



SR 09-4: Primer

The Federal Reserve Board recently elevated its scrutiny of bank capital adequacy with Supervisory Letter SR 09-4 ("Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," 2/24/2009 revised March). SR 09-4 clarifies regulatory expectations that all BHCs -- whether or not recipients of TARP/CPP funds -- provide their examiner with comprehensive documentation and analysis prior to the declaration of any dividend, redemption, or repurchase. While not providing explicit safe harbor, SR 09-4 provides a list of critical capital management capabilities that regulators expect of banks your size and complexity before declaring a dividend. Second Pillar Consulting would like to clarify these requirements and discuss our ability to help assess and fill any gaps you might have.

SR 09-4 reiterates the insufficiency of simply having regulatory capital ratios that exceed "minimum" or "well-capitalized" statutory levels. This guidance directs examiners to scrutinize the complete institutional risk profile in their determination of capital adequacy. The most demanding aspect of SR 09-4 is an emphasis on an integrated capital planning process that includes:

- 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, including off-balance sheet and contingent liabilities
- Quality and level of current and prospective earnings, including earnings capacity under a number of plausible economic scenarios
- Current and prospective cash flow and liquidity
- Ability to serve as an ongoing source of financial and managerial strength to depository institution subsidiaries insured by the Federal Deposit Insurance Corporation, including the extent of double leverage and the condition of subsidiary depository institutions
- Other risks that affect the BHC's financial condition and are not fully captured in regulatory capital calculations
- Composition and quality of capital
- Ability to raise additional equity capital in prevailing market and economic conditions.

SR 09-4 also emphasizes that ownership of this capital planning process must reside with the Board, *which should provide a complete evaluation prior to the declaration of each dividend*. Finally, TARP/CPP and other capital program participants must ensure that a plan exists to redeem capital without impairing safety and soundness.

A bank must meet or exceed the following criteria prior to issuing a dividend:

- Previous four quarters of net income must be sufficient to cover a dividend
- Prospective earnings must be consistent with capital need
- BHC can safely meet minimum regulatory capital ratios

In addition, bank management must inform supervisors sufficiently in advance of paying a dividend to ensure the institution meets the criteria established in the guidance.



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Finally, TARP participants must adhere to the following:

- A plan must exist to payback TARP
- Must have Fed approval to payback TARP
- Discouraged from using proceeds of CPP to pay dividends on trust preferred securities or repay debt

Therefore, to remain in compliance with the guidance outlined in SR 09-4 Banks must be able to answer **yes** to **all** of the following questions:

- Does the Board receive and evaluate critical risk and capacity information prior to approving dividends and share repurchases?
- Are risk management policies and procedures integrated with the strategic plan, capital plan and dividend policies?
- Can you systematically assess the ability to issue dividends and repurchase shares within a model of stressed future income linked to the macro economy?
- What impact will redeeming common or preferred have on your capital ratios?
- How might a liquidity crisis impact your ability to pay a dividend?
- How can the firm raise new capital in a stressed environment?
- Do you have the appropriate personnel to manage this process?

Second Pillar Consulting has significant experience helping institutions develop robust capital adequacy processes. We consider capital management a key bank competency and can help institutions craft and refine an SR 09-4 approach that includes:

- Phase I: Triage
 - Gap analysis and preliminary remediation plan that quickly sizes the challenge
 - Flat \$10,000 fee, results in about a week
- Phase II: Rescue Kit
 - Analytics, such as stress testing and capital contingency modeling
 - Governance, including Board training and policy/ procedure overview
 - Implementation, ensuring that reports are generating appropriate awareness of and investment in the capital adequacy challenge
 - Regulatory relations, fostering a productive dialog with the regulators charged with ensuring adequate capital adequacy
 - Flat fee quoted prior to commencement of Phase II based upon Triage results

Capital adequacy is hardly a new notion in regulatory circles, but with SR 09-4 the ante has been raised. This document spells out the scrutiny Boards and senior management should expect from their examiner each and every time a dividend is issued or shares are repurchased/redeemed. We look forward to speaking with you soon to discuss whether Second Pillar Consulting can help ensure that your capital management process passes muster.

For more information visit our website at www.secondpillar.com