REGULATORY GUIDELINE

Internal Capital Adequacy Assessment Process

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I. INTRODUCTION

PURPOSE

This regulatory guideline is a Regulatory Guidance Document as contemplated by the Standards of Sound Business Practice (the Standards). It supplements and expands upon section 2.1, *Financial Management* of the Standards and must be adhered to by Saskatchewan credit unions.

The Standards specify the principles and requirements for an effective financial management framework. This guideline provides information and identifies requirements and expectations with respect to ICAAP, as described in Pillar 2 of the Basel Committee on Banking Supervision's Basel II capital framework.

BACKGROUND

The primary objective of the Basel II capital framework is to accurately align the capital requirements of financial institutions with their risk profile. Pillar 1 of the Basel II capital framework, which came into effect for Saskatchewan credit unions in 2009, outlines standardized rules for calculating minimum capital adequacy requirements based on the credit risk, market risk and operational risk profile of the institution. The objectives of Pillar 2 of the Basel II framework are to ensure that institutions maintain adequate capital to support all material risks on an ongoing basis, and to encourage institutions to develop and use better risk management techniques in monitoring and managing their risks through the ICAAP process.

Pillar 2 contains four key principles, which will be expanded upon throughout this guideline:

- Financial institutions should have an annual process (or more frequent as required) for assessing their overall capital adequacy in relation to their risk profile, and a strategy for maintaining their capital levels.
- Supervisory authorities (Supervisors) like the Corporation should review and evaluate financial institutions' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with the results of the ICAAP.
- Supervisors should expect financial institutions to operate above the prescribed minimum regulatory capital ratios and should have the ability to require them to hold capital in excess of the minimum.
- Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular institution and should require rapid remedial action if capital is not maintained or restored.

II. REGULATORY PRINCIPLES

Capital requirements specified in the Corporation's Standards of Sound Business Practice (SSBP) are regulatory minimum standards and assume that each credit union maintains a portfolio of risk exposures that is diversified, for example, by size, type and geographical dispersion. Because minimum regulatory capital requirements contain restrictive and simplified assumptions, the Corporation does not consider it prudent for credit unions to rely solely on compliance with regulatory minimums when assessing capital adequacy. The

Corporation expects credit unions to maintain capital levels above regulatory minimum standards, at levels appropriate for their individual risk appetite and risk profile.

Each credit union is responsible for developing and implementing its own ICAAP for the purpose of setting internal capital targets and developing strategies to achieve them. Strategies for achieving internal capital targets must be consistent with the credit union's business plans, risk profile and operating environment. The ICAAP should be enterprise wide and forward looking. It should be integrated with the credit union's strategic and business planning function, operational departments, and enterprise risk management function. The ICAAP should generate information that is integral to sound management and decision-making, and is not intended to be a regulatory compliance exercise.

The Corporation will evaluate how well credit unions assess their capital needs and their strategies for achieving internal targets. This will aid in the assessment of inherent risks, risk management techniques, and the potential need for regulatory supervision. This interaction is intended to foster an active dialogue between credit unions and the Corporation such that, when deficiencies are identified, prompt action can be taken to reduce risk or restore capital. While the Corporation makes use of information gleaned from a credit union's ICAAP to assess the quality of risk management and the adequacy of capital levels, the Corporation does not approve a credit union's ICAAP.

The Corporation recognizes the relationship that exists between the amount of capital held by a credit union against its risks, and the strength and effectiveness of its risk management and internal control processes. However, increased capital should not be viewed as the only option for addressing increased risks confronting the credit union. Other means for addressing risk, such as strengthening internal controls and risk management processes, and applying internal limits should also be considered. Furthermore, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

III. ICAAP PRINCIPLES

Credit unions should have a process in place for assessing their overall capital adequacy in relation to their risk profile, and a strategy for building and maintaining their capital levels. Credit unions must be able to demonstrate that chosen internal capital targets are well founded and consistent with their overall risk profile and control environment. In addition to internal factors, management should be mindful of external factors such as the economic environment, and the impact they may have on the credit union. Thorough, forward-looking stress testing should be performed to identify possible events or changes in market conditions that could have an adverse impact.

The six main areas of an effective ICAAP include:
- board and senior management oversight
- sound capital assessment and planning
- comprehensive assessment of risks
- stress testing
- monitoring and reporting
- internal control review

While these fundamental features of ICAAP are broadly prescribed, there is no single 'correct' approach or ICAAP template, and one approach does not fit all credit unions. An

ICAAP should be as simple or complex as required, and should reflect how the credit union is organized and managed. It should not be established solely to fulfill a regulatory requirement, nor should it be based on allocating existing capital on a purely relative basis. It requires a determination of the amount of capital that should be attributed to the credit union's risk profile given its circumstances.

The level of sophistication of ICAAPs will differ among credit unions, and will depend on their individual size, complexity, range of business activities, risk profile, and operating environment. Although there is no single correct approach to ICAAP, credit unions may wish to use the template provided to federally regulated financial institutions by the Office of the Superintendent of Financial Institutions (OSFI) as a guide. A link to this template is included in the Resources for Credit Unions section of this guideline.

BOARD AND SENIOR MANAGEMENT OVERSIGHT

A sound risk management process is the foundation for an effective assessment of the adequacy of a credit union's capital position. A credit union's board is responsible to oversee, and its management is responsible to design and implement an internal capital adequacy assessment process. In order to effectively assess its capital adequacy, a credit union should have in place a sound risk management program. Management should understand the nature and level of risk taken by the credit union and how this risk relates to adequate levels of capital. Management should also ensure that the formality and sophistication of the risk management processes are appropriate to the risk profile and business plan of the credit union.
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 define and describe the credit union's capital needs in relation to, among other things, board approved risk tolerance, anticipated capital expenditures, desirable capital level and, if appropriate, access to capital resources. Senior management and the board should view capital planning as a crucial element in a credit union's ability to achieve its strategic objectives.

The board of directors has responsibility for setting the credit union's tolerance for risk, and approving the overall capital plan. It should ensure that management:
- establishes a framework for identifying and assessing all material risks
- develops a system to relate risk to the credit union's capital level as part of its internal assessment of capital adequacy
- establishes a method for monitoring compliance with internal policies

The board should also adopt and support strong internal controls and written policies and procedures that align with the credit union's risk-taking ability and appetite, and ensure that management effectively communicates them throughout the credit union.

SOUND CAPITAL ASSESSMENT AND PLANNING

Capital planning refers to the higher level aggregation and decision-making processes at a credit union. It takes into account the short term tactical and long term strategic business plan, and capital numbers that are generated by the risk quantification process.

A sound capital assessment process should include the following fundamental elements:

- 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[1]
- policies and procedures designed to ensure that 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
- a process of internal controls, reviews and audits to ensure the integrity of the overall risk management process

Most 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 identified risk concentrations in credit and other activities
- their current and desired composite risk rating, as assigned by the Corporation
- potential severe adverse events, including historical experiences of the credit union and the external economic environment
- planned changes in the credit union's business or strategic plans, identified changes in its operating environment, and consequential changes in its risk profile

Credit unions with more complex and varied risk profiles will likely use risk modeling techniques and integrated scenario analyses to evaluate risks. These should be incorporated into their overall assessment of capital adequacy. Quantifiable estimates of risk used in this assessment should also have a business use (i.e. should not be made solely for use in ICAAP) and should by subject to validation.

Smaller, less complex credit unions are likely to continue to rely heavily on subjective, well-documented considerations when evaluating the adequacy of capital relative to risk, and when determining the appropriate level and structure of capital. Subjective considerations may include regulatory expectations, peer group analysis, and other qualitative factors including forward-looking stress tests and sensitivity analysis. For risks that cannot be directly quantified (e.g. reputation risk), credit unions may use well-documented, qualitative considerations.

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
- 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.

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[1] Not all risks can be directly quantified and capitalized. Material risks, including those that are difficult to quantify in an ICAAP framework should be mitigated by internal controls and contingency plans.

COMPREHENSIVE ASSESSMENT OF 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. The following risk exposures, which is not a complete list of all risks, should be considered.

Credit Risk

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 four areas:

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

The sophistication of the methodologies used to quantify credit risk should be appropriate to the scope and complexity of the credit union's risk-taking activities. Less complex credit risk-taking activities may include a variety of methodologies but should, at a minimum, take into consideration:

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

Risk Concentrations

The impact of risk concentrations on both assets and liabilities should be reflected on a credit union's ICAAP. Typical situations in which risk concentrations can arise include exposures to:

- a single counterparty, borrower or group of connected counterparties or borrowers
- industry or economic sectors
- geographical regions
- 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.

A credit union may also incur a concentration to a particular asset type indirectly through investments backed by such assets (e.g. collateralized debt obligations) as well as through collateral or guarantees used to mitigate credit risk. Credit unions that place more reliance on collateral values than on an evaluation of a borrower's or counterparty's capacity to perform may see themselves exposed to unexpected risk.

Risk Diversification

Credit unions should exercise caution when including risk diversification benefits in ICAAP. Assumptions on diversification are often based on judgment and are difficult to validate. Credit unions should be conservative in their assessment of diversification benefits, in particular between different classes of risk, and should consider whether such benefits actually exist under stressed conditions.

Operational Risk

Similar rigour should be applied to the management of operational risk as is done for the management of other significant risks facing credit unions. Failure to properly manage operational risk can result in a misstatement of the credit union's risk profile, and expose it to significant losses.

Credit unions should have appropriate policies and procedures outlining approaches to identify, assess, monitor and control / mitigate operational risk. These should articulate the board's appetite and 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 enterprise risk management framework.

Interest Rate Risk

The ICAAP should include all material interest rate risk positions of the credit union and consider all relevant repricing 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. Given uncertainty in such assumptions, stress testing and scenario analysis should be used in the assessment of interest rate risks.

Liquidity Risk

Liquidity is crucial to the ongoing viability of any financial institution. While credit unions are not expected to separately capitalize their liquidity risk, the stress testing scenarios for target capital planning and liquidity risk management should be complementary.

Other Risks (Strategic, Reputation, and Legal and Regulatory)

Although such risks as strategic, legal and regulatory, and reputational are not easily measurable, credit unions are expected to develop techniques for managing all material aspects of these 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 institution. Reputation risk is a key issue for credit unions, as the financial industry relies on the confidence of member and non-member customers, and the general marketplace.

Credit unions should identify potential sources of reputational risk to which they are exposed. This includes the credit union's business lines, liabilities, affiliated operations, off-balance sheet vehicles and the economic market. The risks that arise should be incorporated into the credit union's risk management processes and appropriately addressed in its ICAAP and liquidity contingency plans.

STRESS TESTING

Stress testing is a risk management technique used to evaluate the potential effect that a set of specified changes in risk factors, corresponding to exceptional but plausible events, has on the financial condition of an institution. To complement and validate other quantitative and qualitative risk management approaches, credit unions should include rigorous, forward-looking stress testing that identifies possible events or changes in market conditions as a component of an ICAAP. Stress testing should be appropriate to the nature and complexity of the credit union and its risk profile.

The results of stress tests can be used for many different purposes, including:

- testing the ability of the institution to absorb losses
- adjusting risk appetite and existing controls
- developing capital management plans and targets

The results of stress testing should be considered when evaluating the adequacy of a credit union's capital.

MONITORING AND REPORTING

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

- evaluate the level and trend of material risks and their effect on capital levels
- evaluate the sensitivity 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
- assess the future capital requirements based on the credit union's reported risk profile and make necessary adjustments to the credit union's strategic plan

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 involvement of internal and external audits. The board should regularly verify whether its system of internal controls is adequate to ensure the well-ordered and prudent conduct of business.

The board of directors is responsible 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
- establishes a method for monitoring compliance with internal policies

Credit unions should conduct periodic reviews of risk management processes to ensure their 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
- stress testing and analysis of assumptions and inputs

IV. SUPERVISORY REVIEW

The Corporation requires credit unions to operate above minimum prescribed regulatory capital ratios. Credit unions must have sufficient capital to support their risk profile, (e.g. inherent risks and overall net risk), as determined through the Corporation's risk-based supervisory process.

The Corporation's supervisory review process evaluates the inherent risks within each significant activity undertaken by a credit union and then evaluates the quality of risk management applied to mitigate these risks. The Corporation's assessment of a credit union's ICAAP supplements its assessment of inherent risks and risk management policies and practices.

As a credit union's ICAAP is intended to be integrated with its strategic and business planning function, operational departments and enterprise risk management function, ICAAP reviews will occur during the regular credit union review process. The review of a credit union's ICAAP will be proportional to the level of capital it holds, the nature, scale and complexity of its activities, and the risks posed to the safety and soundness of the credit union. The Corporation will intervene at an early stage to prevent capital falling below minimum levels required to support the risk characteristics of a particular credit union, and will require prompt remedial action if its capital is not maintained or restored.

The Corporation will review a credit union's internal capital adequacy assessments and strategies, and assess the degree to which internal targets and processes incorporate the full range of material risks it faces. To this end, the Corporation will review the adequacy of risk measures used to assess internal capital adequacy and the extent to which these risk measures are used operationally to set limits, evaluate business line performance, and evaluate and control risks more generally. The results of sensitivity analysis and stress tests conducted by the credit union will be considered, particularly in terms of how the results relate to capital plans.

The dialogue between the Corporation's assessment of inherent risks and the credit union's ICAAP will include the following three elements:

- the level of conservatism in the internal estimates of the risks faced by the credit union
- the extent that material risks are fully captured by the credit union (e.g. have credit risks been fully captured, has the credit union fully considered all aspects of reputation risk, or underestimated strategic risks)
- external factors, where not already considered in the previous points, including stress testing, the impact of economic cycles and other external risks and factors

The Corporation expects the capital assessment will not become a formula-driven process of add-ons. Expert judgment will continue to be necessary to operationalize the assessment and quantification of risk, and integrate those results into the overall assessment of capital.

V. RESOURCES FOR CREDIT UNIONS

Credit Union Deposit Guarantee Corporation - Risk-Based Monitoring Assessment Criteria

VI. ADDITIONAL INFORMATION FOR CREDIT UNIONS

OSFI Guideline E-19 - Internal Capital Adequacy Assessment Process (ICAAP) for Deposit-Taking Institutions

Bank for International Settlements - Basel II, Pillar 2, Part 3 - The Supervisory Review Process

Bank for International Settlements - Enhancements to the Basel II Framework