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, 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 (FR 4199; OMB No. 7100-0320). The Paperwork Reduction Act (PRA) classifies reporting, recordkeeping, or disclosure requirements of agency guidance as an "information collection."[1] This supervisory guidance assisted financial institutions implementing revisions to the risk-based capital standards in the United States, the Advanced Capital Adequacy Framework - Basel II (framework).[2] In addition, this supervisory guidance provided detail for the supervisory review process that helped banks satisfy the qualification requirements in the final rule. For the Pillar 2 guidance, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS)[3], the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC), (the agencies) determined that paragraphs 37, 41, 43, and 46 contain information collection requirements that were beyond the scope of the burden estimates developed for the final rule. The Pillar 2 guidance contains certain documentation or recordkeeping requirements for state member banks and bank holding companies (BHCs).

The Federal Reserve's total annual burden for this information collection is estimated to be 7,560 hours for the estimated 18 financial institutions that are likely to be subject to the Pillar 2 guidance. The number of respondents includes both institutions for which the Basel II risk-based capital requirements are mandatory and institutions that may be considering opting-in to Basel II. There are no required reporting forms associated with this information collection.

Background and Justification

Section 1831(o) of the Federal Deposit Insurance Act (FDI Act) requires each Federal banking agency to adopt a risk-based capital requirement, which is based on the prompt corrective action framework in that section. The International Lending Supervision Act (ILSA) (12 U.S.C. § 3907(a)(1)) mandates that each Federal banking agency require banks 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

[1] See 44 U.S.C. § 3501 et seq.

[2] These revisions were published in the *Federal Register* on December 7, 2007 (72 FR 69288) as a final rulemaking.

[3] On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). 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 abolishes the OTS ninety days after the transfer date. As a result of the Dodd-Frank Act, OTS transferred this information collection to the OCC.

major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.

General U.S. risk-based capital requirements are based on an internationally agreed upon framework for capital measurement that was developed by the Basel Committee on Banking Supervision (BCBS) and endorsed by the central-bank governors of the Group of 10 (G–10) Countries in 1988. This international framework (1988 Accord) accomplished several important objectives. It strengthened capital levels at large, internationally active banks and fostered international consistency and coordination. The 1988 Accord also reduced disincentives for banks to hold liquid, low-risk assets. Moreover, by requiring banks to hold capital against off-balance-sheet exposures, the 1988 Accord represented a significant step forward for regulatory capital measurement. Although the 1988 Accord was a stabilizing force for the international banking system, the world financial system became increasingly more complex. The BCBS worked for several years to develop a new regulatory capital framework that recognizes new developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses capital charges in relation to risk. On April 29, 2003, the BCBS released for public comment a document entitled The New Basel Capital Accord (Proposed New Accord) that sets forth proposed revisions to the 1988 Accord.

On August 4, 2003, the agencies published an advanced notice of proposed rulemaking (ANPR) in the *Federal Register* to seek public comment on a new risk-based regulatory capital framework.[4] This ANPR was based on the Proposed New Accord. Also, the agencies participated with other members of the BCBS during the development of the New Accord, which was issued in June 2004. The agencies also participated in the BCBS's Fourth Quantitative Impact Study (QIS 4; OMB No. 7100-0303) during the fall and winter of 2004-2005, to better understand the potential impact of the proposed framework on the risk-based capital requirements for banks.

Contemporaneously with the ANPR, the agencies also issued for public comment two proposed supervisory guidance documents relating to the proposed framework.[5] The first proposed 2003 guidance document described supervisory views on the credit risk measurement and management systems that should be implemented by banks that adopt the internal ratings-based (IRB) approach for computing risk-based capital requirements for corporate credit risk exposures. The second proposed 2003 guidance document provided supervisory views on the operational risk measurement and management systems that should be implemented by banks that adopt the advanced measurement approach (AMA) for computing risk-based capital requirements for operational risk, including their operational risk management, data elements, and quantification processes. In October 2004, the agencies also issued for public comment proposed supervisory guidance on IRB systems for retail credit risk exposures.[6]

The agencies issued a notice of proposed rulemaking (NPR) on September 25, 2006,[7] which sought comment on the New Advanced Capital Adequacy Framework that revises the

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[4] See 68 FR 45900 (August 4, 2003).
[5] See 68 FR 45949 (August 4, 2003).
[6] See 69 FR 62748 (October 27, 2004), and 70 FR 423 (January 4, 2005) (correction).
[7] See 71 FR 55830 (September 25, 2006).

existing general risk-based capital standards as applied to large, internationally active U.S. banks.[8] The public comment period on the NPR was extended to March 26, 2007.[9] The framework implements Basel II in the United States. As described in the final rule, Basel II sets forth a three-pillar framework encompassing regulatory risk-based capital requirements (Pillar 1); supervisory review of capital adequacy (Pillar 2)[10]; and market discipline through enhanced public disclosures (Pillar 3). The framework outlined in the final rule for Pillar 1 requires some and permits other qualifying banks to calculate their regulatory risk-based capital requirements using the IRB approach for credit risk and the AMA for operational risk.[11] The final rule also requires a process for the supervisory review of capital adequacy under Pillar 2, and outlines requirements for enhanced public disclosures under Pillar 3. The final rule describes the qualification process and provides qualification requirements for obtaining supervisory approval for use of the advanced approaches.[12] The qualification requirements are written broadly to accommodate the many ways a bank may design and implement robust credit and operational risk measurement and management systems, and to permit industry practice to evolve. On December 7, 2007, the agencies published a final rule for the New Advanced Capital Adequacy Framework.

The Pillar 2 supervisory guidance is companion guidance to the December 2007 final rule and, as such, is designed to be consistent with the rule. It provides additional detail that should help banks satisfy certain qualification requirements in the final rule. The agencies believe that the Pillar 2 supervisory guidance document is necessary to supplement the framework with standards to promote safety and soundness and encourage comparability across banks. A bank's primary Federal supervisor will review the bank's framework relative to the qualification requirements in the final rule to determine whether the bank may apply the advanced approaches and has complied with the rule in determining its regulatory capital requirements.

Description of Information Collection

The final rule sets forth a new risk-based regulatory capital adequacy framework that requires certain large or internationally active 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.

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[8] For simplicity, and unless otherwise noted, the term "banks" is used here to refer to banks, savings associations, and bank holding companies. The terms "bank holding company" and "BHC" refer only to bank holding companies regulated by the Federal Reserve and do not include savings and loan holding companies regulated by the OTS. For a detailed description of the institutions covered by this notice, refer to part I, section 1, of the NPR.

[9] See 71 FR 77518 (December 26, 2006).

[10] 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 institutions. 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.

[11] While Basel II provides several approaches for calculating regulatory risk-based capital requirements under Pillar 1, only the advanced approaches are proposed for implementation in the United States.

[12] See part III, section 22 of the NPR.

A bank is required to comply with the final rule and the guidance 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. To determine total on-balance sheet foreign exposure, a bank sums its adjusted cross-border claims, local country claims, and cross-border revaluation gains (calculated in accordance with the Federal Financial Institutions Examination Council (FFIEC) Country Exposure Report (FFIEC 009)[13]). Adjusted cross-border claims equal total cross-border claims less claims with the head office/guarantor located in another country, plus redistributed guaranteed amounts to the country of head office/guarantor. A bank is required to comply if it is a subsidiary of another financial institution that uses the advanced approaches.

A BHC is required to comply with the final rule and the guidance 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 is a core bank or opt-in bank. Currently 11 top-tier banking organizations meet these criteria. The agencies note that, using this approach to define whether a BHC is a core bank, it is possible that no single DI under a BHC would meet the threshold criteria, but that all of the BHC's subsidiary DIs would be core banks.

Also, some banks or BHCs may voluntarily decide to adopt the framework. Both mandatory and voluntary respondents are required to meet certain qualification requirements before they could use the advanced approaches for risk-based capital purposes.

The Pillar 2 guidance requires respondents to maintain certain documentation as described in paragraphs 37, 41, 43, and 46 of this portion of the guidance. Details of the requirements for each section are provided below.

Setting and Assessing Capital Adequacy Goals that Relate to Risk

Paragraph 37. In analyzing capital adequacy, a bank should evaluate the capacity of its capital to absorb losses. Because various definitions of capital are used within the banking industry, each bank should state clearly the definition of capital used in any aspect of its internal capital adequacy assessment process (ICAAP). Since components of capital are not necessarily alike and have varying capacities to absorb losses, a bank should be able to demonstrate the relationship between its internal capital definition and its assessment of capital adequacy. If a bank's definition of capital differs from the regulatory definition, the bank 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 bank's capital structure, a bank 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 bank should document any changes in its internal definition of capital, and the reason for those changes.

[13] The OMB control numbers for the FFIEC 009 are Federal Reserve (7100-0035), FDIC (3064-0017), and OCC (1557-0100).

Paragraph 41. A bank should maintain thorough documentation of its ICAAP to ensure transparency. At a minimum, this should include a description of the bank'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 bank's sound use of quantitative methods (including model selection and limitations) and data-selection techniques, as well as appropriate maintenance, controls, and validation. A bank 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 bank 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 bank 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 bank'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 bank'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 bank'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 required by 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 Board's Legal Division has determined that section 9(6) of the Federal Reserve Act (12 U.S.C. § 324(B)) and section 5(c) of the Bank Holding Company Act (12 U.S.C. § 1844 (c)(1)(A)) authorize the Federal Reserve to require the FR 4199 with respect to banks or BHCs that are required to comply with the guidance. The FR 4199 recordkeeping requirements are required to obtain the benefit of participating in Basel II with respect to all other banks and BHCs. Because the FR 4199 recordkeeping requirements require that banks and BHCs retain their own records, the Freedom of Information Act (FOIA) would only be implicated if the Federal Reserve's examiners retained a copy of the records as part of an examination or supervision of a bank or BHC. However, records obtained as a part of an examination or supervision of a bank or BHC are exempt from disclosure under FOIA exemption (b)(8), for examination material (5 U.S.C. 552 § (b)(8)). In addition, the records may also be exempt under (b)(4), which exempts from disclosure "trade secrets and commercial or financial information obtained from a person and privileged or confidential," and under (b)(6) for non-public personal information regarding owners, shareholders, directors, officers or employees if the disclosure would "constitute a clearly unwarranted invasion of personal privacy" (5 U.S.C. §§ 552(b)(4) and (b)(6)).

Consultation Outside the Agency

The agencies have agreed that no revisions are necessary for this information collection. On April 21, 2011, the agencies published a notice in the *Federal Register* (76 FR 22450) requesting public comment for 60 days on the extension of the FR 4199. The comment period for this notice expired on June 20, 2011. The agencies did not receive any comments. On August 17, 2011, the agencies published a final notice in the *Federal Register* (76 FR 51123).

Estimate of Respondent Burden

The total annual burden for the Pillar 2 portion of the guidance is 7,560 hours, as shown in the table below. The Federal Reserve estimates that it will take each respondent 420 hours to complete the documentation requirements, which is approximately 50 percent of the hours allocated to documentation for the Pillar 1 requirements in the final rule. These recordkeeping requirements represent less than 1 percent of the total Federal Reserve System paperwork burden.

	Number of respondents[14]	*Estimated annual frequency*	*Estimated average hours per response*	*Estimated annual burden hours*
FR 4199	18	1	420 hours	7,560

[14] Of these respondents, zero are small entities as defined by the Small Business Administration (i.e., entities with less than $175 million in total assets) www.sba.gov/contractingopportunities/officials/size/table/index.html.

The total cost to the public for this information collection is estimated to be $328,104.[15]

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, the cost to the Federal Reserve System is negligible.

[15] Total cost to the public was estimated using the following formula: percent of staff time, multiplied by annual burden hours, multiplied by hourly rate (30% Office & Administrative Support @ $16, 45% Financial Managers @ $50, 15% Legal Counsel @ $54, and 10% Chief Executives @ $80). Hourly rate for each occupational group are the median hourly wages (rounded up) from the Bureau of Labor and Statistics (BLS), *Occupational Employment and Wages 2010*, www.bls.gov/news.release/ocwage.nr0.htm. Occupations are defined using the BLS Occupational Classification System, www.bls.gov/soc/.