Guideline

Internal Capital Adequacy Assessment Process (ICAAP)

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INTRODUCTION

This guideline outlines BC Financial Services Authority's (BCFSA) expectations for a credit union's Internal Capital Adequacy Assessment Process (ICAAP)[1]. For further information on ICAAP submission requirements, refer to BCFSA's ICAAP Submission Instructions.

BACKGROUND INFORMATION

The capital requirements set out in the Financial Institutions Act (FIA), including its regulations and the Credit Union Capital Requirements Rules (Capital Rules) are regulatory measures designed to provide a baseline assessment of capital adequacy. As these requirements may not fully reflect the specific risk profile, business model or concentration risks of an individual credit union, each credit union is expected to conduct their own assessment of capital adequacy and not rely solely on compliance with regulatory minimums.

[1] The intent and principles introduced in the ICAAP are aligned with Part 3 of the Basel II Framework wherever applicable and appropriate.

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A thorough and comprehensive ICAAP is a vital component of a strong risk management program. The ICAAP is expected to produce a level of capital adequate to support the nature and level of a credit union's risk. Each credit union is responsible for developing and implementing its own ICAAP for the purpose of setting internal capital targets (ICTs) consistent with its business plans, risk profile and operating environment.

Furthermore, the ICAAP is designed to capture processes for assessing and managing a credit union's target capital level and provide a comprehensive view of the credit union's risks and its capital adequacy related to these risks. ICAAPs provide several 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
- opportunity for supervisors and credit unions to use the ICAAP as a basis to engage in dialogue regarding capital requirements and targets

For BCFSA, 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 BCFSA does not approve ICAAPs, they are subject to supervisory review to assess the quality of risk management and capital of a credit union.

The regulatory capital adequacy requirements outlined in the Capital Rules apply to credit unions on a consolidated basis. Consistent with this requirement, BCFSA expects credit unions to report on an ICAAP that covers the consolidated operations of the credit union.

Given the broad principles provided for ICAAP, BCFSA expects credit unions to apply professional judgment and adjust these 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 expected to compliment qualitative considerations with quantitative analysis and financial modelling. Quantifiable estimates of risk used in this assessment should also have a business use (i.e., should not be made solely for use in ICAAP) and should be subject to validation. BCFSA recognizes that the approaches for ICAAP will vary, and that there are a number of acceptable approaches.

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

Levels of capital

In addition to regulatory capital requirements, a credit union is also expected to maintain additional capital levels to reflect its specific risk profile and have a margin to cover its other needs. The different levels of capital are described below: (Refer to appendix 1 for guidance on establishing an Internal Capital Target (ICT))

- **regulatory capital:**
  - This level refers to the minimum required capital as established by the Capital Rules and, where applicable, targets established for oversight purposes, in accordance with the capital adequacy framework.

- A credit union with capital below the regulatory minimum requirement is immediately subject to restrictions on its business operations and may attract the use of other statutory powers, including being subject to supervision and/or administration.

- **internal capital target:**
    - The ICAAP is used to develop and determine the credit union's ICT. The ICT is based on the credit union's activities, specifically considering its risk appetite and stress testing. An ICT considers risk related to the implementation of the credit union's strategic plan as well as all the risks the credit union could be exposed to in connection with its current and planned activities.
    - Both the ICAAP report and ICT are subject to supervisory review.
    - BCFSA expects credit unions to develop and maintain two levels of ICT to maintain consistency with the Capital Rules:
        - Level 1 ICT: The credit union's internal capital target for the Tier 1 Capital Ratio, set above the applicable regulatory minimum plus the Capital Conservation Buffer.
        - Level 2 ICT: The credit union's internal capital target for the Total Capital Ratio, set above the applicable regulatory minimum plus the Capital Conservation Buffer.
    - Please refer to appendix 1 for guidance on establishing an ICT. A credit union with capital below its applicable ICT, whether Level 1 or Level 2, is expected to initiate corrective action to restore its capital position above the relevant ICT threshold.

- **excess capital:**
    - This refers to the available capital exceeding the ICT established by the credit union. Excess capital is normally maintained for strategic purposes. For example, additional capital could be maintained to carry out acquisitions and projects, achieve or maintain a credit rating, or simply absorb annual variations in financial results to ensure that available capital does not fall below the ICT.

FEATURES OF AN EFFECTIVE ICAAP

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
6. internal control review

Board and management oversight

In order to effectively assess its capital adequacy, a credit union is expected to 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 is expected to 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 is expected to analyze its current and future capital requirements in relation to its strategic objectives. At a minimum, the strategic plan is expected to clearly describe the credit union's capital needs in relation to, among other things, anticipated balance sheet growth and acquisitions, the approved risk appetite and ICT.

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

Please refer to the following guidelines for BCFSA's expectations of credit union boards of directors regarding the management of capital:

- Corporate Governance Guideline
- Risk Management and Resilience Guideline

Sound capital assessment and planning

A sound capital assessment process is expected to 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
- 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, a credit union is expected to consider the following factors:

- 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
- 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 enables 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

The credit union is expected to identify the time horizon over which it is assessing capital adequacy. It is expected to 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 is expected to factor in the potential difficulties of building capital during economic downturns and other times of stress.

Comprehensive assessment of material risks

The ICAAP is expected to capture all material risks faced by the credit union, related to the adequacy of its capital base, including risks captured in regulatory capital requirements as well as risks that are not explicitly captured under minimum regulatory capital requirements. 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.

Where quantitative models are used in the ICAAP to assess material risks, the credit union is expected to ensure that models are fit for purpose, appropriately monitored, independently validated where appropriate, and subject to ongoing review. Key assumptions, limitations and uncertainties should be considered in the assessment of capital adequacy and supported through complementary analysis and stress testing.

Please refer to the following guidelines which describes a set of principles for managing risks:

- Outsourcing Guideline
- Risk Management and Resilience Guideline

Credit risk

In assessing credit risk capital adequacy under this guideline, the credit union is expected to ensure that its ICAAP aligns with the requirements under the Capital Rules and the expectations under the Commercial Lending Guideline and the Residential Mortgage Underwriting Guideline. The risk profile identified under these instruments should be appropriately reflected in the ICAAP's credit risk capital assessment, commensurate with the credit union's nature, size, complexity, and overall risk profile.

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

- risk rating systems
- where the exposure is material, portfolio analysis is expected to segment the credit book into key risk categories, each assessed under its relevant Capital Rules risk weights
- large exposures and risk concentrations
- 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

- other characteristics directly affecting the collectability of a pool or portfolio of loans

The credit union is expected to assess the capital required for credit risk using the approaches described above.

Risk concentrations

The impact of risk concentrations on both assets and liabilities is expected to be reflected in the 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
- trading exposures or market risk
- 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 is expected to understand its credit risk concentrations resulting from similar exposures across different business lines. The credit union is also expected to consider BC-specific economic characteristics relevant to their membership base, including residential real estate market concentration in higher-value markets, single-employer community exposure in resource-based regions, agricultural lending concentration, and tourism-dependent commercial lending.

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 is expected to include all material concentration risks, commercial concentration risk should expressly be considered 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.

A credit union is expected to have in place adequate, systematic procedures for identifying high correlation between the creditworthiness of a protection provider or collateral and the obligors of the underlying exposures due to their performance being dependent on common factors beyond systemic risk.

Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. This definition includes legal risk[2] but excludes strategic and reputational risk. As such, operational risk may arise from a range of internal and external factors, including failures in processes, systems or controls, human error and external events. This includes, but are not limited to, risks related to technology and cyber risks, data governance, fraud and third-party arrangements, and requires a comprehensive approach to operational resilience.

Similar rigour is expected to be applied to the management of operational risk as for the management of other significant risks. A credit union is expected to have appropriate policies and procedures outlining approaches to identify, assess, monitor and control operational risk. These are expected to cover the credit union's risk appetite and tolerance for operational risk and should include the extent and manner by which operational risk is transferred outside the credit union. The adequacy of capital is expected to be evaluated relative to the degree of operational risk exposure of the credit union.

[2] Legal risk includes, but is not limited to, exposures to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements. (Basel Committee on Banking Supervision OPE 10 Jan. 1, 2023)

Market risk

The credit union is expected to have methodologies to assess and actively manage all material market risks. Many credit unions may not have a material amount of market risk as they do not actively engage in trading activities. The methodologies 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 be expected to incur a write-down.

For institutions with material trading book activities, the assessment of internal capital adequacy for market risk is expected to, at a minimum, be based on quantitative risk measurement models such as value-at-risk (VaR) or similar approaches, together with stress testing. These assessments should capture material risks arising from trading activities, including concentration risk and the impact of illiquidity under stressed market conditions. If an institution does not have a VaR model or any similar models available for this purpose, then the methodologies can include metrics stipulated in Office of the Superintendent of Financial Institutions' (OSFI) method for measuring market risk[3].

Interest Rate Risk in the Banking Book

The ICAAP is expected to include all material interest rate risk in the banking book positions of a credit union and consider all relevant repricing and maturity data. Such information will generally include current balance and contractual rate of interest associated with financial instruments and portfolios, principal payments, interest reset dates and maturities.

The credit union is expected to ensure that the applied methodologies and assumptions fully recognize any changes in exposures. The ICAAP 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.

Please refer to the BCFSA IRRBB Methodology document issued to credit union segment in September 2024 *(available upon request)* for more information on IRRBB.

Credit unions may refer to OSFI Guideline: Interest Rate Risk Management – Guideline (2027) - Office of the Superintendent of Financial Institutions for more information.

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 scenarios for target capital planning and liquidity risk management should be complementary, with appropriate consideration for a potential increase in liquidity costs.

A credit union is expected to 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.

[3] OSFI method for measuring market risk https://www.osfi-bsif.gc.ca/en/guidance/guidance-library/capital-adequacy-requirements-car-2026-chapter-9-market-risk

Other risks

Other significant risks are expected to 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, reputation, and natural catastrophe and climate-related risks (NCCR) cannot be easily measured, the credit union is expected to 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 for identifying responses to address capital pressures that arise when access to securitization markets is reduced.

BCFSA has identified natural catastrophes and climate-related risks as a material risk that may affect the safety and soundness of credit unions. Climate-related risks may amplify existing financial and non-financial risks, including credit, market, operational, liquidity, reputational and strategic risks. The credit union is expected to consider whether material physical and transition risks could affect their risk profile and capital adequacy. The credit union is expected to assess if additional internal capital is required to cover climate-related losses that fall outside standard regulatory minimums.

Stress testing

The credit union is expected to examine future capital resources and capital requirements under adverse scenarios as part of their ICAAP. Stress testing is a risk management technique used to evaluate the potential effect of exceptional yet plausible events on the financial condition of a credit union. A credit union's capital planning process is expected to incorporate rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the credit union. The results of stress testing are expected to be considered when evaluating the adequacy of a credit union's capital.

The credit union may consider the three main approaches to stress testing: sensitivity testing, scenario analysis and reverse stress testing. Sensitivity testing assesses the impact of changes in individual risk factors, while scenario analysis considers the impact of simultaneous changes in multiple risk factors. Credit unions are encouraged to also consider reverse stress testing as part of the ICAAP. Reverse stress testing starts from a defined adverse outcome that would challenge the viability of the credit union and works backward to identify the circumstances and risk drivers that could lead to such an outcome.

The methodologies, assumptions, and outcomes of stress testing should be fully documented and reported to management and the board. Results should be considered against actual performance and emerging trends when assessing current and planned capital levels.

In addition to institution-specific stress scenarios developed by the credit union, BCFSA may periodically provide guidance on key risk drivers, illustrative stress scenarios, and ranges of severity to support consistent and forward-looking assessments across the sector.

Monitoring and reporting

The 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 complies with established capital adequacy goals
- 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

Internal control review

The credit union's internal control structure is essential to the capital assessment process. Effective control of the capital assessment process includes an independent review and, where appropriate, the involvement of internal and external audits. Senior management has a responsibility to ensure that the credit union 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 credit union should conduct periodic reviews of its risk management process to ensure its integrity, accuracy and reasonableness. 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
- governance and independent validation of models used in the capital assessment process
- reasonableness and validity of scenarios used in the assessment process
- stress testing methodology, assumptions and results

> Please refer to the following guideline issued to credit unions to enhance internal controls:
>
> - Information Security Guideline

INTERACTION OF ICAAP WITH SUPERVISORY REVIEW

A credit union must have sufficient capital to meet its regulatory requirements (regulatory capital), as well as sufficient capital to support its risk profile.

The depth and frequency of supervisory review of a credit union's ICAAP will be proportional to the nature, scale and complexity of its activities, and the risks posed to BCFSA's supervisory objectives with respect to the safety and soundness of the credit union. BCFSA may request additional information as needed to support the supervisory review.

Expert judgement will continue to be necessary to operationalize the assessment and quantification of risk and to integrate those results into the overall assessment of capital.

APPENDIX 1: INTERNAL CAPITAL TARGET

ESTABLISHING AN INTERNAL CAPITAL TARGET

Process

A credit union is expected to have a process for determining its ICT. The process is expected to identify, measure and appropriately consider all material risks to the credit union, and quantify the potential impact of these risks on capital. Although the complexity of this process will differ among credit unions, each credit union is expected to have a systematic and reasonable approach to determining its ICT.

Factors

The factors that should be considered in determining the ICT include:

- the business strategy (particularly respecting anticipated acquisitions or divestitures, the introduction of new business lines, products or services as well as other anticipated areas of growth)
- the nature, size and significance of the risks to which the credit union is potentially exposed
- risk concentrations
- deductions from capital
- the capacity of credit union's risk management policies and procedures to identify and mitigate risks
- potential changes in historical correlations among exposures and risks
- current and forecast business and regulatory environments
- stress scenarios and business cycles
- expected changes to the risk profile resulting from the potential volatility of exposures as well as from changes in risks or strategies
- expectations for a capital cushion against unexpected events and uncertainties in risk measurements
- expectations to fund capital needs of subsidiaries (including central credit unions)
- the capacity of the credit union to replace or raise capital
- the regulatory capital requirements
- patronage allocations and dividends