Official Change of Name

On November 1, 2019, BC Financial Services Authority (BCFSA) replaces the Financial Institutions Commission (FICOM) as BC's regulator of credit unions, trust companies, insurance companies, pension plans and mortgage brokers. All references in the attached document to **FICOM** and the **Financial Institutions Commission** should be read as **BCFSA** and **BC Financial Services Authority** until revised or replaced by the name of the Authority. The attached form or document will continue to be used until otherwise revised or cancelled.

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ICAAP Guide

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BC Credit Unions

Financial Institutions Commission

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INTRODUCTION

This guide outlines FICOM's expectations for a credit union's Internal Capital Adequacy Assessment Process (ICAAP). For further information on ICAAP submission requirements and what should be included in a credit union's ICAAP report refer to FICOM's **ICAAP Submission Instructions**.

The ICAAP should produce a level of capital that is adequate to support the nature and level of a credit union's risks and it should be a vital part of a strong risk management program. This requirement is designed to capture processes for assessing and managing a credit union's target capital level, and to provide a more comprehensive picture of the credit union's risks and its capital adequacy related to these risks. ICAAPs provide a number of benefits including:

- target capital level that is clearly matched to the credit union's risk profile;
- clear link between risk appetite and the risk and capital management framework;
- insight into the setting of risk limits;
- quantifiable benchmarks to monitor risks;
- ability to adapt more quickly to adverse situations; and
- opportunity for supervisors and credit unions to use the ICAAP as a basis to engage in dialogue regarding capital requirements and targets.

For FICOM, ICAAPs provide information that can aid in assessing inherent risk and may point to the need for additional supervisory work as part of the normal supervisory review process. While FICOM does not approve ICAAPs, they are subject to supervisory review to assess the quality of risk management and capital.

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

- **Pillar 1** of the Basel II capital framework outlines standardized rules for calculating minimum capital adequacy requirements based on the credit risk, market risk, and operational risk profile of a financial institution.
- **Pillar 2** of the Basel II capital framework is designed to ensure that financial institutions maintain adequate capital to support all material risks on an ongoing basis through the ICAAP process. Pillar 2 also discusses the role of supervisory review of the ICAAP.

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

As outlined in FICOM's Internal Capital Target (ICT) Guideline, FICOM expects credit unions to develop and maintain an internal capital target above regulatory minimum standards. The ICAAP should be developed and used to determine the credit union's internal capital target,

which is consistent with its business plan, risk profile, and operating environment. Both the ICAAP report and ICT are subject to supervisory review.[1]

1. ***Internal Target*** (>10%): a credit union with capital below its Internal Target will be expected to initiate corrective action to return its capital position back above the Internal Target.

2. ***Supervisory Target*** (10%): a credit union with capital below the Supervisory Target will be staged by FICOM and expected to immediately improve its capital position.

3. ***Regulatory Requirement*** (8%): a credit union with capital below the Regulatory Requirement is subject to immediate statutory restrictions on its business operations and may be considered non-viable by FICOM.

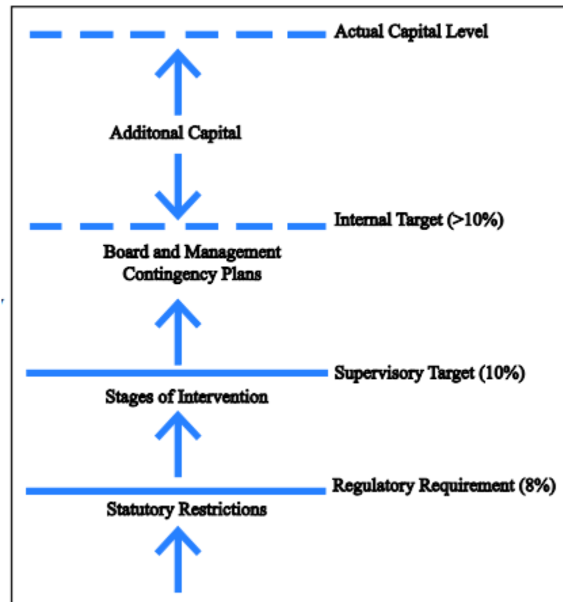

Figure 1: Key Capital Indicators

Given the broad principles provided for ICAAP, FICOM expects a credit union to apply its professional judgment and scale the principles to the size and complexity of its business activities. For example, smaller credit unions with less complex lines of business and high levels of capital may decide that it is appropriate to demonstrate a prudent ICAAP with primarily qualitative considerations. Larger credit unions with more complex lines of business are more likely to compliment qualitative considerations with quantitative analysis and financial modelling. FICOM recognizes that the approaches for ICAAP will vary, and that there are a number of correct approaches.

The ICAAP should be integrated with the credit union's strategic and business planning and risk management program. The ICAAP should not be a formula-driven process of add-ons; rather the assessment of risks should be integrated into the credit union's overall capital planning.

The six key features of an effective ICAAP include:

1. board and management oversight
2. sound capital assessment and planning;
3. comprehensive assessment of material risks;
4. stress testing;
5. monitoring and reporting; and
6. internal control review.

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

FEATURES OF AN EFFECTIVE ICAAP

1. 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 designing and implementing the credit union's ICAAP and should have a strong understanding of the nature and level of risks taken by the credit union and how these risks relate to an adequate level 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. At a minimum, the strategic plan should clearly describe the credit union's capital needs, anticipated capital expenditures, board approved risk appetite and target capital level.

The board of directors is responsible for setting the credit union's tolerance for risk, for approving the overall capital plan, and for reviewing and approving the credit union's ICAAP.

Accountability for Third Party Providers

A credit union may choose to outsource all or part of its ICAAP process. However, the credit union retains ultimate accountability for all outsourced ICAAP related activities. It also retains responsibility for managing the associated risks and having sufficient oversight in place. Management should have a strong understanding of methodologies, risk models and assumptions used in the ICAAP whether the ICAAP process is conducted in-house or outsourced from a third party. Furthermore, FICOM will extend supervisory review to activities related to ICAAP whether they are performed internally or outsourced.

In general, FICOM expects a credit union to conduct internal due diligence to determine the nature and scope of the business activity to be outsourced, its relationship to the rest of the credit union's activities, and how the activity is managed. The credit union should:

- evaluate the risks associated with all existing and proposed outsourcing arrangements;
- develop a process for determining the materiality of arrangements; and
- implement a program for managing and monitoring risks, appropriate for the materiality of the arrangements.

2. Sound Capital Assessment and Planning

A sound capital assessment process should include the following:

- policies and procedures designed to ensure the credit union identifies, measures and reports all material risks requiring capital;
- 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;
- a process that relates capital to the current and anticipated future levels of risk in accordance with board approved risk tolerance;

- a process that states capital adequacy goals with respect to risk, taking into account the credit union's strategic focus and business plan; and
- a process of internal controls, reviews, and audits to ensure the integrity of the overall risk management process.

In relating capital to the level of risk, the following factors should be considered:

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

An effective capital planning process requires a credit union to:

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

The credit union should identify the time horizon over which it is assessing capital adequacy. It should evaluate whether long-term capital targets are consistent with short-term goals, based on current and planned changes in risk profile 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.

3. Comprehensive Assessment of Material Risks

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

Pillar 1 Risks

Credit Risk

A credit union should have methodologies to assess the credit risk exposures from individual borrowers and at the portfolio level. The credit review assessment of capital adequacy should cover the following key areas:

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

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

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

The credit union should assess the capital required for credit risk using the approaches described above. However, FICOM expects credit unions to hold capital for credit risk to at least the regulatory minimum, which is currently 8% of risk weighted assets for credit risk. When calculating its ICAAP capital required for credit risk, the credit union should use the greater of the regulatory minimum or its own assessment of capital required for credit risk.

Market risk

A credit union should have methodologies to assess and actively manage all material market risks. It should identify balance sheet items that are subject to market risk and determine potential capital allocation for normal and stressed conditions. These should include consideration of any material investments held for trading, or any other investments, which could reasonably expect to incur a write down. Many credit unions may not have a material amount of market risk as they do not actively engage in trading activities.

Operational Risk

A credit union should have appropriate policies and procedures outlining approaches to identify, assess, monitor and control operational risk. These should cover the credit union's risk appetite and tolerance for operational risk, and should include 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 of the credit union.

Credit unions are encouraged to refer to the Basel Committee on Banking Supervision's *International Convergence of Capital Measurement and Capital Standards* for methodologies and further guidance. For example, under the basic indicator approach, a credit union may hold capital for operational risk equal to 15% of the last 3 years' annual average positive gross income.

Pillar 2 Risks

Concentration Risk

The impact of risk concentrations on both assets and liabilities should be reflected in 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;
- geographical regions;

- 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. A credit union should have an understanding of its credit risk concentrations resulting from similar exposures across different business lines.

When assessing credit concentration risk, it is important to ensure that adequate additional capital is provided for all risk categories that are not widely diversified. While the credit union should include all material concentration risks, commercial concentration risk in particular should be considered in order to determine whether additional capital should be allocated. For example, this might include applying higher risk weights to larger loans, different industry categories, or to portfolio balances in excess of limits in any one industry sector.

Interest Rate Risk

The ICAAP should include all material interest rate risk positions of a credit union and consider all relevant re-pricing and maturity data. Such information will generally include, for example, current balance and contractual rate of interest associated with financial instruments and portfolios, principal payments, interest reset dates and maturities.

The credit union should ensure that the applied methodologies and assumptions fully recognize any changes in exposures. It should be able to support its assumptions about the behavioural characteristics of non-maturity deposits, and other assets and liabilities. In general, an increase in uncertainty related to modeling and business complexity should result in more capital being held.

Credit unions are encouraged to refer to the Basel Committee on Banking Supervision's *Standards for Interest Rate Risk in the Banking Book* for methodologies and further guidance.

Funding Risk

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

The credit union should also consider the potential impact on its capital of having to fund operations and growth with higher-cost funding than would normally be expected, including the use of securitization vehicles. This might include brokered deposits, lines of credit, or other facilities.

Other Significant Risks

Other significant risks should be incorporated into the credit union's risk management process and appropriately addressed in the ICAAP submission and capital calculation. Although risks

such as strategic, legal, and reputational cannot be easily measured, the credit union should develop techniques to identify and measure 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. Reputational risk may give rise to credit, liquidity, market and legal risk – all of which can have a negative impact on the credit union’s earnings, liquidity and capital position. Where securitization activities are material, a credit union should develop prudent contingency plans identifying responses to address capital pressures that arise when access to securitization markets is reduced.

4. Stress Testing

A credit union should examine future capital resources and capital requirements under adverse scenarios in its ICAAP. Stress testing is a risk management technique used to evaluate the potential effect of highly unlikely yet plausible events on the financial condition of a credit union. The credit union should include forward-looking stress testing in its ICAAP in order to evaluate the impact of negative changes in environmental factors on its risk profile and capital needs.

Stress testing aims to evaluate the impact of unlikely but plausible events. It should reflect exceptional historical events as well as potential future scenarios. Such events would occur beyond normal or expected environmental risks. Considering only normal or expected environmental risks may lead to serious undervaluation of risks and capital needs in unexpected or crisis events.

Stress testing should cover all material risks and should consider the interaction between risks. One single risk event could have impacts in multiple areas and should be considered in its entirety.

The methodologies and outcomes of the stress testing should be fully documented. Management and the board of the credit union should be informed about the outcome of stress testing. Results should be considered against actual performance and trends when assessing current and planned capital levels.

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

5. Monitoring and Reporting

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

- evaluate the level and trend of material risks and their effect on capital levels;

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

6. Internal Control and 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. The credit union's board of directors has a responsibility to ensure that management:

- establishes a system for assessing the various risks;
- develops a system to relate risk to the credit union's capital level; and
- establishes a method for monitoring compliance with internal policies.

The board should regularly assess whether its system of internal controls is adequate to ensure the well-ordered and prudent conduct of business. The credit union should conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and timeliness. Areas that should be reviewed include:

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

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