



### Key Contact

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*“...a firm needs formal and rigorous processes for identifying risks...”*

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## ICAAP: THE INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

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### Overview

**In view of the current economic climate BIPRU firms should be reviewing and updating their Internal Capital Adequacy Assessment Process (ICAAP) to ensure it adequately captures the risks that the business faces. They also need to consider the proposed changes to the current rules on stress and scenario testing in CP 08/24, on which consultation closed at the end of March.**

### Background

The ICAAP is the first of two processes that fall within Pillar 2 of the Basel II Accord and one in which the firm must satisfy itself that it has adequate capital in respect of its key risks. The second process is the Supervisory Review and Evaluation Process (SREP) in which the FSA satisfy themselves that the firm's ICAAP has identified and addressed its key risks and that the firm has a process for ongoing risk management and maintains capital that is commensurate with those risks.

### The ICAAP process

In order to begin the ICAAP process a firm must identify any material risks that it faces. To do this it needs to have formal and rigorous processes in place that are capable of identifying the risks inherent in the business and assessing the level of internal controls which mitigate the risks identified. These risks are likely to be documented in some form of risk register and the firm should then consider what additional mitigating steps it would take if such risks were to materialise. The remaining risk should then be quantified to assess the level of Pillar 2 capital that will need to be held in relation to a particular risk. This process should be carried out in conjunction with the firm's latest financial projections and business plan to arrive at a base case which shows what the firm believes to be its current capital requirements.

Firms should then use this base model to consider how their capital resources might alter in specific “stressed” scenarios. Ideally, stress testing should be performed in respect of a 3-5 year period. This will enable firms to ascertain whether they need to hold additional Pillar 2 capital, either now or at some future point, depending on the probability of such “stressed” scenarios materialising.

ICAAPs should be reassessed regularly to ensure that they remain up to date and that the firm continues to hold the appropriate amounts, types and distributions of capital. Such capital must be commensurate with the level of risk that the firm is or might be exposed to and should be proportionate to the nature, scale and complexity of the firm's activities. The ICAAP should be subject to senior management challenge prior to completion and firms may wish to obtain further external challenge from their advisors.

*"...many firms' stress tests were not fit for purpose.."*

### **Documenting the ICAAP**

ICAAPs must be documented and ideally will consist of an executive summary, background to the ICAAP process, a statement of the firm's risk appetite, the firm's business strategy, material risks identified, capital planning and stress and scenario tests, the challenge process and adoption of the ICAAP.

### **Current FSA findings from ICAAP reviews**

The FSA have published a set of initial observations following a review of ICAAPs from smaller firms and have undertaken further work which is described in CP08/24. Some key findings from this work, plus our own observations from review of ICAAPs are:

- some firms' ICAAPs are unclear in setting out and distinguishing between their Pillar 1 and Pillar 2 figures;
- a number of ICAAPs were very long and disproportionate to the size and activities of the firm. The main body of the report should be relatively short, with supporting material (such as the firm's risk register, financial projections and findings from stress and scenario tests) in appendices;
- some firms did not project forward their business and capital plans by the recommended 3-5 years and used shorter timeframes without adequate reasons;
- some ICAAPs were not reviewed and signed off by the firm's Board;
- many firms' stress tests were not fit for purpose and were not designed for the extreme market events that have recently occurred. In addition, stress testing had not been integrated into businesses, and needs to include more severe scenarios.

### **CP 08/24: Stress and Scenario Testing**

CP08/24 sets out the FSA's views on stress and scenario testing and proposes changes to the current rules and guidance in this area, in the light of recent firm failures and concerns that such testing is not as robust or embedded in decision making as FSA would like. FSA note that firms with stronger governance arrangements and more comprehensive firm wide risk assessment processes had tended to fare better in difficult circumstances.

The changes set out in the CP include:

- a "reverse stress test" requirement which would require firms to consider the scenarios most likely to cause their business models to become unviable. A firm will be assumed unviable at the point that crystallising risks cause the market to lose confidence in it (this test will not be applicable to BIPRU 50K investment firms with funds under management of less than £1bn);
- changes to the existing ICAAP provisions for stress and scenario testing and the existing rules applicable to firms who use internal models to assess their Pillar 1 capital requirements. These will focus on ensuring firms undertake a more comprehensive assessment of their material risks and any planned mitigation and are realistic when evaluating the severity and impacts of adverse scenarios.

### **Summary**

All BIPRU firms should have already completed their ICAAP and should be considering reviewing it in light of both the current economic climate and the greater FSA focus on relation ICAAPs. Firms must ensure that the processes in place for risk identification and stress and scenario testing are robust and appropriate for their business. If you need any assistance with your ICAAP please get in touch with your usual Bovill contact.

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