

## **Standard 4.2**

# **Internal Capital Adequacy Assessment Process ICAAP**

**Regulations and guidelines**



**RAHOITUSTARKASTUS  
FINANSINSPEKTIONEN  
FINANCIAL SUPERVISION**

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# 1

## APPLICATION

### *Supervised entities within the scope of this standard*

*Issued on 1 Dec 2006  
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(1) This standard is applied to the following supervised entities referred to in section 5 of the Act on the Financial Supervision Authority (587/2003):

- credit institutions
- investment firms
- fund management companies engaged in activities referred to in section 5(2) of the Mutual Funds Act (48/1999) (fund management companies engaged in asset management)
- the central body of the amalgamation of cooperative banks, as referred to in the Act on Cooperative Banks and Other Cooperative Credit Institutions (1504/2001).

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(2) The general term 'supervised entity' is used hereinafter for all corporations falling within the scope of this standard.

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(3) 'Consolidated supervised entity' refers in this standard to a group that is supervised in a consolidated manner and an amalgamation of cooperative banks.

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(4) The term 'fund management company' refers hereinafter to fund management companies engaged in asset management.

### *Application of this standard to the internal capital adequacy assessment of an individual supervised entity*

*Issued on 1 Dec 2006  
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(5) The regulations on internal capital adequacy assessment of this standard are applied to the following supervised entities on an individual basis:

- credit institutions
- investment firms
- fund management companies

*Application of this standard in consolidated capital adequacy assessment*

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(6) In accordance with the Act on Credit Institutions, a credit institution's consolidation group refers to a group formed by the group's parent undertaking, which is a credit institution or a foreign credit institution, a holding corporation other than an investment firm that is the parent undertaking of such a credit institution (*consolidation group's parent undertaking*), as well as to the subsidiaries of the parent undertaking that are credit institutions or foreign credit institutions, financial institutions or service companies (*consolidation group's subsidiary*). 'A group', 'a parent undertaking' and a 'subsidiary' refer hereinafter to a group, a parent undertaking and a subsidiary as referred to in the Accounting Act (1336/1997), as well as a foreign group, parent undertaking and subsidiary comparable to them. A *Finnish consolidation group* refers to a consolidation group whose parent undertaking is a Finnish corporation. A *sub-consolidation group* refers to a consolidation group whose parent undertaking is a subsidiary of the consolidation group's parent undertaking.

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(7) The requirements for *consolidated capital adequacy assessment* are basically applied in each consolidation group to the consolidation group's topmost Finnish parent credit institution. As a general rule, the requirements set for consolidated capital adequacy assessment do not, however, concern the parent undertakings of a Finnish consolidation group's sub-consolidation group.

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(8) The requirements for consolidated capital adequacy assessment concern the consolidation group's topmost Finnish parent credit institutions as stated in points (9) and (10) below. The requirements for consolidated capital adequacy assessment concern the parent undertakings of the sub-consolidation groups of the Finnish consolidation groups as stated in point (11) below.

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(9) The following credit institutions must apply the regulations of this standard to their consolidated capital adequacy assessment (*requirement for consolidated capital adequacy assessment*):

- a) a credit institution that is the consolidation group's parent undertaking
- b) a credit institution whose holding corporation, acting as its parent undertaking, is domiciled in Finland and that is the biggest of the subsidiary credit institutions in such a holding corporation in terms of total assets
- c) a credit institution whose holding corporation, acting as its parent undertaking, is domiciled in another state belonging to the

European Economic Area (EEA member state) and in the case of which both of the following conditions are fulfilled:

- there is no foreign credit institution belonging to the consolidation group in the parent undertaking's home state
  - the total assets of the credit institution are higher than those of the parent undertaking's any such subsidiary credit institution or foreign subsidiary credit institution domiciled in an EEA member state.
- d) a credit institution, if the Financial Supervision Authority has agreed with the authorities of other EEA member states responsible for supervision of foreign credit institutions belonging to the consolidation group on it that the Authority acts as the supervision authority responsible for the consolidated supervision of the foreign credit institution and that Finnish law is applied to the consolidated supervision.

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(10) The requirement for consolidated capital adequacy assessment does not, however, apply to a credit institution that is a subsidiary of the credit institution referred to in point (9) above or a Finnish holding corporation's subsidiary other than referred to in point (9).

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(11) Notwithstanding point (10), the requirement for consolidated capital adequacy management concerns a credit institution, if one or several of its or the holding company's acting as its parent undertaking, subsidiaries or participating interest undertakings, is a foreign credit institution, foreign undertaking comparable to a fund management company referred to in the Mutual Funds Act or a financial institution located in a state not belonging to the European Economic Area.

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(12) The requirement for consolidated capital adequacy assessment does not concern a credit institution, if the Financial Supervision Authority has agreed with the other authorities responsible for supervision of the foreign credit institutions belonging to the consolidation group on it that a competent authority of another EEA state is responsible for the consolidated supervision of the credit institution.

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(13) The requirement for consolidated capital adequacy assessment concerns investment firms and fund management companies in accordance with the provisions concerning credit institutions under points (9) - (12).

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(14) The requirement for consolidated capital adequacy assessment does not concern an investment firm whose parent undertaking is a credit institution that has obtained an operating licence in an EEA state or a holding corporation operating in an EEA state that is at the same time the parent

undertaking of the credit institution that has obtained an operating licence in the EEA state, provided that the credit institution is supervised based on its consolidated financial status.

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(15) The provisions on investment firms in point (14) are correspondingly applied to fund management companies.

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(16) The central body of an amalgamation of cooperative banks must apply the provisions of this standard in the capital adequacy management of the amalgamation of cooperative banks. The provisions on consolidated capital adequacy assessment are applied to the amalgamation as a consolidated supervised entity. Then the provisions on the parent undertaking of the consolidation group are applied correspondingly to the central body of the amalgamation and the provisions on the undertakings belonging to the consolidation group are applied to a corporation belonging to the amalgamation.

*Application of the standard to an individual supervised entity in the consolidation group*

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(17) Upon an application by the parent undertaking of the consolidation group, FIN-FSA may grant permission for not meeting the requirements of this standard to an individual credit institution on the level of an individual credit institution. The precondition for granting such permission is that the Financial Supervision Authority can be convinced of the following matters, based on consolidated capital adequacy management:

- the internal objectives of the quantity and type of own funds have been set specifically for each individual undertaking belonging to the consolidation group by business line or in some other appropriate manner
- the risks of each undertaking belonging to the consolidation group have been comprehensively and reliably identified, assessed and measured and reliably combined on the level of the consolidation group's parent undertaking
- the amount of risks of each supervised entity is properly considered in the breakdown of own funds within the group between individual undertakings
- the governance, internal control and risk management of each individual undertaking belonging to the consolidation group are proportionate to the nature, scale and complexity of the operations

- each individual undertaking is committed to the operating practice required by the internal capital adequacy assessment process confirmed on the group level.

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(18) The Financial Supervision Authority may grant the permission referred to in point (17) to a credit institution belonging to an amalgamation of cooperative banks upon the application of the central body of the amalgamation. When assessing the conditions of granting the permission, the provisions on the parent undertaking of the consolidation group laid down in point (17) are applied correspondingly to the central body of the amalgamation and the provisions on the undertakings belonging to the consolidation group are applied to a corporation belonging to the amalgamation.

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(19) The provisions on credit institutions in point (17) are correspondingly applied to investment firms and fund management companies.

*Principle of proportionality*

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(20) The corporations within the scope of this standard differ from each other in terms of their organisational structure and the nature, scale and complexity of their operations, for example. Therefore there may be different kinds of practical solutions in the assessment of the capital adequacy and in management and control of capital adequacy. The supervised entity must adjust the approaches, principles and mechanisms of its internal capital adequacy management in accordance with this standard to the priorities and requirements of its own business as well as to the characteristics of its risk profile. This principle of proportionality is emphasised especially in the methods applied to assessing risk-based capital requirements.

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(21) To concretise the principle of proportionality, the Financial Supervision Authority uses the concepts of 'large supervised entity' and 'small supervised entity' in this standard. These concepts are defined in terms of application of this standard in Chapter 10.

*Application of the standard in financial and insurance conglomerates*

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(22) The Financial Supervision Authority recommends that the parent undertakings of financial and insurance conglomerates mainly engaged in the financial sector organise their internal capital adequacy assessment, as part of corporate governance, in accordance with the general principles of this standard.

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(23) Section 19(3) of the Act on the Supervision of Financial and Insurance Conglomerates (699/2004) contains general provisions on the internal capital



adequacy assessment of conglomerates. According to the above-mentioned section, an undertaking at the head of the conglomerate shall confirm a plan for the conglomerate to maintain its solvency. Sector-specific regulation contains prohibitions that a credit institution or an insurance company may not in their own operations take a risk that essentially endangers the capital adequacy or liquidity of a credit institution or an insurance company (consolidated capital adequacy or liquidity).

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(24) The Financial Supervision Authority's standards on the principles and organisation of corporate governance, internal control and risk management are also applicable to the parent undertakings of financial and insurance conglomerates mainly engaged in the financial sector. The principles of internal capital adequacy assessment in accordance with this standard are closely related to the principles of corporate governance.

*Transitional provisions*

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(25) The transitional provisions on the application of this standard are included in Chapter 8.

# 2

## OBJECTIVES

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(1) Adherence to the principles of Pillar 2 is an integral part of the Basel II capital adequacy regulation and supervision. The principles oblige the supervised entity and the supervisor to examine capital adequacy and its assessment in relation to all essential risks arising from business activity and changes in the external operating environment. Capital adequacy is considered more broadly than the meeting of minimum capital adequacy requirements (Pillar 1) against credit, market and operational risks.

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(2) The supervised entity always bears the primary responsibility for the mapping out of the capital requirement, capitalisation and strategy based on its entire risk profile in order to maintain the capital level. The basis for examining capital adequacy is the supervised entity's own, justified view of the capital required by all essential risks and planned risk-taking as well as the sufficiency of internal control and risk management in relation to the nature, scale and complexity of the operations. Good assessment of capital adequacy also includes consideration of possible valuation effects of the fair value in the amount and type of own funds.<sup>1</sup>

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(3) The Financial Supervision Authority considers it important that the supervised entities have good risk-bearing capacity and reliable internal governance. The supervised entity's risk-bearing capacity is composed of the joint effect of several different factors. These factors are the amount, type, allocation and availability of capital, as well as profitability of business. The capital functions as a buffer against unexpected losses. To be effective, the buffer must be adequate for ensuring undisturbed operations of the supervised entity. The risk-bearing capacity also includes qualitative factors, such as internal governance, internal control and risk management, as well as internal capital adequacy assessment applying the principles of this standard.

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<sup>1</sup> This theme is handled in more detail in the "Supervisory guidance on the use of fair value option for financial instruments by banks" published by the Basel Committee on Banking Supervision on 14 June 2006

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(4) The purpose of the standard in internal capital adequacy assessment is to ensure that

- the supervised entity has a consistent approach, process and mechanisms for proactive capital planning, assessment of capital adequacy and maintenance of capital adequacy;
- the supervised entity sets sustained targets for the amount and type of capital;
- the supervised entity adjusts the amount and type of the capital to its own risk level;
- besides measurable risks, the supervised entity also maps out the risks that cannot be measured and manages these qualitative risks well;
- the supervised entity is capable of allocating the capital among all essential risks in a reliable and risk-based manner ;
- the supervised entity connects internal capital adequacy assessment with strategic planning and operational management of activities;
- an independent regular evaluation is made of the internal capital adequacy assessment process upon the assignment of the management.

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(5) Another goal of the standard is to convey information on which matters the Financial Supervision Authority pays attention to and what it requires from its supervised entities, when it carries out a regular assessment under Pillar 2 of the supervised entity's capital adequacy assessment.

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(6) The aim is also to encourage the supervised entities to continuous development of risk management and capital adequacy assessment based on the best practices of the financial sector. Another objective is to make the supervised entities disclose adequate information to the market on their capital adequacy and capital adequacy assessment.

*Other standards of the Financial Supervision Authority related to capital adequacy assessment*

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(7) Furthermore, when organising internal capital adequacy assessment, the principles set out in the FSA standards [1.3 Internal governance] and 4.1 Establishment and maintenance of internal control and risk management must also be followed.

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(8) When organising internal capital adequacy assessment, the standards on risk management by risk area and the standards regulating minimum capital adequacy belonging to the Financial Supervision Authority's section 4 of the set of regulations, the standard 4.5 Disclosure of capital adequacy information to the market concerning Pillar 3 and, as appropriate, standard 1.5

Supervision of financial and insurance conglomerates belonging to section 1 must be considered.

# 3

## INTERNATIONAL FRAMEWORK

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(1) The EU directives on the implementation of the Basel II capital adequacy regulation are available on the website of the European Commission at [http://europa.eu.int/comm/internal\\_market/regcapital/index\\_eu.htm](http://europa.eu.int/comm/internal_market/regcapital/index_eu.htm).

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(2) The main principles of the EU directives comply with the capital adequacy framework published on 26 June 2004 and updated in November 2005 by the Basel Committee on Banking Supervision. The Basel Committee on Banking Supervision's recommendation "International Convergence of Capital Measurement and Standards – a Revised Framework, Updated November 2005" is available at <http://www.bis.org>

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(3) In the detailed contents of the standard (particularly in Chapter 6), the guidelines adopted in January 2006 by the Committee of European Banking Supervisors (CEBS) for implementation of Pillar 2 and the supplementary technical annexes have been taken into account. The regulation under Pillar 2 is based on principles, unlike the regulations on the calculation rules for minimum capital adequacy under Pillar 1. CEBS's document "Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised)" of 25 January 2006 includes guidelines on internal governance, the Internal Capital Adequacy Assessment Process (ICAAP), the Supervisory Review and Evaluation Process (SREP) and the ICAAP/SREP dialogue in accordance with Pillar 2. CEBS' guidelines are available at: <http://www.c-ebs.org/standards.htm>.

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(4) Other documents that are important regarding this standard are the Basel Committee's recommendations on corporate governance, internal control, risk management, risk-based capital adequacy supervision and the practical implementation of the new capital adequacy framework. The recommendations are available on the Committee's website at [http://www.bis.org/bcb/publ\\_04.htm](http://www.bis.org/bcb/publ_04.htm). Matters of risk management and risk-based capital adequacy are handled in the publications by the Joint Forum of

the Basel Committee on Banking Supervision, IOSCO and IAIS. The publications are available at <http://www.bis.org/bcbs/jfpubl.htm>.

# 4

## LEGAL BASIS

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(1) National regulation on capital adequacy assessment is based on the following EC directives:

- Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (32006L0048); Official Journal of the EU L177,30 June 2006, p1
- Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions (32006L0049); Official Journal of the EU L177, 30 June 2006, p 201.

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(2) Regulation concerning the Internal Capital Adequacy Assessment Process (ICAAP) of credit institutions is included in, Article 123, of Directive 2006/48/EC recasting the Directive relating to the taking up and pursuit of the business of credit institutions. The requirements for the Internal Capital Adequacy Assessment Process are essentially related to, Article 22, of the said directive, regarding the organisation of the corporate governance, internal control and risk management of credit institutions as part of the conditions for taking up the operations of credit institutions. Annex V to Article 22 includes specifying requirements-in-principle for decision-making, steering and supervisory regimes and for rating and handling of risks. The provisions on the application of capital adequacy assessment and other capital adequacy requirements are included in Articles 68–73 of the said directive.

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(3) The regulation regarding the Internal Capital Adequacy Assessment Process of investment firms is included in Title V of the Directive on the adequacy of own funds of investment firms and credit institutions 2006/49/EC. It is provided in Article 34, that besides Article 13 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments every investment firm must meet the requirements laid down in Articles 22 and 123 of Directive 2006/48/EC. The application level is determined by virtue of Articles 68–73 of Directive 2006/48/EC.

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(4) The regulation regarding the Supervisory Review and Evaluation Process (SREP) is included in Article 124 of Directive 2006/48/EC and in Annex XI specifying it and the regulation regarding the supervisory measures in Article 136.

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(5) Section 54 of the Act on Credit Institutions (121/2007) contains national provisions on capital adequacy assessment and section 78 of the said Act on consolidated capital adequacy assessment. The provisions on risk management and consolidated risk management in sections 49 and 74 of the said Act are closely related to the capital adequacy assessment requirements. The application of the above provisions to investment firms, fund management companies providing investment services and an amalgamation of cooperative banks is regulated in the Acts concerning these entities.

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(6) The right of the Financial Supervision Authority to lay down binding regulation on the thematic scope of this standard is based on the following provisions:

- section 93(1) of the Act on Credit Institutions (121/2007)
- section 31(1) of the Investment Firms Act (579/1996)
- section 6(5) of the Mutual Funds Act (48/1999)
- section 8(5) of the Act on Cooperative Banks and Other Cooperative Credit Institutions (1504/2001).



# 5

## BASIS FOR CAPITAL ADEQUACY ASSESSMENT FRAMEWORK

### 5.1 Relationship of the supervisory review process to the minimum capital adequacy requirements under Pillar 1

**Justification**

Issued on 1 Dec 2006  
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(1) The basis of capital adequacy regulation is that the amount, type and allocation of the supervised entity's own funds must continuously be adequate to cover the essential risks to which the supervised entity is exposed. It is not, however, possible to replace with capital any deficiencies in the qualitative factors of the risk-bearing capacity.

**Justification**

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(2) Due to the limitations related to the calculation of the minimum requirement for own funds, the Basel II Framework requires a supervisory review and evaluation of both the supervised entity and the supervisor (pillar 2). The supervisory review process covers the supervised entity's entire risk profile, the various factors of the risk-bearing capacity, capital adequacy assessment and meeting of the minimum requirements. Prudential risk management cannot be based solely on pillar 1 minimum requirements, nor on the mechanical implementation of the provisions of this standard as a calculatory routine for the supervisors. Implementation of capital adequacy management is affected by the demands of the operating environment and the business operational gains that are aimed at.

**Justification**

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(3) The supervised entities calculate the minimum requirement for capital adequacy (Pillar 1) by risk area for credit, market and operational risks. The supervised entity may choose the calculation methods according to the state of advancement of its own risk management. Moving from simpler methods over to more sophisticated ones improves the correspondence between the

risk and the capital requirement. The Pillar 1 requirements for the minimum capital adequacy amount of own funds are always binding on the supervised entities.

**Justification**

*Issued on 1 Dec 2006  
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(4) The Pillar 1 calculation is based on the average risks that the large internationally operating banks are exposed to in the financial sector. The calculation methods include the assumption of a well diversified lending.

**Justification**

*Issued on 1 Dec 2006  
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(5) The minimum capital adequacy requirements of Basel II that are more risk-sensitive and detailed than before do not cover all the dimensions of credit, market and operational risks nor all risks of an individual supervised entity. The characteristics and uncertainty factors of each supervised entity affect the dimensioning of capital adequacy. For instance, concentration of credit risks, financing risks, the interest rate risk of the banking book and the risks of the external operating environment remain outside the minimum capital adequacy requirements.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(6) Supervised entities that have obtained permission from FIN-FSA can, in the calculation of their credit risk minimum requirement, also use their own internal credit ratings and risk parameters. The use of the Internal Ratings Based Approach (IRBA) clearly increases the risk sensitivity of the capital adequacy requirements and leads to different kinds of minimum capital adequacy requirements at the various stages of the economic cycle. This phenomenon, and the possibility that Basel II may have effects that strengthen cyclical trends, are called 'procyclicality' of credit ratings and the capital requirements based on them. As business cycles weaken, the creditworthiness and ratings of customers impair along with the increased risk. Then the capital adequacy requirements also increase and the supervised entities must reserve more capital for the exposures of their credit portfolio.

**Justification**

*Issued on 1 Dec 2006  
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(7) As a means of reducing the procyclicality of the risk-sensitive capital requirements, adequately long-term and adequately prudent reviews for estimating central risk parameters (eg long-term consideration in PD estimates and consideration of economic downturn in LGD estimates) are required of supervised entities applying the Internal Ratings Based Approach. As far as reviews beyond cyclical trends are not yet applied in IRBA calculations, Basel II also requires in application of internal credit ratings special stress tests covering at least a slight downturn, which are used for assessing the variation tendency of the credit risk's Pillar 1 capital requirement.

**Justification**

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(8) Pillar 2 emphasises the importance of adequate capital buffers on the whole in order to reduce the procyclicality effects of risk-sensitive capital adequacy requirements. Pillar 2 requires of all supervised entities identification of the risks of the macroeconomic operating environment and

their examination by stress tests. The supervised entities should increase and maintain adequate capital buffers based on stress tests. Thus it is ensured that the solvency of the supervised entity does not go below the minimum requirement of Pillar 1 and that the entity is able to continue its operations undisturbed when the economic operating environment weakens. Unexpected, but still possible cyclical variations and their effect on one's risk profile and profitability belong to the stress test. The capital buffers are considered to be part of good risk-bearing capacity.<sup>2</sup>

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(9) Capital adequacy assessment and predictive planning of capital adequacy maintenance under Pillar 2 require recognition of the characteristics and uncertainty factors of the entire risk profile of the supervised entity as well as sensitivity analyses and stress tests for analysing the entity's vulnerable points.

## **5.2 Capital adequacy assessment as part of internal governance**

**Justification**

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(10) According to the basics of corporate governance, a supervised entity must be managed professionally and in line with sound and prudent business principles. Sound corporate governance requires that adequate internal control and risk management are ensured.

**Justification**

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Valid from 1 March 2007

(11) Together with risk management and internal control, risk-based capital adequacy assessment under Pillar 2 forms an integrated whole and is thus an essential element of the supervised entity's corporate governance. The principles guiding capital adequacy assessment are closely linked to the principles of corporate governance. Capital planning considering the objectives and priorities of business is part of the management's strategic planning and an important means to meet the strategic targets.

**Justification**

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Valid from 1 March 2007

(12) Capital adequacy evaluation is based on identification, measurement and assessment of risk. Efficient risk management requires the reliable covering of the various risks and operational capital adequacy with adequately maintained capital levels proportioned to existing and planned risk-taking.

**Justification**

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(13) The Financial Supervision Authority must regularly assess, at least once a year, the supervised entity's capital adequacy assessment, its sufficiency and functioning as the management's strategic and operational steering process within the environment in which it is used. Evaluation of the comprehensiveness and functioning of capital adequacy assessment and its

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<sup>2</sup> For the use of stress tests, refer to CEBS guidelines "Technical aspects of stress testing under the Supervisory Review Process" of 14 December 2006

results is part of the Financial Supervision Authority's risk-based capital adequacy supervision, which takes a stand to the sufficiency of the supervised entity's own funds in order to ensure undisturbed operations.

# 6

## ORGANISATION OF INTERNAL CAPITAL ADEQUACY ASSESSMENT

### 6.1 Requirement for organisation of internal capital adequacy assessment

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(1) The requirements for internal governance, internal control and risk management of credit institutions and the risk-based capital adequacy assessment essentially related to them are presented in Articles 22 and 123 of Directive 2006/48/EC and its Annex V, as well as in Article 34 of Directive 2006/49/EC in which the same requirements are extended to cover investment firms.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(2) *Every credit institution must 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.*<sup>3</sup>

**Binding**

Issued on 1 Dec 2006  
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(3) *Such arrangements, processes and mechanisms (as referred to in Article 22(1)) shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities. The technical criteria laid down in Annex V shall be taken into account.*<sup>4</sup>

**Binding**

Issued on 1 Dec 2006  
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(4) *Credit institutions shall have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate*

<sup>3</sup> Directive 2006/48/EC, Article 22(1)

<sup>4</sup> Directive 2006/48/EC, Article 22(2)

to cover the nature and level of the risks to which they are or might be exposed.<sup>5</sup>

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(5) *The capital management strategies and processes shall be subject to regular internal review to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the credit institution concerned.*<sup>6</sup>

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(6) *Every investment firm, as well as meeting the requirements set out in Article 13 of Directive 2004/39/EC, shall meet the requirements set out in Articles 22 and 123 of Directive 2006/48/EC.*<sup>7</sup>

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(7) The requirements set out in Annex V to Article 22 of Directive 2006/48/EC for governance, internal control and risk management are implemented in detail by the Financial Supervision Authority's standards on internal governance, internal control and risk management. The themes by risk area of Annex V have been handled in detail in the FIN-FSA's valid standards 4.4a Management of Credit Risk and 4.4b Management of Operational Risk. The FIN-FSA supplements the field of section 4 with new standards and revises the contents of the existing standards as necessary.

## **6.2 Capital adequacy assessment as the supervised entity's process**

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(8) The supervised entity itself is responsible for organising capital adequacy assessment so that the risk profile according to the supervised entity's business and the risks of the operating environment are considered in the internal capital targets and strategy of maintaining the capital level.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(9) The internal capital adequacy assessment process must suit the conditions and requirements of the supervised entity and be based on the entity's own information and internally applied definitions.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(10) The supervised entity may outsource parts of its internal capital adequacy assessment process. Then the regulations and recommendations given by the Financial Supervision Authority for outsourcing in standards 4.1 Internal Control and Risk Management, 4.4b Management of Operational Risk and the provisions of any other standard and recommendations relating to outsourcing must be complied with.

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<sup>5</sup> Directive 2006/48/EC, Article 123(1)

<sup>6</sup> Directive 2006/48/EC, Article 123(2)

<sup>7</sup> Directive 2006/49/EC, Article 34

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(11) The supervised entity is always responsible for organising the capital adequacy assessment in the manner required by its risk profile regardless of what kinds of parts are outsourced from the internal capital adequacy assessment process.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(12) The supervised entity must be able to describe and report on how its internal capital adequacy assessment meets the requirements of capital adequacy regulation and the regulations and recommendations of the Financial Supervision Authority.

### **6.3 Management's responsibility for organisation of internal capital adequacy assessment**

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(13) The Board of Directors and senior management of the parent undertaking of the supervised entity and consolidated supervised entity are responsible for it that the supervised entity or consolidated supervised entity has continuously enough capital to cover all essential risks arising from business and changes in the external operating environment and that the supervised entity's risk-bearing capacity is adequate.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(14) The Board of Directors and senior management responsibility for the organisation, monitoring and supervision of internal capital adequacy assessment remain also when some part of the capital adequacy process is outsourced to another organisation.

#### Responsibility of the Board of Directors

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(15) The Board of Directors of the supervised entity confirms at least annually the bases, objectives, outlining principles and scale of capital adequacy assessment, as well as the general requirements for measurement and assessment methods, principles guiding the organisation of the internal capital adequacy assessment process and principles of quality assurance in accordance with this standard.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(16) Based on the supervised entity's strategy and business plans, the Board of Directors confirms the supervised entity's risk-taking level and willingness to take risks and accepts the plan for maintaining capital adequacy proportionate to the risk-taking level. The Board of Directors is responsible for integrating internal capital adequacy assessment and proactive capital planning into internal governance and other steering by the management.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(17) The risk-based capital adequacy assessment and proactive capital planning are an integral part of internal governance and the Board of Director's responsibilities belonging to it follow the principles of internal



governance. The principle of proportionality of applying the requirements presupposes that the Board of Directors has a view of its own of the suitability of the choices made to the needs of the own activities and risk profile.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(18) The Board of Directors must adopt a definition for the concept of risk-bearing capacity applied, set a target level for the desired capital adequacy level and confirm the capital level and structure required by the risk profile. The Board of Directors is responsible for proactive capital planning.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(19) Capital planning includes setting qualitative targets for own funds and predictive mapping out of the availability of capital, incl. the available sources of capital and costs.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(20) The capital adequacy strategy and internal capital adequacy assessment process must be described in writing and kept up to date. The supervised entity's Board of Directors must be able to regularly assess the expediency, comprehensiveness and reliability of the capital adequacy assessment.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(21) In accordance with the Board of Director's monitoring and supervision responsibilities, the Board ensures that the senior management implements a capital adequacy assessment according to the adopted principles and practices. The Board of Directors determines the objectives and scope of the reporting related to the internal capital adequacy assessment and ensures that there are adequate resources available for the capital adequacy assessment.

Responsibilities of senior management

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(22) The responsibilities of the senior management include the practical implementation and continuous monitoring and supervision of the internal capital adequacy assessment, as well as reporting to the Board of Directors.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(23) The senior management must clearly define the responsibilities, authorisations, processes and reporting relations connected with capital adequacy assessment. The senior management must ensure that the employees know, to the extent required by their duties, the entire capital adequacy assessment, the related processes and mechanisms, as well as the interfaces with the management's other steering instruments.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(24) Practical implementation includes the organisation of reporting on the results of the internal capital adequacy assessment process and the internal control mechanisms used in the supervised entity for monitoring the functioning and reliability of the process.



**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(25) If such changes take place in the supervised entity's strategy, business planning, operating environment or other factors that have an effect on the underlying scenarios and the methods used in internal capital adequacy assessment, they must be considered as changes as soon as possible.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(26) The senior management must instruct how new risks in business are identified, measured and assessed so that they can be taken into account in the internal capital adequacy assessment process. The senior management must ensure that the description of the internal capital adequacy assessment is updated.

Groups and conglomerates

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(27) The Board of Directors of the parent undertaking of the consolidated supervised entity is responsible for integrating the internal capital adequacy assessment under this standard into the internal governance of the entire consolidated supervised entity.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(28) Corporations belonging to the same consolidation group must have consistent targets, approaches, principles, processes and mechanisms for risk and capital adequacy assessment. The Board of Directors of the parent undertaking of a consolidated supervised entity must ensure that internal capital adequacy assessment covers all the risks to consolidated capital adequacy and that all the supervised entities belonging to the group follow the internal capital adequacy assessment adopted for the group.

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(29) The Financial Supervision Authority recommends that the Board of Directors and senior management of parent undertakings of financial and insurance conglomerates mainly engaged in the financial sector take note in the organisation of the internal capital adequacy assessment of the above-described principles of sharing responsibilities.

## **6.4 Internal capital adequacy assessment as part of the supervised entity's management and decision-making**

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(30) Internal capital adequacy assessment must be part of the supervised entity's management and decision-making on both the strategic and operational level.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(31) The supervised entity's objectives for the relative capital adequacy level and the capital objectives stated in money are determined in the internal capital adequacy assessment process. Capital allocation by risk area and business activity must be based on the results of the internal capital adequacy

assessment process. In the case of a consolidated supervised entity, the process is used to verify that capital is correctly allocated among the various units in terms of the risks.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(32) The internal capital adequacy assessment and the internal capital adequacy assessment process of large supervised entities must be well integrated into the other management and decision-making of the business on the different levels.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(33) Good integration of internal capital adequacy assessment into other management means, for example, that when the Board of Directors and senior management make important or far-reaching business decisions (strategic choices, extension of activities or changes of priorities) or even individual credit decisions, the management can take the effect of the decision on risk-based capital requirement and the supervised entity's capital adequacy into account at the time of the decision-making, and will be able to do so in the future, too. The integration also includes capital allocation eg for the business lines in budgeting as well as utilisation of the capital adequacy assessment analyses in profit follow-up and bonus schemes.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(34) The internal capital adequacy assessment of small supervised entities must be organised so that their Board of Directors and senior management can, on the basis of the assessment, identify and evaluate the essential risks to the activities and decide on the capital required by the nature and scale of the risks or a measure related to the management, monitoring or restriction of risks.

## **6.5 Independent and regular evaluation of the internal capital adequacy assessment**

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(35) To ensure quality, the capital adequacy strategy and internal capital adequacy assessment process must be critically evaluated regularly, at least annually.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(36) The regular critical evaluation aims to ensure that the internal capital adequacy assessment process is adequately comprehensive in relation to the risks and in the right proportion to the nature, scale and complexity of the business. The new weightings of activities, changes in the business plans and operating environment, new risks and changed underlying scenarios are also reflected in changes in internal capital adequacy assessment.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(37) An independent evaluation of internal capital adequacy assessment and its quality assurance processes must be made upon the assignment of the Board of Directors.

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(38) Upon the order of the management, the supervised entity's internal audit or some other expert may evaluate the internal capital adequacy assessment. The evaluator must have a status that is independent of the business activities and the function being evaluated. It must report on its results to the Board of Directors

## 6.6 Risk as the basis for internal capital adequacy assessment

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(39) The assessment of capital adequacy must be proportionate to the risk profile. The supervised entity must set the capital targets so that they correspond to the risk profile and operating environment of its own activities.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(40) The risk profile depends on the nature, scale and complexity of the business. The risks arising from conglomerate structures and, for example, the risks possibly incurred to the supervised entity by insurance activities carried out in the same financial and insurance conglomerate are also covered in internal capital adequacy assessment. Due to the different nature of risk profiles, the sensitivity of the supervised entities' activities to changes in the operating environment varies. Assessment of capital adequacy is founded on the risks. The adequacy of capital should primarily be assessed so that it covers all the essential quantitative risks to the supervised entity's activities.

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(41) Besides the risk profile, an internal capital adequacy assessment must cover other aspects important for the amount and type of capital. These may be objectives of external credit rating, company image objectives and strategic targets. In view of the contacts to the Financial Supervision Authority, the supervised entity should indicate how these other objectives affect internal capital adequacy assessment.

## 6.7 Comprehensiveness of internal capital adequacy assessment

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(42) The internal capital adequacy assessment process is a whole in which the connection between the business strategy and capital strategy becomes specified. Setting capital targets and consideration of capital adequacy are based on the supervised entity's risk-taking level as a whole and also reflect the supervised entity's willingness to assume risks. Converting of risks into capital requirement forms the core of capital adequacy assessment, but it also comprises consideration of the level of risk management and internal control.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(43) Internal capital adequacy assessment must cover all essential risks to the supervised entity's business and external operating environment. The essentiality must be defined based on the own starting points of each supervised entity and the definition must be clearly justifiable. The supervised entity must ensure that both the quantitative (measurable) and qualitative (non-measurable) risks are identified and assessed.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(44) Quantitative risks refer to risks the related unexpected loss of which can be assessed by methods of statistical mathematics or by stress tests. Among qualitative risks are strategic risk, reputation risk, legal risk, risks arising from the regulatory and supervisory environment and risks ensuing deficiencies in governance, internal control or risk management. Many of the risks in financial activities are measurable risks.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(45) In the case of quantitative risks, the supervised entities must develop and take into use adequate measurement methods in terms of effective risk management.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(46) In the case of qualitative risks, the supervised entities must decide on an assessment and a management method that is best suited to each risk.

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(47) In connection with qualitative risks, attention must be paid particularly to the adequacy of risk management and internal control in relation to the scale and complexity of the activities and to the means available to mitigate or curb qualitative risks.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(48) The supervised entity decides itself on the risk division it uses in internal capital adequacy assessment. The Financial Supervision Authority requires, however, that the supervised entity can demonstrate to have examined all essential risks.

Grouping of risks considering the connections to Pillar 1 calculation

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(49) The supervised entity must verify that the assessment of the essential risks covers at least:

- the risks belonging to the Pillar 1 minimum capital requirement calculation
- risks that are only partly considered in Pillar 1 calculation. These risks are, for example, the uncertainty factors of the Pillar 1 calculation methods, concentration of credit risk, residual risk of the techniques applied to mitigate credit risk and the specific risks related to the securitisation positions
- the risks fully remaining outside Pillar 1, such as the interest rate risk in the banking book, property risk, liquidity risk, reputation risk and

strategic risk

- risks related to the external operating environment. The evaluation of the effects of changes in the operating environment must cover, besides the macro and micro economic operating environment, the risks arising from changes in the regulatory and supervisory environment.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(50) The supervised entity defines the concepts it uses in risk measurement and assessment and explains in detail the contents of the concepts and methods applied. The possible differences in risk handling between the capital adequacy assessment process and Pillar 1 minimum capital adequacy must be demonstrated, when required.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(51) The above-mentioned differences may occur when, for instance, the supervised entity's own definition of operational risk deviates from the one used by capital adequacy regulation, when the supervised entity applies the so-called portfolio models of credit risk or when the supervised entity defines and assesses its interest rate risk as interest rate risk to its entire operations.

### 6.7.1 Risks partly considered in Pillar 1 calculation

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(52) Pillar 1 calculation does not consider all the dimensions of credit, market and operational risks. Therefore the supervised entity must pay attention in its internal capital adequacy assessment to the sufficiency of the Pillar 1 minimum capital adequacy requirement.

#### *Methods of mitigating credit risk<sup>8</sup>*

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(53) The minimum capital adequacy requirement of credit risk can be reduced by certain recognised credit risk mitigation techniques.<sup>9</sup> Application of these techniques may, however, lead to residual risk as legality, documentation or liquidity risk, for example. The residual risk reduces the benefit achieved by the techniques and may lead to a situation in which credit risk is realised higher than expected.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(54) The supervised entity must pay attention in its internal capital adequacy assessment to the residual risk of the techniques applied to mitigate credit risk and to it that the possible residual risk is considered in the assessment of capital adequacy.

<sup>8</sup> Directive 2006/48/EC, Annex V, point 4

<sup>9</sup> Further details in the Financial Supervision Authority's standards 4.3e and 4.3f

### *Securitisation<sup>10</sup>*

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(55) The calculation of the minimum capital adequacy of the securitisation position is based on the transfer of considerable credit risk to third parties.<sup>11</sup>

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(56) The supervised entity must ensure that the financial significance, nature and the related risks of securitisation are correctly considered in the capital requirement assessment. Attention must be paid in the assessment to whether the Pillar 1 capital adequacy requirement takes the risk related to the securitisation position adequately into account.

### *Stress tests related to the use of the internal credit ratings of credit risk*

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(57) One of the conditions of applying the Internal Ratings Based Approach of credit risk is that the supervised entity has high-quality methods, stress tests, with which it assesses the detrimental effects of the changes in the operating environment on the type of its exposures, adequacy of capital and, in more general, its risk-bearing capacity (general stress test). In addition, specific, limited stress tests are required to assess the effects of certain economic conditions (slight downturn) on the credit risk position and the IRBA capital requirement for credit risk. Applying stress tests is not supposed to lead to double reservation, when considering the prudence of the supervised entity in observing an economic downturn in LGD estimation. The Financial Supervision Authority's standard 4.3d Capital requirements for credit risk under the Internal Ratings Based Approach also deals with stress tests.<sup>12</sup>

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(58) The supervised entities applying the Internal Ratings Based Approach for credit risk must at least once a year assess their capacity to tolerate the effects of disadvantageous change scenarios of cyclical trends on their credit portfolio and risk-bearing capacity. The results of the stress tests must be considered in internal capital adequacy assessment to cover credit risk in dimensioning of the capital required and in predictive capital planning.

### *Concentrations of credit risk<sup>13</sup>*

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(59) Risks arising from credit risk concentrations may cause significant losses when they materialise. Concentrations may lead to risk in both the banking book and the trading book, if the direct or indirect, on- or off-balance sheet exposure related to one counterparty, group of counterparties or sector is so large that the related possible loss may compromise the supervised entity's capital adequacy or undisturbed continuance of the activities.

<sup>10</sup> Directive 2006/48/EC, Annex V, point 6

<sup>11</sup> Further details in the Financial Supervision Authority's standard 4.3h

<sup>12</sup> Further details also in CEBS guidelines "Technical aspects of stress testing under the Supervisory Review Process" of 14 December 2006

<sup>13</sup> Directive 2006/48/EC, Annex V, points 3 and 5



**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(60) Pillar 1 calculation does not include the risk arising from credit risk concentrations. Concentrations of credit risk occur, when a common factor affects the creditworthiness of individual counterparties or there is interdependence between the affecting factors. Concentrations of credit risk may arise at least from individual counterparties or groups, sectors and geographical areas.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(61) The supervised entity must in its internal capital adequacy assessment recognise and assess the risks arising from credit risk concentrations and their implication on capital adequacy maintenance. The supervised entity must assess the adequacy of capital and means of risk management (appropriate indicators, limits, active credit portfolio management, techniques mitigating risks) in relation to the credit risk concentrations concerning its activities.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(62) The supervised entity must apply stress tests in assessment and management of concentration risks.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(63) The purpose of the stress tests for credit risk concentrations is to assess, for example, how the interdependences between the interlinked exposures change and increase during disadvantageous changes in cyclical trends and to analyse the possible new interlinkages between the exposures. Stress tests can be made against limits set for concentrations, for example, in order to test the safeguards of the limits in various situations. As a result of the stress tests, the supervised entity can assess the effect of disadvantageous changes on its profitability and the quality of its credit portfolio and analyse the sufficiency of the limits or the need to dissolve the risk concentrations.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(64) The detailed principles of managing credit risk concentrations are included in the Financial Supervision Authority's standard 4.4a Management of credit risk. In addition, specific stress testing requirements related to the use of a method covering financial collateral in calculation of large exposures to customers are described in the FIN-FSA's standard RA4.1 Reporting of large exposures.<sup>14</sup>

*Simpler alternatives of Pillar 1 calculation*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(65) The supervised entities that apply the simpler methods of Pillar 1 calculation<sup>15</sup> and take the results given by them as the basis for their internal capital adequacy assessment, must critically evaluate whether the risk profile of the supervised entity's own activities significantly deviates from the basic assumptions included in the Pillar 1 methods and what is the meaning of the

<sup>14</sup> Further details also in CEBS guidelines "Technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the Supervisory Review Process" of 3 October 2006 and Stress testing under the Supervisory Review process" of 14 December 2006

<sup>15</sup> Further details in the Financial Supervision Authority's standards 4.3c and 4.3i

deviations for adequacy of capital.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(66) For instance, the underlying assumptions of a well-diversified credit portfolio of a large credit institution engaged in international operations are behind the calibration of the Basel II Pillar 1 calculation methods. Thus the supervised entity must in its internal capital adequacy assessment genuinely evaluate the quality, characteristics and possible deviations from the underlying assumptions of Pillar 1 calculation of its own credit portfolio.

*Management of market risk<sup>16</sup>*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(67) Regardless of the calculation option applied in calculation of the minimum capital adequacy of market risk, the supervised entities must have appropriate operating policies and mechanisms in place for measuring and managing market risk, which cover all the essential sources and effects of market risk.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(68) As part of the management of market risk, the supervised entities must carry out stress tests for the trading book positions and significant positions containing market risk in the banking book.<sup>17</sup>

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(69) The detailed principles of management of market risk are included in the Financial Supervision Authority's standard 4.4c Management of market risk.

*Management of operational risk<sup>18</sup>*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(70) Regardless of the calculation option applied in calculation of the minimum capital adequacy of operational risk, the supervised entities must have appropriate operating policies and mechanisms in place for assessing and managing operational risk.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(71) The detailed principles of managing operational risk are included in the Financial Supervision Authority's standard 4.4a Management of operational risk.

### 6.7.2 Risks outside Pillar 1

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(72) It is part of the internal capital adequacy assessment that the supervised entity has adequate risk management for risks outside the Pillar 1 calculation as well. This requires that there are adequate methods for risks that are quantifiable but outside Pillar 1 calculation with which the supervised entity

<sup>16</sup> Directive 2006/48/EC, Annex V, point 9a

<sup>17</sup> Further details in CEBS guidelines "Technical aspects of stress testing under the Supervisory Review Process" of 14 December 2006

<sup>18</sup> Directive 2006/48/EC, Annex V, point 8



can assess the amount of the risk-related unexpected loss and utilise the results in the overall assessment of the capital requirement.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(73) The supervised entity must assess in its internal capital adequacy assessment process also the risks essential for its risk profile but outside Pillar 1 calculation. In its internal capital adequacy assessment the supervised entity must analyse the adequacy of both capital and other risk management methods.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(74) The choice of an appropriate risk management method depends on the nature of the risk. In view of good assessment and maintenance of capital adequacy, it is important that the supervised entity sets quantitative limits (risk limits) that are justifiably measured to its own risk-bearing capacity and that can be efficiently monitored and supervised. Under the following points, some risks remaining outside Pillar 1 calculation, which suit at least quantitative reviews, will be handled in terms of dimensioning and maintenance of capital adequacy.

*Interest rate risk in the banking book*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 Mar 2007

(75) In order to assess interest rate risk in the banking book, the supervised entity must be capable of measuring the impact of interest rate changes on both the economic value of items sensible to interest rate movements and accruing net income from financial operations (income risk).

**Binding**

Issued on 1 Dec 12 2006  
Valid from 1 March 2007

(76) Interest rate risks must be calculated and monitored in all levels subject to ICAAP assessment, which are determined in this standard under section 1 Application.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(77) The supervised entity must monitor interest rate risk in the banking book with methods and instruments that are appropriate and adequate in terms of the scale of its activities and the significance of the risk.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(78) Supervised entities must have a well reasoned, robust and documented policy<sup>19</sup> as regards definitions, methods and assumptions relating to the interest rate risk in the balance sheet, which are significant for the interest rate risk relating to the supervised entity's activities.

**Application Guideline**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(79) The detailed principles of management of interest rate risk supplementing these instructions are included in the Financial Supervision Authority's standard 4.4c Management of market risk Regular reporting of interest rate risk in the banking book are regulated separately in connection

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<sup>19</sup> More precise definition of the required contents in CEBS document "Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process" of 3 October 2006, point "IRRBB 4"

with the FIN-FSA's standard RA4.5.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(80) Income risk in the banking book refers to adverse changes arising from a possible fall or rise in interest rate to the supervised entity's net income from financial operations.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(81) The supervised entity must monitor the size of the loss arising from the realisation of the income risk in the banking book in relation to profitability and the amount of own funds. The supervised entity must be able to demonstrate how a possible loss is taken into account in the dimensioning of risk-based capital requirement.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(82) The economic value of the banking book refers to the impact of an interest rate change on the economic value of items sensitive to interest rate movements.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(83) The supervised entity must be able to calculate and report change in economic value based on present value method and an interest rate shift determined by the Financial Supervision Authority.

**Application Guideline**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(84) The supervised entity can use internal measurement systems for calculating economic value, which should adequately and accurately measure economic value relative to the nature and scope of the activities. The supervised entity can also use the standardised methodology in the calculation of economic value.<sup>20</sup>

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(85) If the negative change in economic value is more than 20% of the supervised entity's own funds the supervised entity must immediately report to the supervisor on the type and schedule of the remedying measures.

**Application Guideline**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(86) The Financial Supervision Authority determines the interest rate shift used in the calculation on a currency-by-currency basis. Unless otherwise determined by the FIN-FSA, the interest rate change is a 200 basis point parallel shift.

*Concentration of activities<sup>21</sup>*

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(87) Concentration risk may occur in many risk areas. Concentration risk also arises from activities other than conventional lending. Concentration risk may arise from scarcity of business counterparties, focus of activities on an individual product, currency, product family or service or from the fact that

<sup>20</sup> More precise definition and description of standardised methodology in CEBS document "Technical aspects of the management of interest rate risk arising from non-trading activities under the supervisory review process" of 3 October 2006, Appendix II, p. 18

<sup>21</sup> Directive 2006/48/EC, Annex V, point 5

the transactions made to mitigate risks concentrate on only few counterparties.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(88) The supervised entity must have adequate principles and procedures to manage all the essential concentration risks. These principles and agreed procedures must be followed in practice. In its internal capital adequacy assessment and review of risk-based capital adequacy, the supervised entity must consider the essential concentration risks in the various risks areas.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(89) The supervised entity must be able to identify and monitor essential risk concentrations and their development. The supervised entity must put in place limit arrangements that are adequate in view of its activities in order to manage the concentration risk. The supervised entity must apply stress tests in assessment and management of concentration risks.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(90) Based on stress tests, the supervised entity can demonstrate the kinds of circumstances in which concentration risks affect the risk-bearing capacity and take appropriate measures mitigating risks or strengthening capital adequacy.<sup>22</sup>

*Diversification of activities*

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(91) The assumption in calculation of the minimum capital for capital adequacy is that the supervised entity's activities are extensive, diversified and international and that the risks are well diversified. From this follows that the minimum capital adequacy requirement under Pillar 1 for credit, market and operational risks must be regarded as representative only for a well diversified activity.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(92) The assessment and consideration of the diversification effects related to risks of business operations in the overall dimensioning of the supervised entity's capital level arise especially when advanced methods of economic capital are applied. The diversification of risks is assessed with indicators and methods of statistical mathematics. It is suggested that diversification benefits are created within risks, for example, in credit and market risk, between various risks and between business transactions, geographical areas and/or various units.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(93) In Basel II regulation good diversification into the risk areas of Pillar 1 calculation is included in the calculation rules. Instead, the regulation does not determine the assumptions of the diversification of risks for the risks that are

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<sup>22</sup> Further details eg in CEBS guidelines "Technical aspects of the management of concentration risk under the Supervisory Review Process" of 14 December 2006 and "Technical aspects of stress testing under the supervisory review process" of 14 December 2006

partially or wholly outside Pillar 1 calculation.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(94) The assessment of the diversification effects based on long-term empirical material is still deficient. Good market practice in calculation and verification of diversification effects is not yet established. It is especially challenging to assess and verify in a reliable manner the stability of the interrelations and their behaviour in exceptional circumstances in the operating environment, in crisis situations in the financial sector, for example.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(95) To ensure risk-bearing capacity, the supervised entities cannot in their capital adequacy assessment so far consider the diversification benefits for the risks falling within the scope of Pillar 1 calculation (credit, market and operational risk).

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(96) In other respects the supervised entity is to demonstrate that the diversification benefits considered in internal capital adequacy assessment between the various risks are plausibly justified. The benefits must be based on the analysis of the supervised entity's own activities. The reviews must also cover the crisis situations of the operating environment, so that the permanence of the interrelations can be justified reliably.

*Liquidity risks: liquidity risk and structural financial risk<sup>23</sup>*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(97) The supervised entity must have adequate principles and procedures for managing short-term liquidity risk and structural financial risk in a sufficiently predictive manner.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(98) The supervised entity must ensure the availability of financing, including maintenance of adequate liquid funds and the existence of alternative financing arrangements that can be taken into use when necessary. To curb liquidity risk, the supervised entity must have adequate stress tests and a contingency plan in case of a liquidity crisis.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(99) Liquidity risk refers to the uncertainty arising from the imbalance of short-term incoming and outgoing cash flows. The supervised entity must be able to continuously monitor its net financial situation and its development with risk management systems. Structural financial risk refers to the uncertainty related to financing of long-term lending. It can be assessed with the proportion of deposits and lending and through the market-based costs arising from covering their difference.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(100) The stress tests for liquidity risks include in general alternative scenarios on the disadvantageous changes in total liquidity on the market

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<sup>23</sup> Directive 2006/48/EC, Annex V, point 9

essential for the supervised entity (external factors) and the disadvantageous changes related to the supervised entity's own net financial situation (internal factors). Attention is paid specifically to the justifiability of the assumptions underlying the scenarios.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(101) The detailed principles of management of liquidity risks are included in the Financial Supervision Authority's standard 4.4d Management of liquidity risk.<sup>24</sup>

*Other risks*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(102) If essential property risk, for example, is connected with the supervised entity's activities, also this risk must be considered in internal capital adequacy assessment and in the review of the adequacy of risk-based capital.

**6.7.3 Risks of the external operating environment<sup>25</sup>**

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(103) The supervised entity must have adequate methods for assessing the effects of changes in the macro economic operating environment. The assessment systems must allow determination of profitability effects and the loss possibly arising from changes. These effects must be taken into account in setting capital targets and measuring risk-based capital. The supervised entity must apply stress tests to assessing the risks in the operating environment.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(104) The impacts of exceptional, but possible, changes in the operating environment on the supervised entity's risk profile, profitability and capital adequacy can be assessed by stress tests that include sensitivity analyses and scenario tests. The purpose of stress tests is to help understand the characteristics and uncertainties of the supervised entity's own activities in exceptional change situations. The time span and methodological requirements of the reviews are proportionate to the business plans and business requirements.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(105) Risks related to the macro economic operating environment include the effect of the economic cyclical stage on the quality of the credit portfolio, changes in interest and currency rates, as well as changes in equity and property prices. Among risks related to the micro economic operating environment are structural changes within the sector, the changing competition situation and measures by competitors that require adjusting the supervised entity's own strategy to ensure profitable business. The risks of the supervisory and regulatory environment arise from changes in legislation and supervision. In the regulatory environment such changes are, besides the

<sup>24</sup> Further details eg in CEBS guidelines "Technical aspects of stress testing under the Supervisory Review Process" of 14 December 2006

<sup>25</sup> Directive 2006/48/EC, Annex V, point 2

capital adequacy reform, amendments to the financial reporting regulation (IFRS), other international regulation and amendments to EU legislation.

#### 6.7.4 Summary of the use of stress tests in internal capital adequacy assessment<sup>26</sup>

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(106) Stress tests constitute a predictive instrument for internal capital adequacy assessment when evaluating factors influencing profitability and adequacy of capital. Stress tests are performed for all risks essential for the supervised entity's risk profile, taking into account the quality and significance of the risk. These methods supplement the statistical models, such as the Value-at-Risk models, in determination of the risk-based capital requirement.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(107) Based on its risk profile and the essential risks to its activities, the supervised entity must define the factors for which stress testing must be performed. The stress tests must be based on exceptional but possible situations. Stress tests are performed at least once a year.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(108) The tests can be based on historical scenarios, but, depending on the situation, the use of hypothetical scenarios should also be considered. The historical scenarios do not necessarily reflect situations that are exceptional but possible. Stress tests should be carried out by varying the criticality and probability of the scenarios.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(109) In consolidation groups, stress tests are performed in internal capital adequacy assessment mainly based on the consolidated financial situation. The parent undertaking of a consolidation group must ensure that the stress tests performed cover deeply enough the characteristics of the market and business lines and the differences of their development stages in various countries. This may require several tailor-made stress tests in a consolidation group.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(110) The table below shows a combination of analysis and testing requirements related to risk management and possible references to the Financial Supervision Authority's other standards that include more detailed requirements for the risk area concerned.

Risk area	Analysis	References
Internal ratings based approach for credit risk	The supervised entity must have high-quality methods (stress tests) with which it assesses the possibly detrimental effects that changes in the	Points (57) - (58) of this standard 4.3d Capital requirements for

<sup>26</sup> Further details in CEBS guidelines "Technical aspects of stress testing under the supervisory review process" of 14 December 2006



	operating environment may have on the quality of the liabilities granted by it. The supervised entity must assess the adequacy of its capital and other capacity to manage in these situations. The supervised entity must regularly assess the impact of certain economic circumstances on its credit risk position and capital requirement for credit risk. The test circumstances must be reasonably severe so that they reflect the effects of at least a slight economic downturn. The supervised entity must in this connection assess how the credit ratings of the exposures would change. The majority of the supervised entity's credit portfolio must fall within the scope of the above-mentioned analyses.	credit risk under the Internal Ratings Based Approach
Concentration of credit risk	The supervised entity must make different kinds of estimates on how rare but problematic situations could affect the amount of credit risk. Among such situations are major fluctuations of market prices, bankruptcies of large market actors, unexpected changes in liquidity, realisation of considerable country risks and similar situations.	Points (62) - (63) of this standard 4.4a Management of credit risk
Large exposures	The supervised entities that apply a comprehensive method in calculation of large exposures to customers when considering financial collateral or that have been permitted to use their own LGD estimates and counter-value factors must identify the situations that could have an adverse effect on the realisation value of the financial collateral.	Point (64) of this standard RA4.1 Reporting of large exposures
Internal models of credit risk mitigating techniques	The supervised entity must carry out stress tests regularly. The management must go through the results of these tests and they should be reflected in the policies adopted and limits set.	4.3f Credit risk mitigating techniques under the Internal Ratings Based Approach
Internal model	The supervised entity must have	4.3k Capital

method for counterparty risk	appropriate stress test methods in place for internal capital adequacy assessment. The supervised entity must compare these stress indicators with the EPE indicator <sup>27</sup> and integrate them into the internal capital adequacy assessment process.	adequacy requirement for counterparty risk, chapter 12.5.3
Market risks	The supervised entity must carry out stress tests for the trading book positions and significant positions containing market risk in the banking book.	Point (68) of this standard [4.4c Management of market risk]
Internal models for market risk	The supervised entity carries out comprehensive stress tests often enough and the management goes through the results of the tests. The results of the stress tests must be reflected in the policies adopted and limits set.	4.3g Capital adequacy requirement for market risk, chapter 12.1
Concentration of activities	The supervised entity must assess the concentration risk of its activities with adequate stress tests.	Points (89) - (90) of this standard
Liquidity risk	The supervised entity must have adequate stress tests in place in order to manage the liquidity risk.	Points (98) and (100) of this standard 4.4d Management of liquidity risk
Risks of the external operating environment	The risks of the operating environment must be considered when examining the adequacy of capital with means that are sufficient in view of the supervised entity's activities eg by stress tests.	Points (103) - (104) of this standard

## **6.8 Forward-looking capital adequacy assessment**

### **Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(111) Capital adequacy assessment is based on a predictive approach. In its internal capital adequacy assessment, the supervised entity must take note of the business strategy and the plans based on it, as well as the impacts of the various factors of the operating environment on these plans.

<sup>27</sup> EPE = expected positive exposure



**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(112) The supervised entity must have a strategy for maintaining the capital level in line with the targets set. The supervised entity must have a capital plan containing capital level targets and a time span for achieving them, which is approved by the Board of Directors.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(113) Besides risks, factors affecting internal capital adequacy assessment may be lending growth targets, fund-raising sources, use of funds and changes in these, dividend policy and variation of the capital requirement under Pillar 1 following cyclical trends.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(114) The capital plan indicates how the supervised entity aims in the future to ensure capital adequacy considering the limitations related to capital acquisition. The capital plan also deals with the possible measures that are available to the use of the supervised entity in case of unexpected situations affecting capital adequacy.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(115) Such measures may be acquisition of additional capital, restriction of business or application of techniques mitigating risks.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(116) The process and responsibilities connected to capital planning must be described as part of the description of the internal capital adequacy assessment process.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(117) The Financial Supervision Authority recommends that the capital plan be updated at least once a year and always in connection with updating of the strategy or business plans and that it would cover, besides the current year, at least two following years.

## **6.9 Bases for assessing risk-based capital requirement**

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(118) The supervised entity's internal capital adequacy assessment must be based on adequate risk measurement and evaluation methods. All supervised entities must have a documented process in place for measuring and assessing the risk-based capital requirement. The results of the internal capital adequacy assessment process must be reflected in the supervised entity's business strategy and willingness to take risks.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(119) The documentation of the measurement and assessment methods applied to the supervised entity's risks must include descriptions of the process with its stages and exposures, the definitions and assumptions, the measurement methods used and their descriptions, the information systems applied and their description and a description of quality assurance.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(120) The methods applied in measuring and assessing risk-based capital requirement must have quality assurance. The quality assurance covers the correctness of the initial data and assumptions as well as the correctness of the end results obtained with the measurement methods applied. The management's responsibility for organisation of the internal capital adequacy assessment in accordance with chapter 6.3 also comprises the quality assurance of the results of the process.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(121) The principle of proportionality and the advancement of the practices in the sector are reflected in the internal capital adequacy assessment and its planning. The supervised entities can build their internal capital adequacy assessment process in many different ways. There is no single correct way of measuring and assessing risks.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(122) In internal capital adequacy assessment, the following approaches, for example, can be applied in measurement and assessment of risks:

- the supervised entity may take the results of the Pillar 1 calculation methods as the bases for the capital requirement for credit, market and operational risk and complement the examination to cover its entire risk profile, taking all the essential risks into account.
- the supervised entity may apply measurement methods that deviate from the Pillar 1 calculation methods when determining the risk-based capital requirement for the various risk types. The capital requirement required by the overall risk profile may be calculated as the sum of all the results produced by the various methods.
- when measuring risk-based capital requirement, the supervised entity may apply quantitative models that are more sophisticated than the approaches described above, for example, the economic capital model.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(123) The Financial Supervision Authority requires the supervised entity to proportionate the methods applied in risk measurement and assessment to the requirements and characteristics of its own activities. All supervised entities must take note of the comprehensiveness of internal capital adequacy assessment and the matters mentioned in point 6.7 on the essential risks, their measurement and assessment.

## **6.10 Risk-based capital requirement assessment of small supervised entities**

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(124) Small supervised entities may take the results of the Pillar 1 calculation methods as the basis for measuring and assessing risk-based capital requirement in their internal capital adequacy assessment. Small supervised

entities may measure and assess the risk-based capital requirement also by other means.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(125) When the supervised entity chooses the results of the Pillar 1 calculation as its bases, it assesses the capital requirement required by the credit, market and operational risk based on the results given by the Pillar 1 calculation methods and deepens the examination by also considering such dimensions of these risks that remain outside Pillar 1 calculation (Pillar 2 elements). The supervised entity supplements its estimate to deal with the risks in ICAAP that Pillar 1 does not cover at all.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(126) The supervised entity applying the standardised approach for credit risk assesses how its own credit portfolio differs from the underlying assumptions of Basel II calculation and eg whether the minimum capital adequacy requirement under Pillar 1 is enough to cover the credit risk related to receivables with weak creditworthiness or depending on weak collateral.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(127) The supervised entity can base the assessment of the income risk in the banking book on the maturity imbalance figures to be reported to the Financial Supervision Authority or on its own assumptions on the maturity imbalances (static approach) or on the systems of its own balance sheet management (dynamic approach).

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(128) The review based on the economic value method must at least take into account a change in interest rate equalling to the shift in interest rate determined by the Financial Supervision Authority.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(129) The supervised entity can assess the risk related to its investment property on the basis of the size of the property holding, quality of the property portfolio, property strategy and the current value of the portfolio. The location of the property, the level of net income from the property, the utilisation rate and the proportion of property with low returns in the portfolio affect the quality of the property portfolio.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(130) The supervised entity can assess its structural financial risk by examining the difference between the credit stock and deposits. The risk related to liquidity can be assessed based on the difference in short-term cash flows.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(131) The supervised entity can draw up a relatively simple stress test scenario for the development of macro economy in order to assess the amount of losses deriving from disadvantageous changes in cyclical trends.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(132) The result of assessment of the supervised entity's risk profile may be that the risks remaining outside the minimum capital requirement do not

concern the supervised entity at all or are negligible, or that the supervised entity takes them adequately into account by holding a simply dimensioned capital buffer on top of the Pillar 1 minimum capital adequacy requirement.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(133) In the above approach the Financial Supervision Authority requires that the supervised entity presents how it has analysed the risks outside Pillar 1. A further requirement is that the supervised entity is able to demonstrate to have mapped out its risk-based capital requirements to an adequately predictive extent.

### **6.11 Risk-based capital requirement assessment of large supervised entities**

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(134) The Financial Supervision Authority expects large supervised entities to adopt the approaches and mechanisms complying with the international best practices for their risk-based capital management. This means that in the internal capital adequacy assessment process risks are measured based on the economic capital model or some other quantitative model.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(135) According to the view of the Financial Supervision Authority, the utilisation of economic capital models may be connected with many benefits. The models allow commensurate review of risks and their combination and possibly also taking the correlations between the risks into account. Besides risk-based dimensioning of the capital requirement, the results of the economic capital models can also be utilised in allocation of capital, fixing of risk limits, pricing of risks and setting of the return requirement for capital.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(136) The supervised entities using models based on the concept of economic capital or other quantitative models must consider the comprehensiveness of internal capital adequacy assessment and the matters presented under point 6.7. The supervised entity must be capable of demonstrating the differences in the handling of credit, market and operational risk between Pillar 1 calculation and its own internal capital adequacy assessment process.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(137) The assessment and management of income risk relating to interest rate risk in the banking book of large supervised entities must be based on the dynamic approach (forecasts on changes in balance sheet items and interest rates).

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(138) The review based on the present value method must take into account at least a change in the interest rate level equalling the shift in interest rates determined by the Financial Supervision Authority.

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(139) In addition to standard shock, the supervised entity must be capable of calculating its interest rate positions and their sensitivity to:

- changes in the slope and shape of the yield curve
- risks arising from relations between different market interest rates (basis risk)
- changes in assumptions used, for example changes in customer behaviour.

*Interest rate risk of the banking book*

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(140) The supervised entity can define and measure its interest rate risk as an interest rate risk for its all activities. The assessment and management of the interest rate risk of a large supervised entity's balance sheet must be based on the dynamic approach (forecasts on changes in balance sheet items and interest rates). The sensitivity analyses of interest rate risk cover at least the following matters: sensitivity to changes in the interest rate level, sensitivity to changes in the yield curve, basis risk (changes in the interest rate differences of various markets) and effects of customer behaviour.

*Risks of the external operating environment*

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(141) Risks related to the operating environment must also be taken into account when measuring and assessing the risk-based capital requirement. These risks can be considered either in the model used or stress tests carried out separately. The stress tests must cover the changes in the macro-economic balance factors.

**6.11.1 Use of quantitative models**

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(142) The approaches utilising a quantitative model should meet at least the following general requirements:

- the model's purpose of use and scope of application in internal capital adequacy assessment and capital planning must be defined. Furthermore, it must be defined how and on what grounds economic capital is distributed for various risks, business lines, units, etc. In addition, the supervised entity must define how the model is used for operational management of activities, pricing of products, setting of risk limits, evaluation of profitability and possibly for bonus schemes.
- the contents of the central concepts of the model must be clearly defined. The definitions must reliably indicate the risk division criteria, criteria of essentiality and the content-related dimensions of various risks. Furthermore, the criteria of choosing the reliability level and review period must be indicated.

- the various methods of measuring risks must be justifiable in relation to the best practice prevailing in the financial sector. They must meet the high reliability criteria of modelling of statistical mathematics. The supervised entity must carefully analyse the assumptions related to the risk indicators, input information needs and the analytical strengths, weaknesses or interpretative problems of the indicators utilised.
- an extensive survey of the solutions used for combining risks and analytical methods must be available. Considering the possible diversification benefits between risks in calculation of the need for economic capital must be justified convincingly.

**Recommendation**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(143) In the internal evaluation of the models applied by the supervised entity, at least the following aspects should be considered:

- functioning of the calculation and its reliability as a process,
- correctness and limitations of the approaches and central assumptions applied,
- appropriateness and reliability of the analytical methods and indicators,
- combining the calculation process with the management's other steering systems and continuous operational steering at the various levels of the organisation.

## **6.12 Justifiability of results**

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(144) The internal capital adequacy assessment process gives the following result: an estimate on the amount of capital required to cover the supervised entity's overall risk profile, a critical charting of qualitative risks and a survey of the sufficiency of the existing risk-bearing capacity. Internal capital adequacy assessment according to point 6.6 must also cover other aspects important for the amount and quality of capital.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(145) The supervised entity must be able to justify how the capital requirement is determined in relation to the overall risk profile and other aspects important for internal capital adequacy assessment. The supervised entity must be capable of specifying the similarities and differences of the results produced by its process in relation to the minimum capital adequacy requirement (Pillar 1). When necessary, how the concepts used by the supervised entity differ from those applied by the Financial Supervision Authority must be explained.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(146) The supervised entity must disclose at least the information required by the disclosure of capital adequacy information to the market (Pillar 3). The information to be disclosed must include, among others, the strategies and processes applied in risk management and a summary of the assessment of capital adequacy based on current business and business plans.

**Recommendation**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(147) It is recommendable that the supervised entities also disclose the results of their internal capital adequacy assessment process so that they indicate the capital requirement and capital adequacy level required by their risk profile, their own definitions of the own fund items to be included in the risk-bearing capacity and the quantitative and qualitative targets set for capital adequacy in the internal capital adequacy assessment process. Assessment of the supervised entity's real capital adequacy requires good market information on the internal capital adequacy assessment process and its results. This enables the comparability between the supervised entities. The supervised entity ought to compare the results of its internal capital adequacy assessment process with the corresponding results available to its own peer group and thus ensure the rationality of the results. The analysis of the results in relation to the peer group should be made at least for the internal use of the supervised entity.



# 7

## SPECIAL FEATURES OF ICAAP FOR INVESTMENT FIRMS

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(1) Investment firms are, as a general rule, regarded as small supervised entities as referred to in this standard. Particularly all licence holders whose capital requirement for establishment of operations is EUR 125,000 are small supervised entities for the purpose of this standard. The real scale and complexity of operations and the supervised entity's belonging to a group or a consolidation group may, however, restrict the applicability of the guidelines applied to investment firms.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(2) The regulations and guidelines on organising internal capital adequacy assessment under chapter 6 of this standard concern investment firms. A written description of the internal capital adequacy assessment process, approved by the Board of Directors and fulfilling the minimum requirements set in chapter 6, is required of all investment firms:

- the Board of Directors sets an internal capital target proportionate to the risks of the business and operating environment
- internal capital adequacy assessment must be organised so that the senior management and the Board of Directors can use it as the basis for continuously assessing significant risks arising from the operations
- risks are the basis for an internal capital adequacy assessment, which must cover all essential risks and the targets set in terms of the amount and quality of capital
- internal capital adequacy assessment must be based on prediction considering strategic business plans and effects of operating environment factors
- the results produced by the Pillar 1 calculation methods can be taken as the basis for measuring and evaluating the risks of the internal capital adequacy assessment process.

**Justification**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(3) Investment firms assess the risks mentioned in point 6.7 as applicable. There are additional instructions below to supervised entities providing small-



scale investment services in order to assess risks characteristic of investment service activities.

**Binding**  
Issued on 1 Dec 2006  
Valid from 1 March 2007

(4) All investment firms must assess the concentration risk occurring in their activities. The concentration risk may arise from, not only the customer risks and risk concentrations in accordance with standard RA4.1, but also from circumstances resulting from, for example, a low number of counterparties or customers, the size of an individual transaction or dependence of activities on one single product or service. For instance, in corporate arrangements the supervised entity should consider a situation in which the commission agreed on is not paid, because the counterparty contests the agreement, which leads to unexpected losses. A supervised entity providing asset management, for example, must take into account a situation in which the already originally low amount of customers' assets or assets managed suddenly decreases.

**Binding**  
Issued on 1 Dec 2006  
Valid from 1 March 2007

(5) All investment firms must assess the effect of external factors on the adequacy of their own capital. This means, for example, that the supervised entity must draw up plans for its own strategy and business in case the market situation weakens or assess the adequacy of capital in a situation where activities are extended either regionally, to new markets or by a new product.

**Binding**  
Issued on 1 Dec 2006  
Valid from 1 March 2007

(6) Investment firms providing receipt, brokerage or implementation of orders related to a financial instrument must especially assess the legal risks that may arise from a situation in which the procedures laid down for the protection of the customer have been breached, or realisation of reputation risk on the same grounds.

**Binding**  
Issued on 1 Dec 2006  
Valid from 1 March 2007

(7) Investment firms engaged in trading for their own account must particularly assess their own direct market risk and liquidity risk and the market risk that ensues from implementation of a customer's order, if the order is not cleared and delivered.

**Binding**  
Issued on 1 Dec 2006  
Valid from 1 March 2007

(8) Investment firms providing asset management must assess, in the same manner as dealers, the legal risks that may arise from a situation in which the procedures laid down for the protection of the customer have been breached, or effectuation of reputation risk on the same basis.

# 8

## TRANSITIONAL PROVISIONS

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(1) If a credit institution exercises its right by virtue of section 178 of the Act on Credit Institutions (121/2007) to calculate in 2007 the minimum amount of own funds referred to in paragraph 1 of section 55(1) of the said Act complying with the provisions upon the entry into force of the said Act, this standard will not be applied to the external credit assessment institution (ECAI) until as of 1 January 2008.

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(2) A transitional provision corresponding to the one mentioned above is applied to investment firms by virtue of the transitional provision in the Act (135/2007) amending the Investment Firms Act (579/1996).

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(3) A transitional provision corresponding to the one mentioned above is applied to fund management companies by virtue of the transitional provision in the Act (134/2007) amending the Mutual Funds Act (48/1999).

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(4) A transitional provision corresponding to the one mentioned above is applied to a central body of an amalgamation of cooperative banks by virtue of the transitional provision in the Act (124/2007) amending the Act on Cooperative Banks and Other Cooperative Credit Institutions (1504/2001).

**Binding**

Issued on 1 Dec 2006  
Valid from 1 March 2007

(5) This standard will not be applied before 1 January 2011 to an investment firm that by virtue of the licence conditions may provide investment service solely under derivative agreements related to the commodities market.

# 9

## PROVISION OF ICAAP INFORMATION TO FIN-FSA

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(1) Good internal capital adequacy assessment requires that the supervised entity has adequate principles and procedures in writing that are proportionate to the nature and scale of its activities and cover the identification, measurement and reporting of risks concerning capital adequacy, as well as taking and limitation of risks and other risk management and covering of risks with own funds.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(2) A description of the internal capital adequacy assessment process meeting the requirements of this standard and the justifiability of the results of the process are key bases in the annual overall internal capital adequacy assessment carried out by the supervisor and in the so-called ICAAP/SREP dialogue.

**Binding**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(3) When commencing compliance with the requirements of this standard, the supervised entity must provide the Financial Supervision Authority in advance with sufficient information on its internal capital adequacy assessment as a whole and the practical implementation and results of the process. The updated ICAAP material is delivered annually according to a schedule established separately with FIN-FSA and always immediately following the implementation of essential changes.

**Justification**

*Issued on 1 Dec 2006  
Valid from 1 March 2007*

(4) There is no single correct model for the description of ICAAP. The supervised entity is able to utilise other strategic and operational steering processes, descriptions and guidelines regarding its activities, as well as supervisory and decision-making structures. The purpose of the ICAAP material delivered to the supervisor is to give a good picture of how the amount and quality of capital are enough to cover the essential risks to which the supervised entity is exposed, how internal capital targets are set and what kind of predictive capital planning the supervised entity is using. Attention is also paid to the linkage of internal capital adequacy assessment to business

planning and the management's other steering and supervisory systems, as well as the continuous quality assurance of the ICAAP process and regular independent evaluation of the process.

# 10

## DEFINITIONS

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(1) In this standard risk profile refers to risks to which the supervised entity is exposed and which arise from its activities and operating environment.

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(2) Board of Directors refers here to a body that sets the supervised entity's general operational framework and bears ultimate responsibility for the organisation's operations, for its decisions on business plans and objectives and for the functioning of its internal control. The Board of Directors usually refers to the supervised entity's board of directors. If the supervised entity has both a supervisory board and a board of directors, they are here together referred to as the Board of Directors. In which case the supervised entity's internal instructions must contain detailed specifications on which duties of the Board are the responsibility of the supervisory board and which are the responsibility of the board of directors.

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(3) Senior management refers to body that is responsible for the daily operative management of the supervised entity in line with the principles adopted by the Board of Directors and the execution of the decisions made by the Board of Directors. The senior management consists of the managing director and a management group appointed for his or her support. Senior management also includes persons operating directly under the managing director to whom the managing director has delegated his or her power of decision even if they were not members of the management group.

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(4) The concept of economic capital describes in general the amount of capital required to cover the unexpected losses arising from the supervised entity's risks. Economic capital is calculated with methods of statistical mathematics for a certain review period and with a certain probability (confidence level chosen in advance).

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(5) In this standard large supervised entity refers to a supervised entity engaged in wide-scale and complex activities, which is a major actor in the financial sector and operates internationally and/or in many business lines. The supervised entity may use the economic capital model or some other quantitative model for determining its risk-based capital requirement. Typically, the supervised entity uses more sophisticated alternatives in calculation of the Pillar 1 capital adequacy requirement, such as the Internal Ratings Based Approach (IRBA), internal models of market risk, the Advanced Measurement Approach (AMA) of operational risk or the Standardised Approach (SA). When organising the internal capital adequacy assessment process, the supervised entity itself considers its activities to be complex, as described here.

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(6) In this standard small supervised entity refers to a supervised entity whose business is not wide-scale and does not constitute a complex whole. The supervised entity operates in Finland without any major international activity. The supervised entity does not apply in its capital management the economic capital model or some other quantitative model for measuring its risk-based capital requirement. When calculating the Pillar 1 capital adequacy requirement, the supervised entity typically uses simple methods, such as the standardised approach of credit risk or the basic approach of operational risk. A small supervised entity does not necessarily have a Pillar 1 minimum requirement for market risk. When organising the internal capital adequacy assessment process, the supervised entity itself considers its activities to be simple, as described here.

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(7) Residual risk in this standard refers to residual risk related to the use of credit risk mitigating techniques, such as legal risk or liquidity risk.

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(8) Interest rate risk refers to uncertainty arisen from changes in interest rates in the supervised entity's activities. The elements of interest rate risk are: (a) income risk, which arises from maturity imbalances of the on-balance sheet assets and liabilities; (b) investment risk arising from changes in the market values of debt instruments and derivative instruments, and (c) basis risk ensuing from the linkage of lending and financing at different interest rates.

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(9) Liquidity risk refers to the uncertainty arising from the difference of short-term incoming and outgoing cash flows.

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(10) Structural financial risk refers to the uncertainty related to financing of long-term lending.

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(11) Methods of assessing changes in the operating environment:

- Sensitivity analyses examine the effect of changes in individual factors on the financial situation of the organisation subject to the analysis without defining the individual reasons behind the changes.

- Stress tests are techniques applied to risk management and evaluate the changes in individual actions or economic variables affecting the subject's financial situation. The actions or variables examined tend to be exceptional to the norm, but possible.

- Scenario analyses examine the mutual reconciliation of concurrent changes of several risk factors and closely define the reasons for the changes observed.

# 11

## **FURTHER INFORMATION**

Contact information on the person responsible for this standard is available in on the FIN-FSA website, in the list of [Persons in charge](#) of standards. Further information is also provided by:

- Institutional Supervision, tel. +358 10 831 5207



# 12

## **APPENDIX: THE SUPERVISORY REVIEW AND EVALUATION PROCESS (SREP) IN BRIEF**

The purpose of the supervisory review process (SRP) is to ensure that the supervised entity has enough own funds to cover all the essential risks to which its activities are exposed and that the supervised entity has in place risk management systems that are adequate in relation to its operational risks. In the supervisory review process under Pillar 2 the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) function in close interaction. The dialogue between the two processes plays a key role in view of the results of the supervisory review process. The Financial Supervision Authority emphasises, however, that the supervised entity's internal capital adequacy assessment process and the supervisor's supervisory review and evaluation process are two independent processes, separate from each other.

The supervisor's obligations in the supervisory review process and the supervisor's right to require corrective measures are based on Articles 124 and 136 of Directive 2006/48/EC and on its Annex XI and ultimately on the principles under Pillar 2 of the Basel Committee's recommendation. Section 85 of the Act on Credit Institutions (121/2007) contains provisions on the Financial Supervision Authority's obligation to annually check and assess the supervised entity's internal capital adequacy assessment process, strategy for maintaining capital adequacy and the supervised entity's capacity to meet the capital adequacy requirements. Sections 86 to 88 of the said act contain provisions on the supervisory measures available for rectifying economic operating conditions.

In its own supervisory review and evaluation process the Financial Supervision Authority examines and evaluates the supervised entity's capital adequacy assessment as a whole and produces an independent estimate on

the supervised entity's risk profile. In the supervisory review process the supervisor's estimate on the supervised entity's ICAAP process and its results are supplemented by supervisory measures, as needed. The Financial Supervision Authority emphasises that the evaluation concerns the supervised entity's own internal capital adequacy assessment process and its results.

Contacts between the Financial Supervision Authority and the supervised entity in various forms are a key element when evaluating the supervised entity's internal capital adequacy assessment process and its results. Based on the contacts, the Financial Supervision Authority forms a picture of the supervised entity's organisation of its internal capital adequacy assessment as a whole. The review comprises eg the connection of internal capital adequacy assessment with other management, the management's roles and responsibilities in organising ICAAP, as well as predictive capital planning based on business plans. In addition, other central review objects are the risk base of the ICAAP process, comprehensive identification of risks, the assumptions and methods used in risk measurement and assessment as well as the combination of risks. The supervised entity's task is to demonstrate how it measures and assesses its essential risks and adequately distributes capital for quantitative risks to cover them. Possible differences in the internal capital adequacy assessment process between the capital allocated for risks and the requirement for own funds must be explained.

In its estimate, the Financial Supervision Authority must take a stand as to whether the amount and quality of the supervised entity's own funds are enough to cover the risks. The contacts between the Financial Supervision Authority and the supervised entity are based on four entities listed under chapter 6.7:

- risks belonging to the Pillar 1 minimum capital requirement calculation
- risks that are only partly considered in Pillar 1 calculation
- risks remaining outside Pillar 1, and
- risks related to the external operating environment.

In its contacts with the supervised entity, the Financial Supervision Authority deepens and extends the picture of the supervised entity's internal capital adequacy assessment process, the assumptions used in risk measurement and assessment and the results produced by the process. At the same time the Financial Supervision Authority may, by setting questions, test the supervised entity's capital process and thus facilitate the evaluation of the results of the process. Based on the contacts, the supervised entity can make changes to its process in order to respond to the feedback from the Financial Supervision Authority.

The Financial Supervision Authority decides how and to what extent each supervised entity is contacted. In the implementation, the supervised entity's organisational structure and the nature, scale and complexity of its business are taken into account.

The Financial Supervision Authority continues to develop its current risk assessment system which will be used in the supervisory review and evaluation process (SREP) and in supporting the dialogue between the Financial Supervision Authority and the supervised entity in order to implement the evaluation of the internal capital adequacy assessment process.<sup>28</sup>

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<sup>28</sup> See also *FIN-FSA's Risk assessment system as an instrument of risk-based supervision (FSA Newslines 1/2005)*.