



THE CENTRAL BANK OF THE BAHAMAS

**Consultation Paper on Guidance for the Internal Capital Adequacy
Assessment Process (ICAAP)**

Bank Supervision Department

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INTRODUCTION

The Central Bank of The Bahamas (“the Central Bank”; “the Bank”) is responsible for the licensing, regulation and supervision of banks and trust companies operating in and from within The Bahamas pursuant to the Banks and Trust Companies Regulation Act, 2000, and the Central Bank of The Bahamas Act, 2000. Additionally, the Central Bank has the duty, in collaboration with financial institutions, to promote and maintain high standards of conduct and management in the provision of banking and trust services.

This guideline is based on the Basel Committee on Banking Supervision’s (BCBS) document entitled ***International Convergence of Capital Measurement and Capital Standards: A Revised Framework***, also known as Basel II (finalised in June 2006) and the BCBS’s document entitled ***Enhancements to the Basel II Framework***, (finalised in July 2009). The major objective of Basel II has been to align a bank’s regulatory capital more closely with its risks, taking into account the bank’s progress in the measurement and management of risk and the opportunities which these provide for strengthened supervision. **This Guideline is meant to serve as a general guide to the formulation and implementation of a licensee’s ICAAP. The Central Bank does not intend to make a licensee’s ICAAP subject to specific approval.**

PURPOSE

A thorough and comprehensive Internal Capital Adequacy Assessment Process (“ICAAP”) is a vital component of a strong risk management process. The ICAAP should produce a level of capital adequate to support the nature and level of an institution’s risk. These guidelines specifically addresses licensees’ responsibility in developing and implementing its own ICAAP for the purpose of setting internal capital targets and developing strategies for achieving those internal targets that are consistent with its business plans, risk profile and current operating environment.

Consultative Period

To make an informed and impartial decision on this topic, the Central Bank wishes to obtain comments from its licensees and other interested parties. The consultative period will run for thirty (30) days, from 9th October to end on 9th November, 2015. In that regard, we welcome your comments on these proposals.

Questions and/or Comments

You are encouraged to submit any questions and/or comments relative to this consultation paper to the Policy Unit, Bank Supervision Department via postal mail or email.

The Policy Unit
Bank Supervision Department
Central Bank of The Bahamas
Market Street
P.O. Box N-4868
Nassau, Bahamas
Tel: (242) 302-2615
Fax: (242) 356-3909
Email: Policy@centralbankbahamas.com

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Applicability

1. This guideline applies to all locally incorporated unrestricted (public) banks and banks and trust companies.
2. The Central Bank recognizes that some licensees are subsidiaries of larger banking groups and the ICAAP process may be led and/or managed by their Head Office. In these instances, the Central Bank expects the management of the local licensee to be aware of how the Head Office's global capital allocation process is accounting for the licensee and how risk management at the local level fits into the Group's ICAAP approach.
3. Local management must understand the licensee's risk profile and be prepared to engage in discussions with the Central Bank as needed. The Central Bank expects licensees to have relevant documentation in place to address these matters, as responsibility for compliance with the requirements of this Guideline remains with the licensee.

Definition

4. The ICAAP is the formal process through which a licensee adequately identifies, measures, aggregates and monitors material risk, to ultimately build a risk profile that would become the basis for allocating economic capital i.e. the amount of capital that a licensee holds and allocates internally to support the risks it takes on.

Overview

5. A licensee's ICAAP should be tailored to its operations and may not include some of the areas discussed within this guideline or may include other areas relevant to a licensee's operations. In this regard, an ICAAP may be as simple or complex as a licensee's operations warrant and should reflect how the licensee is managed and organized in practice. Through its ICAAP, each licensee will assess the total amount of capital that it calculates is necessary to safeguard itself against all of the risks inherent in its current and future business operations. While some licensees may wish to adopt a sophisticated economic capital model in formulating their ICAAP, for others the ICAAP will more likely be derived from their Pillar I calculation, together with appropriate capital add-ons determined by each licensee to cover other material risks. In each case, it must be evident from the Central Bank's review that the licensee has adequately considered and understood all of its material risks.
6. Given the importance of risk management, the motivation for ICAAP implementation should not be driven by supervisory considerations, but more so by the promotion of a sound risk management culture within the licensee, built on risk based capital and adequate risk management techniques. Accordingly, the ICAAP should be integrated into the strategic planning process by emphasizing, inter alia, that strategic decision-making involves risk-taking, which ultimately has to be offset by adequate levels of capital.

Main Features of the ICAAP

7. At a minimum, licensees should incorporate the following features in their ICAAPs:
 - a) board and senior management oversight;
 - b) established policies, procedures, limits and control;

- c) sound capital assessment and planning;
- d) comprehensive assessment of risks;
- e) stress testing;
- f) monitoring and reporting; and
- g) internal control review.

a) *Board and senior management oversight*

8. A sound risk management process is the foundation for an effective assessment of the adequacy of a licensee's capital position. It is the responsibility of the Board of Directors ("the Board") and senior management to define the licensee's risk appetite and to ensure that the licensee's risk management framework includes detailed policies that set specific firm-wide prudential limits on the licensee's activities. Management should understand the nature and level of risk being taken by the licensee and how this risk relates to adequate capital levels. Management should also ensure that the formality and sophistication of the risk management processes are appropriate for the risk profile and business plan of the licensee. The Board must also ensure that management effectively communicates these policies throughout the institution.
9. The Board and senior management must possess sufficient knowledge of all major business lines to ensure the appropriate policies, controls and risk monitoring systems are effective. They must have the necessary expertise to understand the capital markets activities in which the licensee is involved – such as securitisation and off-balance sheet activities and the associated risks. The Board and senior management must remain informed on an on-going basis about these risks as financial markets, risk management practices as the licensee evolves. In addition, the Board and senior management should ensure that accountability and lines of authority are clearly delineated. With respect to new or complex products and activities, senior management must understand the underlying assumptions regarding business models, valuation and risk management practices. Further, senior management must evaluate the potential risk exposure of those assumptions fail.
10. Before embarking on new activities or introducing products new to the licensee, the Board and senior management must identify and review the changes in firm-wide risks arising from these potential new products or activities and ensure that the infrastructure and internal controls necessary to manage the related risks are in place. Licensees must also consider the possible difficulty in valuing the new products and how they might perform in a stressed economic environment.
11. The risk management function must be independent of the business lines to ensure an adequate separation of duties and to avoid conflicts of interest. Licensees must ensure that its risk function and its Chief Risk Officer ("CRO") or equivalent person reports directly to the Chief Executive Officer ("CEO") and the Board. The risk function must also highlight to the Board and senior management risk management concerns such as risk concentrations and breaches to tolerable risk limits.

b) *Policies, procedures, limits and control*

12. Firm-wide risk management programmes must include detailed policies that set specific firm-wide prudential limits on the principal risks relevant to the licensee's activities. The licensee's policies and procedures must provide specific guidance for the implementation of broad business strategies and should establish, where appropriate, internal limits for the various types of risk to which the licensee may be exposed. These limits must consider the licensee's role in the financial system and be defined in relation to the licensee's capital, total assets, and earnings or, where adequate measures exist, its overall risk level.

13. A licensee's policies, procedures and limits must:

- provide for adequate and timely identification, measurement, monitoring, control and mitigation of the risks posed by its lending, investing, trading, securitization, off-balance sheet, fund management, fiduciary and other significant activities at the business line and firm-wide levels;
- ensure that the economic substance of the licensee's risk exposures, including reputational risk and valuation uncertainty, are fully recognized and incorporated into the licensee's risk management processes;
- be consistent with the licensee's stated goals and objectives, as well as its overall financial strength;
- clearly delineate accountability and lines of authority across the licensee's various business activities, and ensure there is a clear separation between business lines and the risk management function;
- provide for the escalation of breaches to the Board and address breaches of internal position limits;
- provide for the review of new businesses and products by bringing together all relevant risk management, control and business lines to ensure that the licensee is able to manage and control the activity prior to it being initiated; and
- include a schedule and process for reviewing the policies, procedures and limits and for updating them as appropriate.

c) *Sound capital assessment and planning*

14. As part of the strategic planning process, a licensee should perform an analysis of its current and future capital requirements in relation to its strategic objectives. The strategic plan must clearly outline the licensee's capital needs in relation to, among other things, anticipated balance sheet growth and acquisitions, Board approved risk tolerance and access to external capital resources. Senior management and the Board should view capital planning as a crucial element in the licensee's ability to achieve its desired strategic objectives.

15. Fundamental elements of sound capital assessment include:

- a clear and documented process for evaluating risks and determining whether or not a risk must result in an explicit amount of capital being held;
- policies and procedures designed to ensure that licensees identify, measure, and report all material risks;
- a process that relates current and anticipated future capital to the level of risk in accordance with the Board's approved risk tolerance;
- a process that states capital adequacy goals with respect to risk, taking account of the licensee's strategic focus and business plan; and
- a process on internal controls, reviews and audit to ensure the integrity of the overall management process.

16. During the capital planning process, licensees must identify the time horizon over which capital adequacy is being assessed and must evaluate whether long-run capital targets are consistent with short-run goals. Licensees must also be cognizant that additional capital needs can require significant lead time and capital planning which can be costly. As such, licensees must factor in the potential difficulties of raising additional capital during downturns or other times of stress.

d) Comprehensive assessment of risks

17. The ICAAP must address all material risks faced by the licensee as they relate to the adequacy of capital, including all risks explicitly captured in minimum regulatory capital requirements as well as risks that are not fully captured under minimum regulatory capital requirements. The techniques used in assessing material risks must be commensurate with the scope and complexity of the licensee's risk taking activities. The following risk exposures, which by no means constitute a comprehensive list of all risks should be considered:

Credit risk

18. Licensees must have methodologies that enable them to assess the credit risk involved in individual exposures and at the portfolio level. The credit review assessment of capital adequacy should cover four areas:

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

19. Internal risk ratings are an important tool in monitoring credit risk. The internal risk ratings must support the identification and measurement of risk from all credit exposures, as well as being integrated into the overall analysis of credit risk and capital adequacy of the licensee. The credit review process must be comprehensive and at a minimum, have the ability to:

- generate detailed internal ratings for all credit exposures;
- determine an adequate level of loan loss reserves and provisions for losses in other assets held;
- identify credit weakness at the portfolio level, especially large exposures and credit risk concentrations; and
- consider the risks involved in securitization programmes and complex credit derivative transactions.

20. The sophistication of the methodologies used to quantify credit risk should be appropriate to the scope and complexity of the licensee's credit risk taking activities. Less complex credit risk taking activities may incorporate a variety of methodologies but should at minimum take into consideration:

- 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.

21. Licensees should refer to the Central Bank's "***Guidelines for the Management of Credit Risk***" and the "***Guidelines for the Management of Large Exposures***" as well as the supporting Basel Committee document "***Principles for the Management of Credit Risk***" for further guidance on expectations for managing credit risk.

Market risk

22. Licensees must have methodologies that enable them to assess and actively manage all material market risks, wherever they arise throughout the institution (i.e., position, trading desk, business line or firm-level). For more sophisticated licensees, the assessment of internal capital adequacy for market risk, at a minimum, should be based on both value-at-risk (VaR) or similar modeling and stress testing, including an assessment of concentration risk and the assessment of illiquidity under stressful market scenarios. A licensee's VaR model should be adequate to identify and measure risks arising from all its trading activities and should be integrated into the overall internal capital assessment as well as subject to rigorous ongoing validation. A VaR model's estimates should be sensitive to changes in the trading book risk profile.

Interest rate risk in the banking book

23. A licensee's ICAAP should include all of its material interest rate risk positions and consider all relevant repricing and maturity data. The system should have well-documented assumptions and techniques. A licensee should be able to support its assumptions about the behavioural characteristics of non-maturity deposits and other assets and liabilities, especially those exposures characterized by embedded optionality. Given uncertainty in such assumptions, stress testing and scenario analysis should be used in the analysis of interest rate risks. In general, an increase in uncertainty related to modeling and business complexity should result in more capital being held.
24. Licensees should refer to the Central Bank's "Guidelines for the Management of Interest Rate Risk" and the supporting Basel Committee document "Principles for the Management and Supervision of Interest Rate Risk" for further considerations relevant to the measurement of interest rate risk.

Liquidity risk

25. Liquidity is crucial to the ongoing viability of any banking organization. A licensee's capital position can have an effect on its ability to obtain liquidity, especially in a crisis. Licensees must have adequate systems for measuring, monitoring and controlling liquidity risk. Licensees should refer to the Central Bank's "***Guidelines for the Management of Liquidity Risk***" and the supporting Basel Committee document "***Principles for Sound Liquidity Risk Management and Supervision***" for further considerations relevant to the management of liquidity risk.

Operational risk

26. Operational risk is a significant component of any licensee's risk profile. The failure to properly manage operational risk can result in a misstatement of a licensee's risk/return profile and expose the licensee to significant losses. Licensees must develop a framework for managing operational risk and evaluate the adequacy of capital given this framework. The framework must cover the licensee's appetite and tolerance for operational risk, as specified through the policies for managing this risk, including the extent and manner in which operational risk is transferred outside the licensee. It should also include policies outlining the licensee's approach to identifying, assessing, monitoring and controlling/mitigating the risk. Licensees should refer to the Central Bank's "***Guidelines for the Management of Operational Risk***" and the supporting Basel Committee document "***Principles for the Sound Management of Operational Risk***" for further considerations relevant to the management of operational risk.

Other risks

27. Although risks such as strategic and reputation risk are not easily measurable, licensees are expected to develop techniques for managing all aspects of these risks. Reputation risk is a key issue for an industry that relies on the confidence of consumers, creditors and the general marketplace. For example, when an institution acts as an advisor, arranges or actively participates in financial transactions, it may assume

insurance, market, credit, and operational risks. Reputation risk often arises because of inadequate management of these other risks, whether they are associated with direct or indirect involvement in the sale or origination of complex financial transactions or relatively routine operational activities.

28. Reputational risk can lead to the provision of implicit support, which may give rise to credit, liquidity, market and legal risk – all of which can have a negative impact on a licensee’s earnings, liquidity and capital position. A licensee should identify potential sources of reputational risk to which it is exposed. This includes the licensee’s business lines, liabilities, affiliated operations, off-balance sheet vehicles and markets in which it operates. The risks that arise should be incorporated into the licensee’s risk management process and appropriately addressed in its ICAAP and liquidity contingency plans.

e) *Stress testing*

29. Stress testing is a risk management technique used to evaluate the potential effects on a licensee’s financial condition, of a set of specified changes in risk factors, corresponding to exceptional but plausible events. The ICAAP should incorporate stress testing to complement and help validate other quantitative and qualitative assessments, so that senior management may have a more complete understanding of the licensee’s risks and interaction of those risks under stressed conditions. In their ICAAPs, licensees should examine future capital resources and capital requirements under adverse scenarios. The results of forward-looking stress testing should be considered when evaluating the adequacy of a licensee’s capital.

f) *Monitoring and reporting*

30. The licensee must establish an adequate system for monitoring and reporting risk exposures and assessing how changes to the licensee’s risk profile affects the need for capital. Licensees should also have adequate management information systems (MIS) that provide the Board and senior management with timely and relevant reports on the licensee’s risk profile and capital needs. These reports should allow senior 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 measurement system;
 - determine that the licensee 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 licensee’s reported risk profile and make necessary adjustments to the licensee’s strategic plan accordingly.
31. The information must include all risk exposures, including those that are off-balance sheet. Management must understand the assumptions behind and limitations inherent in specific risk measures.

g) *Internal control review*

32. The licensee’s internal control structure is essential to the capital assessment process. The Board has a responsibility to ensure that management establishes a system for assessing the various risks, develops a system to relate risk to the licensee’s capital level, and establishes a method for monitoring compliance with internal policies. The Board must regularly verify whether its system of internal controls is adequate to ensure the well-ordered and prudent conduct of business.
33. Effective control of the capital assessment process includes an independent review and, where appropriate, the involvement of internal and external audits. Internal and external auditors must frequently monitor and

test risk management processes. The intent is to ensure that the information on which decisions are based is accurate so that processes fully reflect management policies and that regular reporting, including the reporting of limit breaches and other exception-based reporting, is undertaken effectively.

34. The licensee must conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and reasonableness. Areas that should be reviewed include:
- appropriateness of the licensee’s 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 licensee’s assessment process;
 - reasonableness and validity of scenarios used in the assessment process; and
 - stress testing and analysis of assumptions and inputs.

Central Bank’s Supervisory Review and Evaluation Process

35. The Central Bank will conduct periodic reviews and assessments of licensees’ ICAAPs. This supervisory review and evaluation process (“SREP”) will reflect the principle of proportionality, as it relates to the nature, scale and complexity of its activities, and the risks posed to the Central Bank’s supervisory objectives. The Central Bank also endorses the ten principles of the Committee of European Banking Supervisors (“CEBS”) ¹ which provide guidance for licensees in the implementation of the ICAAP. The Central Bank will generally assess the licensees’ ICAAP reports against these principles to determine whether the licensee is in compliance with same. The SREP will form a significant part of the Central Bank’s risk based supervisory framework (“RBSF”). It is the intent of the Central Bank to use the review and assessment of each ICAAP report as the basis for ongoing discussions with the licensee.
36. In addition to the RBSF, the SREP will form an integral part of the Central Bank’s overall supervisory approach and is expected to enable assessment of the effectiveness, completeness and quality of licensees’ ICAAPs in relation to their overall risk profile. The SREP will leverage from information collected and assessments carried out as part of the wider supervisory regime, including offsite reviews, periodic on-site examinations, discussions with the licensees’ management, periodic reporting and reviews completed by internal and external auditors.
37. The SREP will also involve a quantitative review of the licensees’ Pillar 2 inherent risk exposures. However, where risks are not readily quantifiable, the Central Bank will exercise its supervisory judgment where necessary. This may include qualitative assessments of the licensees’ ability to contain actual risk exposures within prudent, planned levels through effective risk governance, oversight, management and control practices. Additionally, the SREP will consider other important factors which licensees need to take into account in arriving at its overall capital targets. These might include capital cover for plausible adverse stress scenario outcomes if there are uncertainties on the sufficiency of risk estimates, additional capital to support planned business growth, and additional capital to provide a general buffer for contingencies. The Central Bank will assess both the adequacy of licensees’ capital targets and their strategies and the capacity for achieving and maintaining these targets.
38. Licensees must complete the ICAAP report at least once a year, and upon any significant change(s) in risk exposure and the Board must be kept abreast of any change(s). A copy of the ICAAP report must be submitted to the Central Bank within 120 days of the end of each calendar year.

¹ The ten principles are summarised in the Appendix of this guideline.

39. Once the SREP has been carried out, the Central Bank may write to the Board providing the results of the assessment. This letter should advise whether the licensees' ICAAP figure is considered to be appropriate; reasons for any capital adjustments and limits, if any; and where appropriate, what actions the Central Bank may take if it is not satisfied with the results of the licensees' own risk assessment and capital allocation. As such, the Central Bank will consider a range of actions outlined in its Ladder of Supervisory Intervention guidelines and licensees should be guided accordingly.

APPENDIX

Principles of the ICAAP

- **Principle 1: Every bank must have in place a process for internally assessing its risk-based capital requirements relative to its risk profile.**
- **Principle 2: The ICAAP is the responsibility of the bank.** The ICAAP should be tailored to the bank's circumstances and needs, and it should use the inputs and definitions that the bank normally uses for internal purposes.
- **Principle 3: The ICAAP's design should be fully specified, the bank's capital policy should be fully documented, and the bank's management or supervisory body should take responsibility for the ICAAP.** The bank's management body should approve the conceptual design, level of implementation, general methodology and objectives of the ICAAP, and is responsible for integrating capital planning and capital management into the ICAAP. The management body should ensure that capital planning and capital management policies are communicated to the bank's managerial and expert personnel, and properly implemented. The results of the ICAAP should be reported to the management or supervisory body.
- **Principle 4: The ICAAP should form an integral part of the risk management process and the decision-making culture of the bank.** The ICAAP's results can be used, for example, in the allocation of capital to business units, in the individual credit decision and approval process, and in general business decisions (e.g. expansion plans) and the adoption of budgets.
- **Principle 5: The ICAAP should be reviewed regularly.** The bank should ensure that the ICAAP is reviewed as often as is deemed necessary to ensure adequate capital coverage of the risks to which the bank is or could be exposed. This review should take place at least annually. Any significant changes in the bank's strategic policies, business plan, operating environment or other factors that materially affect assumptions or methodologies used in the ICAAP should initiate appropriate adjustments to the ICAAP. The bank should ensure that new risks to which it is exposed are promptly and properly identified and incorporated into the ICAAP.
- **Principle 6: The ICAAP should be risk based.** The bank should set capital targets that are consistent with their risk profile and operating environment. In so doing the bank may take other aspects into account, such as its own targets regarding its external rating, market reputation and strategic objectives. In this case the bank should clarify how these aspects impact on the amount of its capital.
- The bank should ensure more qualitative assessment for some types of (less readily quantifiable) risks. The bank should clearly establish to which risks quantitative assessment is more suited, and to which risks qualitative assessment is more suited.
- **Principle 7: The ICAAP should be comprehensive.** The ICAAP should capture all the materially significant risks to which the bank is exposed, irrespective of whether they are included in minimum capital requirements under Pillar 1.
- **Principle 8: The ICAAP should be forward-looking.** The ICAAP should take into account the bank's strategic plans and how they relate to macroeconomic factors. The bank should develop an internal strategy for maintaining capital levels that can incorporate factors such as loan growth expectations, future funding and use of funds, and similar factors (such as pro-cyclicality); and
- The bank should have a capital plan with defined targets in capital policy, and the time horizon for achieving it. The plan should also lay out an approach to upholding compliance with regulations and a general plan of contingency measures for unexpected events (e.g. a capital increase, restrictions on certain business

activities, risk mitigation techniques). Banks should conduct appropriate stress tests of exceptional but plausible situations that take account of specific risks and the specific stage of the business cycle.

- **Principle 9: The ICAAP should be based on adequate measurement and assessment processes.** These processes should be documented. The results of the ICAAP should influence the bank's strategic planning and risk management. The bank is not required to use economic capital (or other) models, although it is expected that more sophisticated banks will elect to do so. There is no single "correct" risk assessment process. Banks may design their own ICAAPs in different ways.
- **Principle 10: The ICAAP should produce a reasonable outcome.** The ICAAP should produce an appropriate result in the sense of the internal assessment of risk-based capital requirements and the internal capital assessment. The bank should be able to satisfactorily explain to the supervisor the similarities and differences between its internal assessment of risk-based capital requirements and the minimum capital requirements.