

**Methodological Instruction
of the Financial Market Supervision Section
of the National Bank of Slovakia
No 1/2007 on the
Internal Capital Adequacy Assessment Process for Banks**

Purpose of the Methodological Instruction

The aim of this Methodological Instruction is to detail the requirements for banks ensuing from Article 27 (3) of Act No 483/2001 Coll. on banks and on the amendment of certain acts as amended by Act No 644/2006 Coll. in connection with the implementation of the internal capital adequacy assessment process (hereinafter simply "ICAAP"), as well as to acquaint banks with information connected with requirements of the NBS Financial Market Supervision Section (hereinafter "the Supervisor") for assessing the internal capital adequacy assessment process.

This Methodological Instruction is categorized as a **"Risk Management Process"**.

Content of the Methodological Instruction

- A. [Internal capital adequacy assessment process from the aspect of existing legal regulations.](#)
- B. [General requirements for the internal capital adequacy assessment process.](#)
 - 1. Tasks and responsibility a bank under the second pillar of the New Basel Capital Accord (hereinafter simply "the second pillar"),
 - 2. Tasks and responsibility of the Supervisor under the second pillar,
 - 3. Proportionality principle,
 - 4. Internal governance at a bank,
- C. [Principles for creating and using the internal capital adequacy assessment process.](#)
 - 1. ICAAP as a component of the management process,
 - 2. Implementing ICAAP,
 - 3. Internal capital management and planning,
 - 4. Determination of adequate level of internal capital,
 - 5. Identifying risks,
 - 6. Measuring risks,
 - 7. Assessing the internal capital need.
- D. [Supervisor's assessment process for an ICAAP.](#)

A. Internal capital adequacy assessment process from the aspect of existing legal regulations

1. In connection to the requirement under the Directive 2006/48/EC of the European Parliament and of the Council that Member States transpose into their legal regulations with effect as of 1 January 2007 the regulatory framework corresponding prevalingly in its content to the New Basel Capital Accord the National Council of the Slovak Republic in December 2006 passed an Act amending Act No 483/2001 Coll. on banks and on the amendment of certain acts (hereinafter simply the "Banks Act"), published in the Digest of Laws of the Slovak Republic on 19 December 2006 as Act No 644/2006 Coll.

2. The duty of a bank to ensure, to provide for in internal regulations and to maintain an ICAAP as of 1 January 2007 ensues from the wording of Article 27(3) and in connection with Article 27(2) and with Article 23 (6)(d) and (e) of the Banks Act. With the aim of achieving efficiency in those provisions of the Banks Act concerning the ICAAP, an ICAAP under the mentioned provisions of the Banks Act is to form an integral component of a bank's risk management process,

and this extending through to all possible consequences resulting for the bank in the field of its risk management under the Banks Act.

3. A part of the transposition of the Directive's respective provisions concerning the ICAAP is the subsequent enactment of NBS Decree No 12/2004 on risks and risk management systems, as ensues from the amending NBS Decree No 15/2006 effective as of 15 January 2007. This decree, equally as the Banks Act, amended the provisions so that risk management system also contains an ICAAP (see primarily the new wording of Article 4 of the Decree).

4. Under the Directive a transitional period to the end of 2007 also applies to ICAAP, whereby provided certain conditions are satisfied a bank shall not be bound until the end of 2007 to prove the establishment, provision for in internal regulations and maintenance of an ICAAP. This exception is laid down in Article 122f (9) in connection to Article 122f (3) of the Banks Act. In the case of satisfying the conditions laid down by the act and if the bank decides to exercise the exception, it shall automatically apply to the related provisions of NBS Decree No 12/2004.

B. General requirements for the internal capital adequacy assessment process.

5. The new regulatory framework for capital adequacy under the New Basel Capital Accord of 2004 comprises three parts, or pillars. The first pillar regulates minimum capital requirements for covering credit risk, market risk and operational risk. The second pillar focuses on the checking and monitoring of capital adequacy by supervisory bodies. The third pillar deals with the issue of market discipline and publication of information on a bank so that it is possible to compare the capital adequacy between individual institutions.

6. Requirements resulting from the first and third pillar are dealt with in more detail in the legislative framework formed by Act No 644/2006 Coll. and related NBS decrees.

7. The second pillar is aimed at the supervision process, a component of which is also the process of the bank's assessment of its internal capital adequacy in the ICAAP framework. This obligation is regulated in Article 27, (3) of the amendment to the Banks Act. The aim of the second pillar is to ensure that banks apply a correct risk management process, whereby it introduces a new aspect on assessing the sufficiency of a bank's capital. A bank is bound to assess and maintain on an ongoing basis the level of its internal capital it deems adequate for covering risks to which it is or might be exposed. The basic aim of processes in the second pillar is to improve the link between a bank's risk profile, the bank's system of management, the mitigation of the bank's risk and its capital.

8. Requirements under the second pillar are elaborated in detail by the Committee of European Banking Supervisors (hereinafter simply "the CEBS") in the Guidelines on the Application of the Supervisory Review Process under Pillar 2, CP03¹¹, having the nature of a recommendation for individual countries of the European Union.

This document leads to a convergence of the practical procedures of supervision and supervision methods, with the aim of lessening the room for potential competition between Supervisors, or for negative effects resulting from differing procedures and methods of supervision in individual states on the overall competitiveness of subjects in the single European market in financial products and services. The approach of the Supervisor will be in accordance with the recommendations stated in this Instruction.

B.1. A bank's tasks and responsibility under the second pillar

9. A bank's management shall be responsible for implementing a correct risk management process ensuring a detailed and precise identification of risks to which the bank is exposed and for assessing and determining the level of internal capital for covering these risks. The process of assessing internal capital adequacy shall be a process developed and managed by the bank and thus will be unique for any particular bank.

B.2. Supervisor's tasks and responsibility under the second pillar

10. The Supervisor shall be responsible for assessing whether a bank has sufficient internal capital for covering all material risks it is exposed to. In this, the Supervisor shall focus on whether the bank has identified all risks it is exposed to, how the bank manages these risks and whether it takes into account the relationships between particular risks, as well as on assessing the bank's system of management. The Supervisor is responsible for verifying the suitability of the process for determining the level of the bank's internal capital.

B.3. Proportionality principle

11. Requirements under the second pillar on banks as well as on the Supervisor take account of the proportionality principle, i.e. account is taken of the differences in the size of banks and the nature, scale and complexity of individual banks' activities. For banks this principle means that the expectations of the Supervisor regarding the ICAAP at individual banks will take account of these differences.

B.4. Internal governance

12. The broader framework of a bank's ICAAP is represented by the bank's internal governance, meaning its internal organization and management. The bank's management and supervisory body (hereinafter simply "the bank's management") is responsible for setting the bank's business strategy and aims, organizational arrangement and system of internal control. A bank's internal governance includes in particular the setting of business objectives and the bank's "risk appetite", its organizational structure, division of responsibilities and competences, the implementation of suitable information flows and an internal control system.

13. Requirements for a bank's internal governance and requirements for a risk management system are governed in particular by the Banks Act (in particular Articles 23 to 27) and NBS decrees, in particular NBS Decree No 12/2004 on risks and risk management systems. Banks whose system of internal governance and risk management system are in accordance with these legal regulations should have the prerequisites in place for an effective risk management system.

C. Main principles for creating and using the ICAAP

14. An ICAAP should be a process by which the bank's management ensures the use of a reliable risk management system, the development of this system and maintenance of an adequate level of internal capital with regard to the bank's risk profile. The bank is responsible for defining and developing its ICAAP. A bank's ICAAP must be comprehensive, proportionate to the bank's scope and complexity of activities so as to cover all risks to which the bank is or may be exposed, as well as risk factors from the environment in which it operates. In assessing the internal capital need a bank should take into consideration also the effect of business cycles and sensitivity to other external factors.

15. CEBS has formulated ten main principles for the ICAAP:

1. Every bank must have a process for assessing its capital adequacy relative to its risk profile (an ICAAP).
2. The ICAAP is the responsibility of the institution.
3. The ICAAP's design should be fully specified, the institution's capital policy should be fully documented and the management body (both supervisory and management functions) should take responsibility for the ICAAP.
4. The ICAAP should form an integral part of the management process and decision-making culture of the institution.
5. The ICAAP should be reviewed regularly.
6. The ICAAP should be risk-based.
7. The ICAAP should be comprehensive.
8. The ICAAP should be forward-looking.
9. The ICAAP should be based on adequate measurement and assessment processes.
10. The ICAAP should produce a reasonable outcome.

The Supervisor's expectations for a bank's ICAAP derive from the principles listed and are detailed in a further part of the Instruction.

C.1. The ICAAP as a component of the management process

16. The implementation of the ICAAP is a duty for every bank under Article 27 of the Banks Act. A bank should set target amounts for internal capital consistent to its risk profile and the environment in which it pursues business. In implementing an ICAAP the bank should link to management processes and systems used, the suitability of which must however be reviewed with regard to the requirements for the ICAAP. The Supervisor does not expect from banks that they replace their traditional management procedures that fulfill the bank's needs, though on the other hand recommends banks assess whether the management procedures in place are adequate and sufficient also for the ICAAP. The ICAAP should be an integrated part of a bank's culture, of the bank's overall risk management process and everyday business, organizational and decision-making processes at the bank.

C.2. Implementing ICAAP

17. A bank's management, both the management and supervisory body, is responsible for the implementation and design of the ICAAP. The supervisory body should approve the bank's ICAAP concept; the management body is responsible for drawing up the concept into a more detailed design and for its implementation into the bank's individual organizational components. Any reassessment of and changes in the ICAAP should be approved by the bank's management.

18. The process of implementing, using and reviewing the ICAAP should be formally documented, in particular the methods used, assumptions and procedures, the determined level of internal capital, the manner of maintaining an adequate level of internal capital. The manner of performing this process as well as the decisions that led to it should be stated in records from meetings of the bank's management and should be a component of the bank's strategic documents (risk management strategy, business and financial plan) and in the bank's internal regulations.

19. The aforementioned processes are closely connected with more general issues of the bank's corporate governance. Statutory and regulatory requirements and recommended best practices for the field of a bank's internal governance are contained in various legal regulations and other documents²¹

C.3. Capital management and planning

20. Pursuant to Article 27 of the Banks Act an ICAAP shall include the drawing up of a strategy for managing the amount of internal capital. A bank may incorporate this strategy as a component of its risk management strategy²¹, which should contain a specification of the amount of internal capital allocated for covering risks and the principles for determining an adequate level of internal capital.

21. The amount of internal capital and its composition should be determined and reviewed in accordance with the bank's strategic aims and business plan. The risk management strategy should in this part contain in particular the bank's long-term aims in the field of its capital need, where these take account of risks to which the bank is or might be exposed, its business objectives and bank's planned profit, as well as relevant external factors such as market expectations, the standing of the bank in the market and the external rating the bank wants to achieve. A change in the bank's orientation to a different market segment may entail a change in its risk profile and thereby also a different requirement for the level of capital.

C.4. Determining an adequate level of internal capital

22. Principles six to seven form the core of the requirements for the ICAAP and concern in particular the process of translating quantitative data on the risk exposure into internal capital requirements. The following steps may be seen in this process:

- identification of all material risks to which the bank is or might be exposed
- adequate management of risks

- assessment of the internal capital need

C.5. Identifying risks

23. At the start of the ICAAP a bank should identify all material risks to which it is or might be exposed in connection with its activity.

24. The classification of risks used by the bank should correspond to the bank's size, nature, scale and complexity of activities and should be used consistently in all the bank's business, activities, processes and systems. The bank should be able to identify risks and to include them in the ICAAP according at minimum to this risk classification:

- pillar one risks (credit, market and operational), including the main differences in the approach of calculating capital requirements under the first pillar and the treatment of these risks in the ICAAP
- risks not fully captured under pillar one (in particular residual risk and securitization risk, underestimation of credit risk in using the standardized approach, underestimation of operational risk in using the basic indicator approach and the standardized approach)
- pillar two risks, all material risks to which the bank might be exposed, particularly interest rate risk in the banking book, concentration risk, liquidity risk, reputation risk and strategic risk
- risks resulting from external factors, in particular from the economic and business environment that were not included in the preceding categories

25. This classification should, however, not be seen as exhaustive and every bank should itself consider its classification of risks for the ICAAP. The minimum classification of risks given above should, however, help a bank in preparing an ICAAP and will at the same time be used by the Supervisor for assessing the ICAAP.

26. Identification of all risks to which the bank is exposed and determining their materiality is based on a comprehensive assessment of existing and potential risk properties of the bank's individual deals, products, activities, processes and systems, and this at the level of individual products, and the portfolio level. Further components of identifying risks are an assessment of the bank's financial state and an assessment of the external environment in which the bank pursues its activity. A component of the ICAAP is also the identification of risk factors resulting from new types of business and activities.

C.6. Measuring risks

27. The measurement of risk represents the process of quantifying the possible loss resulting from the bank's business, activities, processes and systems. Banks may use a variety of approaches for quantifying the possible loss, the method selected should, however, be proportionate to the scale and complexity of the bank's activities. Not all risks and the correlation between them can be measured in a simple manner; any quantification of the risk exposure will thus be a combination of precise calculations and estimates.

28. Risk management comprises stress testing and sensitivity analyses, which are necessary for assessing the possible negative influence of various economic or external events on the risk exposure.

29. Banks with a smaller scope of activity may use simpler manners of identifying and measuring risks. Such banks should, however, take account of the fact that the level of risk to which they are exposed need not be high due to the scale and complexity of activities pursued, but may be high, for example, due to the overall volume of their deals with a small number of clients, e.g. the risk of losing an important client, or the failure of an important client.

C.7. Assessing the internal capital need

30. After identifying all risks and quantifying the risk exposure resulting from them a bank should assess the manner of covering the risks identified. Every material risk identified should be covered in an appropriate manner, whereby the coverage of a risk need not in all cases be by internal capital. Capital is intended in particular for covering unexpected losses; expected losses should be covered by provisions and reserves.

31. A bank should assign internal capital to individual activities, processes and systems so that risks resulting from them are covered, or the scope of activities and quality of processes and systems should reflect the amount of internal capital assigned. A bank should be able to formulate and determine the current and future amount of internal capital necessary for covering the quantified level of risk, including taking account of stress testing results.

32. Besides the amount of internal capital thus determined, it is appropriate to determine also a further amount of capital necessary for covering uncertainty resulting from the calculation, meaning a certain capital buffer for covering the risk of the ICAAP calculation model used.

33. After taking account of all material risks, the manner of covering the other factors mentioned above, the bank should calculate the total internal capital need, and this in the form of an amount of internal capital, or an indicator of internal capital adequacy. The amount of a bank's internal capital should be a function of the bank's risk profile and should be in accordance with the bank's long-term goals in the field of the acceptable risk exposure for the bank and in accordance with the environment in which the bank operates.

D. Supervisor's assessment process for an ICAAP

34. A component of the Supervisor's assessment process is an assessment of the ICAAP. The Supervisor is responsible for assessing whether a bank has sufficient internal capital for covering all material risks to which it is exposed. In this the Supervisor focuses on whether the bank has identified all risks to which it is exposed, how the bank manages these risks and whether it takes account of the relationships between particular risks, as well as focusing on evaluating the bank's system of management.

35. In the process of the Supervisor's assessment of a bank's ICAAP, the bank must be able to explain the adequacy of its target amount of internal capital and the system of its allocation to activities, processes and systems. In assessing a bank's ICAAP the Supervisor will take account of the proportionality principle, i.e. to pay regard to the differences in the

size, nature, scope and complexity of activities of individual banks. A bank must, however, be able to comprehensively assess all risks to which it is or might be exposed and to allocate to them an adequate amount of internal capital.

36. For the purposes of assessing the ICAAP the Supervisor classifies banks into two basic groups. The first group comprises large banks; the second group is formed by savings banks, small- and medium-sized banks. From the first group of banks the Supervisor expects more comprehensive methods of assessing internal capital adequacy. For the second group it is sufficient to use methods from the first pillar for calculating the internal capital need and to add to them a calculation of and estimates of risks not covered in the first pillar.

37. The choice of methods for assessing internal capital adequacy is connected also to the choice of methods the bank will use for calculating capital requirements for credit, market and operational risk in the first pillar. A component of the qualitative requirements for approving advanced approaches for the first pillar is proving the way how the bank uses the advanced approach internally for ICAAP. Banks using advanced risk measurement methods in the first pillar are then expected to use these methods in assessing the internal capital need. The Supervisor will expect banks using advanced risk measurement approaches in the first pillar to use them appropriately for ICAAP.

38. The frequency of assessing a bank's ICAAP will depend on the development of its risk profile, changes in the bank's strategy and products, and on the bank's systemic importance. An assessment of the ICAAP will as a rule be a component of an on-site inspection. The sequence of steps for assessing an ICAAP will include the requesting of documents, meetings with the bank's representatives, evaluation of documents and information from meetings, as well as the use of other information obtained in the on-site inspection.

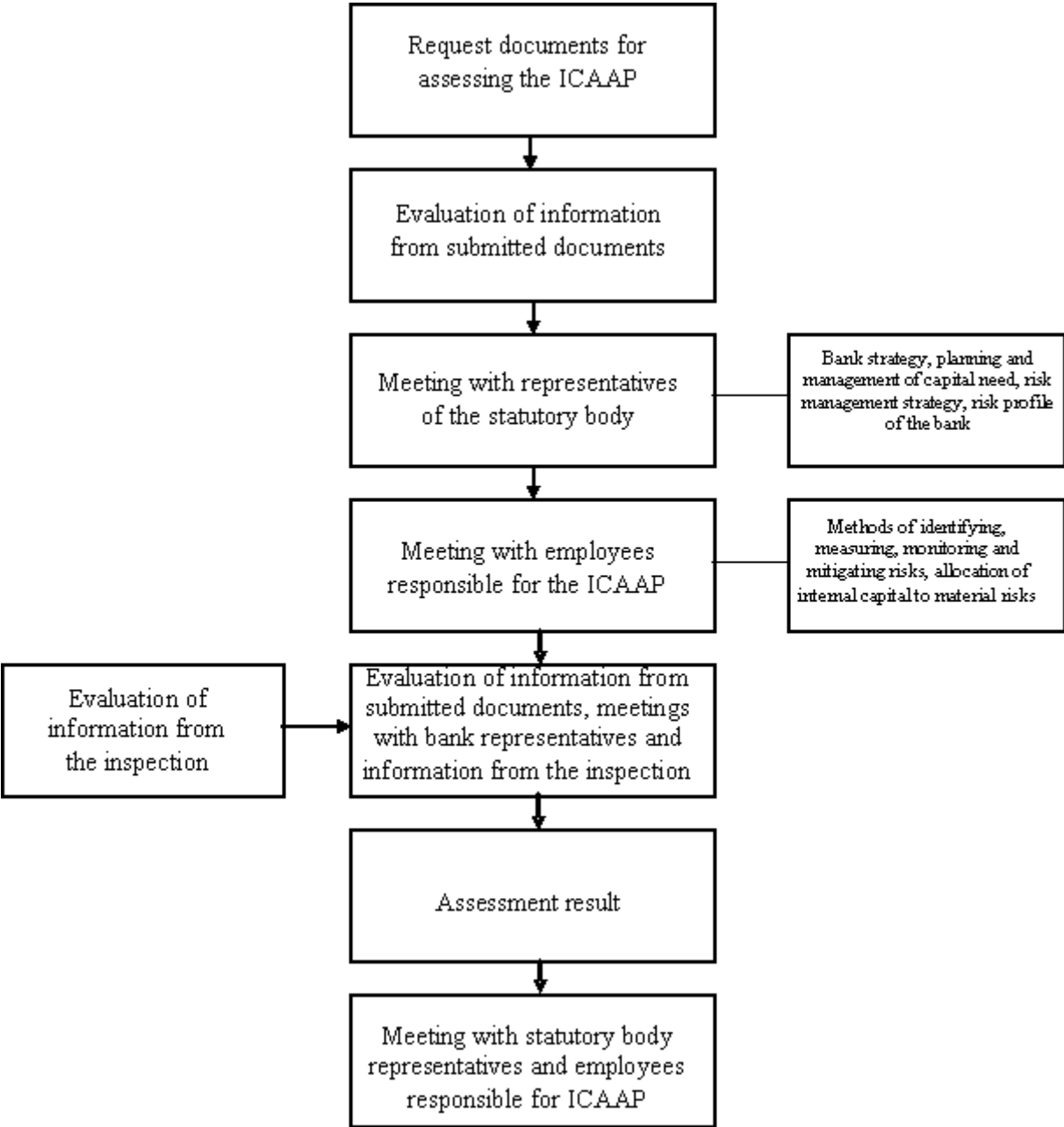
39. Each level of management at a bank has its duties and responsibilities ensuing from laws, other legal regulations, and the bank's internal regulations and documents. The division of responsibilities will be taken into account also in the Supervisor's assessment of the bank's ICAAP. The dialogue with bank's representatives will be divided into at least two basic parts:

- meeting with representatives of the statutory body
- meeting with employees responsible for the ICAAP.

40. The meeting with representatives of the statutory body will concern particularly questions connected with the bank's overall strategy, planning of its capital need, the manner of obtaining capital, the bank's risk management strategy, its risk appetite and risk profile. The meeting with employees responsible for ICAAP will concern questions regarding the identification, measurement, monitoring and mitigation of risks, and the methods of calculating the resulting internal capital need.

41. After evaluating all information from submitted materials, meetings with bank representatives and other information from the on-site inspection a final meeting with representatives will follow, where they will be informed of the Supervisor's resulting assessment of the ICAAP.

The sequence of steps for assessing the ICAAP is depicted in the following diagram.



37. For the purpose of achieving an efficient assessment of the ICAAP a draft list of information and documents that the Supervisor will request from a bank for assessing the ICAAP is given in the annex (Annex 1). **Annex 1**

List of information and documents for ICAAP assessment

1. **General information**
 - Name of the bank.
 - Organizational unit of the bank responsible for the ICAAP and contact persons for communication with the Supervisor for assessing this system (address, telephone, e-mail).
 - The date as at which the bank submitted the last internal capital adequacy assessment and the frequency of the assessment process at the bank.

- A description of events that have or might have a significant influence on the assessment submitted and that have occurred in the period between the date as at which the bank drew up the last assessment and the date of providing the assessment to the Supervisor.
2. **Bank strategy**
 - The bank's strategy for managing the amount of internal capital. (Article 27 of the Banks Act).
 - Description of the current financial situation of the bank, expected development of economic conditions, business objectives of the bank ("risk appetite").
 - Plan for ensuring sufficient level of internal capital (capital management plan) with regard to the bank's objectives and expected development.
 3. **Bank internal governance**
 - Description of the responsibilities of individual organizational units at the bank and the bank's committees in the process of developing, approving and using the ICAAP.
 - Description of the role and activities of the supervisory board, board of directors and managerial employees in forming, approving and reviewing the ICAAP.
 4. **Material risks and the system of managing them**
 - Definitions of all risks to which the bank is exposed and that it has identified as material.
 - Methods and procedure by which the bank evaluates the materiality of risks, as well as the procedures for identifying, measuring (estimating) the size of risks, monitoring and mitigating material risks (if they are not a component of internal regulations pursuant to point b).
 - Internal regulations of the bank for managing material risks (pursuant to the requirements of NBS Decree No 12/2004, whereby material risks for a bank may be also risks other than those defined in this regulation).
 5. **Method used for determining internal capital adequacy and its development**
 - Procedures of the bank for assessing the level of internal capital.
 - Description of the method(s) used for assessing internal capital adequacy (allocation of internal capital to risks).
 - Documentation of the bank regarding the development and approval of the method used for assessing internal capital adequacy.
 - List of types/kinds of documents (reports) that the bank creates in its ICAAP, in particular reports submitted to the board of directors and managerial staff at the bank (name of the report, who draws up the report, for whom is the report intended and the frequency of the report).
 6. **Assessment of internal capital adequacy**
 - The components of the bank's internal capital and its level as at the date of the assessment submitted.
 - Information on all quantifiable risks exposure to which the bank is exposed and that it has identified as material and information on the manner of covering them.
 - For material risks covered by internal capital, information on the amount of internal capital allocated to the respective risk exposure and to individual organizational units. The bank shall attach a comparison in an appropriate structure (type of risk, risk exposure, organizational units of the bank, and amount of internal capital) taking account of and explaining the method used for aggregating particular risks.
 - A comparison of the amount of internal capital and regulatory capital, and an explanation of differences if the amount of internal capital differs significantly from the regulatory.
 - Description of the use of the IRB model in the ICAAP (for banks that have an IRB model approved).

Note:

1) www.c-eps.org

2) Act No 483/2001 Coll. on banks and on the amendment of certain acts, Articles 23 to 25, 34, 37; the Commercial

Code; Enhancing Corporate Governance for Banking Organisations, Basel, September 1999;

The Unified Corporate Governance Code, Financial Market Authority and Ineko, May 2002; Corporate Governance Principles, OECD, 1999 and 2004.

3) NBS Decree No 12/2004, Article 6(1)(e)