

BEST PRACTICE GUIDELINE

From the Banking Regulation and Supervision Agency:

**GUIDELINE ON THE ASSESSMENT CRITERIA CONSIDERED IN THE
SUPERVISORY REVIEW PROCESS**

SERIAL NO 1:	REGULATORY AND INTERNAL CAPITAL ADEQUACY, LIQUIDITY, STRESS TESTING, SECURITISATION EXPOSURES, AND FAIR VALUE PRACTISES
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I. OBJECTIVE AND SCOPE

1. The objective of this guideline is to provide information to the banks about assessment criteria considered in the supervisory review process to be performed by the Agency as part of the Article 7/A entitled “Best Practices Guides” of “Regulation on Principles and Procedures Concerning the Audit to be performed by the Banking Regulation and Supervision Agency (Regulation on Audit)” published in the Official Gazette dated July 22, 2006 Nr: 26236.
2. The guideline is based on the provisions of Article 93 of Banking Law Nr: 5411 dated October 19, 2005 and the Article 7/A entitled “Best Practices Guides” of Regulation on Principles and Procedures Concerning the Audit to be performed by the Banking Regulation and Supervision Agency published in the Official Gazette dated July 22, 2006 Nr: 26236.
3. The Agency considers assessment criteria which is said in this guideline in accordance with the audit planning and to the extent that resources allow.
4. The Agency performs the audit process through an appropriate composition of on-site examinations and off-site reviews.
5. In this guideline;
 - Regulatory Capital Adequacy,
 - Internal Capital Adequacy,
 - Liquidity,
 - Stress Testing,
 - Securitisation Exposures, and
 - Fair Value Practices

issues will be declared in terms of the assessment criteria considered in the audits to be performed by the Agency.

II. DEFINITIONS

6. The phrase “Internal Systems and the ICAAP Regulation” in this Guideline expresses the Regulation on Internal Systems and Internal Capital Adequacy Assessment Process of Banks published in the Official Gazette dated July 11,2014 Nr:29057.
7. Other terms used in this Guideline have the meanings as the other “Best Practice Guides” prepared concerning the Regulation on Audit.

III. REGULATORY CAPITAL ADEQUACY

8. The Agency examines the regulatory capital adequacy and calculation process, models and assumptions.
9. The Agency may wish to adopt an approach to focus more intensely on those areas where risks are concentrated.
10. The Agency considers the following issues in addition to the matters contained in the relevant legislation for the bank that uses the IRB approach.

{1} Independence of the rating assignment process can be achieved through a range of practices that will be carefully reviewed by the Agency.

{2} Subject to supervisory review, equity portfolio correlations can be integrated into a bank’s internal risk measures. The appropriateness of implicit correlation assumptions will be evaluated by the Agency in the review of model documentation and estimation techniques.

{3} In relation to the internal model used for equity portfolio correlations;

- a. The modelling process itself,
- b. The systems used to validate internal models including all supporting documentation, validation results, and
- c. The findings of internal and external reviews

are subject to oversight by the top management (senior management and the board of directors) and they should be reviewed by the Agency as well.

11. Agency reviews the cases where risks that banks are exposed are mitigated by credit conversion factors, risk mitigation practices and credit quality steps as well as practices that are subject to approval.

{1} In order for certain internal methodologies, credit risk mitigation techniques and asset securitisations to be recognized for regulatory capital purposes, banks will need to meet a number of requirements, including risk management standards, documentation and disclosures. All these requirements will be examined by the Agency. As part of the supervisory

review process, the Agency must ensure that these conditions are being met on an ongoing basis.

IV. INTERNAL CAPITAL ADEQUACY

12. The Agency examines the internal capital adequacy and calculation process, models and assumptions that are used by banks.

- {1} The Agency is expected to evaluate regularly how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. This interaction is intended to foster an active dialogue between banks and the Agency such that when deficiencies are identified, prompt and decisive actions can be taken to reduce risk or restore capital. Accordingly, the Agency may wish to adopt an approach to focus more intensely on those areas where risks are concentrated.
- {2} During the ICAAP audits, the Agency carries out direct controls of the processes, focuses on the quality of the bank's risk management, internal control and internal audit functions.
- {3} The ICAAP audits, carried out interactively with the bank's top management. The audits can involve some combination of; independent review of work done by external auditors, periodic reporting within the bank, on-site examinations and off-site review.
- {4} If significant methodology and assumption flaws are identified during the ICAAP review, the Agency may ask the bank to take prompt corrective actions or to hold capital buffers as an additional temporary measure until adequate correction actions are taken. In this case, bank management is responsible for elaboration of these flaws and their impacts.
- {5} The Agency assesses the degree to which internal targets and processes incorporate the full range of material risks faced by the bank. The Agency also reviews the adequacy of risk measures used in assessing internal capital adequacy and the extent to which these risk measures are also used operationally in setting limits, evaluating business line performance, and evaluating and controlling risks more generally. The Agency considers the results of sensitivity analyses and stress tests conducted by the bank and how these results relate to capital plans.
- {6} The Agency reviews the bank's processes to determine that:

- a. Target levels of capital chosen are comprehensive and relevant to the current operating environment;
- b. These levels are properly monitored and reviewed by senior management; and
- c. The composition of capital is appropriate for the nature and scale of the bank's business.

{7} The Agency also considers the extent to which the bank has provided for unexpected events in setting its capital levels. This analysis should cover a wide range of external conditions and scenarios, and the sophistication of techniques and stress tests should be commensurate with the bank's activities.

{8} During the ICAAP audits, the Agency considers the quality of the bank's management information reporting and systems, the manner in which business risks and activities are aggregated, and management's record in responding to emerging or changing risks.

{9} In all instances, the capital level at an individual bank is determined according to the bank's risk profile and adequacy of its risk management process and internal controls. External factors such as business cycle effects and the macroeconomic environment are also considered by supervisors.

{10} In the ICAAP audits, The Agency will ensure that the conditions stipulated in the regulations are being met, both as qualifying criteria and on a continuing basis for banks that using advanced methods.

{11} The supervisory review process of the Agency is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

{12} Where the Agency considers that limited liquidity or price transparency undermines the effectiveness of a bank's model to capture the specific risk, it will take appropriate measures, including requiring the exclusion of positions from the bank's specific risk model. The Agency reviews the adequacy of the bank's measure of the default risk surcharge; where the bank's approach is inadequate, the use of the standardized specific risk charges will be required.

13. During the ICAAP audits, the Agency considers the following issues in addition to the matters contained in the relevant legislation regarding the counterparty credit risk.

- {1} When assessing an internal model used to estimate EPE, and especially for banks that receive approval to estimate the value of the alpha factor, the Agency reviews the characteristics of the firm's portfolio of exposures that give rise to CCR. In particular, the Agency considers the following characteristics, namely:
 - a. The diversification of the portfolio (number of risk factors the portfolio is exposed to);
 - b. The correlation of default across counterparties; and
 - c. The number and granularity of counterparty exposures.
 - {2} The Agency will take appropriate actions where the firm's estimates of exposure or EAD under the Internal Model Method or alpha do not adequately reflect its exposure to CCR. Such actions might include directing the bank to revise its estimates; directing the bank to apply a higher estimate of exposure or EAD under the IMM or alpha; or disallowing a bank from recognizing internal estimates of EAD for regulatory capital purposes.
 - {3} For banks that make use of the standardized method, the Agency reviews the bank's evaluation of the risks contained in the transactions that give rise to CCR and the bank's assessment of whether the standardized method captures those risks appropriately and satisfactorily. If the standardized method does not capture the risk inherent in the bank's relevant transactions (as could be the case with structured, more complex OTC derivatives), the Agency may require the bank to apply the CEM or the SM on a transaction-by-transaction basis (i.e. no netting will be recognized).
14. During the ICAAP audits, the Agency considers the following issues in addition to the matters contained in the relevant legislation for the bank that is using the IRB approach.
- {1} The Agency confirms that the bank holds internal capital for receivables that are similar to equities but not included in that class in the ICAAP process.
 - {2} Some exposures in non-significant business units as well as asset classes (or subclasses in the case of retail) that are immaterial in terms of size and perceived risk profile may be exempt from the requirements of IRB approaches, subject to approval of the Agency. Capital requirements for such operations will be determined according to the standardized approach, with the Agency determining whether a bank holds internal capital for that units and classes in the ICAAP process.

- {3} A bank using the IRB approach but doesn't have compliance temporarily with the requirements stated in the "Communiqué on Calculation of the Risk Weighted Exposure Amount for Credit Risk by Internal-rating based Approaches (CIRB)", the Agency considers the measures to be taken including holding additional capital in the ICAAP process until the bank again achieves the requirements.
- {4} The Agency reviews how the stress tests have been carried out according to "Guideline on Stress testings to be Used by Banks in Capital and Liquidity Planning (GST), Paragraph 117A". If the level of capital is below the level required by the stress test results, the Agency considers the measures to be taken including reducing its risks and/or to hold additional capital/provisions.

14A. Where the Agency is not satisfied as to the robustness, suitability or application of the Credit Risk Mitigation policies and procedures they may direct the bank to take immediate remedial action or hold additional capital against residual risk until such time as the deficiencies in the Credit Risk Mitigation procedures are rectified to the satisfaction of the Agency. For example, the Agency may direct a bank to:

- a. Make adjustments to the assumptions on holding periods, supervisory haircuts, or volatility (in the own haircuts approach);
- b. Give less than full recognition of credit risk mitigants (on the whole credit portfolio or by specific product line); and/or
- c. Hold a specific additional amount of capital.

V. ADEQUACY OF LIQUIDITY

15. The Agency reviews the liquidity adequacy of banks and assesses the quality of liquidity management.

- {1} The Agency regularly perform assessments of a bank's overall liquidity risk management framework and position to determine whether they deliver an adequate level of resilience to liquidity stress given the bank's role in the financial system.
- {2} While supervising, the Agency makes use of prudential reports, internal reports and market information by monitoring a combination of internal reports, prudential reports and market information.
- {3} The Agency urgently contacts to banks to require effective and timely remedial action by their senior managements to address deficiencies in banks' liquidity risk management processes or liquidity positions.

- {4} The Agency communicate with other national/international supervisors and public finance authorities to facilitate effective cooperation regarding the supervision and oversight of liquidity risk management within the scope of the authority given to the Agency by the legislations. The cooperation aforementioned increases as appropriate during negative market conditions.
16. The Agency reviews not only regulatory ratios and limits but also internal assessments regarding the adequacy of liquidity.
- {1} The Agency assesses whether the requirements of Regulation on Calculation of Liquidity Coverage Ratio of Banks (RLCR) are met by banks, especially on their compliance of minimum Liquidity Coverage Ratio (LCR) levels and related calculations
- a. During a period of financial stress, banks may use their stock of High Quality Liquid Assets (HQLA), thereby falling below minimum LCRs (for Total version 100%, for Only Foreign Currency version 80%) as maintaining the LCR required by RLCR under such circumstances could produce undue negative effects on the bank and other market participants. The Agency assesses the situation and will adjust its response flexibly according to the circumstances.
 - b. In particular, the Agency's decisions regarding a bank's use of its HQLA are guided by consideration of the core objective and definition of the LCR. The Agency exercises judgement in its assessment and account not only for prevailing macrofinancial conditions, but also consider forward-looking assessments of macroeconomic and financial conditions. In determining a response, the Agency takes into consideration the fact that some actions could be procyclical if applied in circumstances of market-wide stress. The Agency also takes these considerations into account on a consistent basis across jurisdictions in which the banks operate and carries out the following assessments.
 - i. The Agency assesses conditions at an early stage, and take actions if deemed necessary, to address potential liquidity risk.
 - ii. The Agency has an approach that allows for differentiated responses to a reported LCR below required minimums. Supervisory responses are designed to be proportionate with the

drivers, magnitude, duration and frequency of the reported shortfall.

- iii. The Agency assesses a number of firm- and market-specific factors in determining the appropriate response as well as other considerations related to both domestic and global frameworks and conditions, such as:

- {}{a} The reason(s) that the LCR fell below required minimums.

- This includes use of the stock of HQLA, an inability to roll over funding or large unexpected draws on contingent obligations. In addition, the reasons may relate to overall credit, funding and market conditions, including liquidity in credit, asset and funding markets, affecting individual banks or all institutions, regardless of their own condition;

- {}{b} The extent to which the reported decline in the LCR is due to a firm-specific or market-wide shock;

- {}{c} A bank's overall health and risk profile, including activities, positions with respect to other supervisory requirements, internal risk systems, controls and other management processes, among others;

- {}{d} The magnitude, duration and frequency of the reported decline of HQLA;

- {}{e} The potential for contagion to the financial system and additional restricted flow of credit or reduced market liquidity due to actions to maintain an LCR above required minimums;

- {}{f} The availability of other sources of contingent funding (such as central bank funding), or other tools.

- iv. The Agency uses a range of tools at their disposal to address a reported LCR below required minimums. Banks may use their stock of HQLA in both idiosyncratic and systemic stress events, although the supervisory response may be different between the two.

- {}{a} The Agency requires the bank to present an assessment of its liquidity position, including the factors that contributed to its LCR falling below required minimums, the measures that

have been and will be taken and the expectations on the potential length of the situation. Enhanced reporting to the Agency is expected to be commensurate with the duration of the shortfall.

{{b}} If appropriate, the Agency may also require actions by the bank to reduce its exposure to liquidity risk, strengthen its overall liquidity risk management, or improve its contingency funding plan.

{{c}} However, in a situation of sufficiently severe system-wide stress, effects on the entire financial system are also considered. Potential measures to restore liquidity levels are assessed, and designed to be executed over a period of time considered appropriate to prevent additional stress on the bank and on the financial system as a whole.

- v. When designing supervisory responses the Agency's overall approach to the prudential framework is also taken into account.
- c. During LCR examinations, the Agency assesses among others whether the transactions are eligible for being operational deposit according to the related regulation. If any issues (including a high concentration ratio) are found, the Agency then take appropriate measures accordingly.

VI. STRESS TESTS

- 17. The Agency conducts stress tests to determine the risks to which banks are exposed under stress and actions to be taken to manage those risks. The results of the stress test are shared with the banks if necessary.
- 18. The Agency supervises the stress tests conducted by banks with regard to basis, content, sufficiency and efficiency.

{1} The Agency interrogates the effectiveness of processes and controls if the banks' stress testing program has vulnerable points.

{2} During the audits conducted, the Agency review the key assumptions driving stress testing results and challenge their continuing relevance in view of existing and potentially changing market conditions

- {3} The Agency challenges banks on how stress testing is used in internal processes of banks and the way it affects decision-making.
- {4} After assessments made, the Agency determines and transmits to banks the corrective actions to take to ensure a solid stress testing program.

VII. SECURITISATION EXPOSURES

- 19. The Agency assesses capital adequacy level reserved by banks within the scope of the ICAAP for securitisation exposures by taking into account the substance of transactions.
- 20. Processes pertain to securitisation transactions and risks to which a bank is exposed are assessed in detail.
 - {1} The Agency audits not only securitization transactions that explicitly create risk but also whether banks provide implicit support for securitization transactions.
 - {2} The Agency reviews banks' processes regarding the recognition of credit protections within the scope of the securitisation transactions. This assessment includes evaluations about credit protections recognized against first loss credit enhancements. On these positions, expected loss is not likely to be an element of the risk and is likely to be retained by the protection buyer through the pricing. The Agency controls whether banks' take account of this in determining their economic capital.
 - {3} Where the Agency does not consider the approach and processes to protection recognized is adequate, it can take appropriate action such as requiring banks to hold additional capital.

VIII. FINANCIAL INSTRUMENT FAIR VALUE PRACTICES

- 21. The Agency requires banks to provide supplemental information to assist them in assessing valuation and governance processes.
 - {1} In connection with assessing fair values, banks are to disclose information about fair values, including corporate governance, controls, and methodologies, and on the use of the fair value option required by their relevant accounting framework (e.g. International Financial Reporting Standards (IFRS) 7 disclosures). In addition to this publicly available information, the Agency demands supplemental information about fair values and related internal processes from their banks. The Agency may require

banks to periodically report some of those information in case of necessity. This will largely be information that a bank should have developed for internal purposes in order to have an efficient management. It is aimed with supervisory activities to assess the quality of valuations and to better understand the risk of instruments measured at fair value, the volatility and impact on earnings and capital adequacy. When a bank has made significant transfers between asset categories involving assets reported at their fair values, the Agency obtains additional supplemental information about these transfers.

{2} To assess the engagement of the board of directors in valuation issues, the Agency reviews valuation reports provided to the board. To have a better understanding of those reports, the Agency can benefit from assessments of internal auditors, external auditors or independent risk management groups who have no active role in valuation practices.

{3} Where there is material uncertainty surrounding valuation practices, the Agency may consider undertaking test portfolio exercises. However such exercises should be considered as a supervisory method and should not be viewed as providing model validation for banks.

22. The Agency evaluates a bank's financial instruments valuation practices including relevant governance, risk management, and control practices; and incorporate their evaluation when assessing capital adequacy.

{1} Banks should promptly address any deficiencies identified by internal and external auditors with respect to their valuations and related corporate governance, controls, risk management and disclosure policies and practices. On the other hand, when/if the Agency identifies any risk management or control deficiencies regarding valuations and related processes during the supervisions, it may consider any measure including those listed below to ensure that the deficiencies are corrected in a timely manner by the bank:

- a. The Agency may share its supervision findings with the bank's senior management and may evaluate how they address these concerns.
- b. The Agency may factor into supervisory ratings any concerns with respect to a bank's fair value practices.

- c. The Agency may require the senior management to remedy the deficiencies in a specified timeframe and to provide periodic written progress reports.
- {2} It's essential that banks should have strong processes and controls and should promptly correct deficiencies. However there may be certain circumstances in which deficiencies exist and warrant some adjustments to regulatory capital in addition to the prompt action. For example:
- a. A change in regulatory classification of financial instruments may be necessary for capital adequacy or regulatory reporting purposes. This may be the case if a bank exhibits weaknesses in the valuation processes or controls relating to trading book positions or if a bank is not reporting fair valued financial instruments for regulatory purposes consistent with the way the bank measures and manages risk.
 - b. If a bank exhibits significant weaknesses in its risk management policies, systems and controls related to valuations, this may result in a supervisory determination that the bank needs to hold more internal capital in relation to its overall risk exposure (under Pillar 2 of the Basel II Framework). Furthermore, if such weaknesses call into question the reliability of the fair values, in certain circumstances the Agency may exclude from or make adjustments to Tier 1 capital for the associated unrealized gains, or require other prudential adjustments for capital purposes.