

**Supporting Statement for the
Basel II Interagency Pillar 2 Supervisory Guidance
(FR 4199; OMB No. 7100-0320)**

Summary

The Board of Governors of the Federal Reserve System (Board), under delegated authority from the Office of Management and Budget (OMB), proposes to extend for three years, without revision, the Basel II Interagency Pillar 2 Supervisory Guidance (Pillar 2 Guidance) (FR 4199; OMB No. 7100-0320). The Pillar 2 Guidance is intended to assist banking organizations¹ in implementing the Basel II advanced approaches capital adequacy framework (advanced approaches framework).² Paragraphs 37, 41, 43, and 46 of the Pillar 2 Guidance contain, however, information collection requirements for state member banks and bank holding companies (BHCs) that are beyond the scope of the burden estimates developed for the rule, and as such require authorization under the Paperwork Reduction Act.³ The estimated total annual burden for the FR 4199 is 5,460 hours. The burden associated with the guidance is recordkeeping. No required reporting forms are associated with this information collection.

Background and Justification

Section 1831o of the Federal Deposit Insurance Act (FDI Act) requires each Federal banking agency to adopt a risk-based capital requirement based on the prompt corrective action framework in that section. The Bank Holding Company Act and the Homeowners' Loan Act (HOLA) authorizes the Board to issue such regulations and orders, including regulations and orders relating to the capital requirements for BHCs and SLHCs, as may be necessary to enable it to administer and carry out the purposes of the BHC Act and HOLA and prevent evasions thereof.⁴ The International Lending Supervision Act (ILSA) (12 U.S.C. 3907(a)(1)) mandates that each Federal banking agency require banking institutions (generally, commercial banks and their subsidiaries) to achieve and maintain adequate capital by establishing minimum levels of capital or by other methods that the appropriate Federal banking agency may deem appropriate. Section 908 of the ILSA (12 U.S.C. 3907(b)(3)(C)) also directs the Chairman of the Federal Reserve and the Secretary of the Treasury to encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.

¹ Banking organizations include bank holding companies, savings and loan holding companies, and state member banks.

² 78 FR 62018 (October 11, 2013).

³ See 44 U.S.C. 3501 et seq.

⁴ 12 U.S.C. 1844(b); 12 U.S.C. 1467a(g).

On December 7, 2007, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS),⁵ the Board, and the Federal Deposit Insurance Corporation (FDIC) (the agencies) published a final rule to revise the risk-based capital requirements in the United States for large, internationally active banking organizations.⁶ The 2007 final rule set forth a three-pillar framework encompassing regulatory risk-based capital requirements (Pillar 1); supervisory review of capital adequacy (Pillar 2)⁷; and market discipline through enhanced public disclosures (Pillar 3).

The agencies have since substantially amended the 2007 final rule twice. In July 2011, the agencies adopted a final rule that establishes a floor for the risk-based capital requirements applicable to the largest, internationally active banking organizations implementing the advanced approaches framework.⁸ A banking organization operating under the agencies' advanced approaches framework must meet the higher of the minimum requirements under the general risk-based capital rules and the minimum requirements under the advanced approaches framework. In July 2013, the agencies adopted the revised regulatory capital rules, which require banking organizations operating under the advanced-approaches framework to hold more appropriate levels of capital for credit risk and to strengthen the risk-based capital requirements for certain securitization exposures.⁹ The 2013 revisions to the rule did not alter the original Pillar 2 requirements.

The Pillar 2 Guidance supplements the rule. The Pillar 2 Guidance provides additional detail to help banking organizations satisfy certain qualification requirements and provides standards to promote safety and soundness and encourage comparability across banking organizations. A banking organization's primary federal supervisor will review the banking organization's balance sheet relative to the qualification requirements to determine whether the banking organization may apply the advanced approaches framework and has complied the regulatory capital requirements.

⁵ On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) became law. As part of the comprehensive package of financial regulatory reform measures enacted, Title III of the Dodd-Frank Act transfers the powers, authorities, rights and duties of the OTS to other banking agencies, including the OCC, on the "transfer date." The transfer date is one year after the date of enactment of the Dodd-Frank Act, July 21, 2011. The Dodd-Frank Act also abolished the OTS ninety days after the transfer date. As a result of the Dodd-Frank Act, OTS transferred this information collection to the OCC.

⁶ 72 FR 69288 (December 7, 2007).

⁷ The process of supervisory review described in this document reflects a continuation of the longstanding approach employed by the agencies in their supervision of banking organizations. For example, the Federal Reserve introduced in 1999 expectations for certain large, complex banking organizations to develop internal processes for assessing capital adequacy, beyond minimum regulatory capital requirements. See Federal Reserve Supervision and Regulation Letter "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," July 1999.

⁸ 76 FR 37620 (June 28, 2011).

⁹ 78 FR 62018 (October 11, 2013). Minor edits and clarifications were also made to this rule in 2015. 80 FR 41409 (July 15, 2015).

Description of Information Collection

The advanced approaches framework requires certain banks and BHCs to use an internal ratings-based approach to calculate regulatory credit risk capital requirements and advance measurement approaches to calculate regulatory operational risk capital requirements.

A bank is required to comply with the advanced approaches framework if it meets either of two independent threshold criteria: (1) consolidated total assets of \$250 billion or more, as reported on the most recent year-end regulatory reports or (2) consolidated total on-balance sheet foreign exposure of \$10 billion or more at the most recent year-end.

A BHC is required to comply with the advanced approaches framework if the BHC has (1) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of \$250 billion or more, as reported on the most recent year-end regulatory reports, (2) consolidated total on-balance sheet foreign exposure of \$10 billion or more at the most recent year-end, or (3) a subsidiary depository institution (DI) that meets the criteria to be subject to the advanced approaches rule, or elects to adopt the advanced approaches. As of year-end 2017, 13 BHCs meet the above criteria and are therefore subject to the advanced approaches rule.¹⁰

Also, some banks or BHCs may voluntarily decide to adopt the advanced approaches framework. Both mandatory and voluntary respondents are required to meet certain qualification requirements before they can use the advanced approaches framework for risk-based capital purposes. The Pillar 2 Guidance sets the expectation that respondents maintain certain documentation as described in paragraphs 37, 41, 43, and 46 of this portion of the guidance. Details of the expectations for each section are provided below.

Setting and Assessing Capital Adequacy Goals that Relate to Risk

Paragraph 37. In analyzing capital adequacy, a banking organization should evaluate the capacity of its capital to absorb losses. Because various definitions of capital are used within the banking industry, each banking organization should state clearly the definition of capital used in any aspect of its internal capital adequacy assessment process (ICAAP).¹¹ Since components of capital are not necessarily alike and have varying capacities to absorb losses, a banking

¹⁰ Regulation YY permits a bank holding company that is a subsidiary of a foreign banking institution to elect not to comply with the advanced approaches rule prior to formation of an intermediate holding company (IHC) with the prior approval of the Board. 12 C.F.R. 252.153(e)(2)(C). Currently, no SLHCs are subject to the advanced approaches rule.

¹¹ Under the Board's capital plan rule (12 CFR 225.8), a bank holding company with total consolidated assets of \$50 billion or more is required to develop and maintain a capital plan; however, on July 6, 2018, the Board issued a public statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) (Pub L. No. 115-174, 132 Stat. 1296 (2018)). The Board stated, consistent with EGRRCPA, that it will not action to require bank holding companies with total consolidated assets greater than or equal to \$50 billion but less than \$100 billion to comply with the Board's capital plan rule (<https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf>).

Bank holding companies subject to the capital plan rule must have a capital policy that sets forth a capital adequacy process. ICAAP would constitute an internal capital adequacy process for purposes of the capital plan rule, and bank holding companies that have a satisfactory ICAAP generally would be considered to have a satisfactory internal capital adequacy process for purposes of the capital plan rule.

organization should be able to demonstrate the relationship between its internal capital definition and its assessment of capital adequacy. If a banking organization's definition of capital differs from the regulatory definition, the banking organization should reconcile such differences and provide an analysis to support the inclusion of any capital instruments that are not recognized under the regulatory definition. Although common equity is generally the predominant component of a banking organization's capital structure, a banking organization may be able to support the inclusion of other capital instruments in its internal definition of capital if it can demonstrate a similar capacity to absorb losses. The banking organization should document any changes in its internal definition of capital, and the reason for those changes.

Ensuring Integrity of Internal Capital Adequacy Assessments

Paragraph 41. A banking organization should maintain thorough documentation of its ICAAP to ensure transparency. At a minimum, this should include a description of the banking organization's overall capital-management process, including the committees and individuals responsible for the ICAAP; the frequency and distribution of ICAAP-related reporting; and the procedures for the periodic evaluation of the appropriateness and adequacy of the ICAAP. In addition, where applicable, ICAAP documentation should demonstrate the banking organization's sound use of quantitative methods (including model selection and limitations) and data-selection techniques, as well as appropriate maintenance, controls, and validation. A banking organization should document and explain the role of third-party and vendor products, services and information - including methodologies, model inputs, systems, data, and ratings - and the extent to which they are used within the ICAAP. A banking organization should have a process to regularly evaluate the performance of third-party and vendor products, services and information. As part of the ICAAP documentation, a banking organization should document the assumptions, methods, data, information, and judgment used in its quantitative and qualitative approaches.

Paragraph 43. The board of directors and senior management have certain responsibilities in developing, implementing, and overseeing the ICAAP. The board should approve the ICAAP and its components. The board or its appropriately delegated agent should review the ICAAP and its components on a regular basis, and approve any revisions. That review should encompass the effectiveness of the ICAAP, the appropriateness of risk tolerance levels and capital planning, and the strength of control infrastructures. Senior management should continually ensure that the ICAAP is functioning effectively and as intended, under a formal review policy that is explicit and well documented. Additionally, a banking organization's internal audit function should play a key role in reviewing the controls and governance surrounding the ICAAP on an ongoing basis.

Paragraph 46. As part of the ICAAP, the board or its delegated agent, as well as appropriate senior management, should periodically review the resulting assessment of overall capital adequacy. This review, which should occur at least annually, should include an analysis of how measures of internal capital adequacy compare with other capital measures (such as regulatory, accounting-based or market-determined). Upon completion of this review, the board or its delegated agent should determine that, consistent with safety and soundness, the banking organization's capital takes into account all material risks and is appropriate for its risk profile.

However, in the event a capital deficiency is uncovered (that is, if capital is not consistent with the banking organization's risk profile or risk tolerance) management should consult and adhere to formal procedures to correct the capital deficiency.

Time Schedule for Information Collection

Because the documentation set forth in the guidance is a recordkeeping requirement, copies of the documentation are not collected by the Federal Reserve System and are not published. These recordkeeping requirements are documented on occasion. Bank examiners would verify compliance with this recordkeeping requirement during examinations of state member banks and BHCs.

Legal Status

The collection of information is authorized pursuant to the International Lending Supervision Act (12 U.S.C. 3907(a)(1) and (b)(3)), section 1831o of the Federal Deposit Insurance Act (12 U.S.C. 1831o), section 5 of the Bank Holding Company Act of 1956 (12 U.S.C. 1844), section 10(b)(2) of the Homeowners' Loan Act (12 U.S.C. 1467a(b)), and section 171 of the Dodd-Frank Act (12 U.S.C. 5371). The FR 4199 is voluntary.

Because the collections of information associated with the FR 4199 do not involve the submission of information to the Board, no issues of confidentiality would normally arise. To the extent that the Board collects information kept by a banking organization as a record during an examination of the banking organization, confidential treatment may be afforded to the records under exemption 8 of the Freedom of Information Act (FOIA) (5 U.S.C. 552(b)(8)), which protects information collected as part of the Board's supervisory process. Additionally, individual respondents may request that certain information be afforded confidential treatment pursuant to exemption 4 of FOIA (5 U.S.C. 552(b)(4)) if the information has not previously been publically disclosed and the release of the data would likely cause substantial harm to the competitive position of the respondent.

Public Comments and Response

Each agency may update their respective respondent counts if needed. On October 22, 2018, the Board published an initial notice in the *Federal Register* (83 FR 53248) requesting public comment for 60 days on the extension, without revision, of the FR 4199. The comment period for this notice expired on December 21, 2018. The Board received no comments. On February 4, 2019, the Board published a final notice in the *Federal Register* (84 FR 1465).

Consultation Outside the Board

There has been no consultation outside the Board.

Estimate of Respondent Burden

The total annual burden for the Pillar 2 portion of the guidance is 5,460 hours, as shown in the table below. The Board estimates that it will take each respondent 420 hours to complete the documentation requirements. These recordkeeping requirements represent less than 1 percent of the total Board paperwork burden.

	<i>Number of respondents</i> ¹²	<i>Annual frequency</i>	<i>Estimated average hours per response</i>	<i>Estimated annual burden hours</i>
FR 4199	13	1	420	5,460

The total cost to the public for this information collection is estimated to be \$306,033.¹³

Sensitive Questions

This collection of information contains no questions of a sensitive nature, as defined by OMB guidelines.

Estimate of Cost to the Federal Reserve System

Since records are maintained at the financial institutions, there is no cost to the Federal Reserve System.

¹² Of these respondents, none are considered small entities as defined by the Small Business Administration (i.e., entities with less than \$550 million in total assets) www.sba.gov/document/support--table-size-standards.

¹³ Total cost to the public was estimated using the following formula: percent of staff time, multiplied by annual burden hours, multiplied by hourly rates (30% Office & Administrative Support at \$18, 45% Financial Managers at \$69, 15% Lawyers at \$68, and 10% Chief Executives at \$94). Hourly rates for each occupational group are the (rounded) mean hourly wages from the Bureau of Labor and Statistics (BLS), *Occupational Employment and Wages May 2017*, published March 30, 2018, www.bls.gov/news.release/ocwage.t01.htm. Occupations are defined using the BLS Occupational Classification System, www.bls.gov/soc/.