

Statement by Martin J. Gruenberg, Member, FDIC Board of Directors on the Regulatory Capital Rule: Eligible Retained Income

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This Final Rule before the FDIC Board would revise the definition of “eligible retained income” under the capital rule for U.S. banking organizations to facilitate the continuation of capital distributions, such as dividends, even under the stressed economic and financial conditions caused by COVID-19. For this reason, I will vote against this Final Rule.

Under the capital rule, a banking organization in the United States is required to maintain minimum risk-based capital and leverage capital ratios.¹ In addition, a banking organization must maintain a buffer of regulatory capital above its minimum requirements. Failure to maintain this buffer results in restrictions on capital distributions including dividends, share buybacks, and certain discretionary bonus payments.

The maximum amount of capital distributions a banking organization can make if it fails to maintain its buffer depends on its eligible retained income. Until this Final Rule, and the Interim Final Rule which preceded it, the capital rule defined eligible retained income as the preceding four quarters of net income, net of distributions and associated tax effects not already reflected in net income

This Final Rule, identical to the Interim Final Rule issued by the banking agencies in March 2020, revises the definition of eligible retained income. Under the revised definition, eligible retained income is the greater of (1) a banking organization’s net income for the four preceding calendar quarters, net of any distributions and associated tax effects not already reflected in net income, and (2) the average of a banking organization’s net income over the preceding four quarters.

The consequence of this change is to allow a banking organization that has made capital distributions over the past year to continue to count those paid-out amounts as if they were retained in the bank.

The impetus for this change in the definition of eligible retained income is provided in the preamble to the Final Rule:

“The spread of COVID-19 has disrupted economic activity in the United States, causing significant volatility in U.S. financial markets. The magnitude and persistence of COVID-19’s overall effect on the economy remain uncertain. In light of these developments, banking organizations may experience a sudden and unanticipated decline in capital ratios.”²

The rationale for this change is then described in the preamble:

“In ordinary economic circumstances, many banking organizations will distribute a significant portion of their net income and retain the rest to support growth. As banking organizations enter stress periods, the restrictions in the capital rule ... limit distributions and help to preserve capital and support lending. However, if the limits to distributions are too restrictive, banking organizations can face a sharp increase in their distribution limitations when their applicable ratios fall to certain levels. This may create an incentive for banking organizations to reduce lending or take other actions to avoid using their buffers. The revised definition of eligible net income in the final rule allows banking organizations to more gradually reduce distributions as they enter stress and provides banking organizations with stronger incentives to continue to lend in a stressed scenario.”³

The argument seems to be that a banking organization should be permitted to utilize an inflated measure of retained income in order to avoid limitations on its ability to make capital distributions such as dividends. The concern is that the banking organization may reduce lending in order to avoid the constraint on capital distributions.

There are a number of problems with this argument.

First, if there is an objective to reduce the retained income requirement, it should be done in a clear and transparent way, not by allowing capital that has been distributed to count as retained income in the bank.

Second, the premise of the argument is questionable. Allowing a banking organization to deplete its capital through distributions in a period of economic stress may not be an incentive to sustain lending activity. Weaker capital may well be an impediment to lending.

Third, weakening the resilience of the banking organization during a period of economic stress on the questionable assumption that it will provide an incentive to lending is a bad idea. In the current circumstances, banking organizations should be conserving capital not distributing it.

In summary, this is a misconceived rulemaking that allows a banking organization to continue to make capital distributions, such as dividends, that would weaken the capital position of the bank during a period of extraordinary economic stress. This puts the banking system at greater risk. For this reason, I will vote against this Final Rule.

¹See, for example, the FDIC’s capital regulations for state-chartered nonmember banks at 12 CFR Part 324.

²Preamble to the Regulatory Capital and Total Loss-Absorbing Capital Rule: Eligible Retained Income at 9.

³Id. at 16.