Internal Capital Adequacy Assessment Process (ICAAP) For NBFCS

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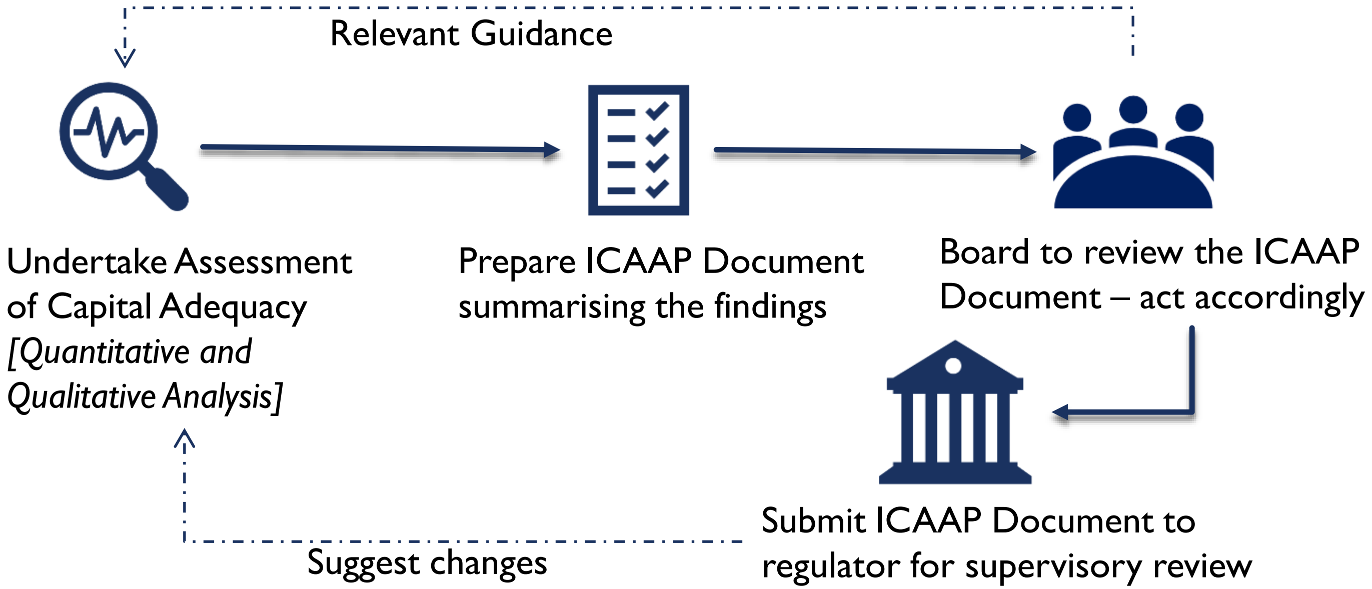
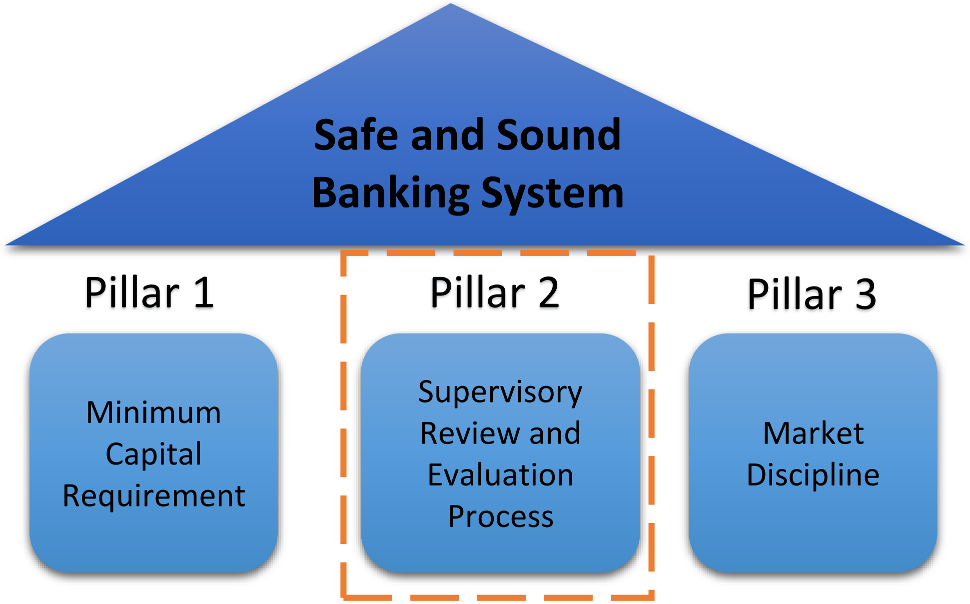
What is ICAAP?

- Basel II, published in 2006, lays out a three-pillar approach to risk and capital management for banks
- FIs have to demonstrate to the regulators that they have implemented methods and procedures to ensure adequate capital resources, with due attention to all material risk. - sufficiency of "*Economic Capital*"
- This process is summarised in the ICAAP document which should be completed by firms on a regular basis.





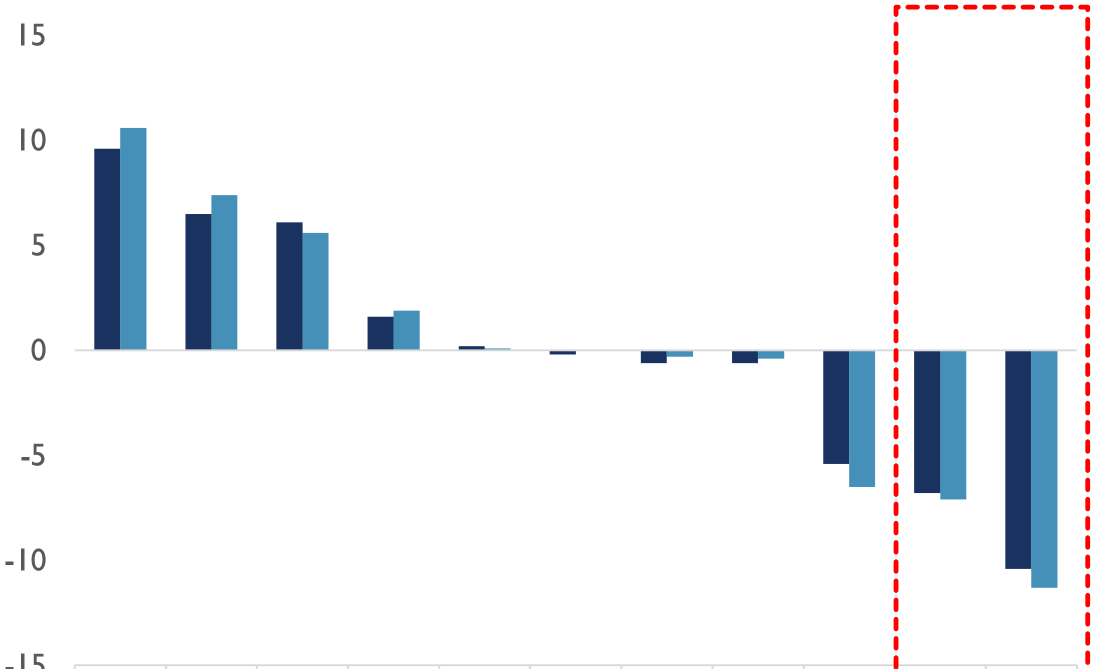
Components of ICAAP

- Capital Adequacy
- Off-balance Sheet Exposures with a focus on Securitisation
- Methodology and Assumptions
- Capital Transferability
- Stress Testing
- Assessment of Reputational Risk and Implicit Support
- Identification of the major risks
- Risk Management System

Why ICAAP for NBFCs – Systemic Importance

- Capital regulations play a pivotal role in risk absorption, however, regulatory capital may not be enough as:
  - NBFCs are growing more and more relevant to the Indian financial sector, they are the largest receiver of funds followed by HFCs.
  - NBFCs have a total asset size of 26,01,000 crores as on Sept 21 and borrowings form approx. 70% of the source of funds.
  - IL&FS has given clear lessons on how NBFC sector can be the one that sets off the domino effect across financial sector
- Hence, risk based regulation of NBFCs along with capital adequacy to ensure proper risk absorption can be a safeguard for entire financial sector.

Net Receivables (+ve) / Payables (-ve) by Institutions



	AMCs	Insurance	PSBs	PFs	UCBs	SFBs	FBs	AIFIs	PVBs	HFCs	NBFCs
Sep-212	9.6	6.5	6.1	1.6	0.2	-0.2	-0.6	-0.6	-5.4	-6.8	-10.4
Sep-22	10.6	7.4	5.6	1.9	0.1	0	-0.3	-0.4	-6.5	-7.1	-11.3

Source: Financial Stability Report, December 2021 & 22|VKC Analysis

Revised Regulatory Framework for NBFCs

- With the increasing importance of NBFCs, the RBI has through its Revised Regulatory Framework for NBFCs (Revised Framework) have inserted the requirements for ICAAP for NBFCs falling in middle layer and above from October 2022.
- All HFCs and NBFCs except those mentioned below shall be required to undertake ICAAP analysis:
  - NBFCs with no customer interface, and access to public funds
  - P2P, AA and NOFHC,
  - NBFCs with asset size upto 1000 cr
- This internal assessment shall be on similar lines as ICAAP prescribed for commercial banks under Pillar 2 *[Master Circular – Basel III Capital Regulations dated July 01, 2015]*
- While pillar 2 regulation are not compulsorily applicable but methodology shall commensurate with size and risk profile of the NBFC
- A board approved policy in this regard has to be put in place
- Based on ICAAP, RBI will review and evaluate the NBFCs' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure compliance with the regulatory capital ratios. If they are not satisfied with the result of this process, RBI may include prescription of additional capital to be maintained.
- Capacity building for ICAAP for NBFCs may take significant efforts from this stage itself.

Objective of ICAAP

- What should be the final goal, or what are we exactly trying to achieve by ICAAP?
- Since the capital adequacy ratio prescribed by the RBI under the Pillar I of the Framework is only the regulatory minimum level,
  - It addresses only the three specified risks (viz., credit, market and operational risks),
- Holding additional capital might be necessary for banks, on account of:
  - the possibility of some under-estimation of risks under the Pillar I and
  - the actual risk exposure of FI

Covered by Regulatory CRAR

- Credit Risk
- Market Risk
- Operational Risk

Not captured by Regulatory CRAR

- Credit concentration risk
- Liquidity risk
- Settlement risk
- Reputational risk
- Strategic risk, etc.

ICAAP

ICAAP should strive to include:

- the risks that are not fully captured by the minimum capital ratio prescribed under Pillar I;
- the risks that are not at all taken into account by the Pillar I; and
- the factors external to the bank.

- The outcome of the ICAAP may be higher or lower than the regulatory capital requirements.
  - FI has to maintain higher of the two.
- Efforts should be made that Tier I capital should be adequate to absorb all risk

Expectations from NBFCs – essential elements

- RBI in the circular itself recognises that "*there is no one single approach for conducting the ICAAP and the market consensus in regard to the best practice for undertaking ICAAP is yet to emerge. The methodologies and techniques are still evolving particularly in regard to measurement of non-quantifiable risks, such as reputational and strategic risks. These guidelines, therefore, seek to provide only broad principles to be followed by banks in developing their ICAAP.* "
- ICAAP for an NBFC commensurate with their size, level of complexity, risk profile and scope of operations
- Ideally ICAAP should be undertaken at various levels:
  - Entity Level – Standalone entity
  - Consolidated basis – Entire group (may include only financial sector entities)
- Authority for Analysis:
  - Ultimate responsibility with Board
  - Undertaken by relevant department supervised by senior management
  - NBFCs are now having Risk Governance Dept.

ICAAP is
entity specific

ICAAP is
Forward looking

ICAAP is
Risk based process

ICAAP is
Integral to decision making

Broad Process for ICAAP

- NBFCs to classify operations as simple, moderate and complex
  - for most NBFCs, the operations are way simpler compared to that of banks, hence we can safely consider that all NBFCs (except for a few very large ones) can use a simple approach.
  - Complex approach would not be of any relevance to NBFCs

Simple Operations

1. Prepare list of *significant* risk faced Based on major losses and Business Plan
2. Risk assessment and determination of capital – Assistance from Stress Testing
3. Consider how capital of entity would look based on business plan for next 3-5 years
4. Document findings – ICAAP Document
5. Board to review the ICAAP Document – act accordingly

Moderately complex operations

1. Prepare comprehensive list of risk faced after considering inputs of operational management, historical data etc.
2. Compute range and distribution of losses, also consider shock stress tests and management weakness to provide risk estimates – Assistance from Stress Testing
3. Projected business plan for 3-5 years and analyses whether capital would be sufficient, and consider multiple scenarios
4. Document findings – ICAAP Document
5. Board to review the ICAAP Document – act accordingly

   Back-test model and check with actual outcome to develop model

Preparing list of risk faced by the entity

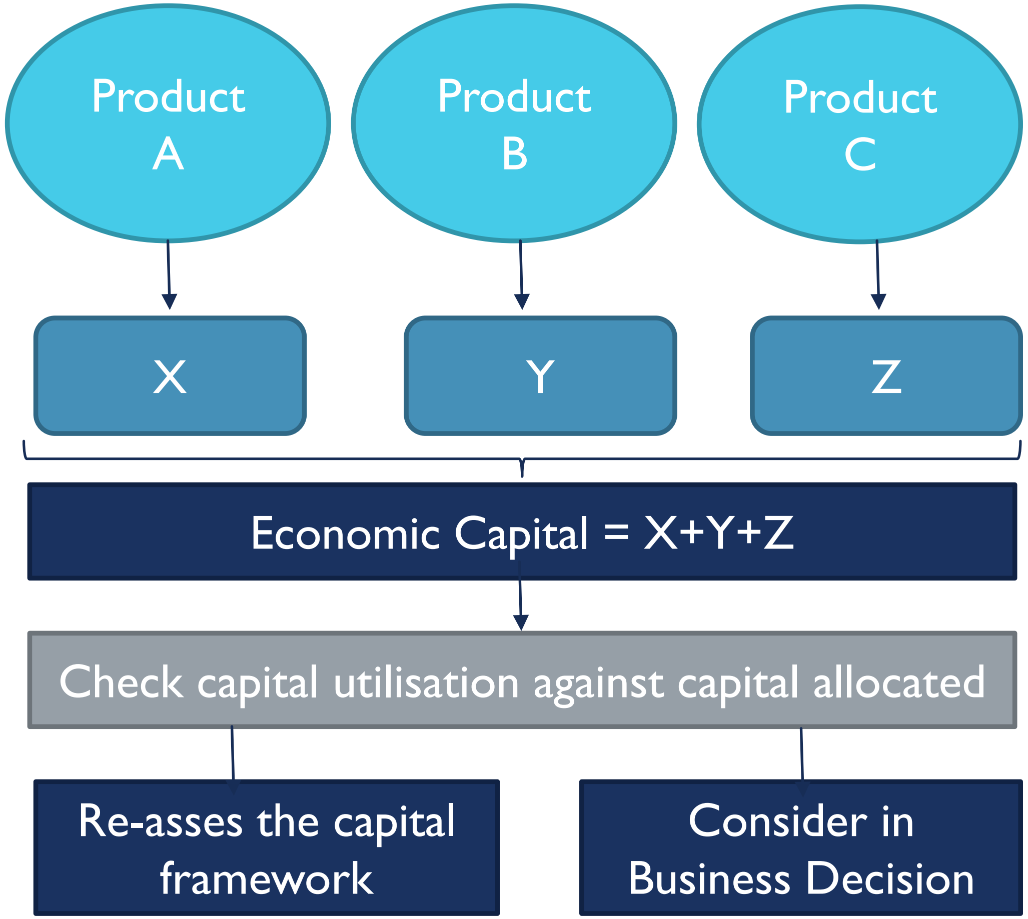
- List of risk is one of the most important aspect of ICAAP – the process and methodology would depend entirely on the list of risk
- List to be divided in quantitative and qualitative assessment
- Major losses in the past should be factored in – while future should be given equal importance as the past
- The risk consideration should be enterprise wide, that is to say – though each department would be responsible for specific risk, the list of risk should be based on entity level analysis and not department level
- Senior management along with Board and RMC should play active role

Indicative list of risk as per RBI Master Circular

- Interest rate risk in the banking book;
- Credit concentration risk;
- Liquidity risk;
- Settlement risk;
- Reputational risk;
- Strategic risk;
- Risk of under-estimation of credit risk under the Standardised approach;
- "Model risk" i.e., the risk of under-estimation of credit risk under the IRB approaches; [not relevant for NBFCs]
- Risk of weakness in the credit-risk mitigants;
- Residual risk of securitisation, etc

Use of Eco-metrics Model & Stress testing

- When we say we need to calculate how much capital is required to maintained for the risk poised, we basically need to analyse quantum of risk that is expected to materialize
- Such projections should be based on past learnings, hence statistical models would be needed to predict future – Though RBI is not expected to ask for complex statistical analysis, RBI would expect a certain degree of sophistication adopted in the ICAAP in regard to risk measurement and management to be commensurate with the nature, scope, scale and the degree of complexity in the business operations.
- Following methods may be used:
  - Linear or logistic regression Analysis
  - Monte-Carlo Simulation
- These models would then be required to be updated based on comparing the results of model with actual outcomes



Stress Testing

- Stress testing forms an integral part of ICAAP, which requires to undertake rigorous, forward looking stress testing that identifies severe events or changes in market conditions that could adversely impact the NBFCs.

Objective

- Determines the risk posed to an entity in different stress scenarios
- Assesses the entity's capability to effectively deal with the same

Categories

- **Sensitive analysis -** Also known as simulation analysis, it captures how target variable is affected by change in other variables
- **Scenario analysis -** process of estimating the expected values of the particular output considering different sets of inputs.

- These may be used either separately or in conjunction with each other.
- The stress events and scenarios identified / developed by NBFC should be plausible and relevant to its portfolio.

Contents of ICAAP Document

Background	• Brief on the operations and practices of the Company • Explain the present financial position and expected changes to the current business profile
Key sensitivities and future scenarios	• How a bank would be affected by an economic recession or downswings in the business cycle or markets relevant to its activities. • Factors that could have a major impact on capital adequacy of the bank
Testing and adoption of the ICAAP	• Describe the extent of challenging and testing that the ICAAP has been subjected to. It would thus include the testing and control processes applied to the ICAAP models and calculations • This section may also include past efficiency of the ICAAP framework
Capital Adequacy	• Risk Appetite of the bank • Where economic capital models are used for internal capital assessment, the confidence level, time horizon, and description of the event to which the confidence level relates, should also be enumerated
Use of the ICAAP	• Information to demonstrate the extent to which the concept of capital management is embedded within the decision-making process. • For instance, use of ICAAP in setting pricing and charges and the level and nature of future business, could be an indicator in this regard
Aggregation and diversification	• Results of the various separate risk assessments are brought together and an overall view taken on capital adequacy. • The overall reasonableness of the detailed quantification approaches might be compared with the results of an analysis of capital planning and a view taken by senior management as to the overall level of capital that is considered appropriate