Supervision News Flash

August 11, 2016

Focus on SR 09-4 and Capital Distributions

Over the past year, we've seen a number of bank holding companies in our Fifth District and across the country increase capital distributions, including common stock repurchase programs. These programs were popular in the early 2000s, but most were suspended following the great recession.

Now as capital levels grow and earnings continue to improve, the popularity of these programs is increasing as bank boards seek the best ways to reward their shareholders. To help you through your planning, we want to remind you about SR Letter 09-4: ***Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions and Stock Repurchases at Bank Holding Companies*** (also now applicable to savings and loan holding companies).

SR Letter 09-4 was released during the peak of the financial crisis and was especially relevant for bank holding companies experiencing financial difficulties or those receiving funds through government programs such as Treasury's TARP Capital Purchase Program.

Seven years later, the principles of SR 09-4 are still applicable to all BHCs and SLHCs, and we want to remind leaders that you should inform and consult with your Richmond Fed contact if your firm is contemplating activities such as common stock repurchase programs or increasing dividend levels that would result in a net reduction in capital over a quarterly period. This means that if dividends are anticipated to exceed a company's earnings over a quarterly or four-quarter period, or redemptions would result in a net reduction in common stock outstanding from the beginning of the quarter, you should notify and consult with your Richmond Fed supervision contact.

If you plan to retire qualifying tier 1 capital instruments, plan for extra scrutiny to ensure your institution remains financially sound after the redemption. In light of this, we require a review before the redemption of trust preferred securities and preferred shares initially issued by Treasury's CPP.

Regulation Q

Likewise, under the Board of Governors' Regulation Q, prior approval is required for the redemption of an "additional tier 1 capital" instrument such as noncumulative perpetual preferred stock and tier 2 instruments such as qualifying subordinated debt. As a general rule it's sound practice to consult with your reserve bank to ensure that there are no issues with your request. In addition to consulting with us on these redemptions, we'd also like to highlight that you should incorporate capital distribution activities into your capital planning process.

We carefully consider all BHC and SLHC capital notifications and prior approval requests. In analyzing a capital distribution request, we'll work closely with your insured depository institution regulator and consider the overall safety and soundness of your firm, including ratings and financial trends. In order to provide you with timely feedback on your transaction, we encourage you to notify us at least 30 days in advance so that we can review the transaction with you.

If you have any questions on SR Letter 09-4 or the Board's Regulation Q, don't hesitate to reach out to your Richmond Fed relationship team.

Assessment Area Delineations Critical

How a bank delineates its assessment areas is a critical component for CRA performance analysis and fair lending reviews. Many years ago, simply drawing a radius around each branch was sufficient. Now when delineating assessment areas, banks must define areas that:

- Consist of one or more Metropolitan Statistical Areas or metropolitan divisions or one or more contiguous political subdivisions, such as counties, cities, or towns
- Include the geographies in which the bank has its main office, its branches, and its deposit-taking ATMs, as well as the surrounding geographies in which the bank has originated or purchased a substantial portion of its loans.

Simple right? Not so much.

Periodically review assessment areas

Given these complexities, you should periodically review assessment area delineations. For banks that haven't reviewed them in a while, you should revisit them, especially if they contain partial MSA or partial political subdivisions. Due to population growth, economic development, changing demographic characteristics as well as enhanced delivery methods of bank products and services, previously defined assessment areas may no longer represent the areas being served.

Additionally bank mergers, branch expansions and closures, and periodic changes to metropolitan areas — found in Office of Management and Budget Bulletins — can create other factors that can dramatically affect assessment areas.

More public scrutiny

Assessment areas may not arbitrarily exclude low- or moderate-income census tracts or reflect illegal discrimination by excluding higher minority census tracts. While regulators will consider assessment areas for both the CRA and fair lending analyses, note that community groups can perform their own analysis, since much of the same information regulators rely on is also available to the public. **We're more frequently seeing community groups filing CRA protests** with allegations of redlining and discrimination as well as assertions of weak lending performance with respect to low- or moderate-income census tracts.

DOJ reviews

More importantly, the U.S. Department of Justice periodically runs data reports and can launch its own investigation unrelated to your primary regulator's mandated examinations. The DOJ also considers assessment-area delineations in its fair lending reviews for redlining and has required institutions to expand assessment areas to include majority-minority areas as a part of settlement agreements.

The takeaways:

- **Set aside time to review your assessment areas every year** from both a CRA and a fair lending perspective
- Have a **well-developed and documented approach** to how your assessment areas are determined
- If an assessment area only includes a few counties within an MSA or a partial county, make sure you **understand the demographics and lending activity within the areas that are excluded** and can justify why those areas can't be served.

For additional information on assessment areas, please reference this 2014 Consumer Compliance Outlook article. If you have additional questions please reach out to Rob Courter, a Consumer Affairs managing examiner, or your Richmond Fed contact for consumer issues.

CECL – Final Rule Issued

In mid-June, the Financial Accounting Standards Board issued the highly anticipated final rule on the Current Expected Credit Loss standard. The next day, the Federal Reserve Board issued

SR 16-12, *Interagency Guidance on the New Accounting Standard on Financial Instruments – Credit Losses*.

The standard and guidance apply to regulated institutions regardless of size and complexity. The interagency guidance covers a summary of the new accounting standard and initial supervisory views.

Also as part of the initial supervisory view, the agencies committed to a supervisory approach where smaller and less complex institutions will be able to adjust their existing allowance methods to meet the requirements of the new accounting standard without the use of costly and complex models.

The final rule closely aligns to the proposal referenced in our November 2015 Supervision News Flash, and our Ask the Fed Session last October, with the exception of the implementation dates, which were pushed back another year. There will be additional supervisory guidance and industry outreach well in advance of the early adoption date of 2019, including another Ask the Fed session later this summer. In the meantime, if you have any questions, please reach out to your institution's relationship team for more information.

Upcoming Banking Events at the Richmond Fed

Community Banking Technology Forum

September 12th

If you're responsible for IT at your institution, you'll want to attend this forum. Open to all banks and holding companies in the Fifth District, this IT forum will cover such topics as risks and rewards of cloud computing, disaster recovery planning, payment systems and cybersecurity — including updates from Secret Service and FBI experts. Didn't get an invite? Email CBTech@rich.frb.org for more information.

Community Bankers Forum

November 14-15th

This forum brings together community bank leaders representing every state in our District to hear a variety of risk-focused topics and emerging issues as well as to share insights with Fed experts and one another. Contact Sean.OHara@rich.frb.org for more information.

Recap of Recent Supervision and Regulation Guidance

Supervision and Regulation Letters, commonly known as SR Letters, address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. Consumer Affairs letters address significant policy and procedural matters related to the Federal Reserve System's

consumer compliance supervisory responsibilities. Active SR and CA letters are listed in reverse chronological order. Here are recently issued guidance letters:

SR 16-13
Imposition of Special Measures by the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN)

SR 16-12
Interagency Guidance on the New Accounting Standard on Financial Instruments – Credit Losses

SR 16-11
Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion

SR 16-10
FFIEC Information Technology Examination Handbook – Retail Payment Systems Booklet

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CA 16-5
Final Interagency Questions and Answers Regarding Community Reinvestment

CA 16-4
Repeal of Regulation AA and Publication of Revised Examination Procedures for Section 5 of the Federal Trade Commission (FTC) Act

CA 16-3
Revised Interagency Examination Procedures for Regulation P

CA 16-2
Interagency Guidance Regarding Deposit Reconciliation Practices

CA 16-1
Revised Interagency Examination Procedures for the Flood Disaster Protection Act

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Monetary Policy Update

• The Federal Open Market Committee voted 9–1 to maintain its target range for the federal funds rate at 0.25 to 0.50 percent during its two-day July meeting. The Committee had set the current target range during its December 2015 meeting.

• Fed policymakers stated that “near-term risks to the economic outlook have diminished,” and noted “strong” job gains in June compared to a month earlier.

• The inflation rate, however, continues to run below the Fed's 2 percent longer-run policy objective. The Committee noted this partly reflects earlier declines in energy prices and prices of non-energy imports.

• The next FOMC meeting is scheduled for September 20–21, and includes Chair Yellen's press conference and the quarterly release of the Committee members' economic projections.

Source: FOMC Statement July 27

The FOMC holds eight regularly scheduled meetings each year.

Regional Economy

• Business conditions improved for manufacturing and service sector firms in the Fifth District, according to our July surveys; the composite diffusion index for manufacturers rose from -10 in June to 10 in July while the revenues index for the overall service sector improved from a reading of 2 to 8 in the month.

• Total employment in the Fifth District grew 0.2 percent in June as employers added 31,700 jobs on net. North Carolina added the most jobs in June (19,400 jobs or 0.5 percent) followed by Maryland, where employers added 9,800 jobs (0.4 percent) in the month. Employment also expanded in Virginia and South Carolina in June but contracted in Washington, D.C., and West Virginia.

• On a year-over-year basis, payroll employment in the Fifth District grew 2.0 percent. Every jurisdiction in the District except West Virginia reported job growth since June 2015, with the largest growth of 2.6 percent coming out of South Carolina, followed by Maryland with 2.2 percent growth.

• The Fifth District unemployment rate fell 0.2 percentage point in June to 4.6 percent. Unemployment rates declined in every District jurisdiction except Virginia, where the rate was unchanged but remained the lowest in the Fifth District at 3.7 percent.

• Since May 2015, home prices in the Fifth District grew 4.0 percent, with a range of 1.5 percent in Maryland to 7.2 percent in South Carolina.

Sources: Snapshot, Regional Economy, Bureau of Labor Statistics, CoreLogic

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For more information on Supervision News Flash subscribe here, or contact Hamilton Holloway. The Supervision News Flash is an occasional publication of the Richmond Fed that provides information on topics and trends affecting financial institutions as well as Supervision, Regulation and Credit throughout the Fifth Federal Reserve District.