CIRCULAR TO BANKING INSTITUTIONS No. 05-2014/BSD: INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS &CAPITAL PLANNING FOR 2020

1. The Reserve Bank announced revised timelines for compliance with minimum capital requirements for banking institutions in the January 2014 Monetary Policy Statement.

2. As part of the new requirements, banking institutions should submit their capitalization plans to the Reserve Bank by 30 June 2014 clearly indicating the internal milestones leading to compliance with the 31 December 2020 thresholds which are as follows:

Type of Institution	Current Minimum Equity Capital Requirement as at 31 December 2012	Minimum Equity Capital Requirement as at 31 December 2020
Commercial Banks	US$25 million	US$100 million
Merchant Banks	US$25 million	US$100 million
Building Societies	US$20 million	US$80 million
Finance Houses	US$15 million	US$60 million
Discount Houses	US$15 million	US$60 million
Microfinance Banks	US$5 million	US$10 million

3. The Reserve Bank places significant importance on bank's internal capital planning processes which shall be subject to regular supervisory assessments.

4. In this respect, the Reserve Bank expects banking institutions to develop and implement practical, credible and realistic capital plans guided by the fundamental components of a sound capital planning process as follows:

a) Formalised Capital Planning Process

5. Banking institutions should adopt a formalised capital planning process that is administered through an effective governance structure.

6. A bank's capital planning process, whether centralized or divided along functional lines, should produce an internally consistent and coherent view of the current and future capital needs.

7. The capital planning process should reflect the input of different experts from across a bank, including but not limited to staff from risk, finance and treasury departments. There should be a strong link between capital planning, budgeting and strategic planning processes within a bank.

b) Foundational Risk Management

8. In line with the **Risk Management Guideline No. 1-2006/BSD**, banking institutions are required to have effective risk identification, measurement, management, and control processes in place to support their internal capital planning.

9. Banking institutions are expected to demonstrate how identified risks are accounted for in the capital planning processes to facilitate informed decision making with respect to overall capital adequacy.

10. A banking institution should adequately identify the potential exposures and risks stemming from their firm-wide activities including consideration of the full scale and scope of exposures, and analysis of how the size and risk

characteristics of exposures and business activities might evolve as economic and market conditions change.

c) Internal Control and Governance

11. A banking institution should have a strong internal control framework that helps govern its internal capital planning processes. These controls should include (i) regular and comprehensive review by internal audit; (ii) robust and independent model review and validation practices; (iii) comprehensive documentation, including policies and procedures; and (iv) change controls.

12. Capital plans must capture a bank's current strategy and regulatory standards, and should be escalated for discussion and approval by the board.

13. A banking institution should subject its capital plans and its underlying processes and models to regular independent validation. This layer of review should confirm whether the processes are strong, are applied consistently and remain relevant for the bank's business model and risk profile.

14. A bank should establish a management committee that works under the auspices of the board of directors in order to guide and review efforts related to capital planning.

15. A bank should develop implement policies and procedures covering the entire capital planning process. Policies and procedures should ensure a consistent process for all components of the capital planning process and provide transparency regarding this process.

16. A banking institution should have clear and comprehensive documentation for all aspects of the capital planning processes, including their risk-measurement and risk management infrastructure, loss and resource estimation methodologies, the process for making capital decisions, and efficacy of control and governance functions.

d) Capital Adequacy Policy and Risk Capture

17. In codifying guidelines that senior management will rely upon in making decisions about capital deployment or preservation, banking institutions should develop and implement a **capital policy** or **Internal Capital Adequacy Assessment Program**.

18. A capital policy refers to the principles and guidelines used by a bank for capital planning, capital issuance, usage and distributions. A capital policy should include internal capital goals; quantitative or qualitative guidelines for dividends and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance procedures around capital policy principles and guidelines.

19. Internal **capital goals and targets** should be sufficient to allow a bank to continue its operations during and after the impact of stressful conditions. As such, capital goals should reflect current and future prescribed regulatory capital requirements, as well as the expectations of shareholders, supervisors, and other stakeholders.

20. The capital policy must be approved by the bank's board of directors or a designated committee of the board.

21. Banking institutions should put in place a strong monitoring framework for capital- and performance-related metrics relating to **capital thresholds, triggers and limits** that is complemented by a clear and transparent escalation protocol for those situations when a trigger or limit is approached or breached.

22. The capital policy should contain **a risk tolerance and risk appetite statement**, approved by the board of directors, which should be reviewed annually. The statement should directly inform the bank's business strategy and capital management, including, through the establishment of return

targets, risk limits and incentive compensation frameworks at the institution and business unit levels.

23. The capital policy should be re-evaluated and revised as necessary to address changes to organizational structure, governance structure, business strategy, capital goals, regulatory environment, risk appetite, and other factors potentially affecting a bank's capital adequacy.

e) Stress Testing and Scenario Analysis

24. An effective capital planning process requires a bank to assess the risks to which it is exposed to and consider the potential impact on earnings and capital from an assumed economic downturn or bank specific factors. As such stress testing needs to be an integral component of the capital planning process, providing essential perspectives on how the bank's capitalisation could be jeopardised if there were adverse bank-specific or economy wide changes.

25. Stress testing should be quantitatively based, incorporate all relevant risks to the bank, conservatively capture and account for changes in key risk factors across all portfolios and businesses under appropriately severe forward-looking scenarios.

26. A bank should be capable of performing ad hoc scenarios outside the normal stress testing procedures estimating the potential capital needs over a specific time horizon presuming at a minimum baseline and downturn economic scenarios, market and bank-specific conditions.

f) Management Framework for Preserving Capital

27. A banking institution's senior management and the board of directors should ensure that the capital policy and associated monitoring and escalation

protocols remain relevant alongside an appropriate risk reporting and stress testing framework.

28. The board should be responsible for prioritising and quantifying the capital actions available to cushion the bank against unexpected events.

29. Management should assess the feasibility of the proposed contingent actions under stress, including potential benefits and long-term costs.

30. In addition, a bank should develop guiding principles for determining the appropriateness of particular actions under different scenarios, which take into account relevant considerations, such as economic value added, costs and benefits, and market conditions.

The Reserve Bank shall continue to closely monitor banking institutions' compliance with current capital requirements and as well as adherence to own capitalisation timelines in relation to the 31 December 2020 minimum core capital requirements.

Please be guided accordingly

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Registrar of Banking Institutions