BANKA QENDRORE E REPUBLIKËS SË KOSOVËS
CENTRALNA BANKA REPUBLIKE KOSOVA
CENTRAL BANK OF THE REPUBLIC OF KOSOVO

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ICAAP – INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

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PURPOSE

In the process of adopting the Basel Capital Framework, through the ongoing Project for Implementation of Basel Framework, as well as for the further harmonization of the Banking Supervision Framework with EU Directives that regulate this field, CBK has prepared the Advisory Letter with the intention to initiate the implementation of ICAAP – Internal Capital Adequacy Assessment Process for banks that operate in Kosovo.

Based on the above, this Advisory Letter shall be considered as a guideline for banks to begin the necessary preparations for the implementation of ICAAP, in order to start to adopt their internal processes that are required for the assessment of their capital adequacy depending on the structure of their balance sheets and their business strategic plans. This Advisory Letter contains the Core ICAAP Principles which are considered essential by the CBK in order to begin the preparation for implementation of ICAAP. In the meantime, the CBK expects from banks to start reviewing and developing their policies and internal systems in order to prepare for the proper implementation of an adequate internal process for the assessment of their capital needs, specifically to implement ICAAP, as one of the crucial parts of Basel Capital Framework - Pillar II requirements.

ICAAP –Internal Capital Adequacy Assessment Process

Advisory Letter for Banks of the Republic of Kosovo

Outline

1. Introduction

This Advisory Letter provides recommendations for the banks operating in the Republic of Kosovo on how they might approach the Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP intends to initiate the Central Bank of the Republic of Kosovo (CBK) Pillar II assessment concept as initially imposed under the "Basel Accord" (2006). Inherently, the ICAAP has the intention to assist banks to identify, assess and manage risks in a required and appropriate manner to conduct the process of the internal assessment of its capital adequacy. The recommendations in this paper are without prejudice to the internal methodologies a bank may have to assess risks. The paper relates only to issues concerning how to determine the internal capital needed according to Pillar II of Basel Capital Standards.

Generally, banks have an own designed strategy to manage their risks. This risk management approach normally is proportional to the nature, scale and complexity of the risks inherent to the banks business model and institution activities and actual influence of the risk management decisions. Every bank whether, formally or informally, follows specific principles and processes to identify, assess, monitor and manage its risks. With the conception of adequate principles and processes of more standardized and transparent risk management, banks can reduce the potential of arising risks.

Besides of the various implemented methods (by regulatory or internal methodologies) for calculating minimum capital requirements and regular public disclosures, standardized internal capital requirements processes of banks became more and more important for an effectively monitoring and managing the range of risks to which they are or could be exposed in their operational business.

The implementation of these required conditions will challenge banks but their duty is to establish a well-functioning internal system including standardized procedures and methodologies to ensure that they have adequate own funds to cover the material risks in a long-term. In essence this requires banks to integrate a forward-looking approach to their risk management processes.

In this regard a bank may develop internal methods that include a variety of qualitative and quantitative components which should limit the exposure to risk and form a basis for a systematic improvement of its risk profile. Banks should demonstrate the appropriateness and integrity of the ICAAP used within a constructive and ongoing dialogue with the CBK. This dialogue should ensure that the CBK appreciates the correctness of the results with taking the essential supervisory measures in the issue of deficiencies being recognized.

Approaches to ICAAP described in this Advisory Letter are not mandatory, banks can use also other approaches to establish and implement their ICAAP. The highlighted recommendations are instead to be seen as a supervisory guidance from which banking institutions can collect ideas on how to approach the ICAAP according to Pillar II of Basel Capital Standards. This paper has been prepared by the CBK with the sole purpose of offering suggestions which might be helpful to banks in designing their ICAAP. According to Principle 1 of Pillar II of Basel Captial Framework Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels. Moreover, designing the appropriate ICAAP should first and foremost be in bank's own interest (and in the interest of the stakeholders that are in any way related to the bank). Notwithstanding that the interests of the individual groups of entities do not always coincide, they all share an interest in the bank not taking up risks in a way (in relation to the level or type) that could endanger its survival. The essential objective of the ICAAP is thus the establishment of the bank’s risk profile, and the early identification of internal and external factors that could adversely affect its performance.

The aim of this Internal Capital Adequacy Assessment Process Advisory Letter of the CBK **is to provide supervisory expectations on standardized framework for establishing and implementing the ICAAP, including reporting to the CBK as an important part in order to ensure a healthy banking system**.

1.1. Definition

In the following section the ICAAP and Risks (speaking in terms of processes for identification, quantification and aggregation of risks, and calculation internal capital and risk bearing capacity) will be defined in more detail.

1.1.1. ICAAP

The Internal Capital Adequacy Assessment Process outlines and determines material risks a bank is or could be exposed. On the basis of established ICAAP a bank calculates its individual internal capital requirements for particular material risks and as a whole and determines its risk-bearing capacity. When determining its risk-bearing capacity a bank defines the level of particular material risks that it is able to take, and to secure sufficient capital to cover such risk. This exercise also provides for an opportunity to critically analyze the amount of risk that it is reasonable to take in relation to the corresponding opportunities and threats.

A bank should demonstrate that its internal capital assessment is comprehensive and adequate to the nature of risks arising from its business activities and its operating environment. The framework under which a bank should develop its ICAAP is expected to be risk-based. It should be noted that ICAAP is oriented towards the quantitative elements of the risk management process (i.e. to the calculation of internal capital requirements), and towards the qualitative elements designed to strengthen the bank's internal environment. For example, the bank can make the argument with the supervisor for a lower internal capital requirements for an individual risk to which it is exposed by virtue of a high-quality internal control environment based on which it can effectively manage and mitigate this risk. Thus, the Advisory Letter emphasizes the importance of both capital planning and the importance of management, including qualitative aspects of risk management.

An important part of the ICAAP is to identify risk as an integral part of the banks business. The changing financial and economic markets conditions require a systematic approach to detect and manage risks. This approach has to be based on functional and effective methods that allow banks efficient identification, assessment, monitoring and managing of the individual risks. In this regard the implementation and accomplishment of the ICAAP should not be solely interpreted as a banks duty within the supervisory expectations, but also as a support for the appropriate information to their own stakeholders. The ICAAP implementation should provide for an appropriate individual risk profile in order to detect early internal and external factors which could threat and affect the performance of banks.

The implementation of the ICAAP is subdivided in two steps which need to be taken by banks. The first step should ensure to identify the amount of risk which is reasonable for the institution in context to its corresponding business profile and strategies, known as the risk appetite of the bank. In the second step banks have to determine their risk-bearing capacity and identify the risks position that they are able to cover within this risk bearing.

1.1.2 Risks

ICAAP should be a part of a bank's comprehensive and individual risk management framework. The CBK anticipates that these risk management and capital adequacy processes should be related and consistent with the business strategies or planning, including the operational part of the bank. The information provided by the bank to the CBK about the risk appetite and the risk management shall include a list of all material risks of a bank. All banks concerned have the responsibility for defining a risk management process and systems that are suitable for their individual business and risk profile.

As an orientation for an initial specification of the bank's risk profile indicators such as the size of the bank, the risk level or complexity of transactions (including intra-group transactions), the scale of business activities and the significance of new markets or transactions (e.g. international exposures) might be useful.

1.1.2.1 Risk Identification

The risk identification is the initial and important stage in the risk management process which should record all material risk exposures that the bank is facing and might influence its financial targets. This step is overly crucial to set the stage for the remainder of the risk management process for the bank to control risks which have been identified. For the process of identifying risks, the bank should define the data and the sources which will be necessary for the quantification of the risk position. This process should also identify changes in the existing risks and the emergence of new risks, including the risks which arise from launching of new business activities or new products.

1.1.2.2 Risk Quantification

The risk management process according to the ICAAP has to cover the detailed quantification of bank's risks. This task is needed to create an objective basis for an overall decision-making process in the bank and is especially important for the board and senior management oversight the bank. The risk quantification ensures that the bank is capable to make clear statements about its risk-bearing capacity and the evaluation of its risk monitoring within the ICAAP.

1.1.2.3 Risk Aggregation

Individual risks of the bank have to be aggregated to determine the overall amount of risk in the ICAAP. It is important to ensure that no material risks are omitted or captured incompletely, while it is also necessary to ensure that risks are not recorded redundantly. More sophisticated and complex banks are required to involve a more appropriated aggregation process with assigned governance responsibilities and to ensure an adequate data quality. Accordingly, a proper documented and comprehensive process is necessary for the risk aggregation in order to ensure an overall perspective for assumptions regarding interdependencies among individual risks.

1.1.2.4 Risk Coverage Capital

Banks are required also to quantify their risk cover which can change due to the banks earnings in the course of the business year. The CBK can require from banks in specific cases to inject additional own funds for inadequate coverage of specific risk exposures, an inadequate risk management system or an adverse impact from external factors (e.g. macroeconomic environment).

1.1.2.5 Risk Bearing Capacity

Risk Bearing Capacity is the maximum amount of risk a bank is able to assume given its capital base, risk management and control measures, as well as its regulatory constraints. Bank should assess its Risk Bearing Capacity in terms of the level of material risks, including the aggregate level of these risks, it is able to bear, especially considering the sufficient capital to cover such risks and other appropriate measures for managing risks (i.e. qualitative measures). Also each bank should critically analyze its risk profile in consideration of the reasonability and also with regard to the corresponding opportunities and threats. The bank’s individual risk profile should be detailed, regularly updated and transparent to ensure appropriate assessment of its risk bearing capacity.

1.2 Requirements for the ICAAP

With the introduction of capital standards a set of minimum requirements for the ICAAP are deemed necessary. The requirements for the ICAAP include processes for assessing the risks arising from bank’s activities and should ensure that the capital held is adequate to the bank’s risk profile. The ICAAP requirements embrace also the idea about the strategic maintaining of capital adequacy in the long-term with setting of capital targets consistent to the risk profile, the risk appetite and minimum capital requirements of the bank.

1.2.1 Proportionality

Every bank should ensure that the implementation of its ICAAP is comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and bank's activities. This means each ICAAP should be tailored to the individual characteristics of the bank. More structural complex banks have to implement a more sophisticated and proportional process approach. On the other hand less complex banks with a simpler business structure can use a more simplified approach, which suits in a better way their individual business profile.

The ICAAP should be prepared by banks which are licensed by CBK and operate in the Republic of Kosovo. Branches of foreign banks may use this advisory letter for their internal purposes in order to strengthen their risk management.

1.2.2 Risk Management Framework

The ICAAP has to consider all material risks, as an indication, for the bank to which they are exposed. This risk indication should include Concentration Risk, Control/management Risk, Credit Risk, Interest Rate Risk, Liquidity Risk, Operational Risk and also Strategic Risks. If an individual bank is exposed to additional risks than the above-mentioned ones, it is in its duty to consider these relevant risks in the ICAAP as well.

1.2.2.1 Concentration Risk

Concentration Risk resulting from concentrated loan portfolios could be a significant factor, especially for smaller banks. If a bank chooses to use the minimum capital requirement as a starting point for its capital assessment, it should note, when assessing its exposure to concentration risk, that the minimum capital requirement is calibrated on the assumption that a bank has a well-diversified portfolio.

In assessing the degree of inherited credit concentration, a bank should consider its degree of credit concentration to individual counterparties and economic or geographic areas. Where the business of a bank is, by its nature, concentrated (for example, a specialized firm lending to one sector only, or where there is collateral concentration), it should consider the impact of adverse economic factors on the concentrated area and its impact on overall asset quality.

1.2.2.2 Control (Quality of internal control environment)/Management Risk

Control/Management Risk could be divided into risk due to control/management deficiencies and risk due to control/management limitations. Control/Management deficiencies relate to circumstances where banks do not comply with minimum legal requirements. Control/management limitations relate to circumstances where the banks comply with minimum legal requirements, but, due to structural reasons inherent in their size, have a limited capacity to set up sophisticated governance arrangements systems and controls.

Control/Management deficiencies should normally be addressed by using other risk mitigates than capital. In fact, the appropriate response must be taken by an adequate action plan to resolve the problems immediately.

Control/Management Risk due to control/management limitations could be a significant factor for banks. Considering the proportionality principle, CBK would not expect the same degree of sophistication of governance arrangements and internal controls in all banks. However, other things being equal, the overall risk profile may be higher in smaller banks after taking into account the proportionate management and control environment (whether in relation to specific risks, or in general). Thus, from less complex banks it will be clearly expected to consider the risk resulting from Control/Management limitations in their internal capital assessment.

1.2.2.3 Credit Risk

The Pillar I minimum requirement seeks to cover the entire Credit Risk. However, the standardized approach might not reflect the full Credit Risk of particular bank. Therefore, it is important that the bank carefully considers whether its Credit Risk is fully captured in the capital requirement, assessed by Pillar I regulatory methodology (Standardized Approach). For example, the bank should make sure that the capital assessment allocates also internal capital for the weaker exposure classes where accounting standards do not require (or allow) that provisions are made and where the Pillar I approach used does not sufficiently reflect the risk of a particular portfolio.

1.2.2.4 Interest Rate Risk

A bank should assess the sensitivity of its financial position to potential adverse movements in interest rates. For instance, it should assess its sensitivity to interest rate risk arising from interest rate mismatches and maturity mismatches between assets and liabilities.

1.2.2.5 Liquidity Risk

When assessing the adequacy of its capital, a bank should also consider the sensitivity of its funding, in particular its ability to raise additional funding in times of economic stress. It should therefore consider whether its funding pool is sufficiently diversified. The possibility of raising new capital normally depends on whether the bank has a financially strong parent company and whether the bank is listed on an exchange or not. Subsidiaries with financially strong parent companies will normally have easy access for additional funding. But if the subsidiary is relying solely on its parent to provide the funding, the bank should also take into consideration that its access to funds may be suddenly restricted if the parent's creditworthiness is downgraded. Thus, an appropriate contingency plan should be developed.

1.2.2.6 Operational Risk

Operational Risk is largely expected to be covered by the Pillar I minimum requirement (i.e. Basic Indicator approach, Standardized approach, Advanced

Measurement Approach). However, there may be additional factors that should be taken into account. The Banks performance may, in some instances, depend on key individuals and bank's information technology, especially in smaller banks. In developing its sensitivity analysis, a bank should therefore consider the impact of losing key individuals in its ability to operate normally, and on its revenues. Furthermore, a bank should consider the IT risk as subcategory of operational risk which is the current or prospective risk to earnings and capital arising from inadequate information technology and processing in terms of manageability, exclusivity, integrity, controllability and continuity, or arising from an inadequate IT strategy and policy or from inadequate use of the institution's information technology.

1.2.2.7 Strategic Risk

A bank should assess the impact of its business plans on its capital over the time horizon which it uses in its business plans. It should evaluate the impact on its capital from diversifying its activities and the risk it runs of failing to manage these new business areas successfully.

1.2.2.8 Additional Risk factors

Banks should also be aware of any impact arising from external factors. However the CBK expects that the impacts from external factors are normally covered by the adequate evaluation of: Credit Risk, Market Risk, Liquidity Risk, Operational Risk, Concentration Risk and Strategic risk.

Furthermore, a potential source of capital volatility could also strive from the correlations between and within the risk categories. Correlations can suddenly swift, especially in times of stress in markets. Concerning these potential impacts on the volatility of capital in assumed correlations, the ICAAP has to be sensitive to such factors.

1.2.3 Capital Management Framework

The capital management of the bank has to be carried out in a forward-looking perspective to ensure changes in the business strategies, operating environment or other factors that could affect the risk profile of the bank and its capital base. In addition, a bank should also hold capital for unexpected changes apart from the agreed strategy for a bank. Besides of possible internal changes also external factors like a high growth period of credits in the economy can have an impact on a bank and should be also considered in the ICAAP.

An important component of an ICAAP is the setting of capital target levels following the capital standards requirements and also based on the individual assessments of capital needs. Banks have to assess the quantity and quality of their capital adequately. The Management body in its management and supervisory function should formally confirm (on a board level) that the set capital targets conform to the expected risk appetite.

The setting of the bank's capital targets needs to consider certain aspects like the risk appetite, regulatory capital requirements, an internal assessments of capital needs including those arising from its business plans and strategy, expected volatility of profits and the capital surplus, capital distribution policy, relevant rating assessments and additional access options to fresh capital. The bank can use therefore different approaches in setting target capital levels or implement stress testing.

In general an economic capital model is not required from the bank even so a bank with a more sophisticated business concentration may choose to use such a model and stress testing framework as well. The capital standards require from a bank to fulfill minimum requirements in terms of Total Regulatory Capital. Banks often consider the possibility of exceeding the regulatory capital requirements. Accordingly, the bank has to consider an appropriate composition of its capital to ensure that the capital can absorb potential losses on an ongoing basis and allows the bank operate in stressed conditions.

Regulated banks have to introduce, as required under the capital standards, strategies for maintaining adequate capital over time which should also include capital-generating and capital-consuming factors.

These capital factors should consider growth of capital through retained earnings and the ability of the bank to access additional external capital regarding the Total Regulatory Capital and the capability to add additional capital from shareholders, holding companies or further parties. Capital-generating and capital-consuming factors should include also the necessary capital to cover planned business growth and adequate immediate and projected capital coverage for several market and economic conditions within different stress scenarios over time periods should ensure. Banks should also incorporate economic capital requirements, possible impact of external rating assessments and the expectations on capital needs of their shareholders or market considerations to ensure a proper capital management.

To prevent capital drops under the bank's individual target levels and hence to not be in conflict with the regulatory requirements, banks are required to follow the capital standards to establish capital triggers that provide the early warning signals for senior management. The Board and senior management should be informed regularly of the status of these triggers to have the possibility to react in an appropriate time range to restore capital while the bank continues to operate.

Banks have different measures to protect their capital position. These approaches could include raising additional external capital, adjustments in the capital distribution or reinvestments policy, slowing or ceasing of new businesses, partial sales of business areas or asset sales and potential improvements in their business or investment strategy.

With regard to these measures and in order to protect the capital positions, banks have to consider also the extent to which the reaction would improve the capital position within specific timeframe with an acceptable impact.

1.2.4 ICAAP Documentation

For the implementation of the ICAAP, Banks will have to arrange a spectrum of processes and systems for assessing capital adequacy relative to the individual risk profile. The risk profiles of the bank have to cover and document the setting of target capital capacities, projecting and monitoring of capital positions or defined capital levels. Banks need to report the results in standardized processes in various policies and procedural documents for the board and senior management. This documentation which should be provided by the banks may include actual capital standard requirements regarding Internal Processes for Assessing Capital Adequacy in the form of an ICAAP report and a summary statement.

1.3 Design of ICAAP

Each bank should take the responsibility for its own ICAAP design, its implementation and development individually. The design, implementation and development should be fully specified within the capital policy and fully documented. In order to express the current state of its own institution , a bank is required to clarify their needs and targets of this assessment and thus it is expected to run a gap analysis (target vs. actual) and to plan or prepare each step of the implementation process carefully.

1.4 Methodology

There is no single correct process when setting up the ICAAP. Banks could, for example, adopt an ICAAP based on the Pillar I minimum capital requirement and assess extra capital proportionate to the non - Pillar I risk. Alternatively, banks could also choose to adopt a building block approach, using different methodologies for the risk types under the different Pillars and then calculate a sum of the resulting capital needs. As a further alternative, a bank might start with its actual capital (risk taking capacity) and break it down to all its material risks. The choice of methodology should clearly be commensurate with the bank's ability to collect the necessary information and also to calculate and evaluate the necessary inputs in a reliable manner.

Regardless which methodology a bank decides to adopt, it needs to compare its actual and future capital with the actual and future internal capital needs arising from the assessment. The actual calculation and allocation of internal capital always needs to be supplemented by sufficiently robust qualitative procedures, measures and provisions to identify, manage, control and monitor all risks.

1.4.1 Pillar I minimum capital requirement approach

A bank which chooses to use the Pillar I minimum capital requirement as the starting point has to consider what additional capital may be required to take into account of those risks which are not included or fully captured by the Pillar I minimum capital requirement. Firstly, this requires an assessment of whether the Pillar I minimum capital requirements fully captures the Pillar I risks (Credit Risk, Market Risk and Operational risk), and second, a bank should assess how much capital it needs to allocate against the Pillar II risks and other external factors.

1.4.2 Structured approach

A bank which chooses to use a structured approach will need to set the internal capital requirement at a starting point to zero capital and then add on capital due to all Pillar I and Pillar II risks and additional external factors. This methodology could be seen as a simple model for calculating economic capital and is not based on the Pillar I minimum capital requirement. The bank should still calculate the Pillar I minimum regulatory capital requirement, but this calculation is not used for the purpose of the ICAAP. All material risk areas, including Credit Risk, Market Risk and Operational Risk, should be assessed and taken into distinctive consideration when assessing the internal capital needs. A sensitivity analysis could form the starting point. The sensitivity analysis should be based on a forecasted but plausible scenario. Risks, which are not included in the sensitivity analysis should than also be considered in terms of the structured approach.

1.4.3 Capital allocation

A bank which chooses to use this method will start from its actual capital (risk-bearing capacity) and compare this figure to its total risks. Thereby it is required to break the capital down to all its material risks. This step in the process requires quantification or at least an estimation method for various risks. The amount of capital provided for each risk category is determined by the current and targeted amount of risk in each category, a potential risk buffer and the risk appetite of the institution. The institution will decide which type of risk quantification/estimation method is suitable and sufficient for its particular use. If the allocated capital seems insufficient, either the risk has to be reduced or the capital has to be raised. The allocated amounts of the capital will therefore work as a limit system, which assists and facilitates the institution in balancing its risk-bearing capacity and its risks. The actual calculation and allocation of capital always needs to be supplemented by sufficiently robust qualitative procedures, measures and provisions to identify, manage, control and monitor all risks.

2. Basic ICAAP principles

The main objective of the ICAAP is to improve the relationship between risk profile of the bank, its risk management and its presently held capital. The ICAAP is a process to ensure that the bank adequately identifies, measures, aggregates and monitors risks it is exposed to, and holds adequate internal capital in relation to its risk profile and has established risk management systems and develops them further on a regular basis.

The implementation of ICAAP shall be based on the following principles determined by the Basel Capital Standards Pillar II and published by the predecessor of European Banking Authority - Committee of European Banking Supervisors (CEBS):

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

Every bank must carry out an ICAAP yearly and document it properly.

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

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

b. At the same time, the institution should also be able to demonstrate how the ICAAP meets the supervisory requirements.

c. The concerned institutions retain the full responsibility for their ICAAP regardless of the degree of outsourcing, and they should understand that outsourcing does not 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 institution’s capital policy should be fully documented, and the management body (both supervisory and management functions) should take responsibility for the ICAAP.

a. The responsibility for initiating and designing the ICAAP rests with the management body (both supervisory and management functions). The supervisory function within the management body 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 dedicated management function.

b. The management body (both supervisory and management functions) is also responsible for integrating capital planning and capital management into the 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 institution's ICAAP (i.e. the methodologies, assumptions and procedures) and capital policy should be formally documented, and it should be reviewed and approved at the top level (management body in the sense of both functions) of the institution.

d. The results of the ICAAP should be reported to the management body (both supervisory and management functions).

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

a. The ICAAP should form an integral part of institutions' management processes in order to enable the management body (both supervisory and management functions) to assess, on an ongoing basis, the risks that are inherent in their activities and 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 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 institution. This review should take place at least annually.

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

c. Any changes in the 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 institution should be identified and incorporated into the ICAAP.

ICAAP 6: The ICAAP should be risk based.

a. The adequacy of an institution's capital is a function of its adequate risk profile arrangement. Thus, institutions should set capital targets which are consistent with their risk profile and operating environment.

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

c. However, if other considerations are included in the process, the institution must be able to show in its dialogue with its supervisor how these 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 a more qualitative assessment of risk management and mitigation. The 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 the starting point for their ICAAP (see below) may also consider developing a fully risk based approach, as the Capital Requirements Standards promotes a risk based approach (including the Standardized Approach for Credit Risk) due to the fact that general management expects that control frameworks will increasingly be installed with a risk based focus.

ICAAP 7: The ICAAP should be comprehensive.

a. The ICAAP should capture all the material risks to which the institution is exposed, albeit that there is no standard categorization of risk types and definition of materiality. The institution is free to use its own terminology and definitions, nevertheless it should be able to explain these in detail to the supervisor, including the methods used, the coverage of all material risks and how its approach relates to its obligations under Pillar I (for example, if the institution uses for the purposes of ICAAP a definition of Operational Risk that differs from the definition in Pillar I, or a definition of Interest Rate Risk that included both banking book and trading book risk).

b. The ICAAP should cover all material Pillar II risks to which the 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 lead themselves to quantitative approaches, in which cases institutions are expected to employ more qualitative methods of assessment and mitigation.
In addition Risk factors external to the institution should be addressed. These include risks which may arise from the regulatory, economic or business environment and which are not included in the above mention risks.

ICAAP 8: The ICAAP should be forward-looking.

a. The ICAAP should take into account the institution's strategic plans and how they relate to macro-economic factors. The institution should develop an internal strategy for maintaining sufficient capital levels which can incorporate factors such as loan growth expectations, future sources and uses of funds and its used dividend policy, and any procyclical variation of Pillar I minimum own funds requirements.
b. The institution should have an explicit and approved capital plan which states the institution's objectives and the time horizon for achieving those objectives. In broad terms the capital planning process and the responsibilities should be highlighted for that process. The plan should also lay out how the institution will comply with capital requirements in the future, any relevant restrictions related to capital, and a general detailed contingency plan for dealing with divergences and unexpected events (for example, raising additional capital, restricting business, or using risk mitigation techniques).
c. Institutions should conduct appropriate stress tests which take into account, for example, the risks specific to the jurisdiction(s) in which they operate and the particular stage of the business cycle. 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. Institutions should have a documented process for assessing risks. This approved and installed process may operate either at the level of the individual institution, or at group level.

b. The results and findings of the ICAAP should feed into an institution's evaluation of its strategy and risk appetite. For less sophisticated institutions in particular, for which genuine strategic capital planning is likely to be more difficult, the results of the process should mainly influence the institution's management of its risk profile (for example, via changes to its lending behavior or through the use of risk mitigants).

c. Institutions will not be required to use formal economic capital (or other) models, although it is expected that more sophisticated institutions will choose to do so.

d. There is no single 'correct' process. Depending on proportionality considerations and the development of practices over time, institutions may design their ICAAP in different ways. For example, the ICAAP may use the results produced by the regulatory Pillar I methodologies (which are themselves risk based) and consideration of non-Pillar I elements. In other words, to obtain a capital goal, institutions may take the Pillar I requirements and then assess Pillar II concepts that relate to Pillar I (such as concentration risk, Residual Risk of CRM and Securitization) and concepts that are not dealt with under Pillar I (such as Interest Rate Risk). The Pillar I approach may be appropriate for some institutions, although they would have to take an active role in justifying this choice, including the consideration of forward looking elements. Supervisors would expect the institution to demonstrate that it had analyzed all risks outside Pillar I and found them which are absent, not material or covered by a simple cushion over the Pillar I minimum. A 'structured' approach, using different methodologies for the different risk types (Pillar I and Pillar II 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. 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 also estimates.

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

g. Non-quantifiable risks should be included if they are material, even if they can only be estimated. This requirement might be eased if the 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 institution should be able to explain to the supervisor's satisfaction the similarities and differences between its ICAAP (which should cover all material risks) and its own funding requirements.

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

3. The Role of the CBK

The role of the CBK in the ICAAP is to introduce an appropriate Supervisory Review Process of the provided ICAAP.

Therefore, the CBK reserves the right to review the ICAAP of a bank at any time, which includes the right to carry out on-site inspections or apply any other supervisory measures they deem appropriate in the circumstances, within their legal powers and responsibilities.