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ICAAP

The FSC's Expectations, Common Errors and
pitfalls

29th January 2010



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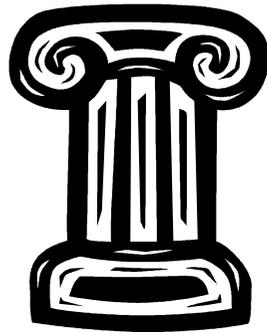
- Background to ICAAP
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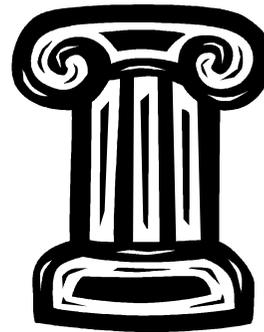
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ICAAP - 2nd Pillar of CRD

CRD = Basel II = 3 pillars



*Minimum
capital
requirements*



*Supervisory
Review
Process*



*Market
discipline*

**ALL 3 PILLARS TOGETHER ARE INTENDED TO ACHIEVE A LEVEL
OF CAPITAL COMMENSURATE WITH A FIRM'S OVERALL RISK
PROFILE**



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Introduction to the ICAAP

- The ICAAP (Internal Capital Adequacy Assessment Process) is a firm's own capital strategy
- Involves an assessment of the additional capital required to mitigate risks not adequately covered by Pillar 1
- Ongoing process
- Followed by a Supervisory Review - evaluation and verification process (SREP)



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The SREP Process - what does it involve?

- Review and evaluation of the ICAAP
- Testing and challenging of the ICAAP
- Will be hand in hand with risk-assessment process
- Dialogue with FSC
- Supervisory intervention can occur if capital is deemed insufficient



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Why is the ICAAP Necessary?

- It is a requirement introduced by the CRD (Articles 123, 124, 136 and Annex XI)
- Encourages better use of risk management techniques
- Ensures that firms have sufficient capital to support all its risks
- Encourages a firm to better manage its capital



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What Must an ICAAP Include ?

- Executive Summary (an overview of the ICAAP methodology and results and details of risk appetite)
- Background to the firm
- Summary of Current and Projected Financial and Capital Positions
- Capital Adequacy
 - Timing
 - *Risks analysed (identification of the major risks faced i.e. credit/operational risk etc.)*
 - *Methodology and assumptions (how assessments for each of the major risks have been approached and the assumptions made - very important for firms using models)*
 - *Stress and scenario tests applied*
 - *Capital transferability (where applicable)*
- ...



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...What must an ICAAP include

- Capital Planning
 - e.g. an analysis of the sensitivity tests undertaken,
 - key assumptions,
 - financial projections for 3-5 years
- Liquidity Planning
- Aggregation and Diversification (an overall view on capital adequacy)
- Challenge and Adoption of the ICAAP
- Use of the ICAAP within the Firm



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For each risk ICAAP needs to:

- Identify the risk
- Explain the risk
- Potential impact of risk
- Likelihood of risk occurring
- Risk mitigation in place by firm e.g. controls
- Determine if Pillar 2 capital is needed and how much
 - (Should also explain why X amount of capital has been assigned or why none has been assigned to a particular risk)



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Stress testing/scenario analysis

- All required to report the result of a 200 basis point shock to interest rates and establish if result exceeds 20% of the firm's capital.
- Typical scenarios: effect of a market downturn on funds under management/transaction volumes; change in business plan.
- For simplest firms - establish a base case scenario and then consider adverse scenarios and effects, and possible actions
- Worst case scenario(s) - should amalgamate two or more scenarios together.
- Larger asset managers should consider a 1 in 200 year event as opposed to a 1 in 25 year event expected of smaller firms.



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Proportionality

- The processes, strategies and systems used, should be proportionate to the nature, scale and complexity of that firm's activities.
- Will use 3 types of firms as examples
 - Non-complex firms
 - Moderately complex firms
 - Credit Institutions and more complex firms



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Non-complex firms

- Cover main risks in more detail (e.g. operational risk and reputational risk)
- Consider whether any other risks are applicable to the firm
- Identify largest losses over last 3-5 years and if these are likely to recur
- Simple stress testing/scenario analysis e.g. shift in key risks identified
- Consider impact of economic or industry downturn on future earnings in business plan.
- Consider capital needed should each of these risks materialise
- Consider holding sufficient capital for an orderly wind down.



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Moderately complex firms

- Comprehensive details of major risks
- Consider losses that might arise from risks using historical data/stress tests
- Assume business will not develop as expected and consider firm's reactions to adverse economic scenarios
- Project business plans in detail for a year and less detail for 3-5 years



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Credit institutions and more complex firms

- Examples of major risks are concentration risk, credit risk, counterparty risk, reputational risk
- Should consider sensitivity of its funding ('sticky').
- Should take into account cyclicalities when assessing amount of capital.
- Should consider independent check/challenge



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Common Errors and Pitfalls

- General issues
- Pillar 1 versus Pillar 2
- Assessment/interpretation of risks
- Risk mitigation



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General Issues - Examples

- Date ICAAP prepared and date approved not stated.
- Not clear if the ICAAP has been approved by the board.
- Not clear if, and by whom, ICAAP has been challenged and level of independence.
- Appendices, figures etc referred to in the report have been omitted entirely.
- Reports are often too brief.
- Not clear how the ICAAP is being used by management
- ICAAP/Pillar 2 figure omitted
- ICAAPs not taking into account all material facts/changes of firm



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General Issues - Examples Ctd

- ICAAP is not forward looking - it needs to cover 3 to 5 year period.
- No stress testing/scenario analysis carried out or limited stress testing/scenario analysis.
- Each scenario was looked at in isolation.
- Statements/judgement are not justified or evidenced/documentated.
- Lack of support for figures and conclusions
- Not Concise/relevant



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Pillar 1 v Pillar 2

- Reference to Pillar 1 capital should be “actuals”.
- Pillar 2 risks are not covered by Pillar 1, hence cannot always justify not assigning capital to a Pillar 2 risk by simply stating that it “is covered by Pillar 1 capital”.
- Pillar 1 plus Pillar 2 needs to be set out as the firm's capital requirement.
- Note, a firm's absolute minimum capital requirement is its initial capital requirement (e.g. 50,000 Euros for a Category 3 firm).



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Assessment/interpretation of risks *Issues*

- Failure to look beyond examples in Guidance Note for specific risks to the firm.
- All of the risks listed in the Guidance Note not necessarily included nor an explanation/indication of why omitted (Note this is expected by FSC)
- Risk appetite not articulated or evidenced.
- Likelihood (and impact) of a particular risk arising not documented.



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Risks - examples of common misunderstandings

- PI insurance - consider the excess
- Operational risk - consider past errors/losses
- FX risk - funds managed in different currencies than reporting currencies?
- Over reliance on a certain individual/or third party
- Credit risk - consider failure of counterparty
- Loss of key staff - cost of replacement



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Risk Mitigation failings

- Mitigation techniques not explained.
- Not clear whether risk mitigants have been incorporated in the firm's business, systems and controls.
- Where no risk mitigation technique in place it is difficult to determine how a firm can justify that no Pillar 2 capital is required.



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What will the FSC be looking for? Summary

- Is each material risk properly identified and adequately monitored and controlled?
- Are numbers and conclusions supported by suitable analysis
- Does the firm have a good risk management culture?
- Does the firm have a positive track record? (e.g. dealing with customer complaints; level, nature & number of complaints received; history of regulatory breaches)
- Is senior management closely involved in managing capital and designing the ICAAP?
- Is it demonstrated that the ICAAP has been embedded into the firm's processes and that senior management are engaged



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When you need to submit an ICAAP

- Firms who have to re-submit an ICAAP, extension been given to end of February to incorporate discussions today.
- Firms which have been requested to submit an ICAAP, extension given till end of March to incorporate discussions today
- Firms who have not yet been asked to submit an ICAAP - we will request as part of risk assessment process/trigger event.



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Future changes to ICAAP

- International bodies carrying out consultation process on aspects of ICAAP
- Further guidelines on concentration risk expected this year.
- Further guidelines expected going forward.



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Any questions?

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