INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS - GENERAL FRAMEWORK

ICAAP 1: ***Every credit institution must have a process (an ICAAP) for assessing its capital adequacy relative to its risk profile.***

The scope and application of the ICAAP will be determined by reference to the relevant provisions of the Banking Act 1994, Banking Rules and where appropriate, the CRD.

ICAAP 2***: The ICAAP is the responsibility of the credit institution.***

a. Each credit institution is responsible for its ICAAP and for setting internal capital targets that are consistent with its risk profile and operating environment. The ICAAP should be tailored to the credit institution's circumstances and needs and it should use the inputs and definitions that the credit institution normally uses for internal purposes.

b. At the same time, the credit institution should be able to demonstrate how the ICAAP meets the authority's requirements.

c. Credit institutions retain full responsibility for their ICAAP regardless of the degree of outsourcing, if any (and which, if undertaken, must meet the Guidelines on Outsourcing issued by CEBS on 14th December 2006) and they should understand that outsourcing does not in any way relieve them of the need to ensure that their ICAAP fully reflects their specific situation and individual risk profile.

ICAAP 3***: The ICAAP's design should be fully specified, the credit institution's capital policy should be fully documented and the Board of Directors and senior management should take responsibility for the ICAAP.***

a. The responsibility for initiating and designing the ICAAP rests with the Board of Directors and senior management. The Board of Directors should approve the conceptual design (at a minimum, the scope, general methodology and objectives) of the ICAAP. The details of the design (i.e. the technical concepts) are the responsibility of the senior management.

b. Both the Board of Directors and senior management are responsible for integrating capital planning and capital management into the credit institution's overall risk management culture and approach. They should ensure that capital planning and management policies and procedures are communicated and

implemented institution-wide and supported by sufficient authority and resources.

c. The credit institution's ICAAP (i.e. the methodologies, assumptions and procedures) and capital policy should be formally documented and it should be reviewed and approved by the Board of Directors.

d. The results of the ICAAP should be reported to the Board of Directors and senior management.

ICAAP 4*: The ICAAP should form an integral part of the management process and decision- making culture of the credit institution.*

The ICAAP should form an integral part of the credit institution's management processes so as to enable both the Board of Directors and senior management to assess, on an ongoing basis, the risks that are inherent in their activities and are material to the institution. This could range from using the ICAAP to allocate capital to business units, to having it play a role in the individual credit decision process, to having it play a role in more general business decisions (e.g. expansion plans) and budgets.

ICAAP 5*: The ICAAP should be reviewed regularly.*

a. The ICAAP should be reviewed by the credit institution as often as is deemed necessary to ensure that risks are covered adequately and that capital coverage reflects the actual risk profile of the credit institution. This review should take place at least annually.

b. The ICAAP and its review process should be subject to independent internal review.

c. Any changes in the credit institution's strategic focus, business plan, operating environment or other factors that materially affect assumptions or methodologies used in the ICAAP should initiate appropriate adjustments to the ICAAP. New risks that occur in the business of the credit institution should be identified and incorporated into the ICAAP.

ICAAP 6*: The ICAAP should be risk-based.*

a. The adequacy of a credit institution's capital is a function of its risk profile. Credit institutions should set capital targets which are consistent with their risk profile and operating environment.

b. Credit institutions may take other considerations into account in deciding how much capital to hold, such as external rating goals, market reputation and strategic goals.

c. However, if other considerations are included in the process, the credit institution must be able to show in its dialogue with the authority, how they influenced its decisions concerning the amount of capital to hold.

d. There are some types of (less readily quantifiable) risks for which the focus of the ICAAP should be more on qualitative assessment, risk management and mitigation. The credit institution should clearly establish for which risks a quantitative measure is warranted and for which risks a qualitative measure is the correct risk mitigation tool.

e. Institutions that take a Pillar I approach as a starting point for their ICAAP (see below) may also consider developing a fully risk-based approach as the CRD promotes a risk-based approach (including the Standardised approach for credit risk) and because general management and control frameworks will increasingly be risk-based.

ICAAP 7*: The ICAAP should be comprehensive.*

a. The ICAAP should capture all the material risks to which the credit institution is exposed, notwithstanding that there is no standard categorisation of risk types and definition of materiality. The institution is free to use its own terminology and definitions, but it should be able to explain these to the authority, including the methods used, the coverage of all material risks and how its approach relates to its obligations under Banking Rule BR/04: *Capital Requirements of Credit Institutions Authorised under the Banking Act 1994* and the Banking Rule BR/08: *Capital Adequacy of Credit Institutions Authorised under the Banking Act 1994* - (for example, if the institution uses for the purposes of ICAAP a definition of operational risk that differs from the definition in BR/04, or a definition of interest rate risk that includes both banking book and trading book risks).

b. The ICAAP should cover:

- *Credit, market and operational risks (Pillar I risks in the CRD).* - These may include major differences between the treatment of these risks in the calculation of capital requirements under BR/04 and their treatment under the ICAAP;

- *Residual risks or risks not fully captured under the Pillar I process.* - Risks which fall into this category could include underestimation of credit risk using the standardised approach, underestimation of operational risk using the basic indicator approach or standardised approach, and for stressed loss given default (LGDs). Specifically, regarding credit risk, the following should be taken into account, for example, residual risk in credit risk mitigation (CRM), and securitisation;

- *Other types of risks (Pillar II risks in the CRD).* - The ICAAP should cover all other material Pillar II risks to which the credit institution may be exposed, such as interest rate risk in the banking book, concentration

risk, liquidity risk, reputation and strategic risk. Some of these risks are less likely to lend themselves to quantitative approaches, in which cases institutions are expected to employ more qualitative methods of assessment and mitigation;

- *Risk factors external to the credit institution.* - These include risks which may arise from the regulatory, economic or business environment and which are not included in the above mentioned risks.

ICAAP 8*: The ICAAP should be forward-looking.*

a. The ICAAP should take into account the credit institution's strategic plans and how they relate to macroeconomic factors. The credit institution should develop an internal strategy for maintaining capital levels which can incorporate factors such as loan growth expectations, future sources and uses of funds and dividend policy, and any procyclical variation of its Pillar 1 minimum own funds requirements.

b. The credit institution should have an explicit, approved capital plan which states the credit institution's objectives and the time horizon for achieving those objectives and in broad terms the capital planning process and the responsibilities for that process. The plan should also lay out how the credit institution will comply with capital requirements in the future, any relevant limits related to capital, and a general contingency plan for dealing with divergences and unexpected events (for example, raising additional capital, restricting business, or using risk mitigation techniques).

c. Credit institutions should conduct appropriate stress tests which take into account, for example, the risks specific to the local market, and the particular stage of the business cycle. Credit institutions should analyse the impact that new legislation, the actions of competitors or other factors may have on their performance, in order to determine what changes in the environment they could sustain.

ICAAP 9*: The ICAAP should be based on adequate measurement and assessment processes.*

a. Credit institutions should have a documented process for assessing risks.

b. The results and findings of the ICAAP should feed into a credit institution's evaluation of its strategy and risk appetite. The results of the process should mainly influence the credit institution's management of its risk profile (for example, via changes to its lending behaviour or through the use of risk mitigants).

c. There is no single 'correct' process. Depending on proportionality considerations and the development of practices over time, credit institutions may design their ICAAP in different ways. For example, the ICAAP may use:

- The result produced by the regulatory Pillar 1 methodologies (which are themselves risk-based) and consideration of non-Pillar 1 elements. In other words, to obtain a capital goal, institutions may take the Pillar 1 requirements and then assess Pillar 2 concepts that relate to Pillar 1 (such as concentration risk, residual risk of CRM and securitisation) and concepts that are not dealt with under Pillar 1 (such as interest rate risk). The Pillar 1 approach may be appropriate for some institutions, although they would have to take an active role in justifying this choice, including consideration of forward-looking elements. Supervisors would expect the institution to demonstrate that it had analysed all risks outside Pillar 1 and found them to be absent, not material, or covered by a simple cushion over the Pillar 1 minimum.

- A 'structured' approach, using different methodologies for the different risk types (Pillar 1 and Pillar 2 risks) and then calculating a simple sum of the resulting capital requirements.

- A more sophisticated and complex system, possibly using 'bottom-up' transaction-based approaches with integrated correlations.

d. Credit institutions are likely to find that some risks are easier to measure than others, depending on the availability of information. This implies that their ICAAPs could be a mixture of detailed calculations and estimates.

e. It is also important that credit institutions do not rely on quantitative methods alone to assess their capital adequacy, but include an element of qualitative assessment and management judgement of inputs and outputs. Considerations such as external rating goals, market reputation and strategic goals should be taken into account.

f. Non-quantifiable risks should be included if they are material, even if they can only be estimated. This requirement might be eased if the credit institution can demonstrate that it has an appropriate policy for mitigating/managing these risks.

ICAAP 10*: The ICAAP should produce a reasonable outcome.*

a. The ICAAP should produce a reasonable overall capital number and assessment. The credit institution should be able to explain to the authority's satisfaction the similarities and differences between its ICAAP (which should cover all material risks) and its own funds requirements.

b. Credit institutions are encouraged to make greater disclosures of information which is not proprietary or confidential. This may provide them with a means for comparing their ICAAP with their peer group, for internal purposes.