

**Capital Management and Future Regulations:
Elements to be Considered by the Financial Supervisor**

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September 26, 2024





The views expressed here are my own and not necessarily those of my colleagues at the Federal Reserve Bank of Cleveland or members of the Federal Reserve staff.



Overview

- The capital planning process implemented in the US is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve's advanced approaches capital guidelines
- Supervisors have many obligations, including development of infrastructure to assess Capital Adequacy Processes (aligned with ICAAP), ensure the appropriateness of outcomes, and enforce the standards applicable to firm's size, risk, and complexity.
- We will walk through key areas of an ICAAP framework and discuss the considerations to have ensure mutually beneficial outcomes for supervisors and firms alike.



Agenda

Presentation will cover key questions and responses supervisors may consider:

- What purpose does ICAAP ultimately serve?
- What are some key aspects for consideration in the evaluation of capital planning processes?
- Risk identification and what is enough?
- What is expected for governance and board oversight?
- What role does independent risk management (including model risk management) play in the process?
- What role should internal audit have?
- What considerations arise at the conclusion of assessing adequacy?

What purpose does ICAAP ultimately serve?

- Assists the board of directors to make informed capital decisions, including setting capital goals, authorizing dividends and other types of capital decisions, and ensuring ongoing capital adequacy
- Helps the firm understand its material risks, exposures and vulnerabilities, including the effectiveness of risk management
- Provides the firm with a forward-looking assessment of risk and the potential impact of stressful events on capital and overall financial condition

Note: Supervisory expectations for capital planning are applied commensurate with a bank's size, complexity, business activities, and risk profile



What are key aspects for the evaluation of capital planning processes?

- A comprehensive capital planning process includes a framework with:
 - Minimum expectations defined as mandatory elements of the capital plan, and
 - A framework for assessment and evaluation of capital planning

Key Aspects: Requirements of a Capital Plan

- For firms subject to the Board's Capital Plan rule, a capital plan is required to be submitted to the Federal Reserve annually
 - A capital plan is "*a written presentation of a company's capital planning strategies and capital adequacy process that includes certain mandatory elements.*"¹
- Four mandatory elements:
 1. An assessment of the expected capital sources and uses over the nine-quarter planning horizon, assuming both expected and stressful conditions
 2. A detailed description of the process for assessing capital adequacy
 3. The capital policy
 4. A discussion of any expected changes to the business plan that are likely to materially impact capital adequacy or liquidity

1. The Board's Capital Plan rule (12 CFR 225.8)

Key Aspects: Evaluation of Capital Planning

The Federal Reserve's guidance for capital planning outlines expectations in the following areas, respectively

- Governance
- Risk Management
- Internal Controls
- Capital Policy
- Scenario Design
- Projection Methodologies

Risk identification and what is enough?

- Supervisors should evaluate whether banks have robust systems in place to identify all material risks (credit, market, operational, liquidity, etc.)
- Assess if banks are capturing emerging risks such as climate-related risks, cyber risks, or geopolitical risks.
- Develop appropriate frameworks to
 - Identify and assess firm's full set of potential exposures that may impact capital adequacy
 - Apply risk measurement methodologies to assess material risks via quantitative and qualitative approaches in a consistent manner

What are governance and board oversight expectations?

- Assess the role of senior management and the board in reviewing and approving ICAAP. There must be strong governance, ensuring ICAAP is integrated into the strategic planning process.
- Supervisors should verify that the board regularly reviews the outcomes of ICAAP and takes corrective actions as needed.

What role does independent risk management play in the process?

- Firms should maintain a risk management infrastructure that appropriately identifies, measures, and assesses material risks arising from its exposures and business activities, and provides a strong foundation for capital planning
- Risk identification systems should be sufficient to facilitate measurement, monitoring, aggregation, and reporting of material identified enterprise risks, exposures, and vulnerabilities
 - Includes sound information technology, management information, and reporting
- Material risks should inform key aspects of the capital planning process, including:
 - The development of stress scenarios
 - The assessment of the adequacy of post-stress capital levels
 - The appropriateness of potential capital actions

IRM: Validation and Independent Review

- US standards expect models used for capital planning and stress testing should be independently reviewed and validated for intended use and monitored on an ongoing basis
- Model validation should include an evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis
 - Outcomes analysis of stress testing models is challenging due to limited realized outcomes.
 - To compensate, banks should use sensitivity analysis and benchmark models
- Banks should address use of models with identified weaknesses or not validated.
 - Ensure compensating controls are applied

What role should internal audit have?

- Internal audit should evaluate the adequacy of capital planning processes, including supporting risk management and internal control practices, to ensure sound assessments of the firm's capital needs.
- Key activities include the identification of auditable processes and develop an audit plan for
 - Control functions are performing as intended
 - Appropriate independent review is occurring
 - Effective processes are in place to identify, track and remediate deficiencies
- Verify that banks have an independent review function, such as an internal audit, to assess the effectiveness and accuracy of the ICAAP process.
- The outcomes of these reviews should be reported to report to senior management and the board of directors (or audit committee thereof) and supervisors.

What considerations arise at the conclusion of assessing adequacy?

- The capital plan process involves treasury, senior management, risk management, business lines, model risk management, internal audit
- The final capital plan and submission is reviewed by senior management committees and approved by the board of directors (or a committee thereof)
- Effective aggregation processes typically demonstrate:
 - Effective multi-level review and challenge; minutes capture key discussions and decisions.
 - Discussion of estimation process effectiveness, key assumptions, and results/outcomes
 - Process weaknesses and limitations are well documented, elevated for discussion, and accounted for
 - Transparent, repeatable and well documented end-to-end process

Final Considerations

- ICAAP is a valuable complement to the capabilities of financial institutions and supervisors alike.
- Realistic outcomes require a partnership between risk and finance.
- The outcomes of capital planning exercises should inform limit setting and risk tolerances.
- No single correct answer to any step; supervisors often are looking for a thoughtful process.