Draft for Consultation FICOM ICAAP Guide

BC Credit Unions

November 2017

Financial Institutions Commission

www.fic.gov.bc.ca

Table of Contents

INTRODUCTION 1
FEATURES OF AN EFFECTIVE ICAAP 2
I. Board and Management Oversight 2
II. Sound Capital Assessment and Planning 2
III. Comprehensive Assessment of Material Risks 3
Pillar 1 Risks 4
Credit Risk 4
Market risk 4
Operational Risk 4
Pillar 2 Risks 5
Concentration Risk 5
Interest Rate Risk 5
Funding Risk 6
Other Significant Risks 6
IV. Stress Testing 6
V. Monitoring and Reporting 7
VI. Internal Control Review 7

INTRODUCTION

This Internal Capital Adequacy Assessment Process ("ICAAP") Reporting Guide outlines FICOM's expectations for credit union ICAAPs. A thorough and comprehensive ICAAP is a vital component of a strong risk management program. The ICAAP should produce a level of capital adequate to support the nature and level of a credit union's risk. ICAAPs provide information that can aid in assessing inherent risk and may point to the need for additional supervisory work as part of the normal supervisory process. While FICOM makes use of information gleaned from a credit union's ICAAP to assess the quality of risk management, FICOM does not approve the ICAAP.

ICAAP was introduced in Pillar 2 of the Basel Committee on Banking Supervision's Basel II capital framework.

- **Pillar 1** of the Basel II capital framework outlines standardized rules for calculating minimum capital adequacy requirements based on the credit risk, market risk, and operational risk profile of the financial institution.

- **Pillar 2** of the Basel II capital framework sets out to ensure that financial institutions maintain adequate capital to support all material risks through the ICAAP process. Pillar 2 also discusses the role of supervisory review of the ICAAP.

The capital requirements set out in the *Financial Institutions Act* and its regulations are regulatory minimum standards and assume that each credit union maintains a portfolio of risk exposures that is widely diversified. As minimum regulatory capital requirements are based on a number of simplified assumptions, credit unions should not rely solely on compliance with regulatory minimums and supervisory targets when assessing capital adequacy.

FICOM expects credit unions to develop and maintain an internal capital target (ICT) above regulatory minimum standards. The ICAAP should be used to derive the ICT. The ICAAP report and ICT are subject to supervisory review. See **FICOM's ICAAP Submission Instructions** for instructions on what should be included in a credit union's ICAAP report to FICOM.

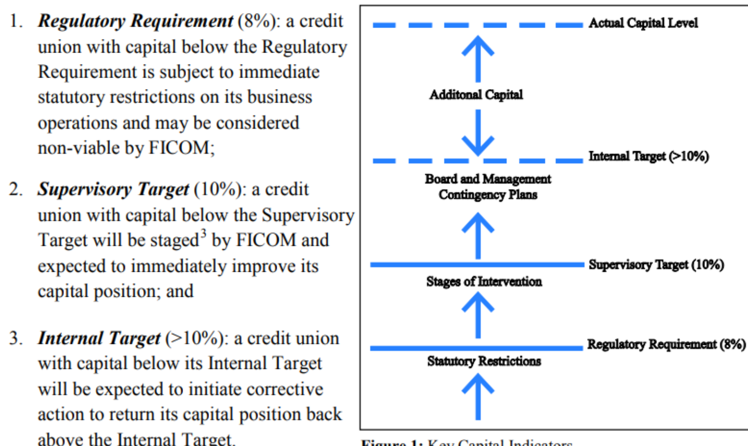

Figure 1: Key Capital Indicators

[3] More detail regarding FICOM's intervention stages can be found in its Guide to Intervention.

The ICAAP should be integrated with the credit union's strategic and business planning function, operational departments, and enterprise risk management (ERM) function. ERM assumptions should be realistic and specific to the credit union. The ICAAP report to FICOM should not be a formula-driven process of add-ons, instead expert judgement will continue to be necessary to operationalize the assessment of risk into capital planning.

The six key features of an effective ICAAP include:

(i) board and management oversight;
(ii) sound capital assessment and planning;
(iii) comprehensive assessment of material risks;
(iv) stress testing;
(v) monitoring and reporting; and
(vi) internal control review.

A credit union's ICAAP should be as simple or complex as needed, and should reflect the range of business activities, risk profile, and operating environment of the credit union.

FEATURES OF AN EFFECTIVE ICAAP

I. Board and Management Oversight

In order to effectively assess its capital adequacy, a credit union should have in place a sound risk management program appropriate for its risk profile and business plan. Management is responsible for the design and implementation of the ICAAP and should have a strong understanding of the nature and level of risk taken by the credit union and how this risk relates to adequate levels of capital.

As part of the strategic planning process, a credit union should analyze its current and future capital requirements in relation to its strategic objectives. The strategic plan should clearly describe the credit union's capital needs in relation to, at a minimum, board approved risk appetite and, where established by management, risk tolerance levels and target capital level. The board of directors has responsibility for setting the credit union's appetite for risk, for approving the overall capital plan, and for reviewing and approving the ICAAP.

II. Sound Capital Assessment and Planning

ERM includes the methods and processes used by organizations to identify and manage significant risks and is a key component of capital planning.

Many of the considerations of ERM overlap with the fundamental elements of a sound capital assessment and planning process, which include:

- a clear and documented process for evaluating risks and determining whether or not a risk should result in an explicit amount of capital being held;
- policies and procedures designed to ensure the credit union identifies, measures and reports all material risks requiring capital;
- a process that relates capital to the current and anticipated level of risk in accordance with board approved risk tolerance;
- a process that states capital adequacy goals with respect to risk, taking into account the credit union's strategic focus and business plan; and
- a process of internal controls, reviews, and audits to ensure the integrity of the overall risk management process.

Credit unions should consider several factors in relating capital to the level of risk, including:

- a comparison of their own capital ratios with regulatory standards and with those of industry peers;
- consideration of risk concentrations in credit and other activities;
- potential severe adverse events, including historical experiences of the credit union and the external economic environment; and
- planned changes in the credit union's business or strategic plans, identified changes in its operating environment, and consequential changes in its risk profile.

An effective capital planning process requires a credit union to:

- assess both the risks to which it is exposed, and the risk management processes in place to manage and mitigate those risks;
- evaluate its capital adequacy relative to its risks; and
- consider the potential impact on earnings and capital from potential economic downturns.

Credit unions should identify the time horizon over which they are assessing capital adequacy. They should evaluate whether long-term capital targets are consistent with short-term goals, based on current and planned changes in risk profiles and the recognition that building additional capital often requires significant lead time. Capital planning should factor in the potential difficulties of building capital during economic downturns and other times of stress.

III. Comprehensive Assessment of Material Risks

The ICAAP should capture all material risks faced by the credit union. Where risks cannot be measured precisely, a process should be developed to estimate risks. The techniques used in assessing material risks should be appropriate to the scope and complexity of the credit union's risk-taking activities, including Pillar 1 and Pillar 2 risks.

Pillar 1 Risks

Credit Risk

Increased credit risk may be evident where loan portfolios indicate a rising average risk profile. One approach is to establish target portfolio risk rating levels, above which additional capital may need to be allocated in addition to loan loss provisions and the regulatory minimum of 8%.

Credit unions should have methodologies that enable them to assess the credit risk involved in exposures to individual borrowers or counterparties, and at the portfolio level. The credit review assessment of capital adequacy should cover the following key areas:

- risk rating systems;
- portfolio analysis/aggregation;
- large exposures and risk concentrations; and
- securitization and complex structured instruments (where relevant).

The methodologies used to quantify credit risk should, at a minimum, include consideration of:

- historical loss experience;
- forecast and past economic conditions;
- attributes specific to a defined group of borrowers; and
- other characteristics directly affecting the collectability of a pool or portfolio of loans.

Market risk

Credit unions should identify balance sheet items that are subject to market risk and determine potential capital allocation for normal and stressed conditions.

Credit unions should have methodologies that enable them to assess and actively manage all material market risks. These should include consideration of any material investments held for trading or any other investments, which could reasonably expect to incur a write down. Many credit unions may not have a material amount of market risk as they do not actively engage in trading book type activities.

Operational Risk

Credit unions should consider whether current conditions represent potentially higher levels of operational risk.

Credit unions should have appropriate policies and procedures outlining approaches to identify, assess, monitor and control/mitigate operational risk. These should articulate risk appetite and the tolerance for operational risk, and the extent and manner in which operational risk is transferred outside the credit union. The adequacy of capital should be evaluated relative to the

degree of operational risk exposure within the credit union's ERM framework. This may be in addition to minimum capital requirements as determined under current regulations.
Credit unions are encouraged to refer to the Basel Committee on Banking Supervision for methodologies and further guidance. For example, under the basic indicator approach, credit unions allocate capital for 15% of the last 3 years' annual average total gross income.

Pillar 2 Risks

Concentration Risk

The impact of risk concentrations on both assets and liabilities should be reflected on a credit union's ICAAP. When assessing credit concentration risk, it is important to ensure that adequate additional capital is provided for all risk categories that are not widely diversified. While credit unions should include all material concentration risks, commercial concentration risk in particular should be considered in order to determine whether additional capital should be allocated.

For example, this might include applying higher risk weights to larger loans, different industry categories, or to portfolio balances in excess of target limits in any one industry sector.

Typical situations in which risk concentrations can arise include exposures to:

- a single counterparty, borrower or group of connected/related counterparties or borrowers;
- industry or economic sectors;
- unsecured or under-secured loans; and
- similar collateral types and other exposures arising from credit risk mitigation techniques.

Risk concentrations can also arise through a combination of exposures across these broad categories. Credit unions should have an understanding of their credit risk concentrations resulting from similar exposures across different business lines.

Interest Rate Risk

Credit unions should ensure that the methodologies and assumptions applied fully recognize any changes in exposures. The ICAAP should include all material interest rate risk positions of the credit union and consider all relevant re-pricing and maturity data. Such information will generally include, for example, current balance and contractual rate of interest associated with financial instruments and portfolios, principal payments, interest reset dates and maturities.

A credit union should be able to support its assumptions about the behavioural characteristics of non-maturity deposits, and other assets and liabilities. In general, an increase in uncertainty related to modeling and business complexity should result in more capital being held.

Credit unions are encouraged to refer to the Basel Committee on Banking Supervision's *Standards for Interest Rate Risk in the Banking Book* for methodologies and further guidance. Credit unions are required to allocate capital based on their interest rate risk exposure. For example, this may be a measure of credit union specific earnings at risk, or a minimum of 6% of eligible capital.

Funding Risk

Funding is vital to the ongoing viability of any credit union. Credit unions should consider the potential impact on capital of having to fund operations and growth with higher-cost funding than would normally be expected, including the use of securitization vehicles. This might include brokered deposits, lines of credit, or other facilities.

A credit union's capital position can have an effect on its ability to obtain funding, especially in a crisis. While credit unions are not expected to separately capitalize their funding risk, the stress testing scenarios for target capital planning and liquidity risk management should be complementary, with appropriate consideration of a potential increase in funding costs.

Other Significant Risks

Other significant risks should be incorporated into the credit union's risk management process and appropriately addressed in the ICAAP submission and capital calculation. Although risks such as strategic, legal, and reputational are not easily measurable, credit unions are expected to develop techniques for managing all material aspects of relevant risks.

Strategic risks often result from organizational changes or changes in fundamental market conditions. Legal and regulatory risks often arise from inadequate management of other risks inherent to the credit union. Reputational risk can lead to the provision of implicit support, which may give rise to credit, liquidity, market and legal risk – all of which can have a negative impact on credit union earnings, liquidity and capital position. Where securitization activities are material, credit unions should develop prudent contingency plans identifying responses to address capital pressures that arise when access to securitization markets is reduced.

IV. Stress Testing

In their ICAAPs, credit unions should examine future capital resources and capital requirements under adverse scenarios. Stress testing is a risk management technique used to evaluate the potential effect of highly unlikely but plausible events on the financial condition of a credit union. A credit union's capital planning process should incorporate forward-looking stress

testing that identifies plausible events or changes in market conditions that could adversely impact the credit union.

This internal stress testing is separate from FICOM's regulatory system-wide stress testing and should incorporate risk factors specific to the credit union.

V. Monitoring and Reporting

Credit unions should establish an adequate system for monitoring and reporting risk exposures, and assessing how changes to their risk profile affect the need for capital. Management and the board should receive regular reports on the risk profile and capital needs of the credit union. These reports should allow management to:

- evaluate the level and trend of material risks and their effect on capital levels;
- evaluate the sensitivity, completeness, and reasonableness of assumptions used in the capital assessment process;
- determine that the credit union holds sufficient capital against the various risks and is in compliance with established capital adequacy goals; and
- assess the future capital requirements based on the credit union's reported risk profile and risk appetite, and make necessary adjustments to the credit union's strategic plan.

VI. Internal Control Review

A credit union's internal control structure is essential to the capital assessment process. Effective control of the capital assessment process includes an independent review and, where appropriate. The credit union's board of directors has a responsibility to ensure that management establishes a system for assessing the various risks, develops a system to relate risk to the credit union's capital level, and establishes a method for monitoring compliance with internal policies. The board should regularly verify whether its system of internal controls is adequate to ensure the well-ordered and prudent conduct of business. The credit union should conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and reasonableness. Areas that should be reviewed include:

- appropriateness of the capital assessment process, given the nature, scope and complexity of its activities;
- identification of large exposures and risk concentrations;
- accuracy and completeness of data inputs into the assessment process;
- reasonableness and validity of scenarios used in the assessment process; and
- stress testing and analysis of assumptions and inputs.

Financial
Institutions
Commission

Financial Institutions Commission

2800 - 555 West Hastings Street
Vancouver, BC V6B 4N6
www.fic.gov.bc.ca

Reception: 604 660 3555
Toll Free: 866 206 3030
Fax: 604 660 3365
General email: FICOM@ficombc.ca