

GUIDANCE NOTE FOR DEPOSIT TAKERS

(Applies to Isle of Man incorporated entities only)

Internal Capital Adequacy Assessment Process

("ICAAP")

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Financial Supervision Commission Barrantee Oaseirys

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I. Background & Scope

- I.1 Key Principle I of the Basel Committee's document "International Convergence of Capital Measurement and Capital Standards", which is more commonly referred to as Basel II, requires that deposit takers (hereinafter referred to as bank or banks as applicable) have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. In addition, Key Principle 3 states that supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- I.2 Rule 2.23 (1)(a) of the Financial Services Rule Book 2008 requires a bank incorporated in the Isle of Man to establish and maintain an internal capital adequacy assessment process ("ICAAP") which is appropriate to the nature and scale of its business.
- I.3 The ICAAP should relate risks to the amount of capital a bank holds. The bank has to have an ICAAP and must be able to explain it to the Commission; the Commission has a duty to review the bank's ICAAP. This review is an integral part of the Commission's risk assessment of the bank and determination of the bank's minimum risk asset ratio ("RAR").

The purpose of this guidance is to:

- Highlight the key features of the ICAAP (section 2);
 - Review a simple ICAAP design (section 3); and
 - Highlight the Commission's key considerations when reviewing the ICAAP (section 4).
- I.4 The minimum regulatory RAR is 8% as prescribed in the Financial Services Rule Book 2008, although this may be set at a higher level for individual banks by way of Direction. All banks are required to observe a non-statutory trigger ratio of at least 1% above the bank's minimum RAR. This is intended to provide a cushion to reduce the risk of a bank breaching the minimum requirement and to provide an early warning signal of deterioration in a bank's capital adequacy.
 - I.5 It is expected that a bank will adopt a proportionate approach to the ICAAP and the Commission expects ICAAPs to vary in detail depending on the nature, scale and complexity of individual banks.
 - I.6 The responsibility for the ICAAP is that of the Board and Senior Management.
 - I.7 The Commission expects the ICAAP to be subject to a periodic review which should be annual as a minimum. If there is no material change to the risk profile of a bank, confirmation of this to the Commission will be sufficient. However, where a bank's risk profile has changed to a material

extent during the year, the Commission will require a revised ICAAP to be submitted which will be reviewed as part of the SREP.

- 1.8 Certain inherent risks are within the scope of the minimum capital requirements of Basel II, Pillar I, and so capital has already been allocated to these. However, there are residual risks arising out of some of the above which are not covered under Pillar I and there are other inherent risks which are not covered at all and which must be addressed by the ICAAP under Pillar 2.

The following table provides a summary:-

Inherent Risks	Covered under Pillar I	To be addressed under Pillar 2 as part of the SREP
Strategic / Business		√
Operational	√	
Residual operational (i/c legal risk)		√
Reputation		√
Liquidity		√
Credit	√	
Credit concentration risk		√
Market Risk	√	
Interest rate risk		√
Foreign exchange risk	√	
Financial Soundness (including ICAAP assessment)		√
<i>Controls</i>		
Corporate Governance & Management		√
Internal Control Systems		√
Systems & Controls		√

2. Key Features of the ICAAP

2.1 Board and senior management oversight

- 2.1.1 The Board and Senior Management have primary responsibility for ensuring that a bank has adequate capital to support its risks. The capital required should, as a minimum, enable a bank to operate as a going concern and be sufficient to provide for business growth.

2.1.2 To meet its responsibility the Board should establish a capital policy that includes:

- A bank's capital adequacy goals in relation to its risk profile, taking into account its strategic focus and business plan;
- The approved capital targets that are consistent with a bank's overall risk profile and financial positions;
- Measures that would be taken in the event capital falls below a targeted level; and,
- Measures to ensure that a bank is in compliance with minimum regulatory standards.

2.1.3 The Board should also maintain policies to supplement the capital policy in relation to:

- Risk Management;
- Stress Testing;
- Dividend Payout; and,
- Provisioning methodology.

2.1.4 The Board is responsible for integrating capital planning and capital management into a bank's overall risk management approach. The ICAAP should form an integral part of the management process and decision making culture of a bank.

2.2 *Sound Capital Assessment*

2.2.1 There should be policies and procedures to ensure that a bank identifies, measures and reports all material risks.

2.2.2 There should be a process that relates capital to the level of risk.

2.2.3 There should be a process of internal controls, reviews and audit to ensure the integrity of the overall process.

2.2.4 The ICAAP should be fully documented (specification, methodologies, assumptions, procedures, responsibilities) as should a bank's capital policy. A periodic review should be carried out by the Board (at least annually).

2.2.5 The ICAAP should be comprehensive and should cover Pillar 1 risks, risks not fully captured under Pillar 1 (e.g. underestimation of credit/operational risks using the simpler approaches), Pillar 2 risks (e.g. liquidity, concentration risk, strategic risk), and risk factors external to a bank which may arise from the regulatory or economic environment.

2.2.6 The ICAAP should be forward looking and should take into account a bank's strategic plans e.g. loan growth expectations. Banks should conduct appropriate stress tests.

2.2.7 The ICAAP should produce a “reasonable” outcome. A bank should be able to explain the similarities and differences between its ICAAP and its own funding requirements.

2.3 *Comprehensive assessment of risks*

2.3.1 The adequacy of a bank’s capital is a function of its risk profile. Capital targets should be consistent with the risk profile and operating environment of a bank. Other considerations such as external rating goals may also be taken into account, although this is not especially relevant to banks on the Isle of Man.

2.3.2 ICAAPs are likely to be a mixture of detailed calculations and estimates with some risks being assessed on a quantitative basis and others being more qualitative. A bank should clearly establish such distinctions.

2.3.3 Non-quantifiable risks should be included if they are material even if it is only possible to estimate them, though this requirement could be eased if there is a clear policy to mitigate such risks.

2.3.4 All material risks should be addressed (please refer to the Supervisory Approach for a list of the inherent risks for banks). A bank should ensure that the following specifics are covered:-

Credit Risk

While banks use credit risk mitigation (“CRM”) techniques to reduce their credit risk, these techniques give rise to risks that may render the overall risk reduction less effective. These additional risks are mainly legal risk and documentation risk.

Credit Concentration risk

A risk concentration is any single exposure or group of related exposures with the potential to produce losses large enough to threaten a bank’s health or ability to maintain its core operations. Such concentrations are not addressed in the Pillar I capital charge for credit risk.

Credit risk concentrations include:-

- Large exposures;
- Credit exposures to parties connected to the bank;
- Credit exposures to counterparties in the same economic sector or geographic region;
- Credit exposures to counterparties whose financial performance is dependent on the same activity or commodity; and,
- Indirect credit exposures arising from a bank’s CRM activities (e.g. exposure to a single collateral type).

The Commission has published guidance on Credit Risk and Large Exposures which is available on its website www.fsc.gov.im.

Operational Risk

Gross income, used in the Basic Indicator and Standardised Approaches for operational risk, is only a proxy for the scale of operational risk exposure of a bank and can, in some cases (e.g. for banks with low profitability) underestimate the need for capital for operational risk. The Commission will consider whether the capital requirement generated by the Pillar I calculation gives a consistent picture of a bank's operational risk exposure.

2.4 *Monitoring and Reporting*

- 2.4.1 A bank should have a system for monitoring and reporting risk exposures and assessing how a bank's changing risk profile affects the need for capital.
- 2.4.2 The Board should regularly receive reports on a bank's risk profile and its capital needs, allowing them to evaluate the level and trend of material risks and their effect on capital levels; evaluate the sensitivity and reasonableness of key assumptions used in the capital assessment measurement system; determine that a bank holds sufficient capital in light of the bank's risks, and assess future capital requirements and adjust the strategic plan accordingly.

2.5 *Internal Control Review*

- 2.5.1 The ICAAP should be reviewed regularly and at least annually (refer Rule 2.23 1(b) of the Financial Services Rule Book 2008) to ensure it is still appropriate. It should also be subject to independent review with the involvement of internal and external audit where appropriate.
- 2.5.2 A bank should conduct periodic reviews of the risk management process including the appropriateness of the capital assessment process, given the nature and scale of the bank's operations, identification of large exposures and risk concentrations, accuracy and completeness of data inputs into a bank's assessment process, and reasonableness and validity of scenarios used in the process.

2.6 *Group/parent ICAAPs*

- 2.6.1 An Isle of Man incorporated bank is a separate legal entity regulated by the Commission and as such, the Commission expects a bank to have its own ICAAP. However, it is appreciated that a bank may wish to leverage off expertise at group level and draw on the group/parent ICAAP. In such cases local management is expected to be able to explain how this relates to the Isle of Man subsidiary and demonstrate why they are satisfied that the level of capital is adequate given a bank's risk profile. It is also expected that the Isle of Man ICAAP will have been reviewed and signed off by Group in these situations.
- 2.6.2 Although there is a requirement for stress testing, identifying possible events or changes in market conditions that could adversely affect a bank, it is recognised that stress testing is often best performed on a group basis. As such, it is acceptable for a banking group to determine the capital

requirement at group level and either retain it at a consolidated or sub-consolidated level or allocate it across the group using a proxy such as balance sheet size.

3. Design of the ICAAP

3.1 There is no prescribed format for the ICAAP and it is acknowledged that ICAAPs will vary depending on the nature and complexity of individual banks' operations. However, *Appendix I* includes details of a suggested format that banks may wish to use.

3.2 A simple option is to use the statutory minimum as a starting point, adjusting it with a capital add-on to take into account elements outside the consideration of Pillar I, including forward looking elements. A bank would need to be able to demonstrate that it had adequately assessed all material risks outside the statutory minimum and found that these were addressed by the capital add-on.

A bank may conclude that no capital add-on is required.

3.3 A bank may decide to take the following approach:-

- Prepare a list of the major risks to which each business line is exposed;
- Identify and consider a bank's largest losses over the past 3 – 5 years and estimate where future losses may arise;
- Consider what actions a bank would take and how much capital would be required in the event that each of the risks materialised;
- Consider the extent to which a bank's Pillar I capital requirement adequately captures the above and how much additional capital may be required;
- Consider a bank's strategy and business projections and estimate the impact on the bank's capital;
- Carry out sensitivity tests to analyse the impact on earnings of a shift in parameters (e.g. an increase in interest rate risks) and consider the impact of a range of adverse economic scenarios on the bank's future earnings;
- Document the conclusions of the above process ensuring that
 - Senior management has been involved in arriving at these conclusions; and,
 - A process is in place to ensure the integrity of the conclusions.

4. **Review of the ICAAP by the Commission** *(also refer to the Commission's supervisory approach in relation to its SREP which is available on the Commission's website)*

4.1 The Commission will have regard to:-

- The soundness of the overall ICAAP given the nature and scale of a bank's business activities;
- The degree of management involvement in the process e.g. whether target and actual capital levels are monitored and reviewed by the Board;
- The extent to which the internal capital assessment is used routinely within a bank for decision-making purposes;
- The extent to which a bank has provided for unexpected events in setting capital levels;
- The reasonableness of the outcome of the ICAAP in terms of whether:
 - The amount of capital required as demonstrated by the ICAAP is sufficient to support the risks faced by the bank; and
 - Whether the levels and composition of capital chosen by the bank are comprehensive, relevant to the current operating environment, and appropriate for the nature and scale of the bank's business activities.

4.2 A bank should be able to explain and demonstrate to the Commission:

- How its ICAAP meets supervisory requirements;
- How its material risks are defined, categorised and measured;
- How internal capital targets are chosen and how those targets are consistent with the overall risk profile, current operating environment and future business needs; and
- The reason for any differences between the ICAAP's level of capital and the regulatory requirement.

Appendix I

ICAAP Submission

The ICAAP document

The ICAAP document is the bank's explanation to the Commission of its internal capital adequacy assessment process. The Commission expects this document to be signed off by the bank's Board of directors.

The level of detail provided will vary from bank to bank but it is suggested that any working papers used to support the document's conclusions are attached as appendices.

1. EXECUTIVE SUMMARY

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This would typically include:

- The purpose of the report and the regulated entities covered;
- The main findings of the ICAAP analysis;
 - The amount of capital the bank considers it should hold compared to the Pillar I calculation;
 - The adequacy of the bank's risk management processes;
- A summary of the financial position of the bank;
- An overview of the bank's strategy;
- A brief description of the capital and dividend plan; how the bank intends to manage capital going forward and for what purposes;
- Commentary on the most material risks, why the level of risk is acceptable or what mitigating actions have been/will be put in place;
- Commentary on major issues where further analysis is required;
- Who has carried out the assessment, how it has been challenged and who has approved it.

2. BACKGROUND

This section should include relevant organisational and historical financial data for the bank. This may include details of the group structure, profitability, dividends, capital

resources, deposit liabilities and any conclusions that can be drawn from trends in the data that may have implications for the future. It would also give a brief description of expected changes to the bank's current business profile.

3. SUMMARY OF CURRENT AND PROJECTED FINANCIAL AND CAPITAL POSITIONS

This section should explain the present financial position of the bank, any changes to its current business profile, projected business volumes, projected financial position and future planned sources of capital.

4. CAPITAL ADEQUACY

This section is the detailed review of the capital adequacy of the bank and should include the following information:-

Timing

- The effective date of the ICAAP calculations, with details of any events that have happened since and that may materially change the ICAAP's calculations. The impact of such events should be included.
- Details of, and rationale for, the time period over which the capital has been assessed.

Risks analysed

- Articulation of the bank's risk appetite;
- Identification of the areas of risk considered and the major risks arising in those areas;
- Details of mitigating actions in relation to major risks;
- Conclusions arising out of the risk assessment.

Methodology and assumptions

- A description of how the risk assessment has been carried out and what assumptions have been made;
- An explanation of how the risk assessment relates to the additional capital the bank concludes is required;
- It is assumed that most banks in the Isle of Man will use the following methodology:-

- Calculation of the capital required under Pillar 1;
 - Consider the risks not covered or not fully covered under Pillar 1 and assess what additional capital is required;
 - Add Pillar 1 and Pillar 2 calculations.
- Where internal models are being used to quantify risks the following information will be required:-
 - The key assumptions and parameters within the capital modelling work and background information on the derivation of key assumptions;
 - How parameters have been chosen, including the historical period used and the calibration process;
 - The limitations of the model;
 - The sensitivity of the model to changes in the key assumptions or parameters chosen;
 - The validation work undertaken to ensure the continuing adequacy of the model(s).

Sensitivity Analysis

This section would detail the sensitivity tests undertaken to key assumptions and factors that have a significant impact on the broader financial condition of the company e.g. changes in interest rates. Material changes in the financial risks to which the business is exposed would be explored and quantified as far as possible.

Stress testing

Where this is performed on a group basis, a decision may be made to retain any required capital at a consolidated or sub-consolidated level. Alternatively, capital may be allocated across the group on a pro rata basis. This section should include an explanation of what methodology has been used and the rationale.

Where stress testing is carried out at the bank level, this section should include details of these. Information such as the range of scenarios, key assumptions and confidence levels should be provided.

Typical scenarios at group level or locally could include:-

- How an economic downturn would affect the bank's or group's capital resources, Pillar 1 capital requirements and its future earnings;
- How changes in the credit quality of the bank's credit risk counterparties affect the bank's capital and its credit risk requirement; and,
- An assessment by the bank or group of how it would continue to meet its regulatory capital requirements through a recession, the severity of the recession being one that occurs once in a 25 year period.

Group Involvement

Where the bank has had recourse to the group ICAAP and/or stress testing, this should be stated together with an explanation as to how this relates to the group's Isle of Man operation.

5. AGGREGATION AND DIVERSIFICATION

This section would describe how the results of separate risk assessments have been combined to obtain an overall view of capital adequacy. This requires some sort of methodology to be used to quantify the amount of capital required to support individual risks so that they can be aggregated into a total figure. Any adjustments made for diversification or risk correlations should be explained.

6. CHALLENGE AND ADOPTION OF THE ICAAP

This section would describe the extent of challenge and testing of the ICAAP. It would include any testing and details of the review and approval process.

Details of the reliance placed on group ICAAPs, or reports obtained from an external reviewer or internal audit should be referred to in this section. Relevant copies of such reports should be attached.

7. USE OF ICAAP WITHIN THE BANK

This would demonstrate the extent to which capital management is embedded within the bank including the extent and use of capital modelling or scenario analysis and stress testing e.g. for setting prices and reviewing the level and nature of future business. Details of any planned future refinements of the ICAAP should also be included.

Appendix 2 – Glossary

“Bank” is the Isle of Man incorporated deposit taker

“SREP” is the supervisory review and evaluation process (in relation to a bank’s ICAAP)