FINANCIAL SERVICES FLASH REPORT

Basel Paper on Sound Capital Planning Processes

February 20, 2014

On January 14, 2014, the Basel Committee on Banking Supervision (BCBS or Basel) released BCBS 277, titled "A Sound Capital Planning Process: Fundamental Elements." While not a formal rule or regulatory guidance, this working paper outlines what the BCBS believes makes up the fundamental components of an effective capital plan and related processes. The purpose of this Flash Report is to highlight the four fundamental components of sound capital planning that the working paper discusses.

Background

In light of the financial crisis, the BCBS conducted a horizontal exercise to understand the capital planning processes across a number of different banks, varying in both size and complexity. Based on the lessons learned from the financial crisis, it was clear that many banking institutions lacked a comprehensive and effective capital planning process and that management at some of these institutions underestimated the risks related to their business strategies and, therefore, misjudged their capital needs. As a result, the level and composition of regulatory capital at many of the banks were not representative of the changing economic environment.

It is the belief of the BCBS that an effective capital plan and planning process benefit the overall banking system in two key ways:

- Banks are better prepared to handle unexpected stress; and
- Bank management is better informed and positioned to make better decisions related to business strategies and optimize capital amounts and composition.

Summary

The BCBS offers four fundamental components it believes will allow banks to have a more effective and comprehensive capital planning process:

1. Internal control and governance
2. Capital policy and risk capture
3. Forward-looking view
4. Management framework for preserving capital

Internal Control and Governance

The internal control and governance concept speaks to the importance of a formalized capital planning process.

Broadly speaking, there are two primary ways in which a bank's capital planning process can be organized: centralized or decentralized. In a centralized process, there is one group that oversees the overall capital plan. In the decentralized model, individual functional groups work separately to develop their own capital targets. Regardless of the way in which the process is organized, there must be a consistent view when the process is aggregated, both to current and future needs. In order to ensure an internally consistent view, it is essential for there to be input from a number of different areas, including, but not necessarily limited to, the lines of business and the risk, treasury and finance groups. These groups need to work together in order to design a coherent overall plan that also ties back to the firm's overall strategic planning and budgeting process.

One of the most vital roles executive management and the board of directors play in the capital planning process is setting the principles in which the capital plan is grounded. This is particularly important when bringing different internal groups together to set capital targets, and managing the business against these targets. Inevitably, there are going to be competing assumptions, particularly when the lines of business are working with independent functional groups, such as the risk function. Given the potential for differing assumptions, executive management and/or the board of directors must have a stake in this process in order to mitigate differences. Setting the principles up front will help accomplish this.

Finally, executive management and the board of directors should actively review and approve the capital plan at least annually. In addition, the capital plan should undergo independent validation on an annual basis, at a minimum.

Capital Policy and Risk Capture

A capital policy is a document that outlines specific principles for management to follow when making decisions about how to deploy capital. A key element of the capital plan should be details surrounding how a bank will maintain access to funding, meet creditor/counterparty obligations and continue to serve as a credit intermediary, particularly during times of stress (primarily idiosyncratic stress).

Typically, a policy references a number of capital- and performance-related metrics used for monitoring. These may include metrics such as Tier I Common Equity Ratio, Return on Equity and/or Risk-Adjusted Return on Capital (RAROC). The policy would then link specific minimum thresholds for the chosen metrics, which are then monitored by management. These thresholds offer insight into the risk tolerance of the bank's management and board of directors.

Bank management should recognize the limitations associated with risk measurement and ensure a comprehensive process is in place to systematically identify and understand these limitations. It should also be recognized that not all risk may be quantified explicitly or systematically and that these risks (e.g., reputational risk) should also be identified and addressed. Finally, the capital plan may be linked to a bank's economic capital. While this is not required and some banks may choose not to do this, a bank's economic capital policies should always be consistent with its capital plan.

Forward-Looking View

Stress testing, or scenario analysis, is an essential part of any capital plan and should be an integral part of the capital planning process. The overall purpose of the stress test or scenario

analysis is to offer a forward view on whether a bank has sufficient capital. With this forward view, management acquires better knowledge of potential vulnerabilities that may strain the capital base. This then allows them to make more informed decisions and better plan for the amount and composition of capital they hold.

An effective stress testing or scenario analysis should:

- Be quantitative in nature
- Incorporate all relevant risks
- Conservatively account for changes in revenues, losses, exposures and risk-weighted assets
- Be easily repeatable
- Use forward-looking estimates (typically 24-36 months)
- Have at least two scenarios: baseline, and an adverse scenario that is plausible with respect to the size and complexity of the bank
- Incorporate, at least to some extent, assumed diversification benefits

Management Framework for Preserving Capital

The overall capital planning process should help inform management of the degree to which a bank's strategy and capital position may be vulnerable. The stress testing or scenario analysis that banks perform should also contain actions management could undertake to mitigate adverse market conditions. Management can then prioritize capital actions to be taken if an unexpected loss event occurs. This might include actions such as:

- Reducing dividends;
- Raising capital via equity markets;
- Balance sheet reductions; and/or
- Divesting business units.

Whichever action(s) management decides might be the most effective, it is important that it adhere to specific guiding principles. Doing so allows management to determine which are most relevant under different scenarios. It is also important that management build into these principles enough flexibility to allow it to update plans in a timely manner to better adjust to potentially changing conditions.

In Closing

The BCBS lays out helpful guidelines for banks to consider as they continue to build out and enhance their capital planning processes. The BCBS recognizes that there is potential for significant variations across jurisdictions with respect to capital planning. While capital planning is a necessary complement to a bank's regulatory framework, it is by no means a one-size-fits-all exercise. One would expect a multinational investment bank with a large and complex trading book, for example, to have a different capital plan than a mid-size regional bank. However, the capital planning processes themselves, particularly the role of executive management and the board of directors, should look very similar, regardless of the size and complexity of the bank.

It is important for financial institutions to understand what constitutes an effective capital plan and capital planning process in light of the expectations established in this guidance. Banks

should assess their current programs against the principles outlined in it. In the end, a strong capital plan and process allows banks to both meet the demands of their specific regulatory regimes, and optimize the capital they hold (amount, type and composition).

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