



Commission de Surveillance
du Secteur Financier

Circular CSSF 07/301

AS AMENDED BY CIRCULARS
CSSF 08/338, CSSF
09/403, CSSF 11/506,
CSSF 13/568 AND CSSF
20/753

IMPLEMENTATION OF THE
INTERNAL CAPITAL AND
LIQUIDITY ADEQUACY
ASSESSMENT PROCESS
(ICAAP/ILAAP)

Circular CSSF 07/301 as amended by Circulars CSSF 08/338, CSSF 09/403, CSSF 11/506, CSSF 13/568 and CSSF 20/753

Re: Implementation of the Internal Capital and Liquidity Adequacy Assessment Process (ICAAP/ILAAP)

Luxembourg, 21 October 2020

Ladies and Gentlemen,

To all credit institutions and CRR investment firms incorporated under Luxembourg law and to the Luxembourg branches of credit institutions and investment firms having their registered office in a third country

In accordance with articles 73 and 86 of Directive 2013/36/EU as transposed by articles 18 and 19 of CSSF Regulation N° 15-02 ("RCSSF 15-02"), CRR institutions (as defined in Article 1(1) of RCSSF 15-02 and hereafter referred to as "institutions") shall have in place an internal capital and liquidity adequacy assessment process (ICAAP/ILAAP).

The ICAAP [ILAAP] is a set of sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amount, types and distribution of internal capital [the level, composition and quality of liquidity buffers] that an institution considers adequate to cover the nature and level of the risks to which it is or might be exposed.

ICAAP and ILAAP are part of the wider internal risk management and mitigation processes. They build on the results of the internal processes for identifying, measuring, managing and reporting the risks. ICAAP and ILAAP results feed into the internal process for capital and liquidity planning and management.

This circular contains the implementing provisions, including documentation and reporting requirements that institutions shall meet in order to comply with articles 18 and 19 of RCSSF 15-02. They complement the general (risk) governance principles of CSSF Circular 12/552, that apply to ICAAP and ILAAP in particular.

The CSSF assesses institutions' ICAAP and ILAAP as part of the supervisory review and examination process (SREP) according to the EBA Revised Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and stress testing, amending EBA GL/2014/13 (EBA/GL/2018/03). The documentation requirements are based on the EBA Guidelines on ICAAP and ILAAP information collected for SREP purposes of 3 November 2016 (EBA/GL/2016/10)¹.

Chapter I. Scope of application

1. This circular applies to all institutions² that are required to have in place an ICAAP and ILAAP pursuant to article 3 of RCSSF 15-02.

¹ Both GL are available on the EBA website <https://www.eba.europa.eu/>

² "Significant supervised entities" as defined in Article 2, point 16 of Regulation (EU) N° 4687/2014 of the European Central Bank (ECB) of 16 April 2014 (SSM Framework Regulation) shall refer to the relevant ECB rules (if any).

Chapter II. Requirements applicable to ICAAP and ILAAP

Sub-chapter II.1. General requirements as regards process

2. The ICAAP and ILAAP are *internal* processes of the institutions, adapted to their organisation and to their specific operational needs so as to ensure the adequacy of capital and liquidity as a risk mitigation in normal (through the cycle) and stressed times. The scope and capacity of the ICAAP and ILAAP increase with the nature, scale and complexity of the institution's activities (including their inherent risks) and organisation. The quantitative and qualitative aspects of the ICAAP and ILAAP have to be consistent with the institution's business model, risk appetite, decision-making as well as risk management, including monitoring.
3. Despite the internal nature of the ICAAP and ILAAP, the informational needs or technical infrastructures necessary for the operation of the ICAAP and ILAAP may be subject to outsourcing, provided that the outsourcing arrangements are sound, robust and tailored such as to guarantee the continuity and effectiveness of ICAAP and ILAAP. Management decisions, risk and internal capital/liquidity management and monitoring may not be outsourced.
4. The ICAAP and ILAAP must be comprehensively documented, including their relation to the business model as well as to the strategy and policy (with respect to risk, capital and liquidity) and covering methodology, description of internal organisation and process (work procedures) as well as the results and decisions as regards internal capital and liquidity. The documentation also covers the data infrastructure and IT frameworks underlying ICAAP and ILAAP.
5. The ICAAP and ILAAP are subject to a periodic review by the management body in order to ensure that:
 - the coverage of risks remains comprehensive and adapted to the nature, scale and complexity of the institution's activities and that the amount, the types and the distribution of internal capital [the level, composition and quality of liquidity buffers] remain appropriate to effectively mitigate risk in normal and stressed times;
 - the ICAAP and ILAAP remain fully operating and effective on an ongoing basis;
 - the outcomes of the capital/liquidity adequacy assessments are reflected in the institution's risk, capital and liquidity management and decision making.

This review shall take place at least once a year. It shall be carried out with the necessary objectivity and with the involvement of the risk control function. Internal audit shall also regularly audit the ICAAP and ILAAP according to its risk-based audit plan.

Sub-chapter II.2. Specific responsibilities of the management body

6. The management body shall demonstrate appropriate commitment to and knowledge of the ICAAP and ILAAP. It shall ensure that, as a result of ICAAP and ILAAP, the institution holds internal capital and liquidity that effectively protect the institution against the materialisation of risk.
7. The authorised management is responsible for the development, implementation and maintenance of an ICAAP and ILAAP in accordance with the risk and the internal capital and liquidity strategy (principles and objectives) established by the management body in its supervisory function and the

applicable regulatory requirements. This responsibility covers the ICAAP's and ILAAP's sound and effective operation and adequacy. It applies to the entire ICAAP and ILAAP, whether or not some aspects have been outsourced.

8. The authorised management informs the management body in its supervisory function on the institution's situation of risks and its internal, current and planned capital and liquidity, in the form that best suits the institution's needs. The frequency of the reporting should be adapted to a.m. risk and business developments, excess capital and liquidity buffers and the internal decision making process. This information contains the capital adequacy statement ("CAS") and liquidity adequacy statement ("LAS") that the management body in its supervisory function is required to endorse.

Sub-chapter II.3. Capital and liquidity adequacy

9. ICAAP and ILAAP shall be comprehensive, scoping in all material risks, wherever they are located within business lines or (legal) entities. In this context, "material risk" refers to a contingency that may cause material economic losses or outflows that would deplete the institution's internal capital or liquidity.
10. ICAAP and ILAAP shall be effective, resulting in all material risks being supported by adequate capital and liquidity where "adequate" refers to both quantity and quality of capital/liquidity including their immediate operational availability to mitigate risk. To ensure effectiveness, and in line with the economic definition of risk as provided here above, the perspective taken on ICAAP/ILAAP shall be the economic one, focussing on substance rather than form. For instance, the institution shall duly reflect in its internal capital and liquidity needs the risks and losses it could face in relation to related entities outside the regulatory perimeter of consolidation.
11. The justifications for not holding internal capital or liquidity shall be duly documented.
12. ICAAP and ILAAP shall not only take into account the current situation of the institution but shall be forward-looking in order to ensure that internal capital and liquidity remain adequate on an ongoing basis, including in times of stress, and considering the economic and regulatory environment in which the institution operates or could come to operate, for instance as a result of internal business decisions or factors external to the institution.
13. The internal capital and liquidity adequacy assessment shall be determined with reference to a credible baseline scenario ("normal times") and a severe, institution-specific, adverse scenario ("stressed times").
14. The institutions shall ensure that their capital and liquidity remains adequate over the long term. The shorter-term perspective of (usually) one year has to be complemented by a longer-term (at least 3 years horizon) forward-looking perspective in line with the horizon of the institution's multi-year capital and liquidity planning. Furthermore, institutions shall have a clear understanding how successive (e.g. 3 years) longer-term planning horizons link up in order to ensure the time-consistent management of internal capital and liquidity over the long run and to avoid potential cliff effects.
15. Besides the internal capital and liquidity adequacy ("economic perspective"), institutions are also bound by regulatory capital and liquidity requirements ("normative perspective") and possibly other external (financial) constraints and considerations on capital and liquidity (e.g. related to their external rating). Institutions shall establish an internal multi-year assessment process regarding

their ability to fulfil all of their capital and liquidity-related demands on an ongoing basis. This process should ensure the consistency of those demands and their full integration into all material management processes and decisions.

Sub-chapter II.4. Reporting requirements

16. For the purpose of point 8 of this circular, the ICAAP and ILAAP information should cover at least the following:
- Where relevant for ICAAP and ILAAP, general summary context information on:
 - i. Business model (strategy);
 - ii. Risk governance and management framework;
 - iii. Risk appetite framework (statement);
 - iv. Stress testing framework and programme;
 - v. Risk data, aggregation and IT systems.
 - ICAAP and ILAAP specific information as set out in points 17 and 18 of this circular;
 - Summary of the main conclusions of the ICAAP and ILAAP including the CAS and LAS as set out in point 19 of this circular.

Institutions may gather all the ICAAP and ILAAP information either in one comprehensive report (for capital and liquidity taken together) or as two separate reports. They may also choose to have the ICAAP and ILAAP information split across different internal documents and use cross-referencing. In that case, a reader's manual needs to be prepared as an overarching document facilitating the assessment.

According to the circular CSSF 19/731, the ICAAP and ILAAP information should be submitted to the CSSF. Institutions should be prepared to provide CSSF with additional supporting information upon request (e.g. minutes of relevant committees and meetings of the management body evidencing the sound set-up and implementation of the ICAAP and the ILAAP).

17. The ICAAP information should provide a broad overview over the methodology and the ICAAP implementation in terms of policies and operations, covering in particular the following aspects:
- a. Risk measurement, assessment and aggregation
 - b. Internal capital and capital allocation
 - c. Capital planning
18. The ILAAP information should provide a broad overview over the methodology and the ILAAP implementation in terms of policies and operations, covering in particular the following aspects:
- a. Liquidity and funding risk management framework
 - b. Funding strategy

- c. Strategy regarding liquidity buffers and collateral management
- d. Cost-benefit allocation mechanism
- e. Intraday liquidity risk management
- f. Liquidity contingency plan

19. The main conclusions of the internal capital and liquidity adequacy assessments shall be set out in a clear and concise statement on the current and future capital adequacy (CAS) and liquidity adequacy (LAS). The conclusion shall also spell out the implications of these assessments for the management and the organisation of the institutions' activities and the management of risks.

Yours faithfully,

Claude WAMPACH
Director

Marco ZWICK
Director

Jean-Pierre FABER
Director

Françoise KAUTHEN
Director

Claude MARX
Director General

Annex: Further guidance on specific aspects of ICAAP and ILAAP.

ANNEX: Further guidance on specific aspects of ICAAP and ILAAP

This annex includes some additional guidance to institutions for the practical implementation of their ICAAP and ILAAP.

I. Business model, strategy and risk appetite

The institution is expected to clearly express how the implementation and monitoring of its business strategy and risk appetite are supported by its ICAAP and ILAAP, and how this effectively allows it to comply with the agreed risk boundaries set out in the risk appetite statement. In order to facilitate sound and effective risk management, the institution is expected to use the ICAAP and ILAAP outcomes when setting up an effective risk monitoring and reporting system and an adequately granular limit system (including effective escalation procedures) that allocates specific limits to, for example, individual risks, sub-risks, entities and business areas.

II. Risk identification

The institution is responsible for defining its own internal risk taxonomy. It is expected not to simply adhere to a regulatory risk taxonomy, unless it can demonstrate that such taxonomy is fit for purpose.

Institutions should take into account all the underlying risks, where material, stemming from their financial and non-financial participations, subsidiaries and other connected entities (for example, step-in and group risks, reputational and operational risks, risks stemming from letters of comfort, etc.).

Each institution is expected to decide internally whether and how it combines risk categories and risk sub-categories. It remains the institution's responsibility to determine all of its material risks, all risk concentrations at the relevant granularity as well as co-movements between and within the risk (sub-) categories.

Institutions shall at least assess:

- Credit risk (including counterparty credit risk, country risk)
- Market risk (including structural foreign exchange (FX) risk)
- Liquidity risk
- Interest rate risk (differentiating EVE and NII scenarios)
- Operational risk (including business disruption and systems failure, IT risk, legal and compliance risk and model risk)
- Risks related to money laundering and terror financing (ML/TF)
- Concentration risks

Institutions providing services in the field of private banking or wealth management, UCI administration or depository banking shall factor related reputational risk, operational risk as well as ML/TF risks in their ICAAP and ILAAP, where relevant.

The data quality framework is expected to ensure reliable risk information that supports sound decision-making, and it is expected to cover all relevant risk data³ and data quality dimensions.

III. Risk and internal capital measurement

Institutions should recognise that, owing to different valuation methodologies and assumptions for assets, liabilities and transactions, the available internal capital under the economic perspective may differ significantly from the own funds under the normative perspective. Consequently, institutions should take a prudent approach when defining their required internal capital. This prudence applies to all underlying assumptions and methodologies used for the quantification of the available and required internal capital.

³ This particularly applies for operational risk for which the loss database should be considered in the ICAAP.

Institutions should adopt prudent and robust risk measurement approaches. They should ensure that their choices regarding the holding period and the aggregation guarantee the objective of permanent internal capital adequacy. For this purpose, they shall act with prudence and good judgement, in particular concerning the hypothesis made on aggregation. The assumptions concerning the way in which the various risks interact together (“co-movements” between risks) shall in particular take into account the variability of these co-movements over time, notably in stress situations.

IV. Consistency between ICAAP/ILAAP and recovery plans

The institution is expected to ensure consistency and coherence between its ICAAP and ILAAP and its own or relevant group recovery planning in terms of early warning signals, indicators, escalation procedures following breaches of these thresholds and potential management actions.



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