FEDERAL RESERVE BANK *of* KANSAS CITY

September 30, 2010

To: Tenth Federal Reserve District Members of Congress

Re: TARP recipients and dividend payments

On September 14, *The Washington Post* published an article referring to small banks as "deadbeats" for deferring the payment of dividends on TARP preferred stock. While this characterization is inaccurate from any source, it is extremely frustrating when it comes in the paper of record for our nation's capital. The article shows an unfortunate lack of understanding of the TARP and how it has been implemented within the banking industry broadly. Given the paper's readership, I wanted to provide a more complete picture of the TARP dividend payments to members of Congress served by the Federal Reserve Bank of Kansas City.

The depth of the economic problems that our nation faced challenged the entire banking industry. Large and small banks both made serious errors during the buildup to this most recent crisis. Banks from both groups also received TARP funds. To suggest that banks in one group are "deadbeats," simply choosing to dismiss their financial responsibilities, while ignoring the concessions allowed for some larger banks is to grossly misrepresent the realities involved in restoring the financial industry.

The banking industry is recovering from a major financial crisis, and the process of rebuilding financial health will be a lengthy one for many large and small banks. In such times, the most prudent course of action for banks is to acknowledge their losses, conserve capital for future losses, and acquire additional capital if necessary. In fact, banks in troubled condition are subject to supervisory actions that expressly limit dividend payments at the direction of bank regulators. Long-standing regulatory policy discourages the payment of dividends during those times when capital needs to be conserved; the health of the institution must come before the wealth of the stockholders.

The Federal Reserve issued updated guidance to bank holding companies in March 2009, reiterating the importance of banking organizations conserving their capital especially when experiencing financial difficulties and/or receiving public funds. In the supporting FAQs, this supervisory guidance specifically addressed under what conditions it would be appropriate for a TARP recipient – large or small – to defer payment of dividends:

> *"A board of directors' decision to defer a dividend on a government investment – as with all other instruments in the capital structure – should be based primarily on the extent to which deferral is necessary for the bank holding company to preserve capital to continue operating in a safe and sound manner and serving as a source of strength to its depository institution subsidiaries."*

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To encourage banks to do otherwise helps neither the banks nor the taxpayers in the long run. The TARP program was initially designed for the largest banks, which received most of the TARP funding. Large banks had many advantages over small banks in repaying these funds, including their "too big to fail" guarantees. Smaller banks fail when they are deemed insolvent. "Too big to fail" also has given the largest banks better access to capital markets. Smaller banks typically are more closely held or thinly traded, and have more limited access to capital especially as their condition weakens. The real estate problems challenging many smaller banks are long-term problems, and their extended recovery is at odds with the TARP incentives for rapid repayment.

So while the only option for some smaller TARP recipients to conserve capital may have been to temporarily defer dividends, some of the largest TARP recipients were able to renegotiate the terms of their TARP funding to eliminate or reduce the dividend obligation. Last year, Citigroup eliminated the dividend obligation on its TARP preferred stock when the government agreed to convert its holdings to common stock. According to recent articles in *The Wall Street Journal*, similar options may be under consideration for Ally Financial and AIG. These actions may be appropriate policy to support financial recovery, but the financial implications may be far more significant than the dividend deferrals criticized by *The Washington Post*. It is worth noting that the government funding provided to Citigroup alone was more than three times the total TARP funding provided to banks with assets below $10 billion.

It remains to be seen whether the application of TARP funds to small banks proves to have been beneficial to the recovery of the banking industry. However, to suggest that banks deferring their TARP dividends are doing so inappropriately is to misrepresent an entire portion of the industry and further distort the reputation of small banks that largely remain a key economic strength in communities across the country.

Although it isn't possible to control how the media presents or misrepresents information, I thought it important to bring this issue to your attention. As always, I am available to answer any questions that you or your staff may have about this or any other issue relating to the health of our financial system and economy.

Sincerely,

Thomas M. Hoenig

Thomas M. Hoenig
President

c: Tenth District Directors
Tenth District Banking Associations and Commissioners