Decision
on the internal capital adequacy assessment process for credit institutions

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Zagreb, February 2010

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I General provisions

Subject matter
Article 1

(1) This Decision prescribes in detail the assessment processes, the method of and the time limits for reporting to the Croatian National Bank on the required internal capital of a credit institution and the internal capital calculation on an individual and consolidated basis.

(2) This Decision shall apply to credit institutions which have their registered office in the Republic of Croatia and are authorised by the Croatian National Bank.

(3) This Decision shall, as appropriate, apply to a branch of a credit institution from a third country authorised by the Croatian National Bank to provide services.

Definitions
Article 2

For the purpose of this Decision, the following definitions shall apply:

(1) "small credit institution" shall mean a credit institution which for the purposes of calculating adequacy of own funds does not apply the approaches which in accordance with Article 128 of the Credit Institutions Act require permission from the Croatian National Bank and which meets one of the following conditions:
1) it is authorised as a savings bank or housing savings bank; or
2) its total assets are all times lower than HRK 7,000,000,000.00;

(2) "required own funds" shall mean the sum of all capital requirements calculated under the Decision on the capital adequacy of credit institutions;

(3) "required internal capital" shall mean the sum of internal capital requirements calculated in accordance with this Decision;

(4) "risk profile" shall mean the measurement or assessment of all risks to which a credit institution is or might be exposed in its operation;

(5) "reputation risk" shall mean the risk of loss of trust in the integrity of a credit institution caused by adverse public opinion on the credit institution's business practices, regardless of whether there are any grounds for such a public opinion or not;

(6) "strategic risk" shall mean the risk of loss caused by adverse business decisions, lack of responsiveness to changes in the economic environment, etc;

(7) "operations risk" shall mean the risk of loss caused by the fact that a credit institution, due to its size, has a limited capacity to put in place sophisticated operational mechanisms, systems and controls;

(8) "stress testing" shall mean a risk management technique used to assess the potential effects of specific events and/or changes in several risk factors on the financial position of a credit institution. Stress testing may be divided into scenario analysis and sensitivity analysis;

(9) "scenario analysis" shall mean a type of stress testing used to assess the impact of a concurrent change in several risk factors on the financial position of a credit institution under clearly defined conditions of stress;

(10) "sensitivity analysis" shall mean a type of stress testing used to assess the impact of a specific risk factor on the financial position of a credit institution wherein the cause of stress is not identified;

Scope of application of the Decision
Article 3

(1) A credit institution shall align its operation with the provisions of this Decision on an individual basis.

(2) By way of derogation from paragraph (1) of this Article, a credit institution which is included in a group of credit institutions in the Republic of Croatia need not meet the provisions of this Decision on an individual basis, provided that in the Republic of Croatia it has a status of:
1) a parent credit institution, or
2) a credit institution which is a subsidiary of a parent credit institution in the Republic of Croatia or a parent financial holding company within a group of credit institutions in the Republic of Croatia.

(3) A credit institution which is excluded from a group of credit institutions in the Republic of Croatia pursuant to Article 282, paragraph (7) of the Credit Institutions Act shall apply the provisions of this Decision on an individual basis.

(4) A parent credit institution within a group of credit institutions in the Republic of Croatia shall meet the provisions of this Decision on a consolidated basis for that group.

(5) A credit institution having its registered office in the Republic of Croatia which is a subsidiary of a parent financial holding company within a group of credit institution in the Republic of Croatia in the manner referred to in Article 282, paragraphs (3), (4) and

(5) of the Credit Institutions Act, shall meet the provisions of this Decision on the basis of the consolidated financial position of that financial holding company.

(6) A subsidiary credit institution having its registered office in the Republic of Croatia or a parent financial holding company within a group of credit institutions in the Republic of Croatia which is a parent of or holds a participation in another credit institution, financial institution, asset management company or pension company having its registered office in a third country, shall meet the provisions of this Decision on a sub-consolidated basis.

Internal capital strategies, plans and processes
Article 4

(1) A credit institution shall develop an internal capital planning strategy which is to ensure that the maintained capital levels are supportive of the factors such as the expected placement growth, future sources of funds and their use, dividend policy and changes in the minimum level of own funds referred to in Article 131 of the Credit Institutions Act.

(2) A credit institution shall adopt a capital plan clearly defining:
1) the strategic objectives and time horizons for their realisation considering the impact of macroeconomic factors and changes in the economic cycle on strategic plans;
2) capital planning processes and responsibilities for these processes;
3) the method by which a credit institution is to comply with capital requirements in the future;
4) the relevant limits related to capital (e.g. the impact of a change in regulations or of the adoption of new regulations);
5) general contingency plans (e.g. the method of the additional capital acquisition, business activity restriction or the application of risk mitigation techniques).

Assessment process establishment and implementation
Article 5

(1) A credit institution shall establish an adequate process to determine and ensure an appropriate level of internal capital, taking into account the risk profile, risk management system and risk mitigation techniques. When choosing a process to determine and ensure an appropriate level of internal capital, a credit institution may also consider other factors, such as the target external rating, market position, entrance to new markets, capital accessibility, acquisitions of other undertakings, and other strategic goals. A credit institution shall analyse and document the impact of these factors on the internal capital level.

(2) The process referred to in paragraph (1) of this Article shall be considered adequate if:

1) it is based on the identification, measurement or assessment, aggregation and monitoring of significant risks;
2) it ensures an internal capital level adequate for the risk profile of a credit institution; and
3) it is adequately incorporated into the governance arrangements of a credit institution.

(3) A credit institution shall prescribe, document and regularly supervise the assessment process referred to in paragraph (1) of this Article, which also needs to be approved by the management and supervisory boards of the credit institution. The internal audit function of a credit institution shall at a minimum on an annual basis assess the appropriateness of the internal capital adequacy assessment process.

(4) A credit institution shall provide the Croatian National Bank with complete and detailed information on the internal capital adequacy assessment process, including the information on:
1) the approaches (methodologies) used for internal capital requirements;
2) the types and levels of risk included in the calculation of internal capital requirements;
3) as regards credit risk, market risk and operational risk - the differences between the approaches used for the calculation of capital requirements in accordance with the Decision on the capital adequacy of credit institutions and those used for the calculation of internal capital requirements; and
4) the differences between the required own funds referred to Article 131 of the Credit Institutions Act and the required internal capital.

II Internal capital adequacy assessment process

Phases of the process
Article 6

(1) A credit institution's internal capital adequacy assessment process shall include the following phases:
1) the identification of risk;
2) the measurement or assessment of individual risks and the determination of related internal capital requirements;
3) the determination of total internal capital; and
4) the comparison of the required own funds and the required internal capital.

(2) A credit institution shall perform the process referred to in Article 1 of this Article at a minimum on an annual basis, and more often in the case of a significant change in the risk profile.

1 Risk identification

Significant risks
Article 7

(1) A credit institution shall on the basis of its risk profile identify significant risks to which it is or might be exposed in its operation, and which it is to include in the internal capital adequacy assessment process, taking into account the type, scope and complexity of its activities and the markets in which it operates.

(2) In order to identify significant risks, a credit institution shall analyse the following:
1) credit risk, market risk and operational risk, also including other risks referred to in the Decision on the capital adequacy of credit institutions;
2) the risks which are not fully covered by minimum capital requirements referred to in the Decision on the capital adequacy of credit institutions (currency induced credit risk, residual risk and risks arising from securitisation transactions, a possible underestimation of credit risk due to the use of the Standardised Approach, a possible underestimation of operational risk due to the use of the Basic Indicator Approach or Standardise Approach);
3) interest rate risk in the non-trading book, concentration risk, liquidity risk, reputation risk and strategic risk;
4) the impact of external factors (economic and business environment); and
5) other risks not referred to in items (1) to (3) of this paragraph.

(3) The identification of all risks and the determination of their significance must be based on a comprehensive assessment of the risks to which a credit institution is or might be exposed, and which are inherent in individual operations, products, activities, processes and systems of a credit institution, both on the portfolio and individual product basis. The risk identification process must also include an assessment of the financial position of a credit institution and the environment in which it operates.

(4) By way of derogation from paragraph (2) of this Article, a small credit institution may within the internal capital adequacy assessment process analyse, at a minimum, the following:
1) concentration risk;
2) operations risk;
3) credit risk including currency induced credit risk;
4) interest rate risk;
5) foreign-exchange risk;
6) liquidity risk including the possibilities of additional capital acquisition;
7) operational risk;
8) strategic risk, and
9) the impact of external factors.

Risk definitions
Article 8

(1) A credit institution may use its own risk definitions which at a minimum include the definitions prescribed in the Credit Institutions Act and subordinate legislation adopted under that act, on the condition that it gives a detailed explanation thereof.

(2) Where a credit institution uses different definitions of the risks for which the calculation of capital requirements is prescribed in the Decision on the capital adequacy of credit institutions, it shall explain the impact of the application of these definitions on the level of capital requirements of the credit institution under the said Decision.

2 Measurement or assessment of individual risks and the determination of related internal capital requirements

Risk measurement or assessment methodology
Article 9

(1) When calculating internal capital requirements, a credit institution shall by quantitative methods measure or, if the risks are difficult to quantify, assess significant risks using the methodology and approaches which are the most suitable for its organisation and business activities.

(2) A credit institution shall establish for which risks, with the exception of credit risk, market risk and operational risk, it is appropriate to use quantitative methods when determining internal capital requirements, and for which risks it is more suitable to exclusively use risk mitigation or control measures instead of determining internal capital requirements.

(3) A credit institution may use various approaches to calculate internal capital requirements for various types of risk, on the condition that it defines an adequate methodology to measure or assess each risk and that it documents and explains the following:
1) the risk measurement methods/approaches;
2) the assessment of non-measurable risks;
3) all corrections in risk amounts undertaken when a credit institution establishes that the methods used to measure or assess a specific risk fail to show the current exposure of the credit institution to that risk.

(4) When calculating internal capital requirements for credit risk, operational risk and market risks, a credit institution shall act in one of the following ways:
1) further enhance and adjust the Basic Indicator Approach and the Standardised Approach, if it uses those approaches for the calculation of capital requirements under the Decision on the capital adequacy of credit institutions;
2) use and/or adjust the Advanced Measurement Approach referred to in the Decision on the capital adequacy of credit institutions; or

3) use other models.

(5) By way of derogation from paragraph (4) of this Article, a small credit institution may when calculating internal capital requirements for credit risk, operational risk and market risks use the methodology and the Basic Indicator Approach or the Standardised Approach referred to in the Decision on the capital adequacy of credit institutions.

(6) A credit institution may when calculating internal capital requirements for interest rate risk in the non-trading book apply the simplified calculation of estimate of change in the economic value of the non-trading book prescribed in the Decision on the interest rate risk in the non-trading book.

Stress testing
Article 10

(1) In order to make a quality assessment of its risk exposure, a credit institution shall regularly, at a minimum on an annual basis, carry out scenario and sensitivity analyses for all significant risks and internal capital. The credit institution shall take the results obtained into account when assessing and maintaining an adequate level of internal capital.

(2) Stress testing must be appropriate for each risk factor significant for the operation of a credit institution which is specific for the business and legal environment in which the credit institution operates and the relevant segment of the business cycle. A credit institution shall analyse the impact of a change in regulations or the adoption of new regulations, competition activities or other factors affecting its operation, in order to determine which changes in the environment it can sustain.

(3) A credit institution shall determine within its risk management policies the scope and frequency of stress testing and the processes and activities to be applied in the cases of adverse stress testing results.

(4) By way of derogation from paragraph (1) of this Article, a small credit institution may only carry out sensitivity analyses, assessing the impact of some most significant factors of risks to which it is exposed, including at a minimum credit risk, concentration risk in the credit portfolio and interest rate risk in the non-trading book. A small credit institution shall carry out scenario and sensitivity analyses for the exposure to liquidity risk.

(5) By way of derogation from paragraph (1) of this Article, a credit institution shall perform stress testing for operational risk in accordance with the Decision on the capital adequacy of credit institutions.

3 Determining total internal capital

Defining available internal capital
Article 11

A credit institution shall define the categories and constituent elements of capital used to calculate the available internal capital, taking into account which individual elements of capital best demonstrate the real value of assets and liabilities and the capacity to cover loss.

Calculation of internal capital requirements
Article 12

(1) A credit institution shall use complex approaches for the calculation of total internal capital requirements and it shall document and explain:
1) the basic methodological assumptions, with the exception of perfect positive correlations between risks, and ensure their robustness by performing stress testing; and/or
2) any other methodology/approach to determine total required internal capital, including the one based on the simulation of concurrent changes in multiple risk factors.

(2) By way of derogation from paragraph (1) of this Article, a small credit institution shall determine total internal capital requirements by adding up capital requirements for:
1) the risks requiring the calculation of capital requirements under the Decision on the capital adequacy of credit institutions; and
2) other significant risks.

(3) A credit institution shall maintain internal capital at least at the level of total internal capital requirements.

4 Comparison of required own funds and required internal capital

Process of comparison
Article 13

(1) A credit institution shall compare required internal capital and required own funds and state their similarities and differences.

(2) Where its is established by the internal capital adequacy assessment process that the amount of required internal capital is lower than the minimum level of own funds referred to in Article 131 of the Credit Institutions Act, a credit institution shall maintain a level of own funds equal to that prescribed in Article 131 of the Credit Institution Act.

(3) A credit institution shall at the end of a business year (as at 31 December) calculate:
1) the total amount of required internal capital, and

2) the target level of available internal capital and own funds at the end of the current financial year, in accordance with the business plan.

(4) A credit institution shall incorporate into the annual business plan corrective measures to be taken in the event of errors or changes in the assessments of internal capital adequacy.

III Integration of the internal capital adequacy assessment processes into governance arrangements

Article 14

(1) The internal capital adequacy assessment process must be a constituent part of a credit institution's corporate arrangements.

(2) A credit institution shall make use of the results of the internal capital adequacy assessment process at a minimum in the following processes:
1) when defining and monitoring the realisation of the risk management strategy;
2) when allocating capital to individual organisational units;
3) when adopting decisions on lending and budgeting issues; and
4) when adopting major strategic decision (e.g. to launch a new product, enter a new market, etc).

(3) The internal capital adequacy assessment process must enable the management and supervisory boards of a credit institution to at all times assess and/or evaluate all significant risks to which the credit institution is or might be exposed in its operation.

Duties of the management and supervisory boards
Article 15

(1) The management board of a credit institution shall:
1) adopt the credit institution's risk assumption and management strategy;
2) ensure the implementation of the internal capital adequacy assessment process and its compliance with strategic policies;
3) ensure that all risks are included into the process;
4) ensure the use of appropriate methods;
5) prescribe in detail the internal capital adequacy assessment process (the methods used, the assumptions, the assessment process, and the method of maintaining an adequate internal capital level) and the internal capital allocation process;
6) establish an adequate internal control system within the internal capital adequacy assessment and maintenance process;
7) ensure that the internal capital adequacy assessment process is documented;

8) ensure adequate resources to implement the internal capital adequacy assessment process and a full understanding of the process by all included employees;
9) prescribe powers and responsibilities assigned to individual functions and organisational units ensuring a clear distribution of powers and clearly defined lines of responsibility;
10) ensure that the internal capital adequacy assessment process is a constituent part of the operational activities of a credit institution; and
11) ensure an ongoing assessment of the appropriateness of the internal capital adequacy assessment process;

(2) The supervisory board of a credit institution shall:
1) give approval to the management board for the risk assumption and management strategy of a credit institution with defined required internal capital and its allocation to individual risks to which the credit institution is or might be exposed;
2) give approval to the management board for the structure of internal capital adequacy assessment process;
3) ensure an adjustment of the internal capital adequacy assessment process with regard to significant changes in the strategies, policies, organisation and business environment;
4) ensure that the results of the internal capital adequacy assessment process are used for strategic purposes and in the decision-making process; and
5) analyse the realisation of the risk assumption and management strategy in relation to the available and required internal capital.

Role of the risk control function
Article 16

A credit institution shall analyse, monitor and report on the internal capital adequacy assessment process within the risk control function.

Outsourcing
Article 17

(1) A credit institution may outsource a part of a phase of the internal capital adequacy assessment process referred to in Article 6, paragraph (1) of this Decision.

(2) The provisions of the Decision on outsourcing shall apply to the outsourcing of a part of a phase of the internal capital adequacy assessment process for credit institutions.

(3) By way of derogation from paragraph (2) of this Article, where the provider of outsourcing services for a part of a phase of the internal capital adequacy assessment process for credit institutions is a parent undertaking in a group of credit institutions, Article 13 of the Decision on outsourcing shall not apply.

Assessment process on a consolidated basis
Article 18

A credit institution which in accordance with Article 3, paragraphs (2) and (4) of this Decision applies the provisions of this Decision on a consolidated basis for a group of credit institutions in the RC shall:
1) when managing risks at the level of the group, define and adjust the processes and procedures, tasks and responsibilities of individual persons and organisational units as well reporting lines within the group;
2) ensure that the methodologies of risk measurement and/or assessment are adjusted at the level of the group;
3) assess significant risks of all undertakings within the group including its own risks and the risks inherent in the conduct of business activities with legal persons outside the group which have an impact on the overall risk profile of the group;
4) calculate the required internal capital on a consolidated basis and adjust required internal capital and required own funds at the level of the group;
5) integrate the internal capital adequacy assessment process on a consolidated basis into the management and decision making process of a credit institution; and
6) report to the Croatian National Bank on the internal capital adequacy assessment process on a consolidated basis.

IV Reporting to the Croatian National Bank

Report
Article 19

(1) A credit institution shall submit a written report to the Croatian National Bank on the internal capital adequacy assessment process. The report at a minimum needs to include the following:
1) the organisational structure, with the specification of powers and responsibilities assigned to various functions and organisational units included in the internal capital adequacy assessment process;
2) a description of the methodologies used to determine required internal capital;
3) a description of the risk measurement/assessment system;
4) the control method and mitigation techniques for significant types of risks;
5) a description of the stress testing which a credit institution uses in the internal capital adequacy assessment process and its results;
6) its own assessment of the internal capital adequacy assessment process which is to identify weaknesses and deficiencies in the process, and timely corrective measures to be implemented towards their elimination, and
7) where an undertaking which has its registered office outside the Republic of Croatia is a parent of a credit institution, the method of adjusting the internal capital adequacy assessment process with the process implemented by the parent credit institution.

(2) Where a credit institution has prepared and submitted to the Croatian National Bank parts of the report referred to in paragraph (1) of this Article while meting other reporting requirement, it may make a reference to these documents and need not prepare them again for the purposes of the report referred to in paragraph (1) of this Article. .

Time limits for reporting
Article 20

A credit institution shall prepare a report on the internal capital adequacy assessment process as at 31 December of the previous year and submit it to the Croatian National Bank at the latest until 30 April of the current year.

V Transitional and final provisions

Time limit for compliance
Article 21

A credit institution shall align its operation with the provisions of Article 9, paragraph (4) and Article 12, paragraph (1) of this Decision at the latest until 1 January 2011. Until the date of compliance, each credit institution shall operate in accordance with Article 9, paragraph (5) and Article 12, paragraph (2) of this Decision.

Entering into force
Article 22

This Decision shall be published in the Official Gazette and shall enter into force on 31 March 2010.