dividend payment capacity and to clarify the circumstances under which state member banks are required to obtain the approval of the Board to pay dividends. The rule will also bring the calculation of dividend paying capacity more closely in line with current regulatory reporting standards and generally accepted accounting principles ("GAAP").¹

While 12 U.S.C. 56 and 60 both place limitations on the ability of a bank to pay cash dividends, the two sections serve different purposes. Before a state member bank can declare a dividend, it must establish that the payment of the dividend will not impair its capital under 12 U.S.C. 56, and that the dividend can be paid out of recent earnings under 12 U.S.C. 60.² If the dividend payment does not meet the requirements of these sections, the state member bank must obtain the approval of the Board before paying the dividend. Both sections 56 and 60 were adopted as part of the National Bank Act. The coverage of these provisions extends to state member banks under section 9 of the Federal Reserve Act, which provides that all state member banks are required "to conform to those provisions of law imposed on national banks * * * which relate to the withdrawal of capital or impairment of their capital stock, and to conform with the provisions of sections 56 and 60(b) of this title with respect to the payment of dividends."³

Under 12 U.S.C. 56, banks may not pay a dividend in excess of undivided profits then on hand or reduce capital by paying a dividend. Historically, banks have added the bank's Allowance for Loan and Lease Loss ("ALLL") back to and deducted bad debts from reported undivided profits to determine the undivided profits then on hand. Under the proposed rule, the ALLL would no longer be added back to reported undivided profits and only bad debts in excess of the ALLL (if any) would be subtracted from reported undivided profits. The proposed rule also provided guidance to banks as to when assets must be considered bad debts for the purposes of the dividend payment restrictions. Finally, the proposed rule

provided that earned surplus could be transferred to undivided profits for the purpose of dividend payment, providing that the transfer had been approved by the bank's board of directors and by the Board.

12 U.S.C. 60 provides that dividends may not be paid in excess of the current year's net profits combined with the retained net profits of the prior two years, unless the approval of the Board is obtained. The proposed rule provided that net profits will be equal to the net income figure reported in the bank's Report of Condition and Income. For the purpose of calculating net profits or retained net profits, therefore, provisions for loan and lease losses ("PLLL") would not be added back to reported net income, and loans charged off during the year would not be deducted from reported net income.⁴

Previously, banks had added their PLLL back to reported net income and deducted loan charge offs from reported net income. Net profits are defined under section 60 as the remainder of earnings plus recoveries on loans after the deduction of current operating expenses, actual losses, accrued preferred dividends, and taxes. Under GAAP and regulatory reporting standards, provisions to loan loss reserves are treated as current operating expenses, and are therefore deducted from earnings. The shift to GAAP standards takes into account the existence of the loan loss reserve account. As a result, under GAAP there are no longer actual losses to be subtracted from earnings, as charge offs merely reduce loan loss reserves. The treatment of PLLL and loan charge offs provided in the proposed rule would be consistent with regulatory reporting standards and GAAP. The proposed rule also included transition provisions that allowed banks the option of applying this rule as of either calendar year 1990 or 1991, and allowed banks the option of recalculating retained net profits for the prior two years using the new rule.

Summary of Comments

The Board received 13 comments on the proposed amendments to Regulation H. Commenters included:

Commercial banks	3
Bank holding companies	3
Trade associations	2
Federal Reserve Banks	5
Total	13

⁴ If loans charged off exceed the amount of loan loss reserves, banks are required to make additional provisions to loan loss reserves. As a result, loan charge offs would not be made directly against income.

Of the thirteen commenters, nine generally supported or did not object to the proposed amendments. Three commenters were generally opposed to the proposal, and one commenter supported some aspects of the proposal while opposing others. One commenter indicated that its support was contingent upon reasonable loans loss reserve requirements, and stressed that the Board should not require banks to make unnecessary provisions to loan loss reserves. Three commenters expressed concern that the proposed amendments could discourage state member banks from maintaining adequate loan loss reserves, and one of these suggested that the Board needed to provide greater guidance as to when provisions to loan loss reserves must be made.

The Board continues to believe that the standard set forth in the Reports of Condition and Income and under GAAP generally provide sufficient guidance for state member banks to determine when provisions to loan loss reserves should be made. At this time, the Board does not propose to alter these standards to make them any more or less rigorous. The Board will, however, consider in the future whether more extensive guidelines are needed in light of experience with the new rule.

One commenter stated that the proposed amendments would make it more difficult for state member banks to raise capital, and particularly objected to the application of the rule to preferred stock. The Board does not anticipate that this rule will make it substantially more difficult for banks to raise capital, as safety and soundness considerations would otherwise restrict the ability of banks to pay dividends even if the rule did not apply. In addition, the Board has not excluded dividends on preferred stock from coverage of the rule, as the statutory prohibition on dividend payments out of capital covers both common and preferred stock.⁵ This is

⁵ The OCC proposal indicated that the provisions of section 56 did not apply to the payment of dividends on preferred stock. This exclusion was based on a provision of the National Bank Act (12 U.S.C. 51b(a)) that the OCC interpreted as overriding section 56 with respect to dividends on preferred stock. Unlike section 56, section 51b is not applicable to state member banks. In practice, there will be no difference between the Board's rule and the OCC's, as a national bank will also be required to obtain the approval of the OCC under 12 U.S.C. 59 to pay dividends on preferred stock if such a payment will reduce the capital of the bank.

¹ The OCC has adopted a similar rule for national banks. 55 FR 51269 (Dec. 13, 1990).

² Sections 5204 and 5199 of the Revised Statutes, respectively.

³ Section 9, paragraph 6 of the Federal Reserve Act (12 U.S.C. 324).

not a new restriction and merely sets forth the scope of the statutory provision.

Three commenters stressed the need for consistency among federal bank regulatory agencies as to the terms and timing of the implementation of the proposals, with one expressing approval with the coordination that had taken place among federal bank regulatory agencies and between regulators at the federal and state levels. Two commenters, however, stated that the Board's proposed rule would conflict with laws of their respective states, North Dakota and Montana, concerning dividend payments. In addition to working closely with the OCC to coordinate the timing and content of the rule, the Board has contacted state supervisory authorities in a number of states with potentially conflicting statutory and regulatory provisions, and will continue to work with state authorities to minimize any conflicts. Staff of the bank supervisory authority in Montana have indicated to Board staff that there is no conflict with Montana state law, while bank supervisory staff in North Dakota have indicated that there is no significant conflict with North Dakota law. Both state supervisory agencies have indicated that they have no objections to the rule.

One commenter approved of the portions of the proposed rule relating to the earnings limitations of section 60, but objected to the provisions concerning the capital limitations on the payment of dividends under section 56. The commenter stated that the rationale for the capital limitations had disappeared with the adoption of capital adequacy guidelines. This commenter also particularly objected to the portion of this provision that allowed dividends to be paid from only the portions of surplus surplus that had been earned, rather than paid in by shareholders. Finally, the commenter stated that if such provisions were adopted, the Board should provide a "transition period" in implementing the provisions.

The prohibition on the payment of dividends from capital contained in section 56 is a statutory provision, and the Board will not waive the approval requirements of this provision. With regard to the portion of the rule concerning surplus accounts, while the OCC had previously adopted an interpretation of section 56 that allowed all of the surplus surplus account to be paid out as dividends, the Board had never adopted such an interpretation. The Board believes that funds paid in by shareholders should be considered

capital under section 56, regardless of whether the funds are placed in the capital or surplus accounts, and that it is not appropriate for funds invested by shareholders to be paid out as dividends, both for considerations of safety and soundness and for statutory compliance. This does not represent a change in policy or interpretation for the Board, and an extended transition provision is therefore not necessary or appropriate.

Two commenters opposed the proposed requirement that regulatory approval be obtained before surplus surplus could be transferred to undivided profits for the payment of dividends, as the requirement for approval could cause unnecessary delays and penalties to institutions with adequate capital. One of these commenters also stated that standards for approval of surplus transfers should be stated.

The Board has restructured the provisions concerning the transfer of funds out of surplus to clarify the purpose of the approval and the requirements for approval.⁶ The provisions of section 56 do not specifically address the treatment of surplus account funds, and the Board must therefore determine whether such funds should be treated as capital or as part of undivided profits. Because shareholder funds have generally been paid into surplus accounts, the Board will normally presume that funds in the surplus account were paid in by shareholders and should be treated as capital. All transfers out of the surplus account for the payment of dividends are subject to the section 56 restrictions on the payment of dividends out of capital. Further, even if the Board did not take the position that shareholder funds in the surplus account are to be treated as capital, there is no basis for treating such funds as undivided profits. Accordingly, the transfer of unearned funds from the surplus account is subject to the section 56 prohibition on the payment of dividends in excess of undivided profits.

In order to satisfy the Board that a proposed transfer is not a withdrawal of capital or a payment in excess of undivided profits, the bank must demonstrate to the Board that the portion of surplus surplus that the bank wishes to transfer came from the

earnings of prior periods, excluding earnings transferred as a result of stock dividends. The rule now states that this information should be submitted to the Reserve Bank in order to request approval of the transfer.

In order to address concerns regarding delays in approval of transfers of surplus surplus, the approval process has been structured as a notice requirement. A bank may consider its request approved if the Board or Reserve Bank does not notify it within thirty days that the transfer request has been disapproved or is subject to continuing consideration.

The responses also included comments on a number of specific accounting issues. Two commenters indicated that the Board's proposed rule was not based fully on GAAP, as the proposed earnings limitation on dividend payments would require dividend payment capacity to be based on the net income figure contained in the Report of Condition, which is based on regulatory reporting standards rather than generally accepted accounting principles.

While net income figure contained in the Report of Income is not fully in accordance with GAAP, the differences are generally not significant. For many institutions, there will be no difference between the GAAP and Report of Income net income figures. Differences between the net income figures under GAAP and the Report of Income arise primarily from differences between GAAP and regulatory reporting standards in the recognition of income on certain recourse, securitization, and hedging transactions. Additionally, the Board is studying ways in which the differences between the two accounting standards can be reduced. Because the net income figure in the Report of Income is readily accessible for all banks and is used for a variety of regulatory purposes, the Board feels that the use of this figure is justified.

One commenter requested clarification concerning the effect of changes in accounting principles in the financial statements and Report of Income of a financial institution. Under GAAP, in some cases a bank that changes an accounting principle may elect to restate its prior year financial statements to reflect the change. In that case, however, the bank would not be permitted to restate its prior year Report of Income. Net income in the Report of Income therefore would differ from the net income in its GAAP-based financial statements. Since the dividend limit is based on net income as defined in the Report of Income, the commenter

⁶ Additionally, the definition of "surplus surplus" has been amended to reflect the fact that state member banks are subject to the provisions of applicable state law concerning capital and surplus, and that not all states require state-chartered banks to maintain surplus equal to 100% of common capital. "Surplus surplus" is now defined as that portion of the bank's surplus account that exceeds the amount required under state law.

believed that an unjust limit on dividends would result. However, the Board is concerned that allowing retroactive restatement may raise questions as to the appropriateness of the prior year's dividend payments that were based on figures prior to any restatement. The Board also believes there is an inherent advantage in simplicity and understanding of the new rule by basing the limitation on net income as reported in the Report of Income without adjustment. Retroactive restatement thus is not appropriate in these circumstances.

One commenter asked for clarification on whether the deduction of bad debts in excess of ALLL from undivided profits would be on a before- or after-tax basis. The Board does not believe that the deduction for bad debts should be taken on an after-tax basis. One advantage of the conversion to GAAP treatment of bad debts and loan loss provisions is to avoid the uncertainty associated with allowing bad debts to be deducted on an after-tax basis, as the future tax benefits from the recognition of bad debt are often uncertain. Any tax benefit might not be realized until the charge off occurs, which could be several years in the future. The Board believes that any excess statutory bad debt should be deducted on a gross basis so that subjective uncertainty and valuations concerning future tax benefits do not affect the dividend calculation.

One commenter addressed the definition of "bad debt" included in the section of the proposed rule concerning capital limitations on the payment of dividends. The commenter stated that leases and time deposits should be explicitly included as obligations that could become "bad debts." The Board concurs with this comment and has revised the definition of obligations to include time deposits and leases. The commenter also stated that demand debt should be defined as "bad debt" after one year's interest has accrued and remained unpaid, including demand obligations on which interest is due on demand. The Board believes that such determinations should be based on whether under the terms of the individual credit the interest is past due rather than the period over which the interest has accrued. Additionally, the commenter stated that "bad debt" should also include any obligation on which interest had not been paid in cash for six months, and that interest cannot be "paid" by taking a note. Although the Board agrees that as a general matter the taking of a note from the borrower would not constitute the payment of

interest for purposes of determining a bad debt, there may be instances where additional collateral or other mechanisms could be provided that may indicate that the obligation is not a bad debt.

The same commenter also noted that the use of terms such as "undivided profits" and "surplus" should conform to their general use in the banking industry, and that use of the term "surplus surplus" was unnecessary. The Board has adopted this terminology in order to be consistent with the OCC. Adoption of differing terminology would raise questions as to whether the Board's standards were intended to differ from those of the OCC. This commenter also suggested that the Board should take the opportunity to address issues concerning the capital structure of state member banks at the same time as dividend payments. As such an effort could result in inconsistencies between the treatment of national and state member banks, the Board does not plan to address the capital structure of state member banks at this time. Additionally, many states have their own statutory requirements concerning the capital structure of state chartered banks, and a federal standard would be likely to result in unnecessary conflicts with many state laws.

On a procedural level, two commenters supported the issue of a regulation on bank dividends, stating respectively that a single regulation would eliminate confusion and would enhance the enforceability of the provisions. One trade association commenter urged the adoption of expedited procedures under the proposed regulation in order to provide prompt responses to applications for the payment of dividends. The Board anticipates that requests for approval under the new regulation may be handled more expeditiously than in the past, as the regulation should clarify a number of issues. However, institutions that believe that they may need regulatory approval to pay a dividend are encouraged to consult with their Federal Reserve Bank in advance in order to avoid delays when approval is actually requested.

Effective Date

Section 208.19(a) will be effective as of January 25, 1991, thirty days after publication of this notice. Section 208.19(b), however, has been given immediate effect under provisions of the Administrative Procedures Act that allow for less than the usual thirty day notice where the rule grants an exemption or relieves a restriction or for good cause. 5 U.S.C. 553(d) (1) and (3).

Section 208.19(b) provides banks with an option for dividend calculation for calendar year 1990 that would not otherwise be available, and therefore provides relief from the restrictions of the current requirements concerning the payment of dividends from current earnings. Although § 208.19(b) is effective immediately, use of the rule is not required for state member banks until January 1, 1991.

Aside from the relief from the current restrictions provided for 1990, there is also good cause for immediate effectiveness in order to preserve parity between state member and national banks. The OCC has published a final rule with the parallel provisions that have been made effective immediately, with mandatory use of the rule beginning January 1, 1991. 55 FR 51269 (Dec. 13, 1990). A delay in the effective date beyond January 1, 1991, would also be contrary to the public interest because the delay would necessitate additional accounting adjustments to apply the rule other than on a full calendar year basis that would not be required if the rule is effective prior to January 1, 1991.

Final Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*) requires an agency to prepare a final regulatory flexibility analysis containing (1) A succinct statement of the need for and objectives of the rule; (2) a summary of the issues raised by the public comments, the agency's assessment of the issues, and a statement of the changes made in the final rule in response to the comments; and (3) a description of significant alternatives to the rule that would minimize the economic impact of the rule on small entities and the reason why the alternatives were rejected. 12 U.S.C. 604(a). The first and second of these requirements are included in the discussion above. With regard to alternatives considered, the Board does not believe that any alternatives exist that would minimize the effects of the statutory restrictions on dividend payment capacity on small banks. The primary alternatives to the rule were to refrain from bringing the accounting methods used in calculating dividend payment capacity into line with generally accepted accounting principles, or to adopt GAAP by amending the miscellaneous interpretations and policy statements concerning dividend payments. The Board believes that by adopting a comprehensive rule as part of

Regulation H which sets out the responsibilities of state member banks, the rules on dividend payments will be more accessible, and state member banks will be able to determine their legal dividend payment capacity more easily. This should be particularly useful for smaller institutions. With regard to the rule's use of GAAP in calculating dividend payments, the Board anticipates that this change will have some effect on the dividend paying capacity of all state member banks, regardless of size, but does not anticipate that there will be any disproportionate or significant economic impact on a substantial number of small banks. For these reasons, the Board believes that the rule adopted will result in the least possible economic impact on small entities.

List of Subjects in 12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set out in the preamble, the Board amends 12 CFR parts 208 and 250 as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

1. The authority citation for part 208 continues to read as follows:

Authority: Sections 9, 11(a), 11(c), 19, 21, 25, and 26(a) of the Federal Reserve Act, as amended (12 U.S.C. 321–338, 248(a), 248(c), 461, 481–486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); sections 907–910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906–3909); sections 2, 12(b), 12(g), 12(i), 15B(c)(5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 78(b)(7), 78(g), 78(i), 78o–4(c)(5), 78q, 78q–1, and 78w, respectively); section 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and sections 1701–1122 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 12 U.S.C. 3310 and 3331–3351).

2. Section 208.19 is added to read as follows:

§ 208.19 Payment of dividends.

(a) *Capital limitations on payment of dividends.* No state member bank shall, during the time it continues its banking

operations, withdraw, or permit to be withdrawn, either in the form of dividends or otherwise, any portion of its capital. If losses have at any time been sustained by a state member bank that equal or exceed its undivided profits then on hand, no dividend shall be paid. No dividend shall be paid by a state member bank while it continues its banking operations, to an amount greater than its net profits then on hand, deducting therefrom its losses and bad debts.

(1) *Exceptions.* Exceptions to the limitations contained in this paragraph (a) may be made only with the prior approval of the Board and of at least two-thirds of the shares of each class of stock outstanding.

(2) *Dividends on common and preferred stock.* The provisions of this paragraph (a) shall apply to the payment of dividends on both common and preferred stock.

(3) *Bad debt.* Under this paragraph (a), bad debts must be deducted from the net profits then on hand in computing funds available for the payment of dividends. The term "bad debt" includes matured obligations due a bank on which the interest is past due and unpaid for six months unless the debts are well secured and in the process of collection. Obligations include every type of indebtedness owed to the bank, including, for example, loans, investment securities, time deposits in other depository institutions, and leases. The six-month period of default may begin at any time, regardless of when the debt matures.

(i) *Matured debt.* Whether a debt has matured for the purposes of this subsection usually will be determined by applicable contract law. Generally, a debt is matured when all or a part of the principal is due and payable as a result of demand, arrival of the stated maturity date, or acceleration by contract or by operation of law. Nevertheless, any demand debt on which the payment of interest is six months past due will be considered matured even though payment on the debt has not been demanded. Installment loans on which any payment is six months past due will be considered matured even though acceleration of the total debt may not have occurred.

(ii) *Well-secured debt.* A debt is well secured if it is secured by collateral in the form of liens on, or pledges of, real or personal property, including securities, having realizable value sufficient to discharge the debt in full, or by the guaranty of a financially responsible party. If a loan that would otherwise be considered a bad debt is partially secured, that portion not

properly secured will be considered a bad debt.

(iii) *Debt in process of collection.* A debt is in the process of collection if collection of the debt is proceeding in due course, either through legal action, including judgment enforcement procedures, or, in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to current status. In any case, the bank should have a plan of collection setting forth the reasons for the selected method of collection, the responsibilities of the bank and the borrower, and the expected date of repayment of the debt or its restoration to current status.

(iv) *Debts of bankrupt or deceased debtors.* A claim duly filed against the estate of a bankrupt or deceased debtor is considered as being in the process of collection. The obligation is well secured if it meets the criteria set forth in paragraph (a)(3)(ii) of this section or if the claim of the bank against the estate has been duly filed and the statutory period for filing has expired and the assets of the estate are adequate to discharge all obligations in full.

(v) *Documentation.* The bank must maintain in its files documentation to support its evaluation of the obligation. In addition, the bank must retain, at a minimum, monthly progress reports on its collection efforts, noting and explaining any deviation from the collection plan.

(4) *Undivided profits then on hand.* For the purpose of this section, the terms "undivided profits then on hand" and "net profits then on hand" shall have the same meaning, and shall be referred to herein as "undivided profits then on hand".

(i) *Allowance for loan and lease losses.* When calculating the amount of dividends a bank can pay under 12 U.S.C. 56 and this paragraph, the bank may not add the balance in its allowance for loan and lease losses to its undivided profits for the purpose of determining undivided profits then on hand. The terms "allowance for loan and lease losses" and "undivided profits" shall have the same meaning as set forth in the instructions for the Reports of Condition and Income.

(ii) *Bad debts.* When deducting its bad debts from its undivided profits then on hand, a bank shall first subtract the sum of its bad debts from the balance of its allowance for loan and lease losses account. If the sum of a bank's bad debts is greater than its allowance for loan and lease losses, the excess bad

debt shall then be deducted from the bank's undivided profits then on hand.

(iii) *Surplus surplus.* State member banks are required to comply with state law provisions concerning the maintenance of surplus funds in addition to common capital. To the extent a bank has capital surplus in excess of that required under applicable state law, the bank has "surplus surplus." Only that portion of the surplus surplus that meets the following conditions may be transferred to the undivided profits account and be available for the payment of dividends:

(A) The bank's board of directors approves the transfer of funds from capital surplus to undivided profits; and

(B) The transfer has been approved by the Board. The bank must be able to demonstrate to the Board that the portion of the surplus surplus to be transferred came from the earnings of prior periods, excluding earnings transferred as a result of stock dividends. Requests for Board approval shall be submitted to the appropriate Federal Reserve Bank. The bank may consider the transfer to be approved if the Board or the Reserve Bank does not notify the bank within thirty days after the Reserve Bank's receipt of the notice that the transfer has been disapproved or that it is subject to continuing consideration.

(b) *Earnings limitations on payment of dividends.* A state member bank may not pay a dividend if the total of all dividends declared by the bank in any calendar year exceeds the total of its net profits for that year combined with its retained net profits of the preceding two calendar years, less any required transfers to surplus or to a fund for the retirement of any preferred stock, unless the bank has received the prior approval of the Board for the dividend under paragraph (b)(3) of this section.

(1) *Dividends on common and preferred stock.* The provisions of this paragraph (b) apply to the payment of dividends on both preferred and common stock.

(2) *Net profits.* "Net profits" shall be equal to the net income or loss as reported by a state member bank in its Reports of Condition and Income. When computing its "net profits" under this section, a bank should not add its provisions for loan and lease losses to, nor deduct net charge offs from, its reported net income.

(3) *Retained net profits.* Retained net profits of any period shall be equal to the net income or loss as reported in the Reports of Condition and Income less any common or preferred stock dividends declared or otherwise charged

to the undivided profits of the period for which retained net profits are computed.

(4) *Approval of dividends.* A bank must request and receive the approval of the Board before declaring a dividend if the amount of all dividends (common and preferred), including the proposed dividend, declared by the bank in any calendar year exceeds the total of the bank's net profits of that year to date combined with its retained net profits of the preceding two calendar years, less any required transfers to surplus or a fund for the retirement of any preferred stock. Requests for the Board's approval shall be submitted to the appropriate Federal Reserve Bank.

(5) *Effective date and transition provisions.* (i) For the purpose of computing "net profits" pursuant to 12 U.S.C. 60, a state member bank must apply paragraph (b)(2) of this section no later than January 1, 1991. A bank may elect to use this paragraph (b)(2) of this section to calculate net profits for 1990, if it applies this provision on a full calendar year to date basis.

(ii) Whether a bank chooses to use paragraph (b)(2) of this section beginning as of January 1, 1990 or 1991, it may elect to apply the paragraph (b)(2) of this section to recalculate retained net profits for one or both of the prior two years.

(iii) Once a bank has elected to calculate net profits or retained net profits for a particular year applying the provisions of paragraph (b)(2) of this section, retained net profits and net profits for all subsequent periods in the calculation must also be calculated using paragraph (b)(2) of this section. If a state member bank has elected to use paragraph (b)(2) of this section for a particular year, the bank may not change the method of calculation used for that year during subsequent periods.

PART 250—MISCELLANEOUS INTERPRETATIONS

1. The authority citation for part 250 continues to read as follows:

Authority: 12 U.S.C. 248(i).

§§ 250.101, 250.102 and 250.103
[Redesignated as 208.125, 208.126 and 208.127]

2. Sections 250.101, 250.102, and 250.103 are redesignated as §§ 208.125, 208.126, and 208.127, respectively.

§ 250.104 [Removed]

3. Section 250.104 is removed.

By order of the Board of Governors of the Federal Reserve System, December 20, 1990.

William W. Wiles,

Secretary of the Board.

[FR Doc. 90-30191 Filed 12-24-90; 8:45 am]

BILLING CODE 6210-01-M