EC No. 88 / DoS - 06/ 2024 10 May 2024

Ref. No. NB. HO. DoS. Pol. / 647 / J-1 / 2024-2025

The Chairman, Regional Rural Banks
The Managing Director, All State Cooperative Banks
The Managing Director/ Chief Executive Officer,
All District Central Cooperative Banks

Madam/Dear Sir,

Guidance Note on Capital Management

As you are aware, an effective capital planning is essential alongside a strong regulatory framework, enabling banks to ascertain the appropriate amount, type, and structure of capital necessary to pursue their business goals while navigating stressful scenarios. Reflecting on lessons from the global financial crisis in relation to the strengthening of capital planning, the Basel Committee on Bank Supervision (BCBS) outlines four key components crucial for a robust capital planning process: (i) internal control and governance, (ii) capital policy and risk assessment, (iii) forward-looking perspective, and (iv) management framework for capital preservation.

2. The Reserve Bank of India had been initiating number of steps to mitigate risks faced by the banking system in India. Based on the Basel norms, the RBI also issued capital adequacy norms for the Indian banks in the year 1998 and as per the extant regulatory guidelines, the minimum capital adequacy as measured by capital to risk-weighted assets ratio (CRAR) for Regional Rural Banks and Rural Co-operative Banks in India is 9% computed based on using standardised risk weighting of assets under Basel-I.

3. Since the capital adequacy ratio prescribed by RBI is only the regulatory minimum level, holding additional capital might be necessary for banks, on account of (i) the possibility of some under-estimation of risks and (ii) the actual risk exposure of a bank vis-à-vis the quality of its risk management architecture. Consequently, it is essential for SEs to adopt and implement more effective risk management strategies to observe and control their risks.

राष्ट्रीय कृषि और ग्रामीण विकास बैंक
National Bank for Agriculture and Rural Development
पर्यवेक्षण विभाग
प्लॉट क्र सी-24, 'जी' ब्लॉक, बांद्रा-कुर्ला कॉम्प्लेक्स, बांद्रा (पूर्व), मुंबई - 400 051. टेली: +91 22 6812 0039 • फ़ैक्स: +91 22 2653 0103 • ई मेल: dos@nabard.org
Department of Supervision
Plot No. C-24, 'G' Block, Bandra-Kurla Complex, Bandra (E), Mumbai - 400 051 • Tel.: +91 22 6812 0039• Fax: +91 22 2653 0103 • E-mail: dos@nabard.org
गाँव बढ़े >> तो देश बढ़े www.nabard.org Taking Rural India >> Forward

4. NABARD has introduced Enhanced CAMELSC (E-CAMELSC) based supervisory approach with effect from 01 April 2023 for a set of banks based on a differentiated approach. In tune with the changing scenario of Risk Profiling in the banking industry, the E-CAMELSC based supervisory rating provides a forward looking, risk oriented and data driven approach for the pre-eminent assessment of the Supervised Entities. In this connection, Guidance notes on E-CAMELSC based approach have been issued vide circulars no. EC No. 105/DoS-27/2023 and EC No. 106/DoS-27/2023 dated 02 June 2023 to RCBs and RRBs, respectively. The introduction of the E-CAMELSC based supervisory approach emphasizes robust risk management systems to navigate the dynamic banking scenario.

5. The E-CAMELSC model comprises of seven (7) key factors, i.e., Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Systems & Controls, and Compliance. Each of these parameters further comprises of several quantitative sub-parameters as well as qualitative value statements. It is pertinent to note that the 'Capital Adequacy' aspect, which mandates that banks establish a capital management policy, along with internal controls and procedures concerning the management of capital. Banks are now required to enhance both the quantity and quality of their capital, highlighting the importance of managing and efficiently utilizing equity capital to meet shareholders' return expectations and drive optimal business decisions. In the circumstances, a need for issuance of comprehensive guidelines on capital management was felt and accordingly the Guidance note on Capital Management is being issued underscoring the importance of managing and efficiently utilising equity capital.

6. Guidance note on capital management aims to encourage SEs to manage the level of capital, through a well-defined internal process, and maintain an adequate capital cushion for such risks. The guidance note contains guidance on comprehensive capital management policy, roles and responsibilities of the Board and senior management, capital planning process, internal controls around capital management.

7. A comprehensive capital management policy is indispensable within a robust risk management framework, aiding in determining the optimal capital level to support the bank's risk profile. Banks are advised to develop a capital management policy and maintain capital levels that are commensurate with their risk profiles and control environments. Banks must ensure that the outcome of the capital management policy is forward looking (i.e. considers a minimum of 3-years projections) and not a static capital target. Banks must ensure that the capital management policy covers the following:

(a) A business plan and evaluation of short-term and long-term capital needs.
(b) All material risks and potential vulnerability to its business and operational environment.
(c) Capital requirements in benign and adverse forward-looking environments; and considers capital buffers during benign conditions to help meet any surge in capital demand under adverse conditions.
(d) Rigorous stress-testing and scenario analysis that identifies possible events or changes in market conditions that could adversely impact the bank; and
(e) Results of stress tests and analyses are incorporated, where applicable, into the capital adequacy assessment.

8. We advise that all RRBs, all scheduled StCBs, and other SEs with over Rs. 3000 crores in business size by 31 March 2024, will undergo E-CAMELSC based supervisory approach based on their financial position by the same date. The remaining banks will be brought under E-CAMELSC approach in a phased manner. The SEs covered under E-CAMELSC based supervisory approach are advised to put in place effective and robust capital management by ***30 September 2024.***

9. Remaining banks are advised to put in place effective capital management framework by **31 March 2025.**

10. We shall be glad if you will place a copy of this circular before the next meeting of the Board of Directors of your bank so as to take a suitable decision on implementation of the guidelines in your bank.

11. Please acknowledge the receipt of this circular to NABARD Regional Office in your State/ UT.

Yours faithfully

Sd/-
(Sudhir Kumar Roy)
Chief General Manager

Encl: Guidance note

Main Document

Document title	Guidance Note on Capital Management
Drafted by	Department of Supervision
Date of approval	26 March 2024
Document classification	External
Document no. / Version no.	1.0

Version history

Version No.	FY	Changes / Comments	Changed by
1.0	2024-25	New	-

Version Approval

Version No.	Date of approval	Changes / Comments	Approved by
1.0	2024-25	New	Board of Supervision

Guidance Note
on
Capital Management

NABARD

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Guidance Note on Capital Management for Supervised Entities (SEs)

1. General Description

An important lesson drawn from the 2008 financial crisis underscores the requirement for banking institutions (“banks”) to strengthen their capital planning and management frameworks. Capital management involves the implementation of measures by banks to uphold adequate capital levels, evaluate internal capital sufficiency, and compute the capital adequacy ratio. It is of utmost importance for banks to calculate this ratio and procure adequate capital to mitigate risks, thereby fostering the establishment of a robust capital management system. This approach is vital for ensuring the resilience and suitability of the bank's operations.

2. Objective

This guidance note outlines sound practices for banks to enhance their capital planning and management. Adhering to these practices can assist banks in preventing breaches of statutory capital requirements and in preparing for future capital needs. By implementing these guidelines, banks can promptly and efficiently address any adverse changes in their capital ratios, such as falling below regulatory or internal thresholds.

3. Capital Management Policy

A capital management policy serves as a crucially important written agreement among a bank's senior management, delineating the principles and procedures guiding the effective utilization, allocation, and oversight of the institution's capital resources.

This policy necessitates approval from the bank's Board and should manifest as a distinct, comprehensive document, encompassing the fundamental elements of the bank's capital planning processes. Furthermore, it ought to interlink with and draw support from other pertinent policies, such as risk management protocols and operational manuals.

Capital management policy is used by banks for capital planning, issuance, usage and distributions. It should include internal capital goals; strategies for addressing potential capital shortfalls; and internal governance procedures around capital management policy.

In detail, the policy should outline the mechanisms through which the bank supervises, evaluates, and decides on all aspects of capital planning. Moreover, it must delineate the roles and responsibilities of decision-makers, establish robust process and data controls, and stipulate expectations for the content of the bank's capital plan.

The policy should articulate specific targets for capital levels and composition, elucidating the bank's objectives in capital management and its alignment with maintaining a resilient capital position, especially during stress periods.

The policy should provide insights into how management ascertains the appropriateness, sustainability, and consistency of capital ratios vis-à-vis the bank's objectives and business model. It should also prescribe the capital metrics that senior management and the board ought to monitor regularly.

A thorough and comprehensive capital management policy forms an integral pillar of a robust risk management framework, aiding in determining the optimal capital levels necessary to adequately support the bank's risk profile.

Contents of Capital Management Policy

Banks must develop a capital management policy that is commensurate with the nature, size, complexity and scale of the bank's activities and includes clear statements on the following matters:

1. The roles and responsibilities of the Board and the senior management regarding capital management
2. The bank's risk appetite statement and capital adequacy objectives
3. Organizational frameworks concerning capital management
4. Process for maintaining sufficient capital
5. Internal and regulatory capital limits
6. Calculation of the capital adequacy ratio
7. Assessment, monitoring and control of capital adequacy levels
8. The actions the bank will take in the event of breaching a capital goal
9. Policy on capital allocation process
10. The process of Board level discussions for revision of capital needs or targets

4. General Requirements

4.1 Capital Management to be a Board-approved process

The ultimate responsibility for designing and implementation of the capital management lies with the board of directors of the bank. The structure, design and contents of a bank's capital management policy should be approved by the board of directors to ensure that the capital management forms an integral part of the management process and decision-making culture of the bank. Since, a sound risk management process provides the basis for ensuring that a bank maintains adequate capital, its board of directors shall ensure that the bank has an appropriate strategic plan in place, which, as a minimum, shall duly outline the bank's:

a. Current and future capital needs
b. Anticipated capital expenditure
c. Desired level of capital

4.2 Submission of the Outcome of Capital Management to the Board

As capital management is an ongoing process, a written record on the outcome of the capital management should be periodically submitted by the banks to their board of directors. Such written record of the internal assessment of its capital adequacy should include, inter alia, the risks identified, the manner in which those risks are monitored and managed, the impact of the bank's changing risk profile on the bank's capital position, details of stress tests/scenario analysis conducted and the resultant capital requirements. The reports shall be sufficiently detailed to allow the board of directors to evaluate the level and trend of material risk exposures, whether the bank maintains adequate capital against the risk exposures and in case of additional capital being needed, the plan for augmenting capital. The board of directors would be expected to make timely adjustments to the strategic plan, as necessary.

4.3 Review of the Capital Management Outcomes

The board of directors shall, at least once a year, assess and document whether the processes relating to the capital management policy implemented by the bank successfully achieved the objectives envisaged by the board. The senior management should also receive and review the reports regularly to evaluate the sensitivity of the key assumptions and to assess the validity of the bank's estimated future capital requirements. In the light of such an assessment, appropriate changes in the capital management should be instituted to ensure that the underlying objectives are effectively achieved.

4.4 Forward-looking Approach

Banks must ensure that the outcome of capital management is forward looking (i.e. considers a minimum of three years projections) and not a static capital target. A forward-looking approach in capital management policy involves anticipating future financial needs and planning accordingly to ensure the availability of adequate capital resources. It involves assessing potential risks and opportunities, setting strategic goals, and implementing measures to optimize the allocation and utilization of capital resources to support future business growth and sustainability. This approach typically involves forecasting future cash flows, evaluating investment opportunities, managing debt levels, and maintaining appropriate levels of liquidity to meet future obligations.

4.5 Risk-based Approach

A risk-based approach in formulating capital management policy involves assessing and managing various types of risks that a company may face, such as credit risk, market risk, liquidity risk, and operational risk. In this approach, the bank identifies and evaluates its risk exposures, determines the level of risk tolerance, and establishes appropriate capital buffers to absorb potential losses. The policy may include stress testing to assess the impact of adverse scenarios on the bank's financial position and capital adequacy.

Additionally, it may involve implementing risk mitigation strategies, such as diversification of investments, hedging techniques, and setting aside reserves to cover unexpected losses.

Overall, the goal is to ensure that the bank maintains sufficient capital to withstand potential risks and uncertainties while pursuing its strategic objectives.

4.6 Conduct of Stress Tests and its Utilisation

As part of capital management, the management of a bank shall, as a minimum, conduct relevant stress tests periodically, particularly in respect of the bank's material risk exposures, in order to evaluate the potential vulnerability of the bank to some unlikely but plausible events or movements in the market conditions that could have an adverse impact on the bank. The use of stress testing framework can provide a bank's management a better understanding of the bank's likely exposure in extreme circumstances.

In this context, the attention is also invited to the guidelines issued in this regard. The banks are urged to take necessary measures so that results of stress tests and analyses are incorporated, where applicable, into the capital adequacy assessment.

5. Roles and Responsibilities of Board and Senior Management

For a capital planning process to be meaningful, a bank's senior management and directors should rely on it to provide them with views of the degree to which a bank's business strategy and capital position may be vulnerable to unexpected changes in conditions.

Sound practice entails senior management and the board of directors ensuring that the capital policy and associated monitoring and escalation protocols remain relevant alongside an appropriate risk reporting and stress testing framework.

In formulating the capital management policy in a bank, the roles and responsibilities of the Board of Directors and senior management are crucial and are summarised below:

Board of Directors

- *Setting Strategic Direction*: The board sets the overall strategic direction for the bank, including its capital management objectives and risk appetite.
- *Approving Policy Framework*: The board approves the capital management policy framework, which outlines the principles, guidelines, and procedures for managing capital.
- *Oversight and Review*: The board provides oversight and periodically reviews the effectiveness of the capital management policy in achieving strategic goals and managing risks.
- *Ensuring Compliance*: The board ensures that the bank complies with regulatory requirements related to capital adequacy and capital management practices.
- *Risk Oversight*: The board oversees the bank's risk management practices, including those related to capital adequacy, and ensures that appropriate risk management processes are in place.

Senior Management

- *Implementation*: Senior management is responsible for implementing the capital management policy approved by the Board.
- *Risk Assessment*: Senior management conducts ongoing risk assessments to identify and evaluate capital-related risks, including credit risk, market risk, liquidity risk, and operational risk.
- *Capital Planning*: Senior management develops and executes capital planning strategies to ensure that the bank maintains adequate capital levels to support its business activities and regulatory requirements.
- *Reporting and Disclosure*: Senior management is responsible for reporting on capital adequacy and related risks to the board, regulators, and other stakeholders. This includes providing accurate and timely disclosures in financial reports and regulatory filings.
- *Monitoring and Review*: Senior management monitors the bank's capital position and performance against established targets and takes corrective

actions as needed. This may involve adjusting capital allocation, capital-raising activities, or risk management practices.

Overall, the board and senior management work together to establish a robust capital management framework that aligns with the bank's strategic objectives, complies with regulatory requirements, and effectively manages capital-related risks. A detailed role and responsibilities of board and management are given in Annexure I.

6. Development and Dissemination of Internal Limits

Banks should ensure that all risks are appropriately accounted for when assessing capital requirement. In designing and implementing a capital management policy for a bank, the development and dissemination of internal limits play a crucial role. Bank should put in place a risk appetite and its limit framework for capital which sets hard limits on balance sheet and RWAs consumption, among others. The following steps need to be followed:

Establish a Risk Appetite Framework

- Define the bank's risk appetite, considering factors such as its business strategy, risk tolerance, regulatory requirements, and market conditions.
- Engage the board of directors, senior management, and key stakeholders in the development of the risk appetite framework to ensure alignment with the bank's objectives and values.

Identify Key Capital Management Metrics

- Determine the key metrics and indicators that will be used to monitor and manage capital adequacy, such as capital ratios, liquidity measures, leverage ratios, and risk-weighted assets.
- Consider regulatory requirements, industry best practices, and the bank's specific risk profile when selecting these metrics.

Set Internal Limits

- Based on the risk appetite framework and identified metrics, establish internal limits for each key aspect of capital management.
- Ensure that internal limits are clear, measurable, and enforceable, taking into account the bank's risk profile, business activities, and strategic objectives.
- Involve risk management experts, finance professionals, and relevant stakeholders in the process of setting internal limits to ensure robustness and accuracy.

Document Internal Limits

- Document the internal limits in the capital management policy and other relevant policy documents.
- Clearly articulate the rationale behind each limit, the process for monitoring and enforcing them, and the consequences of breaching the limits.
- Ensure that the documentation is accessible to all relevant stakeholders within the organization, including board members, senior management, risk managers, and front-line staff.

Communicate and Disseminate Internal Limits

- Develop a communication plan to effectively disseminate internal limits throughout the organization.
- Conduct training sessions and workshops to educate staff members on the internal limits and their implications for the bank's operations.
- Use multiple communication channels, such as internal memos, training materials, intranet portals, and town hall meetings, to reach different segments of the organization.
- Encourage open dialogue and feedback from staff members to ensure understanding and buy-in.

Monitor, Review, and Adjust

- Implement robust monitoring and reporting mechanisms to track compliance with internal limits and identify any breaches or exceptions.
- Conduct regular reviews of internal limits to assess their effectiveness in managing capital-related risks and achieving strategic objectives.
- Be prepared to adjust internal limits as necessary based on changes in the bank's risk profile, regulatory requirements, market conditions, or business strategy.

By following these steps, the bank can effectively design and implement internal limits as part of its capital management policy, ensuring prudent risk management and alignment with strategic goals.

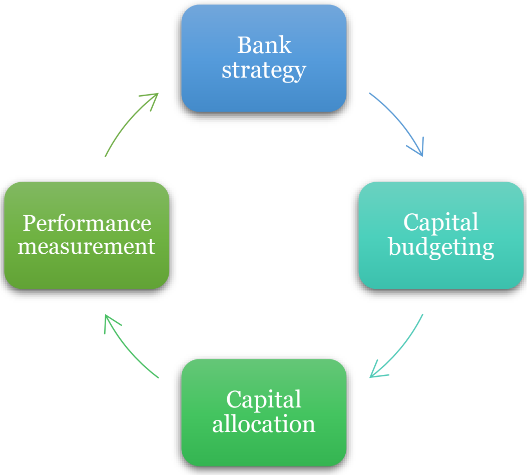
7. Development of Capital Management Framework

The bank's business strategy for the current year and the next three years should align with the capital management process. Capital management involves assessing future capital requirements, optimizing return on capital, and allocating capital across various channels. The bank should develop a framework for capital management through establishment of risk appetite, internal limits on capital, comprehensive capital planning process and assessment of capital adequacy.

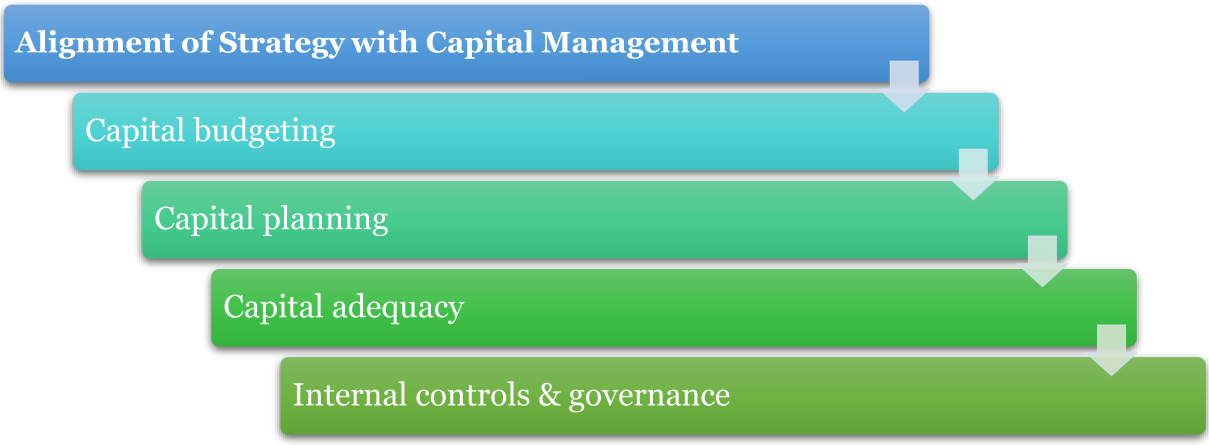
Capital management should be an integral part of the management and decision-making culture of a bank.

The bank's business strategy for the year and plan for next 3 years should be aligned with capital management process. The business strategy of the bank may be based on targets on profit, net income, growth in loans and advances, growth in deposits. Alternatively, banks may track profitability ratio such as return on equity, return on total assets, return on average working fund, etc. The bank should align the capital management decisions with the strategic plan set by the board.

The cycle that links bank strategy, capital budgeting and capital allocation with performance measurement is shown below:


Bank strategy
Capital budgeting
Capital allocation
Performance measurement

Management of capital involves the aspects related with an assessment of capital requirements with a futuristic outlook, return on capital, and allocation of capital through various channels.


Alignment of Strategy with Capital Management
Capital budgeting
Capital planning
Capital adequacy
Internal controls & governance

7.1 Capital Budgeting

Banks translate their strategic plans into detailed capital budgets. A bank's strategic plan sets out the strategy such as where to grow, which businesses to downsize and where to make strategic investments to secure future, profitable growth.

7.2 Capital Planning

Banks with sound capital planning processes should have a formal process in place to identify situations where competing assumptions are made. Capital planning process involves planning of level of internal capital to be maintained, composition of capital, avenues for raising capital, allocation of capital and usage of capital. The planning process also entails plan for distribution of surplus to shareholder / members.

The bank's capital plan should aim at the sound practice of producing an internally consistent and coherent view of a bank's current and future capital needs. The capital planning process forecasts capital requirements for determining optimum levels capital.

Capital planning process should reflect inputs of different experts from across a bank, including but not limited to staff from business, risk, finance and treasury departments.

Key elements to include in the capital plan are:

1. Summary of bank's business strategy.
2. Narrative on the business, local market and economic scenario for the next five years.
3. Analysis of the balance sheet and profitability.
4. Assessment of key risks and uncertainties, including credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation.
5. Summary of key capital policies, including dividends and capital adequacy
6. Sources, cost, availability of capital

Develop an internal strategy for maintaining capital levels which must not only reflect the desired level of risk coverage, but also incorporate factors such as portfolio growth expectations, future sources and uses of funds, and dividend policy. Banks must state their objectives in deciding how much capital to hold. Banks must ensure that the capital objectives go beyond the regulatory minimum to support risks and to consider the following:

a. Fluctuations in capital adequacy ratios, because of changes in type and volume of activities and risk exposures in the normal course of business.

b. Cost of capital-raising, especially in situations where capital injections need to be carried out quickly, or at a time when market conditions are unfavorable.
c. Potential breach of the minimum regulatory capital requirements and regulatory actions in such an event.
d. Limitations in risk assessment infrastructure and methodologies.

An outline of capital planning process is given in Annexure II.

7.3 Capital Adequacy

Banks must ensure that adequate capital is held against all material risks not just at a point in time, but over time, to account for changes in their strategic direction, evolving economic conditions and volatility in the financial environment.

For instance, banks may choose to base their capital adequacy on the results of the capital calculation (as done in capital planning process) combined with the additional capital for significant & material risks (e.g. credit risk, operational risk, market risk, etc.) assessed separately and added to the existing level of capital.

8. Internal Controls and Governance

8.1 System for Internal Regulation of Capital

The board shall specify matters or events that require reporting and those that require approval. The board shall ensure that the senior management reports to them, without delay, any matters that would seriously affect capital management.

The board must regularly and timely enable the appropriate assessment and judgment of the matters listed below:

- The levels and trends of major risks and their impact on the bank's capital.
- The definition of capital and the methods of determining the range of risks to be covered by capital management and evaluating such risks.
- Status of internal capital adequacy in light of the scale and nature of the bank's business and its risk profile.
- Consistency among the capital level, objectives and the risk profile.
- Necessity for revising capital plans.

8.2 Independent validations

The bank may involve exposing capital plans and their underlying processes and models to regular independent validation. This layer of review is important for confirming that the processes are strong, are applied consistently and remain relevant for the bank's business model and risk profile.

8.3 Development of Internal Audit Guidelines & an Internal Audit Plan

The board shall form an Internal Audit Division which appropriately identifies the matters to be audited with regard to capital management, develop guidelines that specify the matters subject to internal audit and the audit procedure (hereinafter referred to as "Internal Audit Guidelines") and an internal audit plan, and form such guidelines and plan.

The following matters shall be clearly specified in the Internal Audit Guidelines or the internal audit plan and provide a system to have these matters appropriately audited:

- Status of development of the capital management system.
- Eligibility of the bank's capital under regulations on capital requirements.
- Status of compliance with the capital management policy and the capital management limits.
- Appropriateness of the internal capital adequacy assessment process commensurate with the scale and nature of business and the risk profile.
- Validity of the internal capital adequacy assessment method (technique, assumptions).
- Accuracy and completeness of the data used in the internal capital adequacy assessment.
- Validity of scenarios, etc., used in stress tests.
- Appropriateness of the process of calculating the capital adequacy ratio.
- Status of improvement of matters pointed out in an internal audit or on the occasion of the last inspection.

Annexure I

Roles and Responsibilities of Board and Senior Management

a. Roles and Responsibilities of Board of Directors

- It should attach importance to capital management, fully recognizing that the lack of such an approach could seriously hinder the attainment of strategic objectives.
- It should establish a policy regarding capital management (hereinafter referred to as the "Capital Management Policy") and disseminate it throughout the bank.
- It should oversee establishing an adequate capital management system with a full understanding of the assessment, monitoring and control techniques of capital adequacy.
- It shall be responsible for approving and periodically reviewing the capital management policy of the bank.
- It shall have the overall responsibility for management of capital.
- It shall set limits in lines with the bank's risk appetite.
- It shall decide the capital management policy of the bank and make sure that the regulatory requirements are fulfilled.
- It shall analyse how much capital the bank needs presently and will need in the future considering the bank's strategic objectives and take into consideration the desirable level of capital thus determined, the amount of capital that must be raised to achieve that level and suitable capital-raising methods.
- It shall ensure consistency between capital management with the bank's risk profile and the situation surrounding its business.
- It shall hold a management team accountable for demonstrating that adherence to a capital management policy which will allow the bank to maintain ready access to funding, meet its obligations to creditors and other counterparties, and continue to serve as a credit intermediary under normal and stress scenarios.

b. Responsibilities of Senior Management

- Senior management of a bank shall be responsible for implementing the capital management policy approved by the board.
- They will ensure that bank personnel involved in capital management activities have the adequate skills, including complex financial risk management skills, and that employees are adequately enabled through training.

- They will ensure that they have adequate understanding of the material risks that are impacting the business, as well as an awareness of emerging risks and vulnerabilities.
- They will ensure effective implementation of relevant policies, procedures, systems and controls.
- They will ensure that they communicate the internal controls and written policies and procedures throughout the bank.
- They will be monitoring risk exposures in accordance with the risk appetite and limits approved by the board.
- They will ensure that the board receives adequate information pertaining to risk management and capital management, under both normal and stressed business conditions.
- They will be monitoring and reporting of status against ICAAP to the board.
- The roles and responsibilities of risk management, financial control and compliance in relation to ICAAP must be clearly documented in the related policies and procedures.

Annexure II

An illustrative outline of the Capital Planning Process

1. Capital Planning Process

The board in their capital management policy shall develop capital plans designed to achieve an appropriate level of capital targeted by the bank.

2. Contents

Capital planning process should contain the following sections:

I. Executive Summary

II. Background

III. Summary of current and projected financial and capital positions

IV. Methodologies and assumptions for capital planning

V. Aggregation and diversification

I. Executive Summary

The purpose of the executive summary is to present an overview of the capital planning process and results. This overview would typically include:

a) The purpose of the report and the regulated entities within a banking group that are covered by the capital planning process.

b) The main findings of the capital planning process:

i. How much and what composition of internal capital the bank considers it should hold as compared with minimum CRAR requirement.

ii. The adequacy of the bank's risk management processes.

c) A summary of the financial position of the bank, including the strategic position of the bank, its balance sheet strength, and future profitability.

d) Brief descriptions of the capital raising and dividend plan including how the bank intends to manage its capital in the days ahead and for what purposes.

e) Commentary on the most material risks to which the bank is exposed, why the level of risk is considered acceptable or, if it is not, what mitigating actions are planned.

f) Commentary on major issues where further analysis and decisions are required.

g) Who has carried out the assessment, how it has been challenged / validated / stress tested, and who has approved it.

II. Background

This section would cover the relevant organisational and historical financial data for the bank, operating profit, profit before tax, profit after tax, dividends, shareholders' funds, capital funds held vis-à-vis the regulatory requirements, customer deposits, deposits by banks, total assets, and any conclusions that can be drawn from trends in the data which may have implications for the bank's future.

Definition of Capital

It would be necessary to clearly spell out in the document whether what is being presented represents the bank's view of the amount of capital required to meet minimum regulatory needs or whether it represents the amount of capital that a bank believes it would need to meet its business plans. For instance, it should be clearly brought out whether the capital required includes buffers for strategic purposes or seeks to minimise the chance of breaching regulatory requirements.

If the bank uses the regulatory own funds as a starting point for its internal capital definition, it is expected that a large part of internal capital components will be expressed in Common Equity Tier 1 (CET1) own funds.

Banks may, however, for the purpose of allocation, make certain simplification adjustments to the way CET1 capital is calculated for regulatory purposes. One example of those adjustments is to not use the same deductions as specified in the regulatory framework or not make any deductions at all when computing allocated CET1 capital.

III. Summary of current and projected financial and capital positions

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

The starting balance sheet used as reference and date as of which the assessment is carried out should be indicated.

The projected financial position could reckon both the projected capital available and projected capital requirements based on envisaged business plans. These might then provide a basis against which adverse scenarios might be compared.

IV. Methodologies and assumptions for capital planning

There are multiple approaches a bank may adopt for capital planning process. A description of methodology adopted by bank for assessment and planning of capital along with main assumptions made may be provided.

Risk-weighted Asset (RWA) based

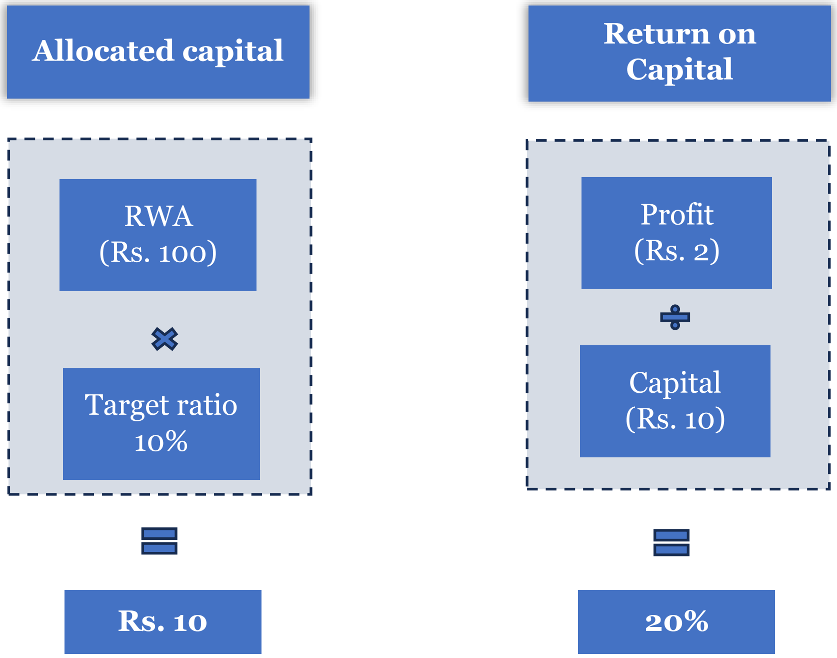
Risk-based capital requirements specify the amount of capital that banks need to have, based on their RWAs. Banks may also maintain additional CET1 capital to cover the deterioration in their capital positions under stress situations.

Under the RWAs-based approach, the amount of CET1 capital to be maintained is determined on the basis of their RWAs usage. The advantage of this approach is the ease of use and transparency. Given that banks already calculate RWAs at the granular level of individual assets and exposures and have well-embedded RWAs reporting capabilities, RWAs lend themselves well to an allocation mechanism that can be applied at all levels of the organisation. The product / sector returns can also be easily aligned with the targets set under the banks' overall Return on Equity (RoE), Return on Capital Employed (RoCE) and Return on Total Assets (RoTA).

Banks may use RWAs in their capital allocation framework either as a standalone metric or in combination with other regulatory metrics. Among banks that use RWAs as a standalone metric, some choose to allocate to business lines only the minimum component of their risk-based capital requirements. Others have opted to allocate all the components of their regulatory capital requirements, i.e. capital buffers as well. This aims to make business lines accountable for the full suite of regulatory capital requirements that banks have to meet.

Banks determine a target CET1 capital ratio as part of their business strategy. A target capital ratio is the level of capital ratio that banks aim to maintain in normal conditions. They take into account all of the components of the risk-based CET1 requirements including regulatory capital buffers as well as an internal operating buffer to determine this target ratio. The internal operating buffer is an additional capital buffer determined by banks' management to avoid falling below the regulatory capital requirements because of unexpected fluctuations in the equity capital due to market-related factors.

Figure 1 depicts an example in which a bank uses RWAs as a standalone metric to allocate CET1 capital. In this example, we have assumed for simplicity that the bank's CET1 target capital ratio is 10% of RWAs.



This target capital ratio is applied to the RWAs consumed by various sectors that the bank operates in, to determine the CET1 capital allocated to them. If the RWAs consumed by a sector are Rs. 100 and the profits it generates are Rs. 2, the CET1 capital allocated would be Rs. 10 (Rs. 100 *10%) and the return on the capital allocated would be 20% (Rs. 2 /Rs. 10*100)

The advantage of using this approach is its transparency and its linkage to the bank-wide target for RoE / RoCE / RoTA. However, if the bank has significantly higher levels of CET1 capital compared to its RWAs-based requirement, it will need to adjust the target return on CET1 capital allocated for each sector to ensure that the bank-wide RoE target is met.

V. Aggregation and diversification

This section would describe how the results of the various separate risk assessments are brought together and an overall view taken on capital adequacy. At a technical level, this would, therefore, require some method to be used to combine the various risks using some appropriate quantitative techniques. At the broader level, 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.

In undertaking an overall assessment, the bank should describe how it has arrived at its overall assessment of the capital it needs taking into account such matters as:

i) The inherent uncertainty in any modelling approach.

ii) Weaknesses in the bank's risk management procedures, systems or controls.

iii) The differences between regulatory capital and internal capital.

iv) The differing purposes that capital serves: shareholder returns, rating objectives for the bank as a whole or for certain debt instruments the bank has issued, avoidance of regulatory intervention, protection against uncertain events, depositor protection, working capital, capital held for strategic acquisitions, etc.