



ICAAP Implementation for Banks in Canada

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Pillar 2 Framework: The Four Principles

Supervisory Purpose of Pillar 2:

- To ensure that banks have adequate capital to support all the risks in their business
- To encourage banks to develop and use better risk management techniques in monitoring and managing their risks

The Four Principles of Pillar 2:

Principle 1	<i>Banks should have a process in place for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels</i>
Principle 2	<i>Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process</i>
Principle 3	<i>Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum</i>
Principle 4	<i>Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored</i>



Pillar 2 Framework: Principle-based Approach with Specific Focus

Principle-based and flexible

- Principles-based (four overarching principles of Pillar 2) containing supervisor “expectations” (*unlike Pillar 1*)
- Bank responsible for the ICAAP (*Pillar 1 is not a safe harbour*)
- Supervisor responsible for assessing how well banks assess their capital needs relative to their risks and to intervene, where appropriate
- Increased capital may not be the only or most appropriate response to increased risk; fundamental control expectations remain unchanged

Specific Areas of Focus

- Risks considered, but not fully captured under the Pillar 1 process (e.g., credit concentration risk)
- Risks not considered by Pillar 1 process (e.g., interest rate risk in the banking book, business and strategic risk)
- External factors (e.g., business cycle effects)
- Ongoing review of compliance with ‘advanced’ Pillar 1 standards
- Supervisory transparency and accountability
- Enhanced cross-border communication and cooperation



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AIRB Banks ICAAP Roadmap (Process/Milestones)

- 2007** → Pillar 2 Pilot Project
- 2008** → 1st cross-system review, incl. Governance & Control + Risk measurement (wholesale focus) + Recommendation
- 2009** → 2nd cross-system review, incl. Governance & Control + Risk measurement (Retail focus) + Recommendation
- Spring 2009** → Letter to Industry re. ICAAP Implementation
- Jun 2009** → Internal ICAAP Training
- Since Q2 2009** → Internal Capital Comparison submitted + Target Capital View produced (on a quarterly basis)
- Oct 2009** → 2009 ICAAP Panel
- Mar 2010** → CEO ICAAP SAP Submission, incl. EWST
- Apr - Dec 2010** → SAP Assessment + Bank-specific Review + Panel
- Oct 2010** → ICAAP Guideline E-19
- 2011** → Bank-specific Review, incl. Foreign IRB Banks



STDZ Banks ICAAP Roadmap (Process/Milestones)

- Pre-Nov 2008** → **Industry Consultation + Pillar I/II letters in 2007 & 2008**
- Nov 2008** → **Progress Check**
- Mar 2009** → **1st ICAAP Submission**
- Apr 2009** → **Internal ICAAP Training**
- Jun 2009** → **Internal Audit Review Due**
- Apr – Dec 2009** → **Assessment by RMs + Top Down Review + Panels**
- Dec 2009** → **2009 Letter to Industry re. ICAAP Submission**
- Jun 2010** → **E-18 SAP Submission**
- Sept 2010** → **2nd ICAAP Submission**
- Jul 2010 – Mar 2011** → **Assessment by RMs + Top Down Review + Panels**
- Apr 2011** → **2011 Letter to Industry re. ICAAP going forward**



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General Observations

1. ICAAP processes in Canada are maturing consistent with our expectations, although work remains and further changes may be expected under Basel 3.
2. A positive correlation was observed between the level of senior management engagement in ICAAP and the speed of progress in ICAAP implementation.
3. The robustness of a bank's stress testing framework was observed to be directly related to the extent of business involvement. Stress testing at banks with significant business involvement were often very robust.
4. ICAAP approach for STDZ banks is different than for the Conglomerate AIRB banks (scaled for size and complexity). Regulatory review approaches could be harmonized through the adoption of ICAAP panels, the 'bottom-up' approach to target capital and the roll-out of the AIRB approach for ICAAP to applicable foreign bank subsidiaries.



Specific Observations

1. Capital supporting ICAAP - Range of definitions. Banks need to assess the consistency between quality of capital supporting ICAAP assessments and the degree of conservatism in the application of risk quantification standards.
2. Risk identification - Lack of formal process. Banks need to formalize and properly document their risk identification and assessment process at the enterprise level with criteria established for capitalization.
3. EC \neq ICAAP: This presents a challenge to both banks and supervisors in evaluating ICAAP outcomes based on EC. EC is more 'point-in-time' designed for optimization of portfolio returns, but ICAAP needs to manage current and future needs ('through-the-cycle').
4. Use of vendor model: Many banks use vendor models for EC calculation. Model uncertainty is material, but not reflected in potential conservative adjustments within ICAAP assessments.



Specific Observations, Cont'd

5. ICAAP validation - A challenge for banks (e.g., timing, scope, completeness). Validation of ICAAP methods is generally not as robust as the validation used to support Pillar 1 models. The articulation of 'end-to-end' ICAAP validation needs to be enhanced.
6. Credit concentration risk - Lack of explicit measurement process to transparently capture credit concentration risk within the ICAAP. Dialogue around the capital use related to risk concentration is limited.
7. Counterparty credit risk - Substantial range of practice, in terms of the use of internal models and their impact on capital 'requirements'. Wrong-way risk needs to be addressed for ICAAP purposes.
8. Pro-cyclicality – Lack of explicit measurements or risk analytics performed, as part of the ICAAP process, to assess business cycle / pro-cyclicality impact. Work on the appropriateness of EC relative to ICAAP objectives, and Basel III preparation will likely help focus banks on these dynamics.



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OSFI's Framework for ICAAP Review

- OSFI's Supervisory Framework remains the basis for assessing the overall prudential risks of federally regulated financial institutions (FRFIs).
- Linkage between risk and capital adequacy
 - OSFI is looking for increased ICAAP transparency in the demonstration of the linkage between capital and the level of risk.
- ICAAP Reviews at FRFIs
 - OSFI does not approve ICAAPs.
 - ICAAP assessments by FRFIs are monitored on a regular basis and are increasingly used to inform ongoing capital adequacy assessments by OSFI.
- ICAAP Assumptions
 - Capital assessments are undergoing evolution, not revolution.
 - New tools are being integrated into ongoing capital adequacy assessments.



OSFI Guidance

- OSFI released its ICAAP Guideline E-19 in October 2010. We expect banks to continue refining their ICAAPs relative to the following ICAAP process features:
 1. Board and senior management oversight
 2. Sound capital assessment
 3. Comprehensive assessment of risks
 4. Stress Testing
 5. Monitoring and Reporting
 6. Internal control review.

E-19: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=527

- OSFI sent an industry letter to the AIRB banks in Spring 2009 to clarify our expectations of implementing ICAAP for AIRB banks. Five additional areas of ICAAP implementation that require special attention were identified:
 1. Roles and responsibilities for ICAAP
 2. Senior management ICAAP assessment
 3. Control expectations for validation of ICAAP risk methods
 4. ICAAP information for board and senior management
 5. Internal audit



Control Expectations for ICAAP Validation

Six Principles:

1. Integrity – should deliver an effective challenge to the design and implementation of ICAAP risk methods;
2. Documentation – should produce sufficient documentation for 3rd party review;
3. Timing – should establish regular “validation cycles”, and be responsive to “validation triggers” so that the review of ICAAP methods remains current and relevant;
4. Scope – should consider all models and assumptions, incl. both quantitative and qualitative assumptions;
5. Monitoring – should review the performance outcomes of ICAAP risk methods against expectations; and,
6. Completeness - should provide an integrated view on business and risk coverage to ensure that the risk identification process is complete, all portfolios are covered, and that all material risks (and risk factors) are appropriately reflected in the ICAAP.



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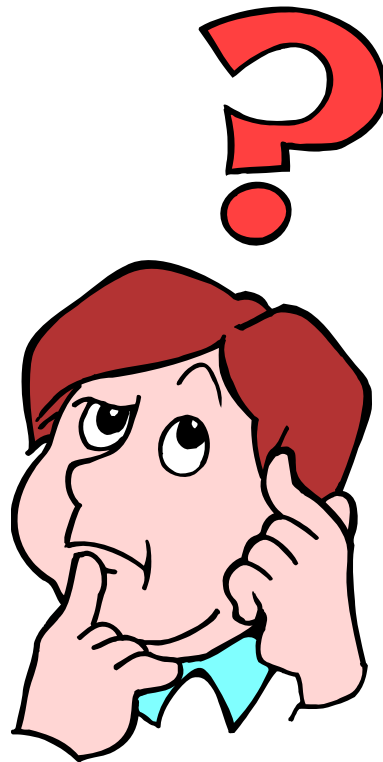
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Conclusions

- Capital adequacy assessments are evolving, but ICAAP is much more than Pillar 1 plus an add-on.
- ICAAP is an important process that continues to evolve and mature. A robust ICAAP will help banks better manage capital through business cycles. ICAAP represent a unique opportunity to banks and supervisors to inform their respective risk and capital adequacy assessments. ICAAP will play an increasing role in the dialogue between banks and supervisors.
- We expect banks to continue to develop linkages among their risk appetite, ICAAP and EWST program in the context of sound risk and capital management practices. ICAAP should incorporate rigorous forward-looking stress testing to assess future capital resources and requirements under adverse scenarios.
- Supervisors and banks will need to refresh ICAAP expectations to reflect Basel 3 requirements.





Questions



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