



Deposit Guarantee Corporation of Manitoba
La Société d'assurance-dépôts du Manitoba

Guideline

Subject: ICAAP (CUCM)

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1.0 Overview

On July 1, 2022, DGCM issued new Prudential Standards pursuant to s. 159.2 of *The Credit Unions and Caisses Populaires Act*. Credit Union Central of Manitoba (CUCM) must comply with the Prudential Standards (s. 159.2).

The Prudential Standards are available at this link:

<https://web2.gov.mb.ca/laws/regs/annual/2022/089.pdf>

The purpose of this Compliance Guideline is to assist CUCM with compliance with the Prudential Standards. Under s. 2.6 of the Prudential Standards, CUCM must establish and maintain an Internal Capital Adequacy Assessment Process (ICAAP).



2.0 Internal Capital Adequacy Assessment Process

Under the Prudential Standards, CUCM must establish and maintain an ICAAP at all times.

Maintaining adequate capital is critical to CUCM's overall safety and soundness and should be assessed in view of the risks facing the organization. As the manager of pooled liquid assets for Manitoba credit unions and the caisse (cu/caisse), CUCM has unique business risks that must be addressed through targeted capital risk management practices.

Under the Prudential Standards, CUCM must meet, at all times, a borrowing multiple capital test. The minimum borrowing multiple is equal to or less than 20 times of Total Capital.

CUCM's ICAAP will assist it to establish internal capital targets which can serve as a buffer over the minimum borrowing multiple. An ICAAP is a CUCM-led process that is assessed by DGCM.

DGCM expects the Board and Senior Management to be engaged in the process and set CUCM's internal capital targets based on their understanding and analysis of the inherent risks associated with CUCM's business activity.

As part of its prudential oversight function, DGCM evaluates CUCM's inherent risks, identifies and reviews each significant activity undertaken by CUCM, and evaluates the quality of CUCM's risk management practices used to mitigate these risks. DGCM's assessment of CUCM's ICAAP is intended to enhance DGCM's oversight work.



3.0 ICAAP Principles

CUCM should not rely strictly on compliance with regulatory minimums when assessing the adequacy of its capital.

A thorough and comprehensive ICAAP is a vital component of a strong risk management program. The ICAAP should produce a level of capital adequate to support the nature and level of CUCM's risks. CUCM is responsible for developing and implementing its own ICAAP to set internal capital targets and develop strategies to achieve those internal targets consistent with its business plans, risk profile, and operating environment.

CUCM's ICAAP provides additional information to help DGCM assess inherent risks and risk management techniques, and may point to the need for additional oversight. While DGCM uses the information from CUCM's ICAAP to assess the quality of risk management and the adequacy of capital levels, CUCM does not need DGCM's approval when setting internal capital targets or establishing an ICAAP.



4.0 Overview of the Process

The ICAAP can be broken down into five components:

1. Board and Senior Management oversight
2. Sound capital assessment and planning
3. Comprehensive assessment of risks
4. Stress testing
5. Monitoring and reporting

CUCM's ICAAP should be as simple or complex as needed, and should reflect how it is managed and organized. It should not be established solely to fulfill a regulatory requirement.

The sophistication of CUCM's ICAAP and resources devoted to the work will depend on CUCM's complexity, range of business activities, risk profile, and operating environment.

4.1 Board and Senior Management Oversight

CUCM's Board of Directors is responsible for overseeing the ICAAP. Senior Management is responsible for designing and implementing the ICAAP.

Senior Management should understand the nature and level of risks taken by CUCM and whether those risks require adequate levels of capital. The Board should be engaged in discussions in this area.

As part of its strategic planning process, CUCM should perform an analysis of its current and future capital requirements in relation to its strategic objectives. Strategic plans should clearly describe CUCM's capital needs in relation to, among other things, anticipated balance sheet growth, Board approved risk tolerances, risks inherent in the liquidity pool management policies, and access to capital.

Senior Management and the Board should view capital planning as a crucial element in CUCM's ability to achieve its desired strategic objectives.

CUCM's Board is responsible for setting the institution's tolerance for risk. It should ensure that Senior Management:

- Establishes detailed policies that set controls on CUCM's activities that are consistent with its risk-taking capacity and appetite
- Effectively communicates these policies throughout CUCM
- Establishes a framework for assessing the various risks
- Develops an ICAAP that ties CUCM's capital level to its assessment of risks



- Establishes strong internal controls and a method for monitoring compliance with internal policies

4.2 Sound Capital Assessment and Planning

A sound capital assessment process should include the following elements:

- A documented process for evaluating quantifiable or qualitative risks and determining whether or not a risk should result in an explicit amount of capital being held
- Policies and procedures designed to ensure that CUCM identifies, measures and reports all material risks requiring capital
- A process that ties capital holdings to current and anticipated levels of risk, and accords with Board approved risk tolerances
- A process that identifies capital adequacy goals with respect to risk, taking account of CUCM's strategic plans
- A process of internal controls, reviews and audits to ensure the integrity of the overall risk management process

CUCM should consider several unique factors when tying capital to its identified risks, for example:

- CUCM's unique role as the manager of the cu/caisse's liquidity within a mandatory liquidity pool and the needs of those institutions
- A comparison of its own capital levels with those of industry peers
- Potential severe adverse events, based on historical experiences, either of CUCM itself or the markets in which it conducts business, as well as non-historical scenarios

CUCM may consider qualitative factors including regulatory expectations (DGCM or other relevant regulators), peer analysis, and the results of forward-looking stress tests and sensitivity analyses of the components of risks that should be covered by capital. For risks that cannot be directly quantified (e.g., systemic reputational risk), CUCM may use well documented, qualitative considerations.

An effective capital planning process requires CUCM to:

- Assess both the risks to which it is exposed and the risk management processes in place to manage and mitigate those risks;
- Evaluate its capital adequacy relative to its risks; and
- Consider the potential impact on earnings and capital from potential economic downturns.



CUCM should identify the time horizons over which it is assessing capital adequacy. It should evaluate whether long-term capital targets are consistent with short-term goals, based on current and planned changes in risk profile and the recognition that accommodating additional capital needs can require significant lead time.

Capital planning should factor in the potential difficulties of increasing capital during downturns or other times of stress including reliance on credit union/caisse injections of capital.

4.3 Comprehensive Assessment of Risks

The ICAAP should address all material risks faced by CUCM as they relate to the adequacy of capital. The techniques used in assessing material risks should be commensurate with the scope and complexity of CUCM's risk taking activities.

Liquidity Risk

Given CUCM's critical role in managing the Systems' Liquidity Pool and the expectation that CUCM must prioritize Systems access to liquidity, the ICAAP should consider capital risks associated with maintaining adequate liquid assets at all times.

CUCM's capital position can have an effect on its ability to obtain liquidity, especially in a crisis. Whereas CUCM is not expected to separately capitalize its liquidity risk, stress testing capital should be complimentary to the liquidity stress scenarios that CUCM conducts.

Risk Concentrations

The impact of risk concentrations should be reflected in CUCM's ICAAP. Typical situations in which risk concentrations can arise include exposures to:

- A single counterparty, borrower or group of connected counterparties or borrowers
- Industry or economic sectors, including exposures to both regulated and nonregulated financial institutions such as hedge funds and private equity firms
- Geographic regions
- Similar collateral types or to a single or closely related credit protection provider, and other exposures arising from credit risk mitigation techniques
- Trading exposures/market risk

Risk concentrations can also arise through a combination of exposures across these broad categories. Some of these traditional concentration categories may not be applicable to CUCM and this should be reflected in CUCM's analysis.

CUCM may have exposure to a particular asset type indirectly through investments backed by assets (e.g., collateralized debt obligations – CDOs), as well as through collateral or guarantees used to mitigate credit risk. Institutions that place more reliance on collateral values than on an evaluation of a borrower's or counterparty's capacity to perform may see themselves exposed to



unexpected market risk in addition to wrong way risk¹, particularly where the value of the collateral declines.

CUCM should have in place adequate, systematic procedures for identifying high correlation between the creditworthiness of a protection provider or collateral and the obligors of the underlying exposures due to its performance being dependent on common factors beyond systemic risk (i.e. “wrong way risk”).

Risk Diversification

CUCM should exercise caution when including risk diversification benefits in ICAAP. Assumptions on diversification are often based on expert judgement and are difficult to validate. CUCM should be conservative in its assessment of diversification benefits, in particular between different classes of risk, and should consider whether such benefits exist under stressed conditions.

Operational Risk

Similar rigour should be applied to the management of operational risk as is done for the management of other significant risks. The failure to properly manage operational risk can result in a misstatement of CUCM’s risk/return profile and expose it to significant losses.

Market Risk

CUCM should have methodologies that enable it to assess and actively manage all material market risks, wherever they arise (i.e., position, trading desk, business line or firm-level).

The assessment of internal capital adequacy for market risk may be based on both value-at-risk (VaR) or similar modelling and stress testing, including an assessment of concentration risk and the assessment of illiquidity under stressful market scenarios.

Interest Rate Risk

The ICAAP should include all material interest rate risk positions of CUCM and consider all relevant repricing and maturity data. CUCM should be able to support its assumptions about the behavioural characteristics of non-maturity deposits and other assets and liabilities, especially those exposures characterized by embedded optionality. Given uncertainty in such assumptions, stress testing and scenario analysis should be used in the analysis of interest rate risks.

In general, an increase in uncertainty related to modeling and business complexity should result in more capital being held.

¹ **General Wrong-Way Risk** arises when the probability of default of counterparties is positively correlated with general market risk factors.

Specific Wrong-Way Risk arises when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty due to the nature of the transactions with the counterparty.



Other Risks

Although risks such as strategic and reputation risk are not easily measurable, CUCM is expected to develop techniques for managing all aspects of these risks. Reputation risk is a key issue for an industry that relies on the confidence of consumers, creditors and the general marketplace. In the case for CUCM, reputation risk should also be considered on a cu/caisse systemic basis.

CUCM should identify potential sources of reputational risk to which it may be uniquely exposed among financial intermediaries.

4.4 Stress Testing

CUCM's capital planning process should incorporate rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact it. In its ICAAP, CUCM should examine future capital resources and capital requirements under adverse scenarios. The results of forward-looking stress testing should be considered when evaluating the adequacy of CUCM's capital.

4.5 Monitoring and Reporting

CUCM should establish an adequate system for monitoring and reporting risk exposures and assessing how changes to its risk profile affects the need for capital. CUCM's Senior Management and Board should receive regular reports on CUCM's risk profile and capital needs. These reports should allow Senior Management and Board to:

- Evaluate material risks and their effect on capital levels
- Evaluate the sensitivity and reasonableness of assumptions used in any capital assessment measurement system or process
- Determine whether CUCM is holding sufficient capital against the various risks and is in compliance with established capital adequacy goals
- Assess future capital requirements based on CUCM's reported risk profile and make necessary adjustments to its strategic plan



5.0 DGCM Oversight

DGCM will regularly assess:

- CUCM's compliance with the minimum borrowing multiple
- CUCM's compliance with internal capital targets and whether those targets sufficiently consider all material inherent risks
- whether CUCM has a sufficiently robust ICAAP

DGCM's risk assessment process begins with an evaluation of the inherent risks within each significant business activity of CUCM. DGCM then examines the quality of risk management applied to mitigate these risks. A robust ICAAP will assist DGCM in conducting this assessment.

The depth and frequency of DGCM's review of CUCM's ICAAP will be proportional to the nature, scale and complexity of its activities, and the risks posed to the safety and soundness of CUCM and the cu/caisse systems.

DGCM will assess the:

- level of conservatism in internal estimates of the risks
- extent that material risks are fully captured by CUCM
- external factors, including stress testing, impact of economic cycles and other external risks

DGCM's assessment of CUCM's ICAAP and internal capital targets will is not a formula-driven process. Expert judgement will continue to be necessary to operationalize the assessment and quantification of risk and integrate those results into the overall assessment of capital.

