Comptroller of the Currency
Administrator of National Banks

US Department of the Treasury

Capital Planning: The "new normal"

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ENSURING A SAFE AND SOUND
NATIONAL BANKING SYSTEM
FOR ALL AMERICANS

Agenda

Key Issues to Cover Today:

- Perspective on capital planning
- Key elements of capital planning – for banks of any size
    - Goal setting
    - Supply and demand of capital
    - Capital contingency planning
- Relevant “other” topics on capital planning

Perspectives on Capital Planning

- Capital planning is one piece of a framework that must include business strategy, risk management, and corporate governance

- Capital planning is both art and science.
  - It is not simply a mechanical mathematical exercise
  - It must look to the future and to stresses that had not been previously contemplated both on the business and on capital itself

- The “new normal” means going back to the basics on many topics:
  - Setting clear and understandable risk tolerances
  - Identifying and understanding risks across the enterprise
  - Developing and maintaining robust stress testing
  - Better linking capital to risk vs. setting arbitrary ROE and debt rating targets

Key Elements

What are the critical elements that must be included in capital planning?

- Risk: Identify and assess material risks; measure risks that are reliably quantifiable; translate risk assessment into required capital
- Capital: Set internal capital adequacy goals that relate direct to risks, assess whether available capital is adequate for risks (regardless of whether the risks are easily measured or not); look at supply and demand
- Governance: Develop and maintain a framework to support the different aspects of capital planning, with particular focus on ensuring that risks continue to be identified and well understood across the organization

Key Elements (continued)

What are the functional elements that must be included in capital planning?

- Identification of risks
- Identification of risk tolerance across the organization
- Measurement of risks
- Goal setting – risks and capital
- Capital supply and demand
- Range of operating environments
- Capital contingency plans

Setting Goals for Capital Adequacy

- Requires translation of risk estimates into assessments of capital adequacy
  - Often done through direct capital attribution (EC)
  - May be done indirectly through stress testing

- Different banks with the same risk profile may have different assessments of capital adequacy
  - Differences in risk tolerance can and should affect assessments of risk and capital adequacy
    - Different banks may target different credit ratings

- At a minimum, must meet or exceed regulatory requirements

Supply and Demand Forecasting

- Capital supply forecasts should incorporate
  - Projected earnings
  - Dividends
  - Stock buybacks
  - Non-earnings impacts to capital

- Capital demand forecasts should incorporate
  - Changes in risk exposures
  - Balance sheet and business growth
  - Acquisition/divestiture plans
  - New requirements due to regulatory changes (e.g., FAS 166/167)

Range of Operating Environments

- In the past, much of the capital planning has been based on a "base case" scenario with relatively minor stresses incorporated into the plan
- The "new normal" and required under Pillar 2, is to look at the range of operating environments to understand the impact on capital and risk management
- Look at:
  - Downside environment
  - Stress testing and scenario analysis
  - Capital contingency plans
  - "Trigger Levels" of capital that may signal problems to external parties
- Stress testing and similar exercises may also be useful to address limitations in the quantitative models
- Expect to see this assessment at multiple levels (not just consolidated)

Capital Contingency Plans

- Contingency planning should address unexpected capital shortfalls arising from downside scenarios
  - Address potential underestimation of risk/capital needs or overestimation of capital supply
  - Direct linkage to stress testing
  - Levers available across a range of scenarios
- Potential actions could include reducing capital demand or increasing capital supply
  - Reducing risk exposures
  - Asset sales
  - Reducing/eliminating dividends, stock buybacks
  - Raising capital

Capital Planning: Other Issues

- Challenges
- The “use test”
- The role of buffers in capital planning

Capital Planning Challenges

Despite the fact that the concepts of capital planning are well known, we saw serious problems in the course of the crisis. These problems highlight the challenges associated with capital planning.

- Data challenges
- Governance challenges
- MIS challenges
- Modeling challenges
- Assumptions and limitations

➢ <u>All of these lead to uncertainty in the results</u>

Capital Planning and the "Use Test"

Not just a Basel II concept

- Governance:
  - Senior management ensures that the capital planning process is functioning effectively on an ongoing basis (monitoring)
  - The Capital Planning process influences decision making
- Risk:
  - Capital planning is incorporated into risk management decisions at the firm-wide and business unit and line level
  - Capital planning is aligned with overall risk management process and business risk measures
- Capital:
  - Capital is used as a "common currency" to measure risks across the bank
  - The capital plan is tied to operating/business plans
  - Provides levers to manage capital on a forward-looking basis

Role of Buffers

If I add enough in the way of "buffers" to my capital base, I should be fully covered, right?

- Capital buffers are important, but not a "catch-all"
- Banks should conduct ongoing analysis to determine whether buffers are adequate
- Buffers may rise and fall with financial/economic cycles
- In general, greater uncertainty calls for larger buffers

Key Points… Revisited

- Capital planning encompasses a number of components. Working together and well, these components positively impact risk management efforts, business results and strategic planning across the organization

- Banks must assess where they are with respect to the capital planning process – have risks been fully identified, what can be measured and what can't, has a review of the supply and demand of capital been undertaken?

- The end result of capital planning is not just a single number, but a well articulated, well supported and understood process around capital and risk

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