DATE: June 13, 2008

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

SUBJECT: Final Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework

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Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation approve the attached final guidance regarding the Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework (hereafter, Pillar 2 guidance). If approved, the final Pillar 2 guidance would be issued on an interagency basis in the *Federal Register* by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (together, the Agencies).

The final Pillar 2 guidance is broadly consistent with the supervisory review process (Pillar 2) outlined in the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (Basel II Accord) issued in June 2006. This guidance supplements the final rule published jointly by the Agencies in the *Federal Register* on December 7, 2007, that allowed for the U.S. implementation of the advanced approaches of the Basel II Accord (advanced approaches rule).

The process of supervisory review in the advanced approaches rule focuses on three areas: comprehensive supervisory review of capital adequacy; compliance with regulatory capital requirements; and the internal capital adequacy assessment process (ICAAP). ICAAP means a bank's own process for determining whether capital is adequate. The fundamental objectives of an ICAAP are: identifying and measuring material risks; setting and assessing internal capital adequacy goals that relate directly to risk; and, ensuring the integrity of internal capital adequacy assessments. Capital must meet or exceed regulatory minimum requirements, regardless of ICAAP results.

The Pillar 2 guidance does not supersede or alter the functioning of the existing Prompt Corrective Action requirements. Similarly, the Pillar 2 guidance does not affect any other requirements for compliance with existing regulations and supervisory standards related to risk management practices, or other areas. The supervisory review process provided in the Pillar 2 guidance supports the supervisors' existing ability to intervene when necessary to prevent an individual bank's capital from falling below the level needed to support all material risks to which the bank is exposed.

Recommendation: That the Board approve publication of the final Supervisory Guidance on Pillar 2 regarding the Supervisory Review Process (Pillar 2).

Concur:

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Sara A. Kelsey
General Counsel

Introduction

The FDIC Board of Directors is being asked to approve the attached final guidance regarding the Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework published jointly by the Agencies in the *Federal Register* on December 7, 2007 (hereafter, Pillar 2 guidance). This final Pillar 2 guidance is broadly consistent with the Pillar 2 requirements outlined in the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version* (Basel II Accord) issued in June 2006. While this guidance reflects a continuation of the longstanding approach employed by the Agencies in the supervision of banks, it provides the augmentation and clarification necessary to support the implementation of the advanced approaches rule. As such, a bank that is subject to the advanced approaches rule would be subject to this Pillar 2 guidance.

With respect to capital adequacy, the Pillar 2 guidance states that:

- Banking supervisors must ensure that a bank's overall capital does not fall below the level required to support its entire risk profile; and
- A bank's capital should exceed the level required by its minimum risk-based capital requirements, and also should be adequate according to its own ICAAP.

Overview

On February 28, 2007, the Agencies published their proposed Pillar 2 guidance in the *Federal Register* with a public comment of 90 days. The Agencies have reviewed comments received and have further enhanced aspects of the proposed guidance in order to better address the market turbulence of recent months.

The Agencies received approximately 10 comments on the proposed Pillar 2 guidance, submitted by or on behalf of certain banking organizations, trade associations representing the banking or financial services industry, and other interested parties. Generally, most commenters supported the principles-based approach of the proposed guidance, noting that it provides sufficient

flexibility for compliance with Pillar 2. However, a few commenters indicated that certain aspects of the proposed guidance were overly prescriptive, particularly with respect to (i) assessing overall capital adequacy (that is, whether a bank should maintain capital in excess of the amount required under Pillar 1); (ii) including liquidity risk in the overall capital adequacy assessment; and (iii) conducting stress tests under both Pillar 1 and Pillar 2. Other commenters indicated that some elements of the proposed guidance present implementation problems or raise concerns that need additional clarification.

In response to the comments, the Agencies revised the Pillar 2 guidance to explicitly state that banks should better assess the capital implications arising from both on- and off-balance sheet positions, including contractual requirements to provide explicit support and the possibility that a bank might extend implicit support even if the bank is not contractually obligated to do so. A bank also must consider the linkage between capital adequacy and reputational risk and the capital implications of damage or potential damage to its reputation. The final Pillar 2 guidance discusses how liquidity risk should be incorporated into a bank's assessment of capital adequacy; directs a bank to incorporate various types of bank-specific and market-wide liquidity environments in its assessments; and requires a bank to evaluate the potential for a material disruption in the liquidity as a result of bank-specific and systemic events.

Supervisory Review Process

The goal of the supervisory review process is to make sure that a bank's overall capital remains adequate on an ongoing basis, as underlying conditions change, by:

- Confirming a bank's compliance with regulatory capital requirements;
- Addressing the limitations of regulatory capital requirements as a measure of a bank's full risk profile, including risks not covered or not adequately quantified in Pillar 1;
- Encouraging a bank to develop and use better techniques to identify and measure risk; and
- Ensuring that a bank is able to assess its own ICAAP, beyond regulatory capital requirements, based on its risk profile and business model.

In assessing compliance with regulatory capital requirements supervisors will ensure that each bank using the advanced approaches rule complies with the qualification requirements both at the consolidated level and at any subsidiary bank also using the advanced approaches rule.

In determining the extent to which a bank should hold capital in excess of regulatory minimums, supervisors will consider: the combined implications of a bank's compliance with qualification requirements for regulatory capital standards; the quality and results of a bank's own process (ICAAP) for determining whether capital is adequate; and the bank's risk management processes, control structure, and other relevant information relating to the bank's risk profile and capital level. This review is consistent with current supervisory practice, under which the Agencies assess a bank's overall capital adequacy through a comprehensive evaluation of all relevant information.

As a result of its comprehensive supervisory review, a bank's primary Federal supervisor may take action if it is not satisfied that capital is adequate. The primary Federal supervisor may require the bank to take actions designed to address supervisory concerns, which may include requiring the bank to hold additional capital to bring capital to levels that the supervisor deems commensurate with the bank's risk profile. In addition, the primary Federal supervisor may, under its enforcement authority, require a bank to modify or enhance risk-management and internal-control processes, reduce its exposure to risk, or take any action necessary to address identified supervisory concerns.

ICAAP

The qualification requirements in the advanced approaches rule state that "a bank must have a rigorous process for assessing its overall capital adequacy in relation to its risk profile and comprehensive strategy for maintaining an appropriate level of capital." ICAAP, which is a component of Pillar 2, is a bank's own process for determining whether capital is adequate.

The fundamental objectives of a sound ICAAP are:

- Identifying and measuring material risks;

- Setting and assessing internal capital adequacy goals that relate directly to risk; and
- Ensuring the integrity of internal capital adequacy assessments.

Identifying and measuring material risks

The design and operation of a bank's ICAAP should reflect the complexity of the bank's operations and risk profile. Assessing overall capital adequacy through the ICAAP requires a bank to thoroughly identify all material risks across the entire bank, measure the risks that can be reliably quantified, and assess the limitations of the minimum risk-based capital requirements. The ICAAP should address the capital implications arising from both on- and off-balance sheet positions, as well as from provisions of explicit or implicit support. Material risks can include those that in isolation do not appear to be material, but when combined with other risks can lead to material losses.

Some of the risks to which a bank is exposed include credit risk, market risk, operational risk, interest rate risk in the banking book, and liquidity risk. However, other risks, such as reputational risk, business risk or strategic risk, and country risk may be equally important and, in such cases, should be given equal consideration to the more formally defined risk types. Additionally, if a bank employs risk mitigation techniques, it should understand the risk to be mitigated and the potential effects of that mitigation (including its enforceability and effectiveness).

A bank should assess whether its capital is sufficient to absorb any losses that may arise from activities that expose the bank to multiple risks within and across business lines or create concentrations across risk types. The ICAAP should take into consideration the linkage between capital adequacy and damage or potential damage to a bank's reputation. A bank might incur losses affecting capital adequacy because of damage to its reputation, or the bank might incur losses trying to prevent or mitigate damage to its reputation. In assessing the linkage between reputational risk and capital adequacy, a bank should assess risks associated with both on-balance sheet and off-balance sheet exposures and activities, as well as risks associated with affiliates, subsidiaries, counterparties, clients or other third parties.

All measurements of risk incorporate both quantitative and qualitative elements. The Pillar 2 guidance emphasizes the need to use stress testing, particularly in the absence of reliable data, and the need for an ICAAP to reflect an appropriate level of conservatism to account for uncertainty in risk identification, risk mitigation or control and risk quantification. Moreover, the Pillar 2 guidance states that a bank should generally hold higher levels of capital to account for uncertainty in its risk aggregation and diversification estimates.

Setting and assessing internal capital adequacy goals that relate directly to risks (Capital Planning)

A bank needs to have an effective capital plan that recognizes short- and long-term capital needs and objectives. Through the ICAAP, a bank should ensure that adequate capital is held against all material risks, and that it remains adequate not just at a point in time, but over time, to account for changes in a bank's strategic direction, evolving economic conditions, and volatility in the financial environment. Recognizing the sensitivity of capital to economic and financial cycles should be a critical component of a bank's planning for current and future capital needs. Different components of capital differ in their ability to absorb losses. In analyzing capital adequacy, a bank should evaluate the capacity of its capital to absorb losses. Since a bank may use its own definition of capital for purposes of calculating its economic capital and ICAAP, each bank should state clearly the definition of capital used in any aspect of the ICAAP. If a bank's definition of capital differs from the regulatory definition, the bank should reconcile the differences and provide an analysis to support including any capital instruments that are not recognized under the regulatory definition of capital.

The level of capital deemed adequate by a bank based on its ICAAP might also be influenced by the bank's intention to hold additional capital to mitigate the impact of volatility in capital requirements, the need to support acquisition plans, or the decision to accommodate market perceptions of capital adequacy and their impact on funding costs.

Ensuring the integrity of internal capital adequacy assessments (Governance)

A bank's ICAAP should incorporate a governance process to ensure the integrity of the internal capital adequacy assessment. A satisfactory ICAAP should ensure proper oversight and controls (including internal audit and validation), clear responsibilities, periodic review, and appropriate response to any deficiencies or inconsistencies. Decisions regarding the design and operation of the ICAAP should reflect sound risk management, and should not be unduly influenced by competing business objectives. A bank's ICAAP should be consistent with the bank's internal governance structure and overall risk-management processes. ICAAP should not be viewed as simply a compliance exercise. Rather, ICAAP is a dynamic and evolving process used by a bank to provide internal assurance that risks are well understood and capital is adequate for its risk profile.