



Internal Capital Adequacy Assessment Process

ICAAP Reporting Template

Banking Surveillance Department
State Bank of Pakistan

The Team

Name	Designation	Contact
Muhammad Ashraf Khan	Executive Director Banking Policy and Regulation Group	Ashraf.khan@sbp.org.pk
Lubna Farooq Malik	Director Banking Surveillance Department	Lubna.farooq@sbp.org.pk
Syed Jahangir Shah	Senior Joint Director Banking Surveillance Department	Syed.jahangir@sbp.org.pk Ph: 92-21-3245-3524
Tahir Naeem	Deputy Director Banking Surveillance Department	Tahir.Naeem@sbp.org.pk Ph: 92-21-3245-3596

Contents

Purpose and Overview	04
ICAAP Reporting Template:	
Section 1: Executive Summary	06
Section 2: Structure and Operations	06
Section 3: Governance Structure	06
Section 4: Risk Assessment and Capital Adequacy	07
Section 5: Stress Testing	08
Section 6: Capital Planning	08
Section 7: Design, Approval, Review, and Use of ICAAP	09
Section 8: Challenges and Further Steps	09
Appendices:	
Appendix 1: Summary of Internal Capital Adequacy Assessment Process	11
Appendix 2: Risk Appetite Statement	12
Appendix 3: Use of Internal Models for Capital Assessment	13
Appendix 4: Review of ICAAP	14

Purpose and Overview

State Bank of Pakistan (SBP) has already issued broad guidelines on ICAAP through BSD Circular No. 17 of 2008. The SBP required the banks and DFIs (hereinafter referred to as banks) to have effective and sound processes for assessing their overall capital adequacy. However, the first ICAAP documents submitted by the banks had varied length and format which necessitated the development of a standardized ICAAP reporting template.

Fundamentally, Pillar 2 should foster a more meaningful interaction and dialogue between SBP and banks for prompt remedial measures to reduce risk and restore capitalization whenever some weaknesses/ deficiencies are identified in the internal assessment processes of the banks. The use of standardized ICAAP reporting template would not only make the Supervisory Review and Evaluation Process (SREP) more efficient for both the bank and SBP, it would also enhance the comparability of respective ICAAPs across different banks having similar business and risk profiles.

The ICAAP reporting template has various sections supplemented by appendices. The information acquired through this template essentially covers the key elements of an effective ICAAP; however banks can further strengthen their ICAAP document with added relevant information. SBP requires banks to review their respective ICAAPs annually, or more frequently in the event of a material change in the banks' risk profile. However, in case of no material change in the banks' risk-profile, banks' ICAAP documents would reflect an update of the previous year's financial results and changes to budgets.

ICAAP Reporting Template

1- Executive Summary

This section should present a summary of the subsequent sections covered in the reporting template and should include:

- 1.1 Purpose of ICAAP report and entities covered therein.
- 1.2 Summary of current financial position of the bank, its business strategy, balance sheet structure, and projected profitability.
- 1.3 Assessment of the adequacy of bank's risk management processes.
- 1.4 Commentary on the material risks, risk materiality level, their assessment, and actions planned for their mitigation.
- 1.5 Composition and amount of capital required in addition to Pillar 1 requirements based on ICAAP exercise and the final results be reflected in Appendix 1.
- 1.6 Summary of bank's capital planning, dividend policy, adequacy of capital resources over its planning horizon including periods of economic downturn.
- 1.7 Impact of stress scenarios on the Capital Adequacy Ratio (CAR) of the bank.
- 1.8 Comments on the adequacy of ICAAP exercise and its key findings, ICAAP implementation within the bank, review and approval process of ICAAP.

2- Structure and Operations

This section should provide information about the bank's structure and its operations and should include:

- 2.1 Bank's structure (including group entities, if any).
- 2.2 Capital, its composition and ownership structure.
- 2.3 Primary customer focus (corporate/ retail, etc.) and summary of the products offered by the bank.
- 2.4 Current financial results indicating contribution of each business line as per Basel Capital Accord (if not available, then bank's own categorization).
- 2.5 Financial data for the last five years, e.g., operating profit, profit after tax, shareholder's funds, total assets, loans, investments, deposits and regulatory capital, etc. Also provide the conclusions that may be drawn from the analysis of the historical data which have implications for the bank's future and commentary on the significant changes in the bank's financial condition during these years.
- 2.6 Significant developments during the past five years, e.g., acquisitions, mergers, changes in the share capital and regulatory/ accounting changes and its impact etc.

3- Governance Structure

This section should include an overview of the Board and senior management structure identifying key individuals and committees and their contribution in improving the overall control environment and should include:

- 3.1 Composition of the Board including brief on the relevant banking experience of its members and number of independent directors, etc.

- 3.2 Organizational structure and senior management team along with their portfolios.
- 3.3 List of Board's sub-committees and management committees. Moreover, provide summary of main areas covered and decision taken by the Board, Board's sub-committees and main management committees.
- 3.4 List of policies in the key areas approved by the Board along with date(s) of initial approval and subsequent updates/ review(s).
- 3.5 Risk management framework and its review by the Board and senior management.
- 3.6 Independent review of internal controls, its key findings and steps taken in the light of such findings for improving the bank's internal controls.
- 3.7 Key audit findings submitted to the Board/ Board's sub committees and actions taken there against.

4- Risk Assessment and Capital Adequacy

This section should cover the identification, measurement/ quantification, control and mitigation of all material risks faced and capital maintained there against by the bank so as to reflect an overall risk position. In this regard, some of the key risks are mentioned in the Appendix 1¹.

- 4.1 A high level overview of the institution's risk appetite² and frequency of the review of risk tolerance by the Board and management.
- 4.2 Identify material risks and for each risk type specify:
 - 4.2.1 Definition and identification procedure of material risks.
 - 4.2.2 Detail of risk assessment and quantification methodology for each risk type³.
 - 4.2.3 For each risk type, specify the risk controls / limits, number of times when these limits have been breached, remedial actions taken there against and changes in such limits (if any) along with reasons.
 - 4.2.4 Composition and amount of capital (under normal as well as stressed circumstances⁴) allocated for each material risk identified during the ICAAP exercise.
- 4.3 State the periodicity for reporting of material risks to the Board and senior management.
- 4.4 Provide the details of internal and external (if any) review of bank's risk management system to verify its relevance with the business activities.
- 4.5 Bank should determine an overall risk position by aggregating the material risks and capital allocation there against. While aggregating the risk position, bank should preferably take into account the interdependencies or correlations among various risk types.
- 4.6 Where relevant, provide an explanation of any other method apart from capital used to mitigate the risks.

¹ Please note that completion of Appendix 1 of this template is mandatory for reporting purposes.

² Please see appendix 2 for components of Risk Appetite Statement.

³ If bank uses internal models for the measurement of material risks, provide additional details required under appendix 3.

⁴ Take input from section 5 on stress testing to determine the amount of capital under stressed scenarios.

5- Stress Testing

This section should cover the details vis-à-vis development of an appropriate and rigorous stress testing framework within the bank while taking into account the impact of economic cycles and sensitivity to other external risks and should include:

- 5.1 General stress testing framework within the bank and its key features.
- 5.2 Role of the Board in the approval and review of bank's stress testing framework including the periodicity of any such review.
- 5.3 Provide a list of material risks covered under stress testing program along with reasons for their inclusion. Also state the reasons for non-inclusion of material risks (if any) in the stress testing program.
- 5.4 Provide details of scenarios, methodologies, assumptions, controls/ mitigating actions applied results and amount of capital required for all the stress tests (both in-house as well as regulatory stress tests). In case of similar/ overlapping internal and supervisory shocks, ICAAP capital amount would be higher of the two.
- 5.5 Review of the stress test results by the Board and senior management and remedial actions taken there-against.

6- Capital Planning

This section should outline the bank's capital needs, anticipated capital expenditures, desirable capital level and external capital sources and must be in line with the bank's desired strategic objectives. Capital Planning should also take into account dividend policy and planned growth while determining the adequate capital level. This section should include:

- 6.1 Projected financial statements for the next three to five years based on the approved business plan.
- 6.3 Future capital requirements based on approved business plan and projections, including capital contingency plan highlighting the sources, quality and composition of capital and/ or alternative arrangements in case of sudden internal business shocks and/ or external economic downturn, major investments, merger, acquisitions and sources to fund new ventures, etc. It would also include capital needs for group entities, foreign branches and subsidiaries.
- 6.4 Review of capital planning process by the Board and senior management to assess its appropriateness in the light of any change in the bank's risk profile and other relevant factors.
- 6.5 Bank's plan for meeting the expected regulatory requirements like MCR and those envisaged in the Basel III capital accord.

7 - Design , Approval, Review and Use of ICAAP

This section should include the following:

- 7.1 Role of the Board in approving the conceptual design of ICAAP with reference to its scope, methodologies and objectives.
- 7.2 Role of the senior management in the implementation of ICAAP.
- 7.3 In case the design of ICAAP (whole or parts thereof) has been outsourced, provide the details of outsourcing entity and associated risks.
- 7.4 Review of ICAAP⁵ by the Board and senior management, external source (if any) and internal audit. For each review, provide separately the periodicity, detailed findings of any such review along with follow-up actions on such findings.
- 7.5 How ICAAP is embedded in the decision making process, business planning and risk management processes substantiated with appropriate examples.
- 7.6 List of all the relevant documents and policies used in the preparation, review, approval and implementation of ICAAP.
- 7.7 Highlight the significant changes made in the current ICAAP report in comparison with the last exercise.

8 - Challenges and further Steps

This section should summarize the extent of challenges for bringing improvements in the overall risk management framework, control processes and other relevant areas within the bank. Bank may also discuss the details of any anticipated future refinements envisaged in the internal assessment process in addition to the information already furnished by the bank.

=====

⁵ Please see appendix 4 for further detail on the review of ICAAP.

Appendices

Appendix 1: Summary of Internal Capital Adequacy Assessment Process (ICAAP)

As of DD/MM/YYYY

Million (PKR)	Amount	Pillar 1 Minimum Regulatory Capital	Capital under ICAAP	Methodology
Regulatory capital				
(i) Eligible Core capital (Tier 1)				
(ii) Eligible Supplementary capital (Tier 2)				
Risk covered under Pillar 1				
Credit risk				
(i) Standardized approach				
(ii) Foundation IRB approach				
(iii) Advanced IRB approach				
Market risk				
(i) Standardized approach				
(ii) Internal Model approach				
Operational risk				
(i) Basic indicator approach				
(ii) The standardized approach				
(iii) Alternative standardized approach				
Pillar 1 total capital requirement (a)				
Risks not fully covered under Pillar 1				
Residual risk				
Securitization risk				
Model risk				
Risks covered under Pillar 2				
Concentration risk				
(i) Individual/ Group				
(ii) Sectoral				
(iii) Other				
Interest rate risk in banking book				
Liquidity risk				
Country risk				
Reputation risk				
Strategic/ Business risk				
Other material risks identified during ICAAP				
ICAAP/ Pillar 2 capital (b)				
Additional capital under stress test (c)				
Risk diversification adjustment* (d)				
Overall capital requirement (a) + (b) + (c) - (d)				
Current Total Capital				
Surplus/ deficit capital				

* Please provide a brief explanation of the risks' diversification adjustment. Also note that SBP will generally not take into account any inter-risks diversification benefit unless it is quantified by a rigorous model with adequate support.

** Minimum Regulatory Capital Requirement (MCR) under pillar 1 would serve as a floor to determine the bank's capital level in case if pillar 2 capital based on ICAAP exercise falls below the regulatory level.

*** Banks are encouraged to use/ develop their internal methodologies for the quantification of various risks under Pillar 2 and capital allocation accordingly. However, as an interim arrangement, bank may allocate capital on judgmental basis to individual risks till the development of appropriate methodologies for the quantification.

Appendix 2

Risk Appetite Statement

Risk appetite is defined as the total impact of risk; a bank is willing to accept in pursuit of its strategic objectives. The definition of a suitable risk appetite is a basic operational pre-requisite for a bank to set consistent risk limits. The amount of risk, a bank is willing to accept will vary from one bank to another depending upon the circumstances unique to each one of them. Factors such as the external environment, business, systems, people and policies will all influence a bank's risk appetite.

Apart from this, within the bank, risk appetite may also vary across different business units and risk types. For example, a bank's risk appetite for market risk may be quite different from that of credit risk. Financial institutions use different ways to measure risk appetite, ranging from simple qualitative measures to developing complex quantitative models. Nevertheless, whichever approach is followed, risk appetite, if properly articulated, should provide a cornerstone for the bank's risk management framework.

To ensure effective monitoring and governance, the risk appetite statement will incorporate a balanced mix of both quantitative and qualitative measure. However, a well defined risk appetite statement, approved by the board, should have the following characteristics⁶.

- It should be reflective of strategy, including institutional objectives, business plans and stakeholders' behavior covering all key aspects of business.
- It should be reflective of acknowledgement of willingness and capacity to take on risks.
- It should consider the skills, resources and technology required to manage and monitor risk exposure in the context of risk appetite.
- It should include tolerance for loss or negative events that can be reasonably quantified.
- It should be periodically reviewed and reconsidered with reference to evolving industry and market conditions.
- It should quantify the desired level of risk the bank is willing to take typically expressed as risk limits, however for ICAAP purposes, these risk limits should be quantified in terms of capital (solvency perspective).

⁶ We expect that the level of sophistication will come over time, however; banks are encouraged to take into consideration the aspects mentioned in this appendix for their Risk Appetite Statement.

Appendix 3

Use of Internal Models for Capital Assessment

When the bank uses internal models for capital assessment, it should explain for each of those models:

- A description of how assessments for each of the major risks have been approached as well as the key assumptions and parameters within the capital modeling work and background information on the derivation of any key assumptions.
- Criteria for selection of parameters including the historical period used and the calibration process.
- Limitations of the model.
- Sensitivity of the model to changes in the key assumptions/ chosen parameters.
- Validation work undertaken to ensure the continuing adequacy of the model.

Appendix 4

Review of ICAAP

Banks should institutionalize a robust system for the continuous monitoring and reporting of risk exposures and assessment of change in capital needs due to any deviation from its risk profile and business plans. Banks should conduct reviews of risk management and capital management processes relating to ICAAP to ensure their integrity, objectivity and consistent application. Though the principles governing ICAAP⁷ are not new to capital management but the transparency and rigor expected out of this process is quite recent. Review of banks' ICAAP would include the following:

- Comprehensiveness and appropriateness of ICAAP in the context of bank's operating environment, nature of business and soundness of internal controls.
- Identification of all key and material risks.
- Appropriateness of measurement methodology employed to support ICAAP exercise and accuracy and completeness of data input.
- Reasonableness of ICAAP input and assumptions used.
- Reasonableness and appropriateness of stress testing analysis and its assumptions.
- Integration of ICAAP results and risk management, e.g., limit setting and monitoring.
- Reasonableness of capital planning and capital targets.
- Adequacy of MIS, level of computerization and networking to support the implementation of ICAAP. If not, what are the plans and targets/ deadlines set for achieving it.

⁷ Refer to general principles for an effective ICAAP by Committee of European Banking Supervisors (CEBS)