

ICAAP submission - suggested format

v2.0

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Firms are not required to adopt this format when asked to submit their Internal Capital Adequacy Assessment Process (ICAAP) document to the FSA for review. The FSA expects there to be a fair degree of variation in the length and format of submissions since firms' business and risk profiles differ and the ICAAP document should be proportional to the size, nature and complexity of a firm's business. However, adopting this format may be convenient for firms as it covers most of the matters which typically would be the subject of review by the FSA and if not provided in the initial submission are likely to be covered in follow up discussions with the firm. Use of this format may therefore make the review process more efficient for both the firm and the FSA.

Equally, use of this template is not a substitute for being aware of the relevant rules.

What is an ICAAP document?

The purpose of the ICAAP document is to inform the Board of the ongoing assessment of the firm's risks, how the firm intends to mitigate those risks and how much current and future capital is necessary having considered other mitigating factors. The ICAAP document is also how the firm explains to the FSA its internal capital adequacy assessment process. Whilst the ICAAP may be based on existing internal documentation, the FSA will clearly find it helpful to have a bespoke summary prepared to communicate the key results and issues to it at a senior level. Since the FSA will be basing many of its views on the information contained in the ICAAP document it would be unusual if the firm's governing body or senior management had not formally approved its contents. Given that the firm's governing body or senior management are likely to approve the ICAAP document we would expect that document to be in a format that can be easily understood at a high level and to contain all the relevant information that is necessary for the firm and FSA to make an informed judgement and decision as to the appropriate capital level and risk management approach.

Where appropriate technical information on risk measurement methodologies, capital models and all other works carried out to validate the approach (e.g. board papers and minutes, internal or external reviews) could be contained in appendices.

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1. EXECUTIVE SUMMARY

The purpose of the Executive Summary is to present an overview of the ICAAP methodology and results. This overview would typically include:

- the purpose of the report and which regulated entities are covered by the ICAAP;
- the main findings of the ICAAP analysis:
 - how much and what composition of internal capital the firm considers it should hold as compared with the *capital resource requirement* (CRR) ‘pillar 1’ calculation, and
 - the adequacy of the firm’s risk management processes;
- a summary of the financial position of the business, including the strategic position of the firm, its balance sheet strength, and future profitability;
- brief descriptions of the capital and dividend plan; how the firm intends to manage capital going forward and for what purposes;
- commentary on the most material risks, why the level of risk is acceptable or, if it is not, what mitigating actions are planned;
- commentary on major issues where further analysis and decisions are required; and
- who has carried out the assessment, how it has been challenged, and who has approved it.

2. BACKGROUND

This section would cover the relevant organisational and historical financial data for the firm.

e.g. group structure (legal and operational), operating profit, profit before tax, profit after tax, dividends, shareholders funds, capital resources held and as compared with regulatory requirements, customer accounts, deposits by banks, total assets, and any conclusions that can be drawn from trends in the data which may have implications for the firm’s future.

3. SUMMARY OF CURRENT AND PROJECTED FINANCIAL AND CAPITAL POSITIONS

This section would explain the present financial position of the firm and expected changes to the current business profile, the environment in which it expects to operate, its projected business plans (by appropriate lines of business), projected financial position, and future planned sources of capital.

The starting balance sheet and date as of which the assessment is carried out would be set out.

The projected financial position might consider both the projected capital available and projected capital resource requirements based on expected plans. These might then provide a baseline against which adverse scenarios (see later) might be compared.

4. CAPITAL ADEQUACY

This section might start with a description of the risk appetite used in the ICAAP. It is vital for the FSA to understand whether what is being presented to it represents the firm’s view of the amount

of capital required to meet minimum regulatory needs or whether what is being presented is the amount of capital that a firm believes it needs to meet business objectives. For instance whether the capital required is based on a particular desired credit rating or includes buffers for strategic purposes or to minimise the change of breaching regulatory requirements. Where economic capital models are used this would include the confidence level, time horizon, and description of the event to which the confidence level relates. Where scenario analyses or other means are used, then some other description of how the severity of scenario has been chosen would be included.

The section would then include a detailed review of the capital adequacy of your firm.

The information provided would include:

Timing

- the effective date of the ICAAP calculations together with consideration of any events between this date and the date of submission which would materially impact the ICAAP calculation together with their effects; and
- details of, and rationale for, the time period over which capital has been assessed.

Risks analysed

- an identification of the major risks faced in each of the following categories:
 - i) credit risk,
 - ii) market risk,
 - iii) operational risk,
 - iv) liquidity risk,
 - v) insurance risk
 - vi) concentration risk
 - vii) residual risk
 - viii) securitisation risk
 - ix) business risk
 - x) interest rate risk
 - xi) pension obligation risk; and
 - xii) any other risks identified (for example this may take the form of your standard risk register)
- And for each, an explanation of how the risk has been assessed and the quantitative results of that assessment;
- where risks have been highlighted as part of your ARROW risk assessment or are included in the ARROW risk mitigation programme, an explanation of how you have mitigated these;
- where relevant, a comparison of that assessment with the results of the CRR pillar 1 calculations;
- a clear articulation of the firm's risk appetite by risk category if this varies from the overall assessment; and
- where relevant, an explanation of any other methods apart from capital used to mitigate the risks.
- For those firms subject to the Fixed Overhead Requirement (FOR), a cash flow forecast showing estimated cash in-flows and out-flows over the period the firm believes it would take to wind down the business in distressed circumstances, either returning client assets and money or transferring them to a purchaser of the business.

Methodology and assumptions

A description of how assessments for each of the major risks have been approached and the main assumptions made.

For instance, firms may choose to base their ICAAP on the results of the CRR calculation with additional risks (e.g. concentration risk, interest rate risk in the banking book etc.) assessed separately and added to Pillar 1. Alternatively, firms may decide to base their ICAAP on internal models for all risks, including those covered under the CRR (i.e. Credit, Market and Operational Risks).

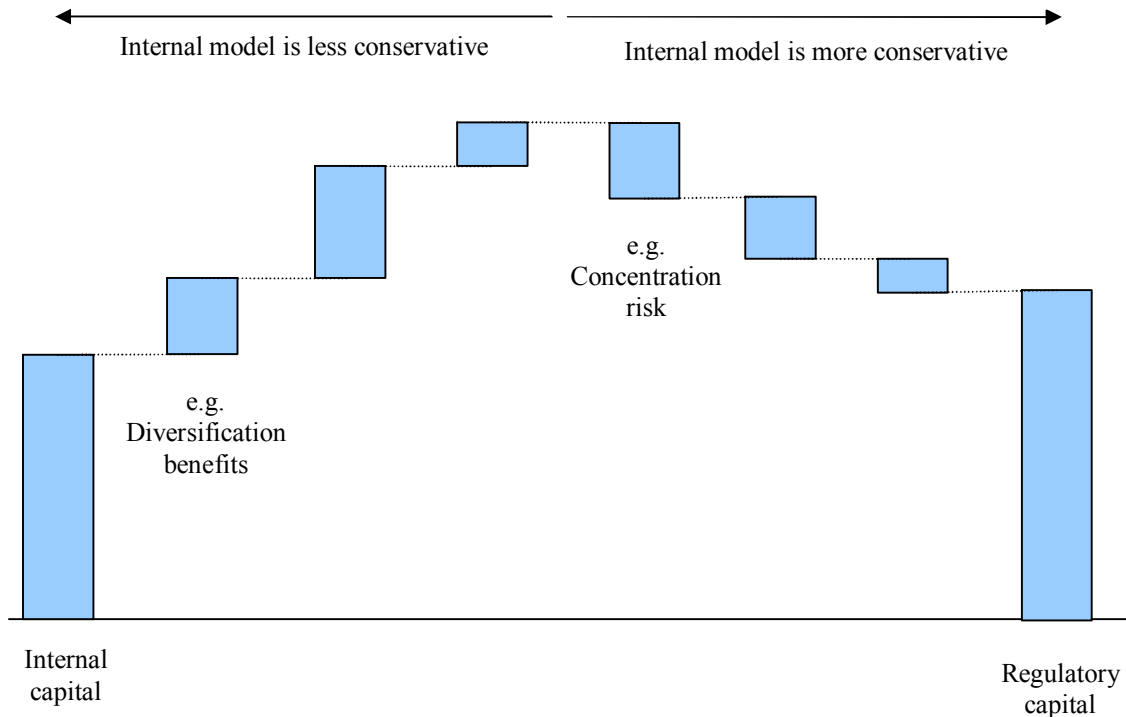
The description here would make clear which risks are covered by which modelling or calculation approach. This would include details of the methodology and process used to calculate risks in each of the categories identified and reason for choosing the method used in each case.

Where the firm uses an internal model for the quantification of its risks, this section would explain for each of those models:

- the key assumptions and parameters within the capital modelling work and background information on the derivation of any key assumptions;
- how parameters have been chosen, including the historical period used and the calibration process;
- the limitations of the model;
- the sensitivity of the model to changes in those key assumptions or parameters chosen; and
- the validation work undertaken to ensure the continuing adequacy of the model.

CRR and ICAAP comparisons

Should the internal models vary from any regulatory models approved for pillar 1 purposes, this section would provide a detailed comparison explaining both the methodological and parameterisation differences between the internal models and the regulatory models and how those affect the capital measures. A chart of the following type may be useful:



The explanation of the differences between the internal model and the CRR would be set out at the level at which the ICAAP is applied. Therefore, if the firm's ICAAP document breaks down the calculation by major legal regulated entities, an explanation for each of those individual entities would be appropriate.

Similarly, we would expect the explanation to be sufficiently granular to show the differences at the level of each of the Pillar 1 risks.

Stress and scenario tests applied

Where stress tests or scenario analyses have been used to validate, supplement, or probe the results of other modelling approaches, then this section would provide:

- details of simulations to capture risks not well estimated by the firm's internal capital model (e.g. non-linear products, concentrations, illiquidity and gapping of prices, shifts in correlations in a crisis period);
- details of the quantitative results of stress tests and scenario analyses the firm carried out and the confidence levels and key assumptions behind those analyses, including, the distribution of outcomes obtained for the main individual risk factors;
- details of the range of combined adverse scenarios which have been applied, how these were derived and the resulting capital requirements; and
- where applicable, details of any additional business-unit-specific or business plan stress tests selected.

Capital transferability

Details of any restrictions on the management ability to transfer capital into or out of the business(es) covered, for example, contractual, commercial, regulatory or statutory restrictions that apply. Statutory restrictions could be limited to the maximum dividend that could be declared and paid following certain actions to maximise distributable reserves, through for example, crystallising unrealised gains. Regulatory restrictions could be the minimum

regulatory capital position acceptable to the local regulator after releasing capital back to the group.

5. CAPITAL PLANNING

This section would explain how a firm would be affected by an economic recession or downswings in the business or market relevant to its activities. The FSA is interested in how a firm would manage its business and capital so as to survive a recession whilst meeting minimum regulatory standards. The analysis would include financial projections forward for, say, three to five years based on business plans and solvency calculations.

For that purpose, the severity of the recession would typically be one that occurs only once in a 25 year period. The time horizon would be from the present day to at least the deepest part of the recession.

Typical scenarios would include:

- how an economic downturn would affect
 - the firm's capital resources and future earnings; and
 - the firm's CRR taking into account future changes in its projected balance sheet.
- In both cases, it would be helpful if these projections showed separately the effects of management actions to change the firm's business strategy and the implementation of contingency plans.
- projections of the future CRR would include the effect of changes in the credit quality of the firm's credit risk counterparties (including migration in their ratings during a recession) and the firm's capital and its credit risk capital requirement (note that this scenario stress test is a requirement for firms with an *IRB permission*);
- an assessment by the firm of any other capital planning actions to enable it to continue to meet its regulatory capital requirements throughout a recession such as new capital injections from related companies or new share issues;

This section would also explain which key macroeconomic factors are being stressed, and how those have been identified as drivers of the firm's earnings. The firm would also explain how the macroeconomic factors affect the key parameters of the internal model (and for credit risk, the regulatory model) by demonstrating for instance how the relationship between the two has been established.

Management Actions

This section would expand on the management actions assumed in deriving the ICAAP, in particular:

- the quantitative impact of management actions - sensitivity testing of key management actions and revised ICAAP figures with management actions excluded.
- evidence of management actions implemented in the past during similar periods of economic stress.

Note that where a firm has an IRB permission then this section may set out management actions which mitigate the additional capital suggested by the mandatory credit rating migration stress test. Alternatively, such actions might be set out in a separate 'capital management plan' or

otherwise approved by senior management as actions the firm is committed to realistically taking in such circumstances.

6. LIQUIDITY PLANNING

This section would summarise how liquidity risk is managed (as distinct from any capital set aside to cover losses incurred in a liquidity stress). In particular, it would set out the key assumptions and conclusions from stress testing of cash flows undertaken to manage the risk¹. It would generally be helpful for the ICAAP to include as appendices the following, where relevant:

- Asset-Liability Committee (ALCO) papers and samples of Management Information (MI) used day to day in Treasury departments: daily cash flow forecasts, weekly, monthly etc
- Liquidity and funding policy documentation (solo and group)
- Internal Audit reports relating to Treasury departments
- An organisation chart that covers liquidity and funding risk management delegated authorities and reporting lines within the firm
- Limit breach policy documentation
- Securitisation documentation detailing how the programmes function.
- Liquidity stress testing documentation
- An explanation of intra-group liquidity arrangements, especially if operating in several countries
- Number, scale and timeline of commitments whether formal or informal towards:
 - off-balance sheet financing vehicles,
 - market counterparties (including margin or collateral obligations) or
 - towards clients
- Analysis of liquidity demands and sources of liquidity (ie funding risk and market liquidity risk affecting assets) by name any considering strategic and tactical management of the risk
- Quantified Contingency Funding Plans

Whilst capital is an imperfect mitigant (ie is not a preventative measure) for liquidity risk, there may well be a capital cost of a liquidity stress. Firms should therefore consider here or in the previous section such scenarios as a ratings downgrade or other event which might increase their cost of funding and therefore absorb capital reserves.

7. AGGREGATION AND DIVERSIFICATION

This section would describe how the results of the various separate risk assessments are brought together and an overall view taken on capital adequacy. At a technical level, this therefore requires some method to be used to combine risks using quantitative techniques of some sort. At

¹ See for instance GENPRU 1.2.30R which requires analysis of liquidity risk and SYSC 11, in particular SYSC 11.1.23E and IPRU(BSOC) 5.2.7R which explain in more detail our expectations for a contingency funding plan and liquidity policies.

the broader level, the overall reasonableness of the detailed quantification approaches might be compared with the results of an analysis of capital planning (see section 5) and a view taken by senior management as to the overall level of capital that is appropriate.

- Dealing with the technical aggregation, this would describe:
 - i) any allowance made for diversification, including any assumed correlations within risks and between risks and how such correlations have been assessed, including in stressed conditions;
 - ii) the justification for any credit for diversification benefits between legal entities, and the justification for the free movement of capital between them in times of financial stress;
 - iii) the impact of diversification benefits with management actions excluded. It might be helpful to set out revised ICAAP figures with all correlations set to '1' i.e., no diversification; and similar figures with all correlations set to '0' i.e. assuming all risks are independent.
- As regards the overall assessment, this would describe how the firm has arrived at its overall assessment of the capital it needs taking into account such matters as:
 - i) the inherent uncertainty in any modelling approach;
 - ii) weaknesses in the firm's risk management procedures, systems or controls;
 - iii) the differences between regulatory capital and internal capital; and
 - iv) the differing purposes that capital serves: shareholder returns, rating objectives for the firm as a whole or certain debt instruments the firm has issued, avoidance of regulatory intervention, protection against uncertain events, depositor protection, working capital, capital held for strategic acquisitions etc.

8. CHALLENGE AND ADOPTION OF THE ICAAP

This section would describe the extent of challenge and testing of the ICAAP. It would include the testing and control processes applied to the ICAAP models or calculations, and the senior management or board review and sign off procedures. It might be helpful if a copy were attached of any relevant report to senior management or the board and their response.

Details of the reliance placed on any external suppliers would also be detailed here e.g. for generating economic scenarios.

In addition, a copy of any report obtained from an external reviewer or internal audit would also be included.

9. USE OF THE ICAAP WITHIN THE FIRM

This would demonstrate the extent to which capital management is embedded within your firm including the extent and use of capital modelling or scenario analysis and stress testing within your firm's capital management policy, e.g. in setting pricing and charges and the level and nature of future business.

This would also include a statement of your actual operating philosophy on capital management and how this links to the ICAAP submitted. For instance differences in risk appetite used in the ICAAP as compared to that used for business decisions might be discussed.

Lastly, it would be helpful if you could detail any anticipated future refinements within your ICAAP (highlighting those aspects which are work-in-progress) and provide any other information that you believe will help us review your ICAAP.