

Kredittilsynet
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Commercial banks no. 6
Savings banks no. 6
Mortgage companies no. 6
Finance companies no. 6
Holding companies no. 4
Investment firms no. 4
Management companies no. 4

**Pillar 2 of the revised capital adequacy framework –
guidelines for assessing risk profile and calculating capital
needs at institutions**

1. Statutory basis and purpose

A revised capital adequacy framework comes into effect in Norway on 1 January 2007, in line with the EU countries. The new framework and associated regulations apply to credit institutions, investment firms and securities fund management companies authorised to engage in active management. The aim is to better align the minimum capital required with risk. The revised framework has a wider compass than the previous minimum capital requirement, adding a calculation for credit risk, market risk and operational risk.

Basel Committee guidelines

The new regime is based on the main principles of the Basel Committee's final report of June 2004 entitled "International Convergence of Capital Measurement and Capital Standards".

The Basel Committee's report is divided into three pillars:

Pillar 1: Calculation of minimum regulatory capital
Pillar 2: Assessment of overall capital needs and individual supervisory review
Pillar 3: Institutions' disclosure of information

The main principles of Pillar 2 are:

1. Institutions should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

2. The supervisory authority should review and evaluate institution' internal capital adequacy assessments and strategies. The supervisor authority should take supervisory action if it is not satisfied with the result of this process.

3. The supervisory authority should expect institutions to operate above the minimum regulatory capital ratios.

4. The supervisory authority should intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular institution. The supervisory authority shall take remedial action if an institution if capital is not maintained or restored.

Principle 3 deals with the minimum capital adequacy requirement enshrined in the supervisory authority's body of rules (Pillar 1), while principle 4 deals with the capital needed in relation to an institution's overall risk exposure.

Norwegian statutes and regulations

The Norwegian capital adequacy regulations contain the following provisions:

- Financial Institutions Act section 2-9 second paragraph – robust governance arrangements (implements Article 22).

Article 22

1. Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures.

- Financial Institutions Act section 2-9 (b) first and second paragraphs – requiring credit institutions to have in place sound and appropriate strategies and processes to assess their need for capital, and to ensure that they are maintained (implements Article 123).
- Financial Institutions Act section 2-9 (b) third and fourth paragraphs – requiring the authorities to review and assess the process introduced by the financial institution to assess its capital need in relation to risk profile (implements Article 124).
- Financial Institutions Act section 2-9 (b) fourth paragraph and section 2-9 (d) – concerning sanctions available to the authorities (implement Article 136).

Corresponding provisions for investment firms are set out in the Securities Trading Act (no. 79 of 19 June 1997) section 8-10 et al.

Chapter 47 of the Capital Requirements Regulations, containing general requirements as to internal governance, further describes the role of the board of directors. It also

indicates which risks, as a minimum, shall be subject to institutions' guidelines and routines for risk management and control.

Section 47-1 on the role of the board of directors states:

“(1) The institution’s board of directors shall approve and regularly assess guidelines for the institution’s incurrence of risk and to identify, manage, monitor and control risk to which the institution is, or may become, exposed, including risk related to macroeconomic conditions.

(2) The board of directors shall lay down guidelines for separation of the institution’s various functions and prevention of conflicts of interest.”

Section 47-2 on risk management and control, first paragraph, states:

"The institution's guidelines and routines for management and control of risk shall at least encompass the following risks:

- (a) credit and counterparty risk
- (b) residual risk (defined in section 1-2 of the regulations),
- (c) concentration risk,
- (d) risks associated with securitisation activities,
- (e) market risk,
- (f) interest rate risk arising in portfolios other than the trading portfolio,
- (g) operational risk, and
- (h) liquidity risk"

Guidelines issued by CEBS (Committee of European Banking Supervisors):

Guidelines for the supervisory review process under Pillar 2, prepared on a joint basis by European supervisory authorities, are set out in a document of 25 January 2006 from CEBS entitled "Guidelines on the Application of the Supervisory Review Process under Pillar 2" (GL03).

The document gives guidance on:

- institutions’ management and control of risk and capital needs (Internal Capital Adequacy Assessment Process - ICAAP)
- supervisory monitoring and evaluation of institutions’ ICAAP
- supervisory authorities’ systems for assessing risk

Guidance is also given to supervisory authorities on how to structure the dialogue on risk level and capital needs with institutions, and a description of different types of supervisory instruments. Kredittilsynet will proceed in line with CEBS’ recommendations. An elaboration is provided in Norwegian in a memorandum issued by Kredittilsynet in December 2006. (Enclosure 2: “Guidelines for the supervisory review process – Pillar 2 of the new capital adequacy framework for credit institutions and investment firms.”)

2. Transitional provisions

Under section 49-2 of the Capital Requirements Regulations institutions can defer switching to the new framework until 2008. In other words institutions can utilise the existing rules to calculate the minimum capital requirement in 2007. They can concurrently spend 2007 preparing to meet the requirements of Pillar 2, i.e. put in place a process to assess their risk profile and appurtenant capital needs.

Recognising that some institutions will wish to postpone the transition to the new capital adequacy framework until 2008, Kredittilsynet requests institutions intending to apply the existing capital adequacy framework in 2007 to advise Kredittilsynet accordingly **by 15 January 2007**.

3. Documentation of assessment of risk profile and calculation of capital needs (ICAAP) in 2007

All institutions intending to utilise the new capital adequacy framework as from 2007 are required to evaluate their risk profile and appurtenant capital needs. The evaluation process and the results should be documented in writing and forwarded by the institution's board of directors to Kredittilsynet for assessment on an annual basis.

Kredittilsynet requires the largest and most complex credit institutions in Norway to report on their assessment of risk profile and capital needs by **13 April 2007**.

The above deadline applies to DnB NOR, SpareBank 1 Gruppen, SpareBank 1 SR-Bank, SpareBank 1 Midt-Norge, SpareBank 1 Nord-Norge, Sparebanken Vest and Nordea Bank Norway.

For other credit institutions the deadline for reporting ICAAP is **15 August 2007**.

Kredittilsynet will release a circular at a later date to investment firms and securities fund management companies authorised to engage in active investment. The circular will inter alia propose a format for reporting documentation of risk profile and adequate capital level (ICAAP) to Kredittilsynet.

Institutions' documentation of ICAAP should give an overview of and underpin the following:

- business units covered by the ICAAP
- the level of all significant risks and adequate capital level
- the quality of the institution's management and control of the various risks
- conclusions as to size and composition of the overall capital that the institution considers it needs to hold, viewed in relation to risk profile, as compared with the Pillar 1 requirement and the level of actual own funds
- a summary of the institution's financial situation, including its strategic and market position and expected future development

- a description of the institution's plans to maintain financial strength, its strategy in regard to dividend distribution and how it intends to determine its desired capital level ahead
- comments on important themes where further analyses and decisions are needed
- details of who analysed the risk profile and capital needs, the means by which the analysis was reviewed and checked and who approved the results.

Proportionality plays an important role in the execution of the new capital adequacy framework. Institutions should gear the scope, and organise the assessment of risk and capital needs, to the nature, scope and complexity of the institution's activities. Kredittilsynet will maintain an open view on the use of differing approaches to fulfil the authorities' requirements and guidelines.

A proposed format for reports is enclosed (enclosure 1). While the format is not mandatory, using or taking a basis in the format may be convenient since it covers most of the themes that will be assessed by Kredittilsynet. Information on any topics not covered in the ICAAP report will most probably need to be provided via additional reporting or via follow-up meetings and discussions with the institution. Using the suggested format will accordingly make for a more effective evaluation process for the institution and Kredittilsynet alike.

The format proposed for documenting ICAAP is particularly geared to large, complex institutions. However, smaller institutions with a limited range of activities are also expected to use or take a basis in the enclosed format for ICAAP documentation and to report on themes relevant to the institution concerned.

4. Kredittilsynet's evaluation of ICAAP and dialogue with institutions

Kredittilsynet's work with various types of institutions depends on their size, complexity and systemic importance, in accordance with the principle of proportionality.

In regard to the largest and most complex institutions, Kredittilsynet will undertake an evaluation process (essentially in the second quarter 2007). The evaluation will be based on the ICAAP documentation filed by each institution along with other types of documents filed by the institution on a periodical basis, for example strategy and policy documents, regular reports on results and risk, reports from on-site inspections and overall risk assessment for the current year.

Where relevant, meetings will be held with the institution. Additional information may also be requested, for example in the form of alternative capital calculations based on different assumptions, choice of parameters etc.

Kredittilsynet will make allowance for internal processes and routines employed by institutions to annually update strategies, and for planning and budget processes. The aim is to issue a final assessment of the largest institutions' ICAAP in the course of the third quarter 2007.

In its communication with institutions Kredittilsynet will give emphasis to explaining its assessments, and areas of weakness will be pointed out. Deadlines may be set for making improvements.

In regard to medium-sized and small institutions, Kredittilsynet's assessments will be less extensive. Assessments will start out from the documentation filed by the institution, and from other data and statistics retrieved from Kredittilsynet's financial database. If warranted by risk factors or the capital situation, small institutions may also be subject to a more comprehensive assessment.

In the case of both large and small institutions, Kredittilsynet will carry out various types of follow-up activities as part of its evaluation of capital needs under Pillar 2. This could entail investigating institutions' credit exposure in exposed industries or regions or other specific risks. In the current phase of strong price increase in the housing market, for example, the question may arise of surveying loan to value ratios. Such information may form part of Kredittilsynet's assessment of the capital needed by the individual institution.

Kredittilsynet expects institutions, based on their assessment of the level of overall risk and associated capital adequacy, to aim for an ample capital buffer above the minimum required. The minimum requirement will be the sum of capital calculated under Pillar 1 in respect of credit risk, market risk and operational risk.

In cases where the methods and assumptions on which institutions' evaluation of their risk level and need for capital are based are uncertain and poorly founded in data from their own business activity, institutions will be expected to display added caution and to assign satisfactory capital buffers.

Until such time as more experience of the new capital adequacy framework has been gained, Kredittilsynet will be disinclined to accept reductions in capital needs justified in terms of diversification effects.

Institutions' analyses and assessments of capital needs should be future-oriented, taking into account plans, growth and access to equity capital markets. Moreover, allowance shall be made for economic conditions and financing needs. It is important for institutions to maintain sufficient capital to enable them to live through economic downturns with negative results in which bringing in new equity capital may be a problem.

5. Kredittilsynet's use of policy instruments

Pillar 2 is based on the assumption that supervisory authorities have an array of policy instruments available to them.

Under the Financial Institutions Act section 2-9 (b) fourth paragraph and section 2-9 (d) and the Securities Trading Act section 8-10 (b) fourth paragraph and section 8-10 (d), Kredittilsynet may impose on institutions:

1. Changes in the organisation, management and control of business activities and in strategies, processes, guidelines and routines on which the operation of business activities is based.
2. Higher capital requirements as a result of loss provisioning practice or treatment of assets.
3. Changes in or restrictions on business activities.
4. Reduction of the risk associated with business activities, including products and systems.
5. A higher level of own funds than the minimum required by law.

Any decision on what instruments are to be applied will be taken by Kredittilsynet based on an evaluation of the institution's risk and capital assessment process, risk level and the quality of management and control, as well as on Kredittilsynet's dialogue with the institution on these aspects. One or more supervisory instruments will be selected based on the gravity of the situation and on the underlying cause.

Requirements may be set in terms of maintaining a specified level of own capital at institutions where there is an imbalance between the risk profile on their business operations and the quality of their management and control systems, and this imbalance cannot be rectified by means of other supervisory orders within a reasonable period of time.

Requirements as to higher capital may also be applied in cases where Kredittilsynet considers that the level of own capital maintained by the institution is not commensurate with the institution's risk profile.

6. Pillar 2 and consolidation

The requirements under Pillar 2 that institutions shall have in place a process for assessing overall capital needs in relation to risk profile, and a strategy for maintaining their level of capital, apply on a consolidated basis.

Institutions that are sub-groups or subsidiaries under foreign ownership will be required to document their process and their calculations of risk profile and capital needs and to report these items in line with other institutions. While the process and evaluation may be based on the group's common methods and processes, they should be tailored to the Norwegian sub-group and should document the risks to which the Norwegian operation is exposed and the appurtenant capital needs.

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Enclosure 1

DOCUMENTATION OF INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (ICAAP)

ICAAP submission suggested format

Institution:

Date:

Chair of the board

Name and signature:

Name of responsible officer in the institution:

Institutions are not required to adopt this format when asked to submit their Internal Capital Adequacy Assessment Process (ICAAP) document to the Kredittilsynet for review. Kredittilsynet expects a fair degree of variation in the length and format of submissions since firms' business and risk profiles differ and the ICAAP document should be proportional to the size, nature and complexity of the business. However, adopting this format may be convenient for institutions as it covers most of the matters which typically would be the subject of review by the Kredittilsynet, and if not provided in the initial submission are likely to be covered in follow up discussions. Use of this format may therefore make the review process more efficient for both the institution and the Kredittilsynet. The format is based on a similar format used by FSA in UK.

Contents:

1. EXECUTIVE SUMMARY
2. CURRENT CAPITAL POSITIONS AND PROJECTED FINANCIAL DEVELOPMENT
3. CAPITAL ADEQUACY
4. SENSITIVITY TESTS AND FORWARD LOOKING SCENARIOS BASED ON SERIOUS ECONOMIC DOWN TURNS
5. AGGREGATION OF CAPITAL
6. QUALITY CONTROL, CHALLENGE AND ADOPTION OF THE ICAAP
7. USE OF THE ICAAP WITHIN THE INSTITUTION

1. EXECUTIVE SUMMARY

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:

- the purpose of the report and which regulated entities are covered by the ICAAP;
- the main findings of the ICAAP analysis:
 - how much and what composition of internal capital the firm considers it should hold as compared with the minimum capital requirement in Pillar 1
 - the quality of the firm's risk management processes;
- a summary of the financial position of the business, including the strategic position of the institution, its balance sheet strength, and future profitability;
- brief descriptions of the capital and dividend plan; how the institution intends to manage capital going forward and for what purposes;
- commentary on the most material risks, why the level of risk is acceptable or, if it is not, what mitigating actions are planned;
- commentary on major issues where further analysis and decisions are required
- information of who has carried out the assessment, how it has been challenged, and who has approved it.

2. CURRENT CAPITAL POSITIONS AND PROJECTED FINANCIAL DEVELOPMENT

This section would explain the present financial position of the institution and expected changes to the current business profile, the environment in which it expects to operate, its projected business plans (by appropriate lines of business), projected financial position, and future planned sources of capital.

The starting balance sheet and date as of which the assessment is carried out would be set out. The projected financial position might consider both the projected capital available and projected capital resource requirements based on expected plans. These might then provide a baseline against which adverse scenarios (see later) might be compared.

3. CAPITAL ADEQUACY

This section might start with a description of the risk appetite used in the ICAAP. Where economic capital models are used this would include the confidence level, time horizon, and description of the event to which the confidence level relates. Where scenario analyses or other means are used, then some other description of how the severity of scenario has been chosen would be included. The section would then include a detailed review of the capital adequacy of your institution. There should be a detailed description for every risk type, how all portfolios and business activities of substance have been included. The information provided would include:

Timing:

- the effective date of the ICAAP calculations together with consideration of any events between this date and the date of submission which would materially impact the ICAAP calculation together with their effects
- details of, and rationale for, the time period over which capital has been assessed

Risks analysed

- an identification of the major risks faced in each of the following categories:
 - i) credit risk (including counter party risk and residual risk)
 - ii) market risk (including risk related to real estate price changes)
 - iii) operational risk
 - iv) liquidity risk
 - v) insurance risk
 - vi) concentration risk
 - vii) residual risk
 - viii) securitisation risk
 - ix) business risk
 - x) interest rate risk in the banking book
 - xi) pension obligation risk; and
 - xii) any other risks identified
- For each risk , an explanation of how the risk has been assessed and the quantitative results of that assessment (risk level and adequate capital)
- Where relevant, a comparison of that assessment with the results of the Pillar 1 calculations;
- A clear articulation of the firm's risk appetite by risk category if this varies from the overall assessment

Enclosed table can be used to illustrate the aggregation of capital.

Methodology and assumptions

A description of how assessments for each of the major risks have been approached and the main assumptions made.

Some institutions may decide to base their ICAAP on internal models for all risks, including those covered under Pillar 1 (i.e. Credit, Market and Operational Risks). The description here would make clear which risks are covered by which modelling or calculation approach. This would include details of the methodology and process used to calculate risks in each of the categories identified and reason for choosing the method used in each case. If the institution on an earlier occasion has forwarded to Kredittilsynet documentation of methods, models etc which the capital calculations are based on, this can be referred to.

Where the firm uses an internal model for the quantification of its risks, this section would explain for each of those models the key assumptions and parameters within the capital modelling work and background information on the derivation of any key assumptions; how parameters have been chosen, including the historical period used and the calibration process. If the input variables used for calculation of credit risk, market risk and operational risk are different from those used in the calculation of the

minimum capital requirement under Pillar 1, the differences should be explained and how this has influenced the calculation of capital.

Other firms may choose to base their ICAAP on the results of the Pillar 1 calculation with additional risks (e.g. concentration risk, interest rate risk in the banking book etc.) assessed separately and added to Pillar 1.

Where stress tests or scenario analyses have been used to validate, supplement, or probe the results of other modelling approaches, then this section would provide:

- details of simulations to capture risks not well estimated by the firm's internal capital model (e.g. non linear products, concentrations, illiquidity and gapping of prices, shifts in correlations in a crisis period)
- details of the quantitative results of stress tests and scenario analyses the firm carried out and the confidence levels and key assumptions behind those analyses, including, the distribution of outcomes obtained for the main individual risk factors
- details of the range of combined adverse scenarios which have been applied, how these were derived and the resulting capital requirements
- where applicable, details of any additional subsidiary- or business unit specific or business plan stress tests selected.

Capital transferability

Details of any restrictions on the management ability to transfer capital into or out of the business(es) covered in this ICAAP, for example lending agreements, restrictions to the dividend payments, other contractual, commercial, juridical or commercial agreements, regulatory or statutory restrictions.

Management action and interventions

Description of management interventions included in the ICAAP to reduce risk. (Examples can be assumed effects of "stop loss" limits in trading with financial instruments, changes in business plans and reduced growth ambitions when unexpected losses or profit variations occurs, or related to serious changes in business environments.) The effects of management interventions on calculated capital should be isolated and illustrated separately.

Pillar 1 and ICAAP comparisons

This section would provide:

- actual level and quality of own funds compared with calculation of adequate capital in ICAAP
- explaining the reasons for differences between the adequate level of capital calculated in ICAAP compared with the calculation of minimum requirement in Pillar 1

4. SENSITIVITY TESTS AND FORWARD LOOKING SCENARIOS BASED ON SERIOUS ECONOMIC DOWN TURNS

This section should give information about the institutions methods and results from stress tests or scenario tests. Such calculations would explain how ICAAP would be

affected by an economic recession or downswings in the business or market relevant to its activities. The analysis should be based on an extraordinary, but plausible scenario and include financial projections forward for minimum three years. The effect on the financial situation of the institution should be projected.

The analyses should in detail show the stress test imposed on parameters of vital importance for the institutions earnings and financial situation. The cases should show key assumptions in internal models and calculation methods which influence changes in capital level.

Scenario and stress tests should include:

- How an economic downturn would affect the institutions future earnings and capital resources; and effecting the minimum capital requirement in Pillar 1.
- A separate assessment of how the institution will manage to meet the Pillar 1 minimum capital requirement. It would be helpful if these projections showed separately the effects of management and other actions to maintain and strengthen the institutions capital situation.
- Cash flow analyses and projection of the institutions liquidity situation under a serious economic recession

The scenarios should include:

- How changes in the credit quality of the institution's credit risk counterparties (including migration in their ratings during a recession) effect the institutions capital adequacy and minimum credit risk capital requirement

5. AGGREGATION OF CAPITAL

This section would describe how the results of the various risk assessments are brought together and aggregated to make an overall view taken on capital adequacy.

On the broader level, the overall reasonableness of the detailed quantification approaches might be compared with the results from the sensitivity tests and scenario calculations mentioned in section 4. The senior management and the board are expected to express a view as to the appropriateness of the overall level of capital and whether it is adequate in relation to the institutions actual and future risk profile.

Institutions will use different methods for aggregation of risks to obtain an overall capital level. The following should be documented:

- i) any allowance made for diversification, including any assumed correlations between risks, how such correlations have been calculated, and use of data
- ii) how correlations are expected to behave under stressed economic conditions
- iii) the justification for any credit for diversification benefits between legal entities, and the justification for the free movement of capital between them in times of financial stress

- iv) impact on calculation of aggregated capital of different assumptions about diversification benefits. It might be helpful to set out revised ICAAP figures with all correlations set to '1' i.e., no diversification; and alternatively use of the highest correlations observed historically.

In the documentation that describe how the institution has arrived at its overall assessment of the capital it needs, there should be a separate description of how the following has been taking into account:

- the inherent uncertainty in any modelling approach;
- weaknesses in the firm's risk management procedures, systems or controls;
- any differences between regulatory capital and internal capital

6. QUALITY CONTROL, CHALLENGE AND ADOPTION OF THE ICAAP

This section would describe how the ICAAP has been worked out in the institution and the extent of challenge and testing of the ICAAP. It would include the testing and control processes applied to the ICAAP models, methods and calculations, and the senior management and board review and sign off procedures.

It might be helpful if a copy were attached of any relevant report to senior management or the board and their response. Details of the reliance placed on any external suppliers would also be included e.g. for generating economic scenarios.

In addition, a copy of any report obtained from the internal audit concerning the assessment of ICAAP, calculation of risk and adequate capital should also be included.

7. USE OF THE ICAAP WITHIN THE INSTITUTION

This section should give a short description of how and the extent to which internal risk- and capital management is embedded within the overall management of the institution.

Enclosure 2

**GUIDELINES ON THE APPLICATION OF THE SUPERVISORY REVIEW
PROCESS UNDER PILLAR 2 (GL03)**

Refer to document GL03 from Committee of European banking Supervisors (CEBS)
available at CEBS web sites.