Office of the Comptroller of the Currency
U.S. Department of the Treasury

OCC BULLETIN 2012-16

Subject: Capital Planning
Date: June 7, 2012

To: Chief Executive Officers of All National Banks and Federal Savings Associations, Department and Division Heads, All Examining Personnel, and Other Interested Parties

Description: Guidance for Evaluating Capital Planning and Adequacy

Purpose

This bulletin summarizes the Office of the Comptroller of the Currency's (OCC) expectations for national banks and federal savings associations (collectively, banks) regarding capital adequacy and provides guidance on capital planning.[1] This bulletin also discusses the OCC's processes for evaluating a bank's capital planning and adequacy, and, as appropriate, the various actions the OCC may take to ensure a bank's capital planning process and capital level remain adequate for its complexity and overall risks. This bulletin rescinds Office of Thrift Supervision CEO Memorandum 380, "Capital Management," March 15, 2011.

Overview

The 2008 economic downturn and the ensuing increase in problem banks underscored the need for all banks to build and maintain sufficient capital to weather stressed environments when raising capital may be difficult. Capital planning helps to ensure a bank's ongoing safety and soundness. The OCC expects every bank, regardless of size or charter type, to have an effective internal process to (1) assess its capital adequacy in relation to its overall risks *and* (2) plan for maintaining appropriate capital levels. National banks and federal savings associations in a holding company structure that conducts capital planning on a consolidated basis are independently responsible for assessing their own capital adequacy based on their individual risk profile and business model.[2] The OCC will evaluate the adequacy of a bank's assessment and its compliance with OCC policies and regulatory capital requirements as part of the OCC's ongoing supervision of the bank.

The appropriate level of capital for an individual bank cannot be determined solely through the application of a mathematical formula or wholly quantitative criteria. In this regard, the regulatory minimum capital ratios are standards that address only a subset of risks[3] faced by banks. Therefore, a bank should maintain capital well *above* regulatory minimum capital ratios,[4] especially during expansionary periods when the economy may be growing robustly and bank earnings are strong but the inherent risks in a bank's operations and balance sheet may be increasing. Equally emphasized in this bulletin, a bank at the *"well-capitalized"* level under the Prompt Corrective Action rule should not automatically assume that it has sufficient capital to cover all of its risks.[5]

Capital levels at peer institutions with similar risk profiles can play a useful role in the capital planning process by providing benchmarks for comparison. While peer comparisons are useful, their value is limited; an effective approach to capital planning and capital adequacy should account for factors that are unique to each bank.

The OCC's assessment of a bank's capital adequacy includes a review of the bank's own capital assessment and planning process. Examiners evaluate the bank's approach to identifying and measuring material risks, assessing capital adequacy, identifying capital sources, raising capital when necessary, and preparing for contingencies. Examiners also consider management's capital assessment processes and the board's oversight.

The guidance contained in this bulletin does not affect the functioning of the Prompt Corrective Action rule. The guidance complements regulations and supervisory standards related to capital and risk management practices. The supervisory process described in this bulletin supports the OCC's existing ability to

- ensure that a bank has sound and effective capital planning processes that appropriately address the bank's overall risk.
- require an individual bank to take measures to prevent its capital from falling below the level needed to adequately support its risks.
- otherwise intervene to ensure that the bank's capital levels are adequate.

Capital Planning

Capital planning is a dynamic and ongoing process that, in order to be effective, is forward-looking in incorporating changes in a bank's strategic focus, risk tolerance levels, business plans, operating environment, or other factors that materially affect capital adequacy. Capital planning assists the bank's board of directors and senior management to

- identify risks, improve their understanding of the bank's overall risks, set risk tolerance levels, and assess strategic choices in longer-term planning.
- identify vulnerabilities such as concentrations and assess their impact on capital.
- integrate business strategy, risk management, capital and liquidity planning decisions, including due diligence for a merger or acquisition.
- have a forward-looking assessment of the bank's capital needs, including capital needs that may arise from rapid changes in the economic and financial environment.

The most effective capital planning considers both short- and longer-term capital needs and is coordinated with a bank's overall strategy and planning cycles, usually with a forecast horizon of at least two years. Banks need to factor events that occur outside of the normal capital planning cycle into the capital planning process; for example, a natural disaster could have a major impact on future capital needs.

The capital planning process should be tailored to the overall risk, complexity, and corporate structure of the bank. The bank's range of business activities, overall risks, and operating environment have a significant impact on the level of detail needed in a bank's capital planning. A more complex institution with higher overall risk is expected to have a more detailed planning process than an institution with less complex operations and lower risks. The corporate structure is also a factor. Mutual savings associations have very limited means to increase capital quickly and build capital almost exclusively through retained earnings. As such, capital planning is critical for a mutual. While the exact content, extent, and depth of the capital planning process may vary, an effective capital planning process includes the following components:

1. Identifying and Evaluating Risks

The first component of capital planning is to identify and evaluate all material risks. Risks that can be quantified with reasonable confidence should be measured to determine how those risks affect the bank's overall capital adequacy. Banks should also consider qualitative factors that incorporate management's experience and judgment in evaluating all risks. A qualitative assessment is especially critical in understanding and evaluating risks that cannot be reasonably quantified.

Some of the risks to which a bank may be exposed include credit, operational, interest rate, liquidity, price, and compliance risks.[6] Other risks, such as reputation risk and strategic risk, may be material for some banks. Risks may also arise from significant subsidiaries and operating units. Every bank should have a process in place that allows it to identify its material risks on an ongoing basis so that it can plan appropriately for those risks.

Banks should not allow current financial performance to mask or compensate for weaknesses that exist in risk management practices and processes. There is often a lag between the creation of risks and when they materialize in a bank's financial performance. Once the bank faces problems in the form of deteriorating credit quality, increased loan charge-offs, strained funding, increased processing errors, or other financial performance measures, the underlying root causes are already well established and difficult to reverse quickly. Furthermore, once weaknesses materialize, it may be difficult, or more expensive, to raise capital. Capital alone does not mitigate excessive risk taking or unsafe and unsound practices that deviate from sound governance, internal controls, risk management principles, or OCC supervisory guidance. Banks need to be alert to deterioration in risk management processes and rising indicators of future risk, such as

- high levels of concentrations that are not paired with strong risk mitigants, including holding additional capital. Banks with high levels of concentrations should have tools or processes to mitigate the heightened risk associated with those concentrations. In some cases, concentration levels may be deemed excessive regardless of capital levels.
- funding asset growth with high-risk or volatile liabilities, or other risk-layering strategies.
- increasing investments in new financial instruments without establishing an understanding of the risks, exposures, and structural complexities and assessing the suitability of the investment for the bank.
- rapid rates of growth that are not accompanied by appropriate changes to staffing levels, systems, and controls.
- entering new lines of business without a well-defined strategy, appropriate risk controls, or the capital needed to support the new lines of business.
- liberalization of underwriting standards, weak underwriting, or increasing credit or collateral exceptions.
- higher delinquencies or high levels or increasing trends of adversely classified or criticized assets, loan charge-offs, repossessed assets, or impaired securities.

2. Setting and Assessing Capital Adequacy Goals That Relate to Risk

The second component of effective capital planning is to determine the bank's capital needs in relation to material risks and strategic direction. A well-run bank regularly assesses capital adequacy to ensure that capital levels remain adequate not just at a point in time, but over time, and recognizes both short- and longer-term capital needs. Because overall risks and choices of risk tolerance may differ across banks, capital needs also differ. Banks with higher risk exposure, plans for acquisition or growth, or less access to capital need to operate with higher levels of capital. Certain identified risks may be deemed too high regardless of capital levels, as capital alone does not compensate for excessive risk taking. Some examples of activities that may warrant higher capital levels are

- highly complex or specialized services with high-volume transaction processing (higher operational risk).
- significant concentrations in higher-risk activities, such as subprime lending programs, construction and development lending, or syndicated/leveraged lending (higher credit risk).
- concentrations that have a high degree of correlation with cyclical changes or economic events, for example, construction and development lending (higher credit risk).
- borrowing sources concentrated among a few providers or providers with common investment objectives or economic influences, such as significant reliance on wholesale funds (higher liquidity risk).
- longer term re-pricing mismatches that are significant, complex, or difficult to hedge (higher interest rate risk).
- high volume of consumer complaints or a significant number of violations or weaknesses in consumer or Bank Secrecy Act/Anti-Money Laundering compliance programs that expose the bank to potential consumer reimbursements, regulatory fines and penalties, significant reputation risk, or litigation risk (higher compliance risk).

In assessing capital needs, a bank should evaluate not only its exposures to risks, including operational, fiduciary, and other off-balance-sheet activities, but also the potential impact of risks arising from third party relationships, contingent exposures, the business cycle, and changes in the financial and economic environment. Incorporating the results of stress testing into capital planning is an effective means of quantifying the potential impact of identified risks particularly for complex banks and those with higher risk profiles.[7] Banks may use a variety of methodologies to translate risks into capital needs; regardless of the methodology chosen, the bank needs to ask the appropriate “what if” questions and incorporate the answers into the risk management process. The overall goal is to quantify loss potential and the impact on earnings and capital adequacy. Other important factors to consider in the capital planning process include

- concentration levels and limits;
- quality of risk management, internal control, and audit processes;
- quality, sustainability, and level of earnings;
- quality, composition, and sources of capital;
- quality of assets and credit administration practices;
- allowance adequacy;
- balance-sheet structure, liquidity needs, and interest rate risk;
- strategic objectives of the institution, including whether the bank effectively assesses and controls risks when executing new products and services—this is critical for de novo institutions;
- historical and planned growth;
- mergers and acquisitions;
- special situations that could cause capital impairment or future losses;
- form of ownership and access to capital;
- dividend practices;

- a holding company's ability to serve as a source of strength and to contribute capital to the bank;
- a holding company's reliance on dividend payments from the bank to service debt or other obligations;
- effect of affiliates; and
- supervisory requirements for corrective action or associated with enforcement actions.

Banks should express their internal capital needs as ratios based on regulatory definitions and capital requirements. In addition, banks may express capital needs based on measures important to key stakeholders. Capital needs or targets may be expressed as a range as well.

3. Maintaining a Strategy to Ensure Capital Adequacy and Contingency Planning

The third component of capital planning is having a strategy to maintain capital adequacy and build capital if needed. Through discussions with senior management, the board or its designee should evaluate both internal and external sources of capital in defining a strategy to build capital when necessary. One strategy may be strengthening capital through earnings retention. Another option may be an infusion from principal shareholders or a parent holding company, or, in the case of a mutual institution, a partial or full conversion to stock. A bank may also be able to raise capital from external sources. During strong economic times, financially sound banks or banks that are subsidiaries of strong bank holding companies can generally find purchasers for their equity and debt issuances. In evaluating external sources of capital, banks should consider their history of public or private offerings, current equity market conditions, and the cost of equity.

A bank's capital planning process should also consider contingency or back-up plans. Contingency planning should be commensurate with the bank's overall risk and complexity. Effective contingency planning includes identification of credible mechanisms and strategies for capital preservation and enhancement during an economic downturn or other times of stress. Effective boards hold management accountable for identifying and taking corrective actions if shortcomings or weaknesses in the capital planning process become apparent or if the level of capital falls below identified needs.

Actions may include increasing capital using one of the strategies noted above, subject to any applicable regulatory approvals. Banks may also adjust the balance sheet to reduce risk exposures (for example, asset sales), improve internal governance processes, strengthen risk management systems, or reinforce internal controls. Banks may need to consider restricting capital distributions. It is particularly important for a bank's board of directors to ensure the dividend level is prudent relative to the bank's financial position. Decisions on the dividend level should not be based on overly optimistic earnings scenarios or pressure from a holding company or other controlling party. Comprehensive capital distribution/dividend policies clearly articulate the institution's objectives and approaches for maintaining a strong capital position, including restricting dividends and other discretionary capital distributions when the institution does not, or may not, meet required capital levels or internal targets.

4. Ensuring Integrity in the Internal Capital Planning Process and Capital Adequacy Assessments

The fourth component of capital planning is ensuring the integrity, objectivity, and consistency of the process through adequate governance. A bank's success depends on the strong and independent oversight by its board of directors in all areas, including capital planning. The board should articulate to management its risk-tolerance level, for example by setting approved limits. A bank's internal audit function also plays a key role in reviewing the controls and governance surrounding the capital planning process. Capital adequacy is influenced by the quality, experience, and depth of bank management. Sound management entails implementing and monitoring policies and procedures, internal controls, and audit coverage. Documenting the capital planning process and expectations/goals approved by the board is important to maintaining the integrity of the capital planning process and appropriateness of capital level determinations.

The board should review the capital planning process and capital goals at least annually to ensure that a sufficient level of capital exists at all times to fully support the bank's overall risks and anticipated needs. When management provides the board with regular reports and updates, the board can clearly understand the financial resiliency of the bank. Reports should typically highlight any changes in the bank's overall risk profile or risk components, proposed risk management enhancements to better manage any new or increasing risks, and, if applicable, stress-testing results that affect the need for capital. A range of techniques, approaches, and models are used by banks for a variety of purposes in capital planning (for example, loss estimation, scenario analysis, sensitivity analysis, or reverse stress testing). As models play an increasing role in decision-making processes, it is critical that bank management reduce the likelihood of erroneous model output or incorrect interpretation of model results. Model risk management begins with robust model development, implementation, and use, followed by a sound model validation process and effective governance.[8]

An effective capital planning process and capital goals would be documented and would include

- roles and responsibilities of key parties in the process, including the board, senior management, internal audit, and lines of business management.
- processes for monitoring risk tolerance levels, capital adequacy, and overall capital planning on an ongoing basis, including procedures for board and management reporting and instituting change as conditions warrant.
- key planning assumptions and methodologies used, as well as limitations and uncertainties in the capital planning process.
- risk exposures and concentrations that could impair or influence the bank's level of capital.
- measures to take in response to changes (for example, in strategic direction or economic conditions), to deficiencies in the capital planning process, or when capital falls below internal targets.
- the results of any stress testing performed and any actions planned or taken in response to those results.

Capital planning needs to evolve with changes in the bank's overall risks and activities, as well as with advances in risk measurement and management practices.

Supervisory Review of Capital Planning and Capital Adequacy

The supervisory review process assesses whether (1) the bank has a sound and effective process commensurate with its overall risk and complexity to determine that its overall capital is adequate and (2) the bank maintains a capital level that is commensurate with its risks and is consistent with the bank's internal assessment and identified capital needs on an ongoing basis and as underlying conditions change (for example, changes in a bank's overall risks or economic conditions). Examiners review the capital planning process at least once during each supervisory cycle. Conclusions about the capital planning process are considered and incorporated in the assessment of the capital and management component ratings.[9]

Examiners should consider the quality of the bank's overall corporate governance of the bank's risk taking activities, including senior management and board oversight, when assessing capital adequacy. As part of this evaluation, examiners should consider the quality of risk management, internal control, model validation, and audit processes as well as management's expertise and ability to identify and control financial and operating risks. When serious deficiencies exist in any of these areas, examiners may determine that the bank should hold capital above the level suggested in the bank's assessments of specific risks.

A bank's failure to have an effective capital planning process may be an unsafe and unsound banking practice. If a bank does not have an effective capital planning process that is commensurate with its overall risks, the OCC may require immediate corrective action. An ineffective or weak capital planning process may invalidate the bank's internal capital assessment and necessitate that examiners determine an appropriate capital level. The OCC may impose higher capital requirements if a bank's level of capital is insufficient in relation to its risks; determining the appropriate capital level is necessarily based in part on judgment grounded in agency expertise.[10] Potential OCC actions to ensure adequate capital may include, as deemed necessary, an individual minimum capital ratio, memorandum of understanding, formal written agreement, consent order, cease-and-desist order, or a prompt corrective action directive.

Examiners should discuss with the board of directors and management any material risks that the capital planning process did not capture and any other material issues regarding capital adequacy or contingency plans. The board should direct management to address any gaps in the bank's capital planning process to ensure that the quality and quantity of capital is sufficient to support the risks in the bank.

When examiners identify inconsistencies between the level of capital and a bank's overall risks, they should articulate which key components are missing from the bank's capital planning process and direct management to incorporate and quantify such components in current and future assessments.

Summary

A robust capital planning process is an integral and significant part of a bank's governance process necessary to ensure safe and sound operations and ongoing viability. The exact content, extent, and depth of the capital planning process should be commensurate with the overall risks, complexity, and corporate structure of the bank. Examiners assess the capital planning process to ensure that the bank maintains sufficient capital to support the risks it faces.

For further information, contact Operational Risk Policy at (202) 649-6550.

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[1]Banks operating under the Basel II advanced approaches should also refer to the supervisory guidance published jointly by the U.S. federal banking agencies at 73 FR 44620. See OCC Bulletin 2008-20, "Final

Guidance on Supervisory Review Process (Pillar 2): Supervisory Guidance on Pillar 2 Reviews Related to Implementation of Basel II Advanced Approaches Rule," July 31, 2008. In general, the Basel II advanced approach is mandatory for banks that have consolidated total assets of $250 billion or more, consolidated on-balance-sheet foreign exposure of $10 billion or more, or are a subsidiary or parent of an advanced approaches organization. National banks should refer to 12 CFR 3, appendix C, section 22(a); federal savings associations should refer to 12 CFR 167, appendix C, section 22(a). See OCC Bulletin 2007-47, "Implementation of the Advanced Approaches of the Basel II Capital Accord: Final Rulemaking," December 7, 2007; and 72 FR 69288. Additionally, this guidance, as well as guidance contained in OCC Bulletin 2007-21, "Supervision of National Trust Banks: Revised Guidance: Capital and Liquidity," June 26, 2007, is applicable to bank and thrift trust-only institutions.

[2]Top-tier bank holding companies with $50 billion or more of total consolidated assets—and those deemed subject to the rule based on size, level of complexity, risk profile, scope of operations, or financial condition—are required to submit capital plans to the Federal Reserve on an annual basis and, under certain circumstances, obtain approval before making a capital distribution (see 12 CFR 225.8, 76 FR 74631). Subsidiary banks of such bank holding companies may be an integral part of the holding company's capital plan and planning process.

[3]Minimum capital ratios are based primarily on broad credit and market risk considerations and do not directly take into account certain risks, both specific to individual banks and more generally to the economy at large, including operational risk (for banks not subject to the Basel II operational risk capital requirements), interest rate risk, liquidity risk, and the amplification of risks through the effects of correlations, concentrations, and the business cycle.

[4]See 12 CFR 3.6 on minimum capital ratios for national banks, and 12 CFR 167.2 and 12 CFR 167.8 for federal savings associations.

[5]12 CFR 6.4 for national banks and 12 CFR 165.4 for federal savings associations.

[6]Comprehensive descriptions of risks, including indicators of high-risk and weak-risk management, are outlined in the "Large Bank Supervision" and "Community Bank Supervision" booklets of the *Comptroller's Handbook*. Basel II banks should also see OCC Bulletin 2011-21, "Interagency Guidance on the Advanced Measurement Approaches for Operational Risk," June 3, 2011.

[7]The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires all banking organizations with total consolidated assets of $10 billion or more to conduct annual stress tests in accordance with regulations to be issued by each primary federal financial regulatory agency. On January 24, 2012, the OCC issued a notice of proposed rulemaking to implement this requirement (77 FR 3408). Separately, on May 17, 2012, the federal banking agencies issued guidance on stress testing for banking organizations with more than $10 billion in consolidated assets (77 FR 29458). See OCC Bulletin 2012-14. That guidance outlines high-level principles for stress-testing practices applicable to all banking organizations with more than $10 billion in total consolidated assets.

[8]See OCC Bulletin 2011-12, "Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management," April 4, 2011, for additional guidance on model risk management.

[9]See the "Bank Supervision Process" booklet of the *Comptroller's Handbook*.

[10]For example, Subpart C of 12 CFR Part 3 (for national banks) and Subpart B of 12 CFR Part 167 (for federal savings associations) outline the procedures that the OCC may use to impose higher individual minimum capital ratios/requirements.