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“ICAAP must be undertaken and signed off by Board by 1st January 2008”

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INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (ICAAP)

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Overview

The FSA’s implementation of Pillar 2 of the Basel II Accord includes the requirement for all BIPRU Investment Firms to undertake an Internal Capital Adequacy Assessment Process (“ICAAP”). This involves the assessment of risks and scenario testing to establish whether additional capital should be held. This process must be undertaken and documented by 1st January 2008.

Background

The aim of Basel II is to create an international standard that banking regulators will use when determining how much capital banks need to put aside to guard against financial and operational risks. The FSA have applied the requirements in Basel II to all BIPRU firms, including Investment Firms. The rules are set out in GENPRU and BIPRU.

There are “three pillars” to Basel II, namely:

- Minimum capital requirements;
- Supervisory review; and
- Market discipline – to promote greater stability in the financial system.

The FSA have implemented the minimum capital requirements in rules in BIPRU and GENPRU. Pillar 2 provides a framework for dealing with the other risks firms may face. FSA’s implementation of Pillar 2 includes two processes: an internal capital adequacy assessment process (ICAAP), which firms must carry out in accordance with the FSA’s ICAAP rules, and a supervisory review and evaluation process (SREP), which will be conducted by the FSA.

ICAAP Process

In order to undertake an ICAAP a firm must carry out regular assessments of the amounts, types and distribution of capital that it considers adequate to cover the nature and level of the risks to which it is or might be exposed; identify the major sources of risk to its ability to meet its liabilities as they fall due; conduct stress and scenario tests; ensure that the processes, strategies and systems are both comprehensive and proportionate to the nature, scale and complexity of the firm’s activities; and document its ICAAP. Firms must take a proportionate approach to the ICAAP and should bear in mind the complexity of their activities.

Risks

The *overall Pillar 2 rule* in GENPRU details the risks that a firm should consider, when undertaking an ICAAP. The most relevant of these are:

- credit risk (e.g. large losses arising from trades which are not settled);
- market risk (risks on positions held on the firm’s trading book);

"Firms must identify major sources of risk"

- liquidity risk (e.g. inability to sell assets quickly);
- operational risk (e.g. impact of operational failure on business);
- concentration risk (e.g. exposures to specific sectors or asset concentration);
- business risk (e.g. effect of market downturn on trading volumes);
- interest rate risk in the non-trading book (effect of interest rate changes).

Once the firm has identified the risks, it should consider the amount of capital that would be absorbed in the event that such risks were to materialise.

Stress and Scenario Testing

Firms are required to perform stress and scenario testing, building in any appropriate risks detailed above, to consider how their capital resources requirement might alter in specific scenarios. Such testing should be performed in respect of a 3-5 year period, unless a shorter timeframe is more appropriate. As part of this testing firms should document the capital that is required for specific scenarios which have been identified, to be able to form a view of the amount and quality of capital that should be held.

Documentation of ICAAP

Firms must document the ICAAP process. The ICAAP document should include an executive summary providing an overview of the methodology and results; a high level overview of the ICAAP process; a statement of the firm's risk appetite and frequency or review of risk appetite; a high level summary of the firm's business and corporate plan; a concise description of the firm's material risks; information on the firm's projection of its capital resources and capital requirements and a description of the extent of challenge and testing of the ICAAP.

The ICAAP must be approved by the Board and will need to be updated as and when risks change and reviewed on a regular basis.

SREP and Individual Capital Guidance

The FSA will review the arrangements, strategies, processes and mechanisms implemented by a firm, and will then determine whether the capital held by the firm is sufficient. The extent of this review will depend on the firm's relationship with the FSA. Following the completion of the SREP, the FSA may give a firm individual capital guidance on how much capital it should hold to meet the overall financial adequacy rule.

ARROW Approach	SREP Approach
Full ARROW	Full SREP for high impact firms (i.e. full assessment of the ICAAP) Likely to include FSA visit
ARROW Light	Streamlined SREP with emphasis on peer group comparisons Typically desk based review with no firm visit
Non-Relationship Managed Firm	Questionnaire Approach via FSA019 Submitted annually within two months of year end from 30 th June 2008 onwards Firm may then be subject to very basic SREP

Summary

All relevant firms should begin undertaking the ICAAP to ensure this is completed and signed off by the Board by 1st January 2008. If you need help with this process please get in touch with your usual Bovill contact.

"FSA's SREP will include submission of FSA019 questionnaire"

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