



Ontario

**Deposit Insurance
Corporation of Ontario**

**Société ontarienne
d'assurance-dépôts**

Guidance Note:

Internal Capital Adequacy Assessment Process (ICAAP) – Credit Unions with Total Assets Greater than \$500 Million

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Ce document est aussi disponible en français.

Applicability

This Guidance Note is for use by all credit unions with assets in excess of \$500 million.

Section 84 of the Act requires each credit union to maintain adequate and appropriate forms of capital in relation to its operations. In accordance with DICO By-law #5, the board of directors is responsible for establishing a capital management policy that, at a minimum, addresses the quantity, quality and composition of capital needed and reflects the inherent risks of the credit union and to support current and planned operations.

This document outlines DICO's expectations with respect to a credit union's internal capital adequacy assessment process ("ICAAP"). It also outlines the criteria DICO will consider when evaluating and assessing inherent risks, the quality of risk management practices and the adequacy of capital.

Credit unions are required to submit an annual summary of their ICAAP, as outlined in Appendix 1, no later than the end of the 3rd fiscal quarter.

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Introduction

This Guidance Note outlines DICO's expectations for credit unions regarding implementation of an effective ICAAP as described 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. The objectives of Pillar 2 of the Basel II framework are to ensure that financial institutions maintain adequate capital to support all material risks on an ongoing basis, and to encourage them to develop and use better risk management techniques in monitoring and managing their risks through the ICAAP process.

Regulatory Principles

There are four key Pillar 2 principles in the Basel II framework:

1. 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.
2. Supervisory authorities 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.
3. 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.
4. 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.

DICO's Expectations

The capital requirements set out in the *Credit Unions and Caisses Populaires Act 1994* (the "Act") and the Regulation 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 several simplified assumptions, credit unions should not rely solely on compliance with regulatory minimums when assessing capital adequacy. DICO expects credit unions to maintain capital above regulatory minimum standards, at levels appropriate for their individual risk appetite and risk profile.

Credit unions are required to implement an ICAAP and conduct an annual assessment of its capital requirements in accordance with the features outlined below. The ICAAP should be appropriately scaled to reflect the size, complexity and risk profile of the credit union.

Credit unions should 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. Forward-looking stress testing should be performed to identify possible events or changes in market conditions that could have an adverse impact.

While DICO evaluates ICAAPs and the extent to which credit unions assess their capital needs and develop strategies for achieving internal targets, DICO does not approve a credit union's ICAAP.

ICAAP Features

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. The ICAAP should be integrated with the credit union's strategic and business planning function, operational departments, and Enterprise Risk Management ("ERM") function. While the ICAAP is a separate requirement, it is not intended to duplicate the work conducted elsewhere, including ERM, but rather to consolidate these considerations as they specifically relate to capital.

The six key features of an effective ICAAP include:

- i. Board and Management Oversight
- ii. Sound Capital Assessment and Planning
- iii. Comprehensive Assessment of Risks
- iv. Stress Testing
- v. Monitoring and Reporting
- vi. Internal Control Review

While these fundamental features of ICAAP are broadly outlined below, there is no single or standard approach that applies to all credit unions. However, credit unions may wish to consider the template outlined in Appendix 1 and additional information provided in DICO's ICAAP Application Guide.

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 an internal capital adequacy assessment process 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 define and describe the credit union's capital needs in relation to, among other things, board approved risk appetite and, where established by management, risk tolerance levels, anticipated capital expenditures, target capital level and, if appropriate, access to capital. 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 has responsibility for setting the credit union's appetite for risk and approving the overall capital plan. It should ensure that management:

- establishes detailed policies that set credit union-wide controls on the credit union's activities that are consistent with its risk-taking capacity and appetite;
- effectively communicates these policies throughout the credit union;
- establishes a framework for assessing the various risks;
- develops a system to relate risk to the credit union's capital level as part of its internal assessment of capital adequacy; and
- establishes strong internal controls and a method for monitoring compliance with internal policies.

Sound Capital Assessment and Planning

Enterprise risk management 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 includes:

- 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;
- 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 identified risk concentrations in credit and other activities;

- 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.

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.

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.

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 the following key areas:

- i. risk rating systems;
- ii. portfolio analysis/aggregation;
- iii. large exposures and risk concentrations; and
- iv. 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 but 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.

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/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 understand their credit risk concentrations resulting from similar exposures across different business lines.

Securitizations

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.

Operational Risk

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 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 enterprise risk management framework. This may be in addition to minimum capital requirements as determined under current regulations.

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 analysis and assessment of interest rate risks in accordance with the considerations set out in DICO Structural (Interest Rate) Risk Guidance Note. This may be in addition to minimum capital requirements as determined under current regulations.

Market risk

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.

Liquidity Risk

Liquidity is critical to the ongoing viability of any financial credit union. 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, with appropriate consideration of a potential increase in funding costs.

Other Significant Risks

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 credit union, while reputation risk is a key issue for credit unions as it relates to confidence of individual members and viability of the credit union.

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 highly unlikely but plausible events, has on the financial condition of an credit union. 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 when evaluating the adequacy of capital.

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

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

In addition, each credit union is required to include the following stress tests in its ICAAP analysis:

1. a standardized (200 basis points) interest rate shock (a single factor test);
2. an economic downturn which includes a 30% reduction in real estate and security valuations with resulting impacts on the level of delinquencies and credit defaults for all material risk areas; and
3. a (reverse stress test) scenario that in management's view would most likely cause a breach of minimum regulatory capital requirements

Monitoring and Reporting

Credit unions should establish a 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 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 make necessary adjustments to the credit union's strategic plan.

Internal Control Review

Effective control of the capital assessment process includes an independent review and, where appropriate, the involvement of internal and external audits. 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.

The Board should regularly assess whether its system of internal controls is adequate to ensure the well-ordered and prudent conduct of business. Credit unions should conduct regular reviews of risk management processes to ensure their integrity, accuracy and reasonableness.

DICO Assessment Process

As part of its on-going review process, DICO undertakes an assessment of the inherent risks within each significant activity undertaken by a credit union and evaluates the quality of risk management applied to mitigate these risks. DICO's review of a credit union's ICAAP is used to supplement this assessment. The review will include an assessment of the degree to which internal targets and processes incorporate the full range of material risks a credit union faces.

This may include a review of 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 performance, and evaluate and control risks more generally.

As part of DICO's overall assessment, DICO will also consider:

- extent and quality of analysis applied;
- 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;
- external factors, where not already considered in the previous points, including stress testing, the impact of economic cycles and other external risks and factors; and
- reasonableness of the assumptions used.

This assessment will also form part of DICO's examination criteria when considering the quality of capital management policies and practices.

APPENDIX 1

ICAAP Submission Template¹

Credit unions are required to submit to DICO a document **summarizing** their ICAAP, no later than the end of the credit union’s 3rd fiscal quarter (270 days after their fiscal year end), incorporating the elements outlined in the following template into their enterprise risk management, annual planning and budgeting processes for the upcoming year. While the use of the sample template outlined below is not mandatory, the summary should cover all the elements outlined. The submission template should be as concise as possible, while reflecting the size and complexity of the credit union.

Please note that completion of the Key Metrics Report outlined in Appendix A of this template (in Excel format) is mandatory for submission purposes. An Excel version is available on DICO’s website.

The submission document must be approved by the credit union’s Board.

Further information regarding the ICAAP submission requirements, including mandatory stress test considerations and sample Key Metrics Report, is provided in DICO’s ICAAP Application Guide.

ICAAP Submission Elements	
1	Executive Summary <ul style="list-style-type: none"> • <i>Overview of material risks</i> • <i>Summary of main findings and results</i> • <i>Adequacy of capital</i> • <i>Financial position</i>
2	Background on ICAAP <ul style="list-style-type: none"> • <i>Overview of ICAAP</i>
3	Statement of Risk Appetite
4	Material Risks <ul style="list-style-type: none"> • <i>Identification and Quantification</i>
5	Capital Planning <ul style="list-style-type: none"> • <i>Forecasts and Process</i>
6	Stress and Scenario Tests <ul style="list-style-type: none"> • <i>Rationale, Assumptions, Methodology, Results and Mitigation</i>
7	Conclusions and Next Steps <ul style="list-style-type: none"> • <i>Issues, Reporting, Plans</i>
Appendix A	Key Metrics Report <ul style="list-style-type: none"> • <i>Recap of capital requirements and position</i>

¹ Sample template available in DICO’s ICAAP Application Guide

SUMMARY KEY METRICS REPORT

Credit Union Name:		Financial Year End:			
Submission date:		Risk Weighted Assets: (\$000s)			
Board Approval:		Eligible Capital: (\$000s)			
(\$'000)	Pillar 1		ICAAP		(Reference) 1
	(Minimum Regulatory Capital)		(Institution's assessment of Capital required for the risk)		
	\$ Capital	%RWA	\$ Capital	%RWA	
Credit risk					
Market risk					
Operational risk					
Other Risks					
Pillar I Risks					
Concentration Risk					
Interest Rate Risk					
Liquidity Risk					
Strategic Risk					
Legal Risk					
Financial Risk					
Pillar II Risks					
Required Internal Capital					
Current Total Capital					
Surplus/(Deficit)					
Additional Capital to cover stress testing 2					
Additional Capital to cover Basel III requirements 3					
Total Capital Required					
Current Total Capital					
Surplus/(Deficit)					

1. Please provide the section reference of the Submission Report for each risk
2. Excluding Reverse Stress Testing Requirement
3. BASEL III requirements have not yet been finalized. This is a note item only.