

July 9, 2019

## Bank Capital Requirements

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### Federal Reserve Eliminates Standalone Prior Approval Requirement for Common Stock Repurchases

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Earlier today, the Federal Reserve eliminated the standalone requirement for prior approval of common stock repurchases in connection with a joint Fed-OCC-FDIC rulemaking designed to simplify certain aspects of the capital rules for non-advanced approaches banking organizations.<sup>1</sup> We will address other aspects of the final rule, including the simplifications for non-advanced approaches banking organizations, in a forthcoming client memorandum.

Section 20(b)(1)(iii) of the Federal Reserve's capital rules previously provided that common equity tier 1 ("CET1") capital instruments—that is, common stock—"can only be redeemed via discretionary repurchases with the prior approval of the [Federal Reserve]."<sup>2</sup> The Federal Reserve had interpreted and applied this provision as requiring banking organizations subject to its capital rules—bank holding companies ("BHCs"), savings and loan holding companies ("SHLCs"), U.S. intermediate holding companies of foreign banking organizations ("IHCs"), and state member banks—to obtain the prior approval of the Federal Reserve before repurchasing any common stock, including in connection with ordinary course buyback programs. This requirement presented significant practical difficulties for BHCs not subject to the Federal Reserve's capital plan rule (12 C.F.R. § 225.8) and Comprehensive Capital Analysis and Review ("CCAR") exercise,<sup>3</sup> particularly when those BHCs sought to implement new repurchase programs promptly in response to market conditions.

The elimination of the standalone requirement for common stock repurchases is a notable change from the 2017 simplifications proposal<sup>4</sup> which, instead, would have introduced an additional separate standalone requirement that any banking organization subject to the Federal Reserve's capital rules obtain the Federal Reserve's prior approval before repurchasing or redeeming a CET1, additional tier 1 ("AT1"), or tier 2 capital

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instrument. The Federal Reserve noted that this requirement is already in its capital rules as part of the definitions of CET1, AT1 and tier 2 capital instruments, but that it proposed a separate standalone requirement “for purposes of clarity and enforceability.”<sup>5</sup> Although the proposal did not explain how the separate standalone requirement would have promoted “clarity and enforceability,” it appears that it was intended to confirm that banking organizations not subject to the capital plan rule and CCAR must receive prior approval before engaging in any common stock repurchases.

The supplementary information accompanying the final rule states that public feedback regarding the prior proposed approval requirement “noted that there was a high burden associated with obtaining prior approval for all redemptions and repurchases of common stock instruments, especially with regard to standard common stock buyback programs, and that the supervisory function of requiring prior approval seemed limited where a firm was not subject to other limitations on capital actions, such as the capital conservation buffer.” In response to this feedback, the Federal Reserve modified its capital rules to require prior approval for repurchases of common stock “only to the extent otherwise required by law or regulation.”<sup>6</sup>

Prior approval for common stock repurchases will therefore only be required to the extent that a BHC, SLHC, IHC, or state member bank is subject to a separate legal or regulatory requirement to obtain prior approval, such as under section 217.11 of the capital rules,<sup>7</sup> section 225.4 of Regulation Y,<sup>8</sup> the capital plan rule and CCAR, or section 11 of the Federal Reserve Act. As a result, BHCs and SLHCs will generally be able to repurchase their common stock without prior approval from the Federal Reserve, unless they are subject to an independent approval requirement, such as under the capital plan rule and CCAR.<sup>9</sup>

Federal Reserve Supervision and Regulation Letter 09-4 (“*SR 09-4*”) provides that BHCs that are not subject to the capital plan rule and CCAR should provide prior notice of share repurchases to Federal Reserve supervisory staff if the repurchases would result in a net reduction in the amount of common stock outstanding during a quarter so that there is a “reasonable opportunity for supervisory review and possible objection should Federal Reserve supervisory staff determine a transaction raises safety and soundness concerns.”<sup>10</sup> SR 09-4 also directs subject BHCs to consult with Federal Reserve supervisory staff before conducting share repurchases if the BHC is experiencing financial weaknesses (or is at significant risk of developing financial weaknesses) or is considering expansion. Although the supplementary information accompanying the final rule does not discuss SR 09-4, these supervisory expectations appear unchanged.

Under the final rule, any redemption or repurchase of AT1 and tier 2 capital instruments will remain subject to the prior approval of the Federal Reserve.<sup>11</sup> AT1 and tier 2 capital instruments include noncumulative perpetual preferred stock and subordinated debt.

The elimination of the standalone prior approval requirement for common stock repurchases will be effective October 1, 2019, but any banking organization subject to the Federal Reserve’s capital rules may elect to adopt this change prior to that date.<sup>12</sup>

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For state member banks, the change will not have any practical impact because section 11 of the Federal Reserve Act includes a prior approval requirement for any reduction of capital stock. Similarly, because section 18(i)(1) of the Federal Deposit Insurance Act and section 59 of the National Bank Act require that state nonmember banks and national banks, respectively, obtain prior supervisory approval for any reduction in their capital stock, the absence of corresponding changes in the capital rules of the FDIC and OCC will not have a practical impact on state nonmember banks and national banks.

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## ENDNOTES

- 1 Federal Reserve, OCC, and FDIC, *Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996* (Jul. 8, 2019), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190709a1.pdf> (hereafter, “*Final Rule*”).
- 2 12 C.F.R. § 217.20(b)(1)(iii).
- 3 Currently, BHCs with \$100 billion or more in assets and IHCs are subject to the capital plan rule and CCAR. As described in note 10, the Federal Reserve has proposed to subject an IHC to CCAR and the capital plan rule only if the IHC has \$100 billion or more in assets.
- 4 Federal Reserve, OCC, and FDIC, *Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*, 82 Fed. Reg. 49984 (Oct. 27, 2017) (hereafter, “*Proposal*”).
- 5 Proposal, at 49995.
- 6 Final Rule, at 33; section 217.20(b)(1)(iii) and (f) of the final rule (Final Rule at 105-106).
- 7 The capital rules require banking organizations to maintain a buffer of CET1 capital in addition to the minimum risk-based requirements that otherwise apply. If an organization does not satisfy the minimum capital requirements plus the applicable buffer, the organization will face graduated constraints on, among other things, distributions (including dividends and certain share repurchases) based on the amount of the shortfall and the organization’s “eligible retained income” (that is, four quarter trailing net income, net of distributions and tax effects not reflected in net income). Share repurchases are treated as distributions subject to potential limitation unless the repurchased shares are fully replaced through the issuance of additional shares in the same calendar quarter in which the repurchase is announced.
- 8 For a BHC that is not subject to CCAR and the capital plan rule, unless the BHC is well capitalized and well managed, and not subject to any unresolved supervisory issues, section 225.4 of Regulation Y requires the BHC to provide prior notice of share repurchases to the Federal Reserve if the gross consideration, when aggregated with the net consideration paid by the BHC for all repurchases and redemptions of its equity securities during the preceding 12 months, is equal to 10 percent or more of its consolidated net worth. For purposes of this requirement, net consideration refers to the gross consideration paid for all equity securities repurchased or redeemed during the period, minus the gross consideration received for all equity securities sold during the period. The notice is subject to the approval of the appropriate Federal Reserve Bank or the Federal Reserve Board.
- 9 All IHCs are currently subject to CCAR and the capital plan rule. In April 2019, the Federal Reserve proposed to retain the IHC threshold at \$50 billion in non-branch U.S. assets but subject an IHC to CCAR and the capital plan rule only if the IHC has \$100 billion or more in assets. Accordingly, under this proposal, an IHC would not be subject to CCAR and the capital plan rule if it had less than \$100 billion in assets. For additional information on this proposal, see our memorandum to clients, “*Regulatory Tailoring for Foreign Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Prudential Standards to Foreign Banking Organizations and Seek Comment on Whether to Impose Standardized Liquidity Requirements on their U.S. Branches and Agencies*” (Apr. 23, 2019), available at <https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Foreign-Banking-Organizations.pdf>.
- 10 Federal Reserve, *SR 09-4: Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies* (Feb. 24, 2009, rev. Dec. 21, 2015), available at <https://www.federalreserve.gov/boarddocs/srletters/2009/SR0904.pdf>.
- 11 Final Rule, at 34; section 217.20(f) of the revised capital rules (Final Rule at 107).
- 12 Final Rule, at 2-3 and 36-37.

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