BANCO DE **ESPAÑA**
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Recommendations for the preparation of internal capital adequacy assessment reports[1]

Introduction

In March 2010 the Banco de España received for the second time the internal capital adequacy assessment report ("capital report") which, since the implementation of Basel II, credit institutions have to prepare every year. To prepare this report, CIs have as a reference the Guidelines on the Internal Capital Adequacy Assessment Process (ICAAP),[2] published initially in June 2008 and subsequently revised on two occasions, in March 2009 and in January 2011. These revisions seek to keep the Guidelines up-to-date and consistent with the European regulatory framework (including the guidelines issued by the CEBS-EBA[3]), and also to make improvements by including and rectifying matters as needed, in accordance with the experience acquired over the years.

The objective of the ICAAP is that institutions ensure there is a balance between their risk profile and the capital available to them. For this purpose, in the capital report institutions explain their internal assessment of the risk inherent in their activity, set out their corporate and internal governance and describe how they manage, measure and control their risks. Finally, they establish their own funds target, which must be compatible with their risk profile, and set out the capital planning, including stress testing, which will enable them to meet that target.

The Banco de España's detailed knowledge of this process helps it to assess the solvency of institutions, and, therefore, the review and assessment of the ICAAP is an essential part of the supervisory process. This is explained in "The Banco de España Supervisory Model"[4] and, more specifically, in the "Guidelines on the Capital Review Process (CRP)", published in February 2010.[5]

The above-mentioned three documents set the framework of the Banco de España supervisory process, the objective of which is not only to ensure that CIs have the necessary capital to cover the risks derived from their business, but also to encourage them to develop and adopt more suitable risk management and control mechanisms.

Guidelines on the Capital Review Process

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[1] Report on Banking Supervision in Spain, 2010. Chapter 2.4.1, pages 48 to 52
[2] Available at: http://www.bde.es/webbde/en/supervision/regulacion/solvencia/ICAAP_guidelines_26_01_11.pdf . See also the 2007 Report on Banking Supervision in Spain.
[3] The European Banking Authority (EBA), created by Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010, took over as from 01.01.2011 all existing and ongoing tasks of the CEBS.
[4] Available at: http://www.bde.es/webbde/en/supervision/funciones/funciones.html. See also the 2008 Report on Banking Supervision in Spain.
[5] Available at: http://www.bde.es/webbde/en/supervision/regulacion/prc.pdf

The objective of the capital review process (CRP) or, as it is more commonly known, the supervisory review and evaluation process (SREP) is to allow the Banco de España to confirm that there is an adequate relationship between the risk profile of each credit institution and the own funds effectively held by it. The main source of information used by the CRP for this purpose is the yearly internal capital adequacy assessment report ("capital report"), i.e. the report in which each institution gives an account of its internal capital adequacy assessment process (ICAAP). This information is supplemented by the own funds return of each institution and other relevant information available to the Banco de España, including that derived from its supervisory actions.

Although the review of the ICAAP is ongoing and forms part of the general supervisory process, it has two separate milestones: a) the yearly off-site reviews to check that the capital report is complete and reasonable and is consistent with the institution's own funds return and other relevant information available to the Banco de España, and b) specific reviews in greater depth and with a broader scope, carried out in on-site inspections. The objective in this case is to confirm that the information contained in the capital report is adequate and accurate, to review and evaluate the methodological aspects of the ICAAP and to identify possible deficiencies and weaknesses.

Further, to increase consistency between the reviews carried out by the various operational inspection groups, certain areas of the capital report are cross-reviewed by groups at the same level, so as to ensure that the analysis of significant aspects of it, such as for example the own funds target, the evaluation of internal governance, the evaluation of certain risks, etc. is carried out as uniformly as possible.

In the case of institutions subject to on-site continuous monitoring, every year an action plan is prepared for the coordinated review of the various sections of the ICAAP.

The yearly review of the capital report focuses particularly on the following sections: a) own funds target; b) capital planning, including the degree of fulfilment of prior years' projections (which is an indicator of the reliability of those projections), stress scenarios and contingency plans; c) consistency between the institution's internal assessment in its capital report and the scores assigned in the Banco de España risk matrix; and d) action plan for the future and, where applicable, degree of fulfilment of past action plans.

In light of the conclusions drawn from this review and if considered necessary, the weaknesses found are explained to and discussed with the institutions in question, so they can be remedied as soon as possible.

Changes in the 2011 ICAAP guidelines

The experience gained from the review of the 2008 and 2009 capital reports showed that it was advisable to make further changes to the ICAAP guidelines to clarify and improve certain aspects of it and to reinforce various criteria communicated to institutions. These changes reflect the main areas of supervisory attention in the recent past and formalise some of the recommendations made by the Banco de España in response to inquiries from institutions or their associations:

a) *Risk profile of institutions.*

It was clarified that, when they value their risks, institutions must refer to the inherent, and not the residual, risk. As explained in the "The Banco de España Supervisory Model", inherent risk is the risk intrinsic to the institution´s various activities and business areas, without considering the control systems.

It was also clarified that, to value their risks, institutions have to use the definitions and scale of scores used by the Banco de España in its supervisory review process, in order to foster a common language and facilitate analysis of whether the institution's perception of risk coincides with that of the Banco de España. That is to say, institutions have to use the definitions and scale of scores (high, medium-high, medium-low and low) of the risk matrix explained in the "The Banco de España Supervisory Model".

b) *Own-funds target*:

The ICAAP guidelines define the own-funds target as that which the institution "considers necessary to maintain both at present and in the future period (...) in keeping with the risks inherent in the institution's activity, the economic environment in which it operates, the governance and risk management and control systems, the strategic business plan, the quality of the capital available (...) and the actual possibilities of obtaining more capital if needed."[6]

The current crisis has made it apparent that only core capital is useful in practice for withstanding losses on a going concern basis and, for this reason, the future rules (Basel III) put all their emphasis on it. In view of this, the Banco de España began, for the purposes of Pillar 2, to focus on core capital and finally included in the ICAAP guidelines the requirement that institutions express their capital target in terms of core capital.

The modified ICAAP guidelines specify that the definition of core capital to be used is that of "common equity tier 1" established by the Basel Committee,[7] including the related implementation criteria set out in EU and Spanish legislation. However, given that the concept of "common equity tier 1" (CET1) will only become compulsory gradually from January 2013, until then the definition of core capital used will be that given in Article 2 of Royal Decree-Law 2/2011 of 18 February for reinforcing the Spanish financial system, which is very similar to the definition of CET1 applicable in 2013.

c) *Assessment of capital needs for credit concentration and structural interest rate risk*

The Banco de España included in the ICAAP guidelines the respective simplified options for assessing the capital needs for credit concentration risk and for on-balance-sheet structural interest rate risk in order to help less complex institutions analyse these risks

[6] Some institutions indicate in their capital report ratios that they act as a threshold for the application of corrective measures ("trigger ratios") instead of true targets to be met and maintained in the long term ("target ratios").

[7] See the Basel Committee document entitled "Basel III: A global regulatory framework for more resilient banks and banking systems".

and, at the same time, to establish objective criteria for comparing the level of inherent risk faced by institutions in relation to these two risks.

The simplified option for calculating capital needs for individual concentration risk was recalibrated in order to fine-tune the multipliers (the simplified methodology for estimating capital needs for sectoral concentration risk is also being revised).

The simplified option for calculating the capital needs for on-balance-sheet structural interest rate has also been modified: rules have been set on the maximum duration and percentage of volatility of non-interest-earning sight deposits in order to harmonise the criteria of the different institutions.

d) *Capital planning and stress tests*

The objective here is to establish a more structured and detailed capital planning framework in both normal conditions (ordinary planning) and stressed conditions (stress scenarios) so as to make these tests more uniform from one institution to another, thereby simplifying the Banco de España's task of reviewing them.

For this purpose, as a result of numerous working meetings with institutions and their associations,[8] the simplified option for stress tests was eliminated, institutions are requested to provide more details on their capital planning and on the stress tests conducted in the ICAAP, and some matters have been modified or clarified. The main changes are as follows:

- Institutions will include each year in their capital report what are known as the "baseline planning scenario" and the "macro stress scenario". In both scenarios, and for the different tests comprised in the planning, they will provide information on the macroeconomic variables used. Based on these variables, institutions will show the changes in their core capital ratio and, in addition, the envisaged amount of the main balance sheet items (including loans to the public and private sectors, private sector deposits, doubtful loans and receivables and loan loss provisions), a representative breakdown of risk-weighted assets, net interest income, gross income, net operating income and profit before tax.

- The "macro stress scenario" will consider a significant fall in economic activity and assume simultaneous adverse changes in at least GDP, interest rates, employment and house prices. For this purpose, the recommendations and predictions of the EBA, and, where applicable, the ECB, will be followed, except where the institution considers, and provides evidence, that they are not appropriate.

- The stress test results will be set out in the ICAAP summary return (return ICAAP 01) disregarding alternative capital items and active management strategies to mitigate their effects, i.e. they will be stated gross of mitigation. Where applicable, the effects of

[8] And also to make the recommendations of the ICAAP guidelines in this section compatible with the recent changes to the CEBS "Guidelines on Stress Testing".

the mitigation produced by alternative capital items or any other means will be stated separately in the ICAAP, so their effect can be evaluated.

With these changes the Banco de España trusts that institutions will continue to improve their internal capital assessment procedures and devote efforts to a process which is key to the Banco de España's supervisory review.