



SR 99-18: Primer

In July, 1999, the Federal Reserve issued supervision and regulation letter SR 99-18 (“Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles”). This document instructs supervisors to evaluate bank capital management as a critical component of safety and soundness.

SR 99-18 history

By 1999, there was growing awareness that minimum capital requirements alone cannot ensure capital adequacy at large or complex banks. The “Basel I” capital rules, which are still in effect for nearly all U.S. institutions, apply simple capital adequacy ratios to on-balance sheet assets and require no capital for off-balance sheet assets. These rules also ignore operational risk, strategic risk, and other exposures not reflected in the sample risk-weighting rules. These risk-insensitive capital rules simply cannot illuminate the larger picture of risk accumulation and capital need at complicated institutions. As a result, the Federal Reserve issued the SR 99-18 guidance that requires large and complex organizations to create a rigorous capital management process that demonstrates overall capital adequacy in a well-governed fashion.

SR 99-18 was initially applied to only a handful of the largest banks and bank holding companies. The Federal Reserve does not disclose a precise number, but we estimate that only about 20 to 30 institutions have been subject to full-blown SR 99-18 exams, complete with specialized on-site regulatory teams that assess compliance. But regulator commitment to the principles of SR 99-18 was demonstrated in the Basel II regulatory process, in which pillar two of the Basel II accord effectively codified SR 99-18 requirements. Throughout the decade following its publication, SR 99-18 motivated examiners to look beyond the calculated minimum capital requirements in ensuring capital adequacy at a wide range of institutions. Regulators are increasingly challenging institutions to demonstrate the adequacy of their capital position, even if not formally subject to SR 99-18. The current credit crisis underscores both the inadequacy of the current regulatory rules and the notion that many banks – not just the largest few dozen – have accumulated risks that justify heightened capital management. The principles of SR 99-18 are now being applied at hundreds of U.S. institutions.

Description of the SR 99-18 Guidance

SR 99-18 directs examiners to “evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the institution's capital needs.” The guidance calls out four specific capabilities required of a capital management process:

1. Identifying and measuring all material risks. Banks should conduct comprehensive analyses of all risk exposures, ensuring sufficient resolution and breadth across risk types and positions. Credit, market, interest rate, operational, and other not-easily quantified risk types should be considered. Both on-balance sheet and off balance sheet exposures, seasoned and new products, should be included. In addition, controls should be instituted that ensure objectivity and consistency and that all material risks are considered.
2. Relating capital to the level of risk. Having developed a comprehensive measure of risk, banks must relate this estimate to capital need. Economic capital models are a well-known



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means of translating risk into capital requirements, but regulators have carefully noted that formal economic capital models are *not* required. Banks can use any objective, well-governed process for quantifying the capital needed against measured risks, such as peer benchmarking and scenario analysis. Banks should also consider the composition of their capital base in this assessment, to ensure that reliance on non-TCE tier one and tier two capital elements does not impair viability.

3. Stating explicit capital adequacy goals with respect to risk. The capital adequacy process should culminate in explicit capital targets that reflect measured risks, buffers and cushions needed to accommodate planning and modeling error, and the strategic imperatives of the firm. The bank can differentiate between short-term and long-term goals, if appropriate, but this guidance requires specific Board-approved numerical capital targets.
4. Assessing conformity to the institution's stated objectives. Both the target level and composition of capital, along with the process for setting and monitoring such targets, should be regularly audited to ensure compliance with internal policy. The results of this audit should be provided to senior management and the Board.

Importantly, the SR 99-18 guidance requires a capital adequacy *process*, not just a quarterly report that gathers dust on the shelf. Regulators want capital management incorporated into the kernel of bank operations. Rigorous policies and procedures, meaningful analysis, and forceful, responsive actions are evidence of a viable process. A collection of capital targets that have no apparent bearing on bank operations are far less convincing.

What SR 99-18 means for your institution

SR 99-18 provides the best insight into evolving regulatory expectations on capital. These principles are already filtering through the system and will eventually touch most institutions, but for now the following banks will most likely receive pointed capital management questions:

1. Large banks. Banks with over \$250B of assets, or \$10B of foreign assets, are formally subject to SR 99-18, but all banks over \$50B should expect exams that include most of the elements of SR 99-18.
2. Rapidly growing banks. Rapid organic or acquisitive growth is capital consumptive and is often accompanied by additional risks that require strong capital management.
3. Complex banks. Regulators require an extra degree of comfort for banks with unique risk profiles, such as concentrated portfolios or significant servicing businesses.
4. Thinly capitalized banks. Institutions with less capital cushion must demonstrate a greater ability to manage their capital stock.
5. Volatile banks. There is no greater evidence of the need for rigorous capital planning than an unanticipated spike in losses or write-downs.

It might be years before banks lacking these features face explicit SR 99-18 demands. Others should be prepared to defend their capital management practices to a circumspect regulatory community.



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The Second Pillar Consulting Solution

Second Pillar Consulting is the leader in regulatory capital support for community and regional banks. We offer low-cost, targeted solutions that help banks prepare for regulatory exams and comply with the broadening array of regulatory capital requirements. Our SR 99-18 solution includes:

- Phase I: Triage
 - Gap analysis and preliminary remediation plan that quickly sizes the challenge
 - Flat \$10,000 fee, results in about a week
- Phase II: Rescue Kit
 - Analytics, such as stress testing and capital contingency modeling
 - Governance, including Board training and policy/ procedure overview
 - Implementation, ensuring that reports are generating appropriate awareness of and investment in the capital adequacy challenge
 - Regulatory relations, fostering a productive dialog with the regulators charged with ensuring capital adequacy
 - Flat fee quoted prior to commencement of Phase II based upon Triage results

We look forward to speaking with you soon to discuss whether Second Pillar Consulting can help ensure that your capital management process passes muster under the requirements of SR 99-18.

For more information visit our website at www.secondpillar.com