

New Guides for ICAAP and ILAAP

The further development of the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP), as well as harmonization efforts within the Single Supervisory Mechanism (SSM), are leading to a comprehensive revision of the prudential assessment of bank-internal risk-bearing capacity (RBC) concepts.

The European Central Bank (ECB) published its final guide for ICAAP and ILAAP on 9 November 2018. These requirements have necessitated a comprehensive revision of the risk-bearing capacity concepts and must be fully implemented from 1 January 2019. For institutions that are not directly supervised by the ECB, the Federal Financial Supervisory Authority (BaFin) finalized its guide for the realignment of the supervisory assessment of bank-internal RBC concepts in May 2018. This guide is largely based on the requirements of the ECB. Both documents are intended as a starting point for supervisory dialogue and do not, therefore, include a final consideration of all aspects of ICAAP and ILAAP.

Point of View **Industry:**

According to Article 73 of Directive 2013/36/EU (Capital Requirements Directive IV - CRD IV), institutions must have in place sound, effective and comprehensive strategies and processes to assess and maintain, on an ongoing basis, the amounts, types and distribution of internal capital that they consider adequate for the quantitative and qualitative coverage of any current and future expected and unexpected risks (Internal Capital Adequacy Assessment Process - ICAAP). Similarly, Article 86 (I) CRD IV requires institutions to have sound policies, principles and systems for measuring, managing and monitoring their liquidity risk (Internal Liquidity Adequacy Assessment Process - ILAAP).

According to Article 97 CRD IV, the ICAAP and ILAAP of an institution will be regularly reviewed by the competent supervisory authority as part of the Supervisory Review and Evaluation Process (SREP). Following the introduction of the Single Supervisory Mechanism (SSM) in November 2014, the ECB has taken over the supervision of European banks. The ECB maintains direct supervision of significant institutions (SIs) and delegates the operational oversight of less significant institutions (LSIs) to the national supervisory authorities. In conjunction with the further development of institutional and supervisory practice, these developments have necessitated

a realignment of the SREP, to harmonize the supervisory assessment of bank-internal RBC concepts in the SSM.

In December 2014, the European Banking Authority set out the basic framework for a uniform basis and quality of the SREP by introducing Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)) (EBA/GL/2014/13). In July 2018, the EBA published a revised version, EBA /GL/2018/03 (Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing). The information requirements for ICAAP and ILAAP had previously been specified in EBA/GL/2016/10 (Guidelines on ICAAP and ILAAP information collected for SREP purposes) and further developed in the guidelines published in November 2018.

The above-mentioned guidelines are intended for the ECB and national supervisory authorities, meaning they have an indirect impact on the supervised institutions.

In January 2016 and then again in February 2017, the ECB sent out letters to the institutions it directly supervises, specifying its expectations of ICAAP and ILAAP. These expectations formed the basis of a project over several years to develop comprehensive SSM guidelines on ICAAP and ILAAP. The discussion papers on the

guidelines on ICAAP and ILAAP developed within this project were first published in March 2018. The final version was released on 9 November 2018 under the titles "ECB Guide to the internal capital adequacy assessment process (ICAAP)" and "ECB Guide to the internal liquidity adequacy assessment process (ILAAP)". Both guides came into effect on 1 January 2019.

For institutions that are not directly supervised by the ECB, BaFin released a discussion paper on the realignment of the supervisory assessment of bank-internal RBC concepts in September 2017. The aim is to harmonize the assessment criteria of RBC concepts, taking into consideration the proportionality principle. The final version of the BaFin guide to the ICAAP was published in May 2018. The requirements for the ILAAP have not yet been set out in a separate guideline and are currently contained in section BTR 3 of the MaRisk of October 2017.

For SIs and LSIs, the new guides replace the previous guide on the supervisory assessment of bank-internal RBC published by BaFin in 2011.

Figure 1 in the appendix provides an overview of the publications over time.

Point of View Customer:

The ECB is expecting a close link between the ICAAP and the ILAAP and has defined seven principles as a basis for both processes. These principles are formulated in a largely congruent way and differ primarily in terms of capital or liquidity aspects. For this purpose, both guides are structured in such a way that the principles are followed by explanatory texts, examples and a glossary.

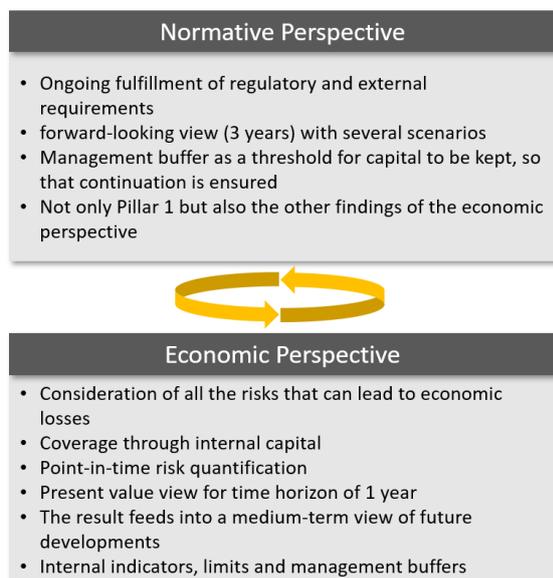
The principles can be summarized as follows:

1. The management body is responsible for sound governance of the ICAAP / ILAAP. In particular, this includes procedures for reviewing, validating and backtesting.
2. The ICAAP / ILAAP is an integral part of the overall management framework of an institution.
3. The purpose of ICAAP / ILAAP is to ensure the continuity of the institution by ensuring

the adequacy of its capital and liquidity. For this purpose, short- and medium-term assessments are performed from different perspectives.

4. All material risks are identified and taken into account in the ICAAP / ILAAP.
5. The internal capital and the internal liquidity buffer are of high quality and clearly defined. Furthermore, there is a clear definition of stable internal refinancing sources.
6. The ICAAP / ILAAP assumptions and risk quantification methodologies are adequate, consistent and independently validated.
7. Regular stress tests are designed to ensure that sufficient capital / liquidity is available to survive periods of extensive stress (adequacy of capital / liquidity in adverse conditions).

It is seen as a significant addition that the provisions for ensuring continuity of the institution and protection of creditors against losses from an economic point of view are now taken into account from two complementary perspectives (normative and economic perspective) in principle 3. These provisions had been previously set out in MaRisk AT 4.1 Tz. 2 (ensuring risk-bearing capacity). They are not congruent with BaFin's previous Going Concern and Gone Concern approaches, which, amongst others, led to the need for adjustments in the context of risk management.



The normative perspective is based on the regulatory indicators and calculation logic set out in Capital Requirements Regulation - CRR (Regulation (EU) No. 575/2013). Its aim is to ensure the continuity of the institutions. The risk coverage potential is based primarily on regulatory capital and liquidity buffers under Pillar 1. Similarly, counterparty, market and liquidity risks, as well as operational risks are quantified based on the requirements of the CRR. For this purpose, it is necessary to perform planning and stress scenarios to receive 3-year projections on capital and liquidity planning.

In contrast, the analysis from the economic perspective is detached from supervisory requirements and external accounting, in order to identify those components that are not adequately specified. The aim is to protect creditors from economic losses. Within the present-value calculation, the risk coverage potential is derived from the present value of all assets and liabilities as well as off balance sheet items. Risk quantification encompasses both unexpected and expected losses, unless these have already been considered when determining the risk buffer. The analysis of the RBC in the economic perspective covers a period of 12 months in the ICAAP.

The normative perspective and the economic perspective offer different views of the RBC of an institution and should therefore be closely linked, i.e. both perspectives should be integrated into the overall bank management

and closely interact with each other. Through the consistency of the methodologies and scenarios, this integration is required not only *within* but also *between* the ICAAP and the ILAAP – whereby both processes increasingly evolve into a “higher-level” combination of ICAAP and ILAAP (ICLAAP).

Taking into account the principle of proportionality, in addition to the present-value RBC as set out by the framework of the economic perspective, two simplified procedures (“present-value RBC” and “Pillar 1+ RBC”) are proposed for LSIs. The choice of procedure depends upon the size and complexity of the respective institution. The procedures themselves approximate the economic perspective based on external accounting data.

In addition, BaFin considers the existing “old-style” going-concern approaches for these institutions to be acceptable until further notice and has therefore incorporated them into an annex. However, due to the harmonization efforts within the SSM, this provision regarding the going-concern approach is likely to be short-lived (deadlines are currently unknown).

Point of View **Solution:**

The principles for the ICAAP and the ILAAP described above give rise to a number of challenges and action fields:

1. The **management body's responsibility** for establishing an adequate **governance structure**, which includes the integration of the ICAAP and the ILAAP, as well as for the mandatory **declarations of adequacy of capital and liquidity** require a greater involvement of the management body in risk-oriented issues.
2. The ICAAP and the ILAAP must be considered **integral components** in the **risk management and control processes**. This requires greater granularity and **interlinking of information related to decision-making**. It is important to ensure **group-wide consistency** and **compatibility with recovery planning**.

3. Ensuring the **institution's continuity** requires extensive **analyses** of individually assessed capital and liquidity scenarios from a **normative and an economic perspective**. In each case, the links between different planning areas as well as the **mutual interactions** of the two perspectives must be considered. This requires a **complete revision** of the **existing risk-bearing capacity calculation**, taking into consideration these two complementary perspectives and their consistent management. For this purpose, flexible infrastructures must be set up to enable the required **scenario analyses**.

4. When **identifying and considering all significant risks**, risk types that have previously been neglected during the risk inventory and the definition of risk sources must be considered (especially non-financial risks such as compliance and reputational risks, IT risks, legal and behavioural risks).

5. The **internal capital designated for risk absorption** must be of very high quality. In addition, the **internal refinancing sources** must be **clearly defined**. It is especially important to assess hidden losses or reserves, as well as deferred taxes.

6. Regarding **quantification methods**, it is of particular importance not only which method is chosen, but also how the **processes for validating the models** are developed. The latter must comply with the standards of the Pillar 1 internal models and the Pillar 2 processes.

7. The **stress testing provisions** require the stress tests to be **adequately designed** according to the respective risk and business situations. Accordingly, the importance of having **flexible scenario capabilities** increases.

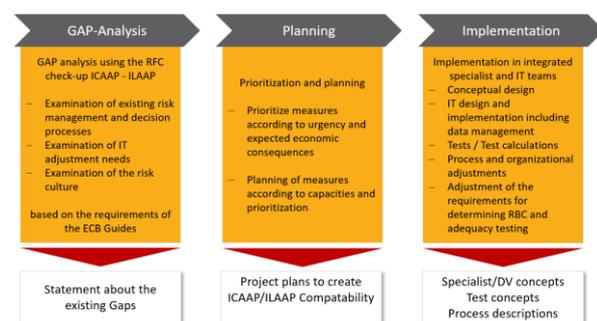
Figure 2 in the annex gives an overview of significant new features and implications.

It highlights that the new guidelines require various new regulations and adjustments to existing requirements for internal risk management processes.

Significant effects can be seen on the areas of governance, capital and liquidity planning, contingency plans, recovering plans, risk inventory, risk culture, risk management process requirements, adequacy assessments, RBC calculation, determination of risk-coverage potential, internal risk models, scenario analyses, validation and stress testing.

Linked to this are changes to the IT systems as well as increased data management requirements.

When implementing the new features from the guidelines for ICAAP and ILAAP, a multi-step approach is recommended. The following figure shows an example of a project approach.



First, it is important to identify any areas where the existing processes and methods deviate from the final requirements of the ECB Guides on ICAAP and ILAAP, and from the respective provisions of the Basel Committee on the SREP. This can be done effectively and in full using our:

„RFC ICAAP / ILAAP Check-up “

In a second step, an implementation plan is drawn up, featuring a list of priorities. When preparing the plan, it is important to consider the severity of any changes and the potential economic consequences of not complying. Economic consequences include not only competitive disadvantages, the reasons for which go beyond comparative process weaknesses, but also large reserves for legal disputes. The existing capacities must also be considered during planning.

The third step is to implement the project using content that is individually tailored to the specific business model.

Point of View **Value Added:**

Overall, based on the new Guides on ICAAP and ILAAP, it is necessary to perform an extensive revision and reorientation of existing RBC concepts.

Our experts at RFC Professionals have a long-standing experience in advising banks on the implementation of RBC concepts. We are happy to assist you in assessing the impact of the ICAAP and ILAAP realignment on your institution. If you would like to get in touch with us, you can find our contact information below.

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Appendix 1 Glossary:

- BaFin Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
- CRD IV Capital Requirements Directive IV
- EBA European Banking Authority
- ECB European Central Bank
- ICAAP Internal Capital Adequacy Assessment Process
- ILAAP Internal Liquidity Adequacy Assessment Process
- LSI Less Significant Institutions
- MaRisk Mindestanforderungen an das Risikomanagement (Minimum Requirements on Risk Management)
- RBC Risk-bearing capacity
- SSM Single Supervisory Mechanism
- SREP Supervisory Review and Evaluation Process
- SI Significant Institution

Appendix 2 Guides and Guidelines:

- 2013/36/EU Capital Requirements Directive IV – CRD IV
- (EU) Nr. 575/2013 Capital Requirements Regulation – CRR
- EBA/GL/2014/13 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)
- EBA/GL/2016/10 Guidelines on ICAAP and ILAAP information collected for SREP purposes
- EBA/GL/2018/03 Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing

Annex Figures:

Figure 1

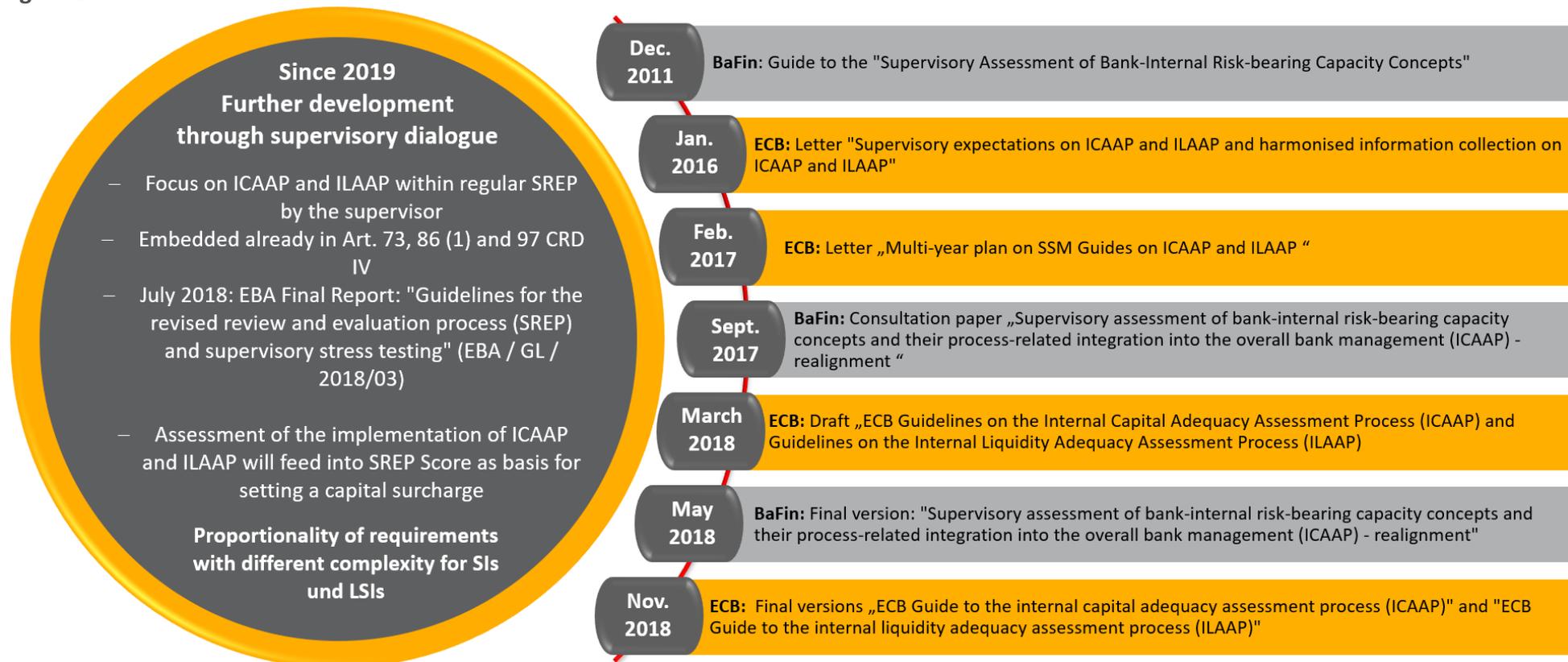


Figure 2

	Significant Changes	Significant Implications
1 Governance	<ul style="list-style-type: none"> – Highlighting and emphasizing the responsibility of the governing body 	<ul style="list-style-type: none"> – Systematic embedding ICAAP/ILAAP in risk governance – Systematically interlinked strategy, capital and liquidity planning process
2 Comprehensive Integration	<ul style="list-style-type: none"> – Highlighting the importance of ILAAP – Similar treatment of ICAAP and ILAAP 	<ul style="list-style-type: none"> – Adaptation and expansion of ILAAP – Parallel frameworks for ICAAP and ILAAP
3 Steering perspective	<ul style="list-style-type: none"> – Two new complementary perspectives (normative and economic) – Multi-year capital planning under normative Going Concern view – Definition of management buffer beyond minimum requirements 	<ul style="list-style-type: none"> – Switch to normative and economic views – Embedding the Going Concern perspective on all risk types in the steering
4 Risk identification	<ul style="list-style-type: none"> – Increasing importance of forward-looking scenario analyses – Binding application of a "gross approach" 	<ul style="list-style-type: none"> – Introduction scenario analysis as an information base for risk strategy governance
5 Quality of risk buffers	<ul style="list-style-type: none"> – Focus on an internal view – Only from the point of view of the continuity of business activities (long-term) 	<ul style="list-style-type: none"> – Conceptual adjustments and adjustments between different perspectives – Deriving risk appetite and risk buffers via stress scenarios
6 Risk quantification	<ul style="list-style-type: none"> – New validation requirements for economic risk models – Validation process also for Pillar 2 risks 	<ul style="list-style-type: none"> – Expansion of scenario capability – Providing flexible infrastructure for scenario analysis – Improve simulation methods and data delivery
7 Stress Testing	<ul style="list-style-type: none"> – Consistency of stress test results from ICAAP and ILAAP – Consideration of interdependencies and feedback effects – More flexibility of scenario models 	<ul style="list-style-type: none"> – Development of an comprehensive stress testing program – Taking stress test results into account in management decisions on risk management and contingency planning