

**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 voluntary Basel II Interagency Pillar 2 Supervisory Guidance (Pillar 2 Guidance) (FR 4199; OMB No. 7100-0320). The Pillar 2 Guidance is intended to assist firms in implementing the Basel II advanced approaches capital adequacy framework (advanced approaches framework), as provided in the 2007 final rule,<sup>1</sup> as amended in 2011 and 2013. 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 2007 final rule, and as such require approval under the Paperwork Reduction Act.<sup>2</sup>

The Federal Reserve's total annual burden for this information collection is estimated to be 5,460 hours for the estimated 13 financial institutions that are likely to be subject to the Pillar 2 Guidance. The number of respondents includes both institutions for which the advanced approaches framework requirements are mandatory and institutions that may opt-in to the advanced approaches framework. No required reporting forms are 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 based on the prompt corrective action framework in that section. Section 5(b) of the Bank Holding Company Act (12 U.S.C. § 1844(b)) authorizes the Federal Reserve Board to issue such regulations and orders, including regulations and orders relating to the capital requirements for BHCs, as may be necessary to enable it to administer and carry out the purposes of the FDI Act and prevent evasions thereof. The International Lending Supervision Act (ILSA) (12 U.S.C. § 3907(a)(1)) mandates that each Federal banking agency require banking organizations 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 organizations involved in international lending.

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<sup>1</sup> See 72 FR 69288 (December 7, 2007).

<sup>2</sup> See 44 U.S.C. § 3501 et seq.

On December 7, 2007, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS)<sup>3</sup>, the Federal Reserve, 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.<sup>4</sup> 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)<sup>5</sup>; and market discipline through enhanced public disclosures (Pillar 3).

The agencies have since 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.<sup>6</sup> 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. The revisions to the 2007 final rule do not alter the original Pillar 2 requirements.

The Pillar 2 Guidance supplements the 2007 final rule, as revised in 2011 and 2013. 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.

## **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, and to

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<sup>3</sup> 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.

<sup>4</sup> 72 FR 69288 (December 7, 2007).

<sup>5</sup> 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.

<sup>6</sup> 76 FR 37620 (June 28, 2011).

meet the higher of the minimum requirements under the general risk-based capital rules and the minimum requirements under the advanced approaches framework.

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 September 30, 2014, 13 BHCs meet the above criteria and are therefore subject to the advanced approaches rule.<sup>7</sup>

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).<sup>8</sup> Since components of capital are not necessarily alike and have varying capacities to absorb losses, a banking 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

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<sup>7</sup> Regulation YY permits a bank holding company that is a subsidiary of a foreign banking organization to elect not to comply with the advanced approaches rule prior to formation of an intermediate holding companies (IHC) with the prior approval of the Board. 12 C.F.R. § 252.153(e)(2)(C).

<sup>8</sup> A bank holding company with total consolidated assets of \$50 billion or more is required to develop and maintain a capital plan, which must set forth a capital adequacy process. 76 FR 74631 (December 1, 2011). ICAAP would constitute an internal capital adequacy process for purposes of the final 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 final rule.

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 Board's Legal Division has determined that section 9(6) of the Federal Reserve Act requires state member banks to "comply with the reserve and capital requirements of this chapter" and to make reports of condition "in such form" and "contain[ing] such information" as the Board may require (12 U.S.C. § 324). Section 5 of the Bank Holding Company Act authorizes the Board to "issue regulations and orders relating to the capital requirement for bank holding companies" and requires BHCs to "keep the Board informed as to [their] financial condition, systems for monitoring and controlling financial and operating risks..." (12 U.S.C. § 1844 (b) & (c)). Because the recordkeeping requirements are contained within guidance (and not a statute or regulation), they are voluntary. 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 May 28, 2015, the Federal Reserve published a notice in the *Federal Register* (80 FR 30459) requesting public comment for 60 days on the extension, without revision, of the FR 4199. The comment period for this notice expired on July 27, 2015. The Federal Reserve did not receive any comments. On August 28, 2015, the Federal Reserve published a final notice in the *Federal Register* (80 FR 52279) for the FR 4199.

## **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 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.

	<i>Number of respondents<sup>9</sup></i>	<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 \$282,555.<sup>10</sup>

### **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.

<sup>9</sup> Of these respondents, none are small entities as defined by the Small Business Administration (i.e., entities with \$550 million or less in total assets) [www.sba.gov/content/small-business-size-standards](http://www.sba.gov/content/small-business-size-standards).

<sup>10</sup> 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 \$17, 45% Financial Managers at \$63, 15% Lawyers at \$64, and 10% Chief Executives at \$87). 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 2014*, published March 25, 2015, [www.bls.gov/news.release/ocwage.nr0.htm](http://www.bls.gov/news.release/ocwage.nr0.htm). Occupations are defined using the BLS Occupational Classification System, [www.bls.gov/soc/](http://www.bls.gov/soc/).