BANK SUPERVISION DIVISION

CIRCULAR TO BANKING INSTITUTIONS NO. 05-2017/BSD: MINIMUM REQUIREMENTS FOR THE INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS REPORT

SEPTEMBER 2017

A. BACKGROUND

1. Further to ***Guideline No: 1-2011/BSD Technical Guidance on the Implementation of the Revised Capital Adequacy Framework in Zimbabwe*** and ***Circular No. 5-2014/BSD: Internal Capital Adequacy Assessment Process & Capital Planning for 2020,*** this circular provides additional guidance in relation to the structure and reporting requirements for the Internal Capital Adequacy Assessment Process (ICAAP) reports.
2. An ICAAP report represents the board and senior management's ongoing assessment of material risks that a banking institution is exposed to, the mitigants that the bank has put in place and the adequacy of the bank's capital to support the risks and future business needs.
3. Within an institution's internal governance framework, the Internal Capital Adequacy Assessment Process seeks to ensure that the board and senior management:
   a) adequately identifies, measures, aggregates and monitors the institution's risks;
   b) ensures that the institution holds adequate internal capital in relation to the institution's risk profile; and
   c) uses sound risk management systems and reviews them with the objective of enhancing them on an ongoing basis.
4. The board and senior management's obligation goes beyond the need to ensure compliance with regulatory capital requirements and requires them to ensure that the bank holds capital that is commensurate with the bank's risk profile.
5. While the ICAAP may be developed by a bank's experts drawn from various departments, the board and senior management must be actively engaged in the development and finalisation of the ICAAP and must have oversight of its implementation on an ongoing basis.
6. The Reserve Bank expects the board and senior management to robustly interrogate the assumptions and methodologies behind the ICAAP as well as the key aspects of ICAAP reports and associated documentation.

7. The ICAAP results must be integrated into the decision-making processes of a banking institution and must form part of key strategic and business planning.

Proportionality…

8. The framework under which an institution should develop its ICAAP should be risk-based and emphasize the importance of capital planning and other qualitative aspects of risk management. When assessing capital needs, all banking institutions should take into account the impact of economic cycles and sensitivity to other external risks and factors. Banking institutions should develop an appropriately detailed and rigorous stress and scenario testing framework.
9. The Reserve Bank recognises that there may be a fair degree of variation in the length and format of ICAAP submissions as banks' business and risk profiles differ, hence the ICAAP document should be proportional to the size, nature and complexity of a bank's business.

ICAAP Review and Submission to the Reserve Bank…

10. The ICAAP should be subject to regular internal review and such assessment should be conducted, at least half yearly.
11. The effective date of the ICAAP calculations should be indicated. Banking institutions must submit their annual ICAAP reports to the Reserve Bank by 31 March of every year, utilizing preceding year end data. In addition, banks must submit half year reviews of their ICAAP reports by 30 September of every year, utilising data as at 30 June of that year.
12. Details of the rationale for the time period over which capital has been assessed and anticipated events over the outlook period that may have a material impact on capital should be outlined in the ICAAP report.

B. COVERAGE OF ICAAP REPORT

13. The ICAAP report should, at a minimum, cover key issues such as governance structure and operations; projected financial and capital positions; risk analysis, capital adequacy and capital planning, as outlined hereunder.

14. These issues typically are the subject of review through Risk-Based Supervision onsite examinations and the Supervisory Review and Evaluation Process, which is carried out by the Reserve Bank. The following are the main components of the ICAAP report.

    a) Executive Summary;
    b) Governance Structure;
    c) Strategy and Risk Appetite;
    d) Summary of Current and Projected Financial and Capital Positions;
    e) Risk Analysis and Capital Adequacy Assessment;
    f) Economic and Regulatory Capital;
    g) Stress Testing and Scenario Analysis;
    h) Capital Planning and Forecasting;
    i) Liquidity Planning;
    j) Management Actions;
    k) Quality Assurance & Adoption of the ICAAP; and
    l) Use of ICAAP within the Bank.

I. Executive Summary

15. The purpose of the Executive Summary is to present an overview of the ICAAP results. This overview should typically include:

    a) the purpose of the report and in the case of a group, the regulated entities covered by the ICAAP;
    b) the main findings of the ICAAP analysis, including a brief on how much capital the bank considers to be adequate given its risk profile, compared to its pillar 1 required regulatory capital, and held capital (available financial resources). In

addition, the brief should include the bank's own judgement on the adequacy of its risk management processes;

c) a summary of the financial position of the bank, the strategic position and direction of the bank, its balance sheet strength, and projected profitability;

d) brief descriptions of the capital and dividend plan; how the bank intends to manage capital going forward and for what purposes;

e) commentary on the material risks the bank is exposed to and a brief on vulnerabilities noted from stress test results, including the mitigants in place or planned;

f) a summary of the ICAAP evaluation in the format outlined in Appendix 1;

g) commentary on major issues where further analysis and decisions are required; and

h) who has carried out the assessment, how it has been reviewed, and who has approved it.

II. Governance Structure

16. This section of the ICAAP should provide an overview of the bank's operations and structure including board and senior management, indicating key individuals and committees and their role in the overall control environment, and should include:

a) bank's structure (including group entities, if any);

b) ownership structure including major shareholders;

c) significant developments during the past year, e.g. acquisitions, mergers, changes in the share capital;

d) composition of the board committee that has the responsibility of overseeing capital management processes of the bank including brief on the relevant banking experience of its members, number of independent directors, including any relevant information that shows experience and skills of the committee;

e) organizational structure and senior management team along with their portfolios;

f) list of board sub-committees and management committees responsible for risk and capital management. In addition, provide a summary of main areas covered and decisions taken over the year by the board, sub-committees and management committees that have a material impact on capital;
g) list of policies and risk management frameworks in the key operational areas approved by the board along with date(s) of last review/approval; and
h) the role of internal audit in the governance process and its certification of the soundness of the system of internal controls in the bank.

III. Strategy and Risk Appetite

17. The section on strategy should cover all issues relating to the bank's strategic decisions and direction that have the potential to significantly impact the bank's capital adequacy. These include strategic position, anticipated business strategies and implementation thereof.
18. **Under strategic position**, the bank should clearly articulate the impact on strategy, of the operating environment, the organisation's strategic capability (resources and competences) and the expectations and influence of stakeholders.
19. On **strategic direction**, the section should indicate how the bank seeks to compete at the *business level*, as well as the methods by which strategy will be pursued. In this regard, issues relating to, inter-alia, asset growth targets and balance sheet composition, pricing strategies, profitability targets, must be highlighted. The basis for competition, such as cost advantage and differentiation, should also be highlighted, so should intended strategic thrusts (defensive and aggressive postures, market penetration etc.).
20. The section on **Risk Appetite** should spell out the level of risk the bank is willing to accept in pursuit of its strategic objectives. The section should further highlight the capacity to sustain losses under both normal and a range of stress conditions. The risk appetite monitoring, escalation and resolution framework should thus specify risk

tolerance limits and risk appetite triggers, as well as the scope and nature of available management actions to prevent breach of risk tolerance limits.

21. Based on appropriate quantitative and qualitative assessments, the risk appetite narrative should incorporate risk tolerance limits on the key risk dimensions, including regulatory capital, liquidity, and stressed earnings.

IV. Summary of Current and Projected Financial and Capital Positions

22. This section should analyse, among other factors, the following:

a) the current financial position of the bank or banking group (if relevant), including any expected changes to the current business profile that have material impact on the financial condition (e.g. acquisitions, expansion abroad etc.). The section should contain financial data for the last three years;

b) the assumptions used in developing the projections;

c) the projected financial positions of the bank, which should be in line with its business plans; and

d) the capital planning and the sources of funds that the bank can access. The bank should perform the necessary comparisons between the capital available and the capital required to fulfil its business plans in light of anticipated strategic thrust and business activities. The means of covering the potential capital shortfalls should also be mentioned. It is to be noted that the capital projections may provide the baseline against which adverse scenarios might be compared.

V. Risk Analysis and Capital Adequacy Assessment

23. This section should cover the identification, measurement, control and mitigation of all material risks faced by the bank including an assessment of the adequacy of capital to support its overall risk profile.

24. The **risk assessment should clearly articulate the banking institution’s risk universe**. The section should identify the sources of the various forms of risks and

where these are to be found at the level of operating units and, where relevant, within the group or from external counterparties.

25. Further, the banking institution is required to outline the approach used to define and categorise its key risk types as well as the governance arrangements in place for the risk assessment process.

26. At a minimum a bank should assess material risks faced in each of the following categories.

Pillar I Risks	• Credit Risk • Market risk • Operational risk
Risks not adequately covered by Pillar I	• Residual risk • Securitisation risk • Model risk
Pillar II risks	• Interest rate risk in the banking book • Credit concentration risk • Liquidity risk • Strategic risk • Reputation risk, etc.

27. In addition, this section should include a **detailed review of the bank's internal capital adequacy**.

28. For each risk type, the bank should provide an explanation regarding the methodology applied for its monitoring and measurement and the quantitative results of that assessment. Where relevant, a comparison of that assessment with the results of the Pillar 1 calculations should be included.

29. The bank should include a clear articulation of the bank's risk appetite separately for each risk category if this varies from the overall assessment; and where relevant, an explanation of any other methods or other specific techniques or arrangements, apart from capital buffers, used to mitigate the risks e.g. insurance, risk management or control structures.

30. Banking institutions are also required to provide a brief explanation of how the risk management process works holistically (e.g. how related policies and procedures fit together in practice) and an outline of reporting, monitoring and governance processes for risk management.
31. Where institutions rely on group-wide policies, they are required to state clearly how group-wide policies are operationalised or tailored for application to the institution.
32. The ICAAP must indicate the overall risk position of the bank based on a combination of all the risk types. In its ICAAP, a banking institution must clearly indicate the ***method of aggregation*** used to come up with an aggregate position on the level of exposure to all identified risk types.
33. The section must also include an explanation as to how factors such as diversification and/ or correlation of risks have been taken into account, where applicable.
34. The risk assessment should detail the amount of capital that a bank needs to meet its business objectives in relation to the risk appetite set by the board. The bank should also provide basis of the capital it requires, supported by both quantitative and qualitative assessments.
35. The justification for the view on the required capital may be based on a number of factors, such as, a desired external credit rating or it may include buffers for strategic purposes or the need to minimise the likelihood of breaching minimum regulatory requirements.
36. The banking institution should ensure that its approach used to relate capital to risk is conceptually sound and that the results are reasonable.
37. The bank should conduct **periodic independent reviews** of its risk management process to ensure its integrity, accuracy, and reasonableness. In this regard, banking institutions are required to include the results of the review of risk management processes in the ICAAP document.
38. Areas to be reviewed, should at a minimum, include:
    a) appropriateness of the bank's capital assessment process given the nature, scope and complexity of its activities;

b) identification of large exposures and risk concentrations; accuracy and completeness of data inputs into the bank's assessment process;
c) reasonableness and validity of scenarios used in the assessment process;
d) stress testing and analysis of assumptions and inputs; and
e) validation of models used.

VI. Economic and regulatory capital…

39. Where banking institutions use economic capital models, the description should explain each modelling or calculation approach. This should include details of the methodology used to calculate risks in each of the categories identified and reason for choosing the method used in each case.
40. A description of economic capital models should include:
    a) the key assumptions and parameters within the capital modelling work and background information on the derivation of any key assumptions;
    b) how parameters have been chosen, including the historical period used and the calibration process;
    c) the limitations of the model;
    d) the sensitivity of the model to changes in those key assumptions or parameters chosen; and
    e) the validation work undertaken to ensure the continuing adequacy of the model.
41. If a banking institution compiles a separate economic capital computation report, the banking institution can provide the economic capital report as a separate appendix or attachment whilst salient detail is maintained within the main ICAAP document.

VII. Stress Testing and Scenario Analysis…

42. Stress tests results should be accompanied with the following information:
    a) details of simulations to capture risks not well estimated by the bank's internal capital model (e.g. non-linear products, concentrations, illiquidity and gapping of prices, shifts in correlations in a crisis period);

b) details of the quantitative results of stress tests the bank carried out including key assumptions of the tests, including, the distribution of outcomes obtained for the main individual risk factors;

c) details of the range of combined adverse scenarios which have been applied, how these were derived and the resulting capital requirements; and

d) where applicable, details of any additional business-unit-specific or business plan stress tests selected.

VIII. Capital Planning and Forecasting

43. This section should explain how a bank would be affected by macro-economic factors and other adverse business or market movements relevant to its activities. The bank should explain how it would manage its business and capital in a manner that enables it to survive a shock whilst meeting minimum regulatory standards. The analysis should include financial projections e.g. for one year or three years or up to the deepest part of the shock based on business plans and solvency calculations.

44. Typical scenarios would include:

a) how an economic downturn would affect the bank's capital resources and future earnings; and the bank's required regulatory risk capital taking into account future changes in its projected balance sheet. In both cases, the bank should show separately the effects of management actions to changes in the bank's business strategy and the implementation of contingency plans on projections.

b) projections of the future required regulatory risk capital should include the effect of changes in the credit quality of the bank's loan portfolio (including migration in their ratings during a recession) and the bank's capital and its credit risk capital requirement; and

c) an assessment by the bank of any other capital planning actions to enable it to continue to meet its regulatory capital requirements throughout a recession such as new capital injections from related companies or new share issues.

IX. Management Actions

45. This section should expand on the management actions assumed in deriving the ICAAP, in particular:
    a) the quantitative impact of proposed or implemented management actions – sensitivity testing of key management actions and revised ICAAP figures with management actions included; and
    b) evidence of management actions implemented in the past during similar periods of stress.

X. Liquidity Planning

46. This section should summarise the bank's exposure to and its management of liquidity risk. In particular, it should set out the key assumptions and conclusions from stress testing of cash flows undertaken to manage the risk.
47. Further, the ICAAP report should include the following, where relevant:
    a) A description of the committees and personnel vested with the responsibility to identify and manage liquidity risk;
    b) Summary of matters raised during the previous internal and external audits of the Treasury department;
    c) An organisation chart that covers liquidity and funding risk management delegated authorities and reporting lines within the bank;
    d) Summary of limit breach policy;
    e) Brief of liquidity stress testing assumptions;
    f) An explanation of intra-group liquidity arrangements, if operating as part of a group;
    g) Liquidity gap analysis; and
    h) A brief on contingency funding in place.

XI. Quality Assurance & Adoption of the ICAAP

48. This section should describe the quality assurance process that the ICAAP report has gone through. Further, it should include the testing and control processes applied to

the ICAAP models or calculations, and the senior management or board review and sign off procedures including any comments or changes they may have made.

49. Details of the reliance placed on any external consultants/reviewers should also be detailed in this section e.g. for generating economic scenarios.

XII. Use of ICAAP within the Bank

50. This section should demonstrate the extent to which capital management is embedded within the bank including the extent and use of capital modelling or scenario analysis and stress testing within the bank's capital management policy, e.g. in setting pricing and charges and the level and nature of future business.

51. This section should also include a statement of the bank's capital management philosophy and how this links to the ICAAP being submitted. For instance differences in risk appetite used in the ICAAP as compared to that used for business decisions should be discussed where applicable.

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Registrar of Banking Institutions

September 2017

Appendix 1: Summary of Internal Capital Adequacy Assessment Process (ICAAP) as at DD/MM/YYYY				
Million (US$)	**Amount**	**Pillar 1 Minimum Regulatory Capital**	**Capital under ICAAP**	**Methodology**
Regulatory Capital				
i) Eligible Core Capital (Tier 1)				
ii) Eligible Supplementary capital (Tier 2)				
Risks covered under Pillar 1				
Credit Risk				
i) Modified standardised approach				
ii) Foundation IRB approach				
iii) Advanced IRB approach				
Market Risk				
i) Standardised approach				
ii) Internal model approach				
Operational risk				
i) Basic indicator approach				
ii) The standardised approach				
iv) Alternative standardised approach				
v) Advanced measurement approach				
Pillar 1 total capital requirement (a)				
Risks not fully covered under Pillar 1				
Residual Risk				
Securitisation 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)				
Overall capital requirement (a) + (b)+(c)				
Current Total Capital				
Surplus / deficit capital				