

# Does your Board understand the ICAAP?

Many Financial Institutions are now on their second or third iteration of the ICAAP and feel the process is bedding in. However, FSA regulators are warning that the depth and quality of the ICAAPs varied enormously even between peer companies.

There have also been clear indications that the regulatory regime will be changing given that the status quo has led to the current financial crisis, British taxpayer costs and the resulting political and media interest. There has already been a clear stiffening in the tone and content of recent Arrow reviews and a less accommodating line is being taken by FSA review panels. Firms, having gained a favourable perception at their exit meeting, are often disappointed at the actual Arrow outcomes.

Hence, senior executives may expect a more rigorous inspection of their ICAAP and its governance process in the future. Failings in the governance processes alone can result in a 50% add-on being applied to the Internal Capital Guidance (ICG) assessed by the FSA and the resulting material costs of capital and constraints on business activity.

Board members and senior executives in Financial Institutions are likely to face considerably more probing of their understanding of their risks, risk reward trade offs and strategy. Delegation of the ICAAP to the Risk and Finance functions with little Board time, discussion or involvement could also result in Board members facing personal consequences if problems arise. The FSA seems clear that all Board members need to prove that they understand the firm's risks and ignorance of these risks cannot be relied on as a defence.

The FSA is also seeking clear evidence of a linkage between the strategy of the firm, the resulting risks, management action in a downside environment and hence the capital required to ensure that at worst, there is an orderly wind-down of the firm. In future, a forward-looking view of the firm's strategy and the business environment will need to be consistent with the ICAAP.

Another impact of the crisis is the likely creation of a European financial services regulator that will intrude more into the workings of the City. The question is whether a European regulator would have the same interest in creating a business friendly and safe regime in the City as the UK government. Once the UK government loses control of the City of London to the EU, will it ever be able to take control back if a European regulator becomes overly bureaucratic, intrusive and political?

In relation to this, reverse stress tests are now being requested that describe the scenario where the firms' current business model becomes unviable. The aim is to ensure that in this scenario, the firm would survive long enough either to restructure its business or conduct an orderly wind down. Possibly a more interesting and germane question, given the proposed current changes in the regulatory, tax and business environment, is at what point would your firm decide to move some or all of its operations to a country with a more friendly regime?

The FSA has also expressed concerns about a wide range of other issues in relation to the ICAAPs and stress tests submitted. Some of the main points are summarised in the attached appendix.

Risk Advisors has helped many Financial Institutions develop their ICAAPs, stress tests, and scenario analysis. Risk Advisors would encourage you to review your current ICAAP, risk systems and in particular the understanding by your Boards. We would be very happy to discuss your current state of readiness for the tougher regime ahead based on our ICAAP checklist. This should help you make your risk and capital systems add value for your institution as well as becoming regulatory compliant.

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## Appendix 1: Issues with the ICAAP, stress testing and ICG.

This appendix summarises some of the main reasons for weaknesses in the ICAAP and stress tests that have been submitted to the FSA. It also indicates some views on the assessment of the ICG by the FSA.

### Weaknesses in the ICAAP process

- Information in the ICAAP was often scattered, disjointed and inconsistent between chapters showing that no overall review of the ICAAP had taken place.
- Evidence of any Board discussion was often missing from Board minutes suggesting that it was a rubber-stamping job without any understanding or debate. In discussions with businesses, there was often a lack of evidence that the ICAAP was being used further down in the organisation.
- In some ICAAPs, strategic changes had been proposed but this was not reflected in the capital planning. More generally, the narrative and numbers in the capital plan were often inconsistent. The FSA had a strong preference for a capital plan of at least 3 years especially if strategic changes were being planned.
- The FSA were looking for evidence that firms had considered forward-looking scenarios that were not in historic data. This would suggest thought and effort had gone into the stress testing process. In particular, what would be the breaking point that would make the current strategy unviable?
- Contagion with group companies was often ignored.

### Weaknesses in risk appetite and stress tests

- There were too many vague expressions of risk appetite, e.g. we have a low appetite for market risk. The FSA was looking for quantified risk appetite statements that could be cascaded down by risk type and business.
- The standard of operational risk assessment was very wide and disparate. The FSA had a strong preference towards a quantification of operational risk although very few firms did this. Most firms seemed to ignore that operational risk controls can fail and the implications of this on both exposure and frequency.
- Some stress tests were purely based on the FSA rules and did not reflect the stated risks of the organisation. This discredited the entire stress testing process. The FSA expects firms to stress test issues that are material to them – not just a tick box compliance exercise. The FSA was trying **not** to give specific guidance on stress testing, as by its nature, the stress tests and their severity will change over an economic cycle.
- Knock on consequences were often ignored when assessing the exposures in the capital planning, e.g. loss of revenues, other dependencies, legal actions, etc.
- The approach to calculating pillar 1 regulatory capital should be specified and details given in appendices. In particular, a table should be given comparing the pillar 1 regulatory capital against the pillar 2 capital assessment from stress tests or economic capital.
- Showing wind down costs if the business had to be closed down was considered best practice although not yet a formal requirement.

## Changes in the regulatory regime

- Regulation is likely to become more intrusive, e.g. with issues such as treating customer fairly (TCF) being viewed by the regulator at an individual client file level.
- There will be less tolerance for special cases; many of the exemptions in the current rules will be removed.

## FSA contact

It should be noted that there was a difference between the sensible and pragmatic line being taken by the FSA policy departments and the experience of many Financial Institutions. Front line FSA staff often appeared to have a general lack of flexibility and made requests for detailed information that may not be appropriate to the businesses concerned.

Risk Advisors would recommend that the ICAAP only reflect the analysis appropriate and useful for the specific circumstances of each business and try to educate the FSA front line staff why this is appropriate. This should increase your ICAAPs credibility with the FSA so long as your rationale and analysis is solid.

## Assessment of the Internal Capital Guidance (ICG)

The FSA seemed to be giving further thought on how to assess their add-on for the ICG. This would include:

- Up to a 50% add on if they perceived that governance was poor.
- An add-on for final salary scheme pension funds reflecting stresses for:
  - Changes in yield on bonds
  - Changes in market value of equities
  - Changes in liability profile
- A minimum add-on to reflect the reduction in surplus capital in the capital plan under stressed conditions, i.e. reduction in retentions plus any increase in the minimum regulatory capital.

Relating to this last point, the view was that the ICG could be decreased by the FSA in a downside environment. However, it was very unclear how this would be done given the length of time to review and give feedback on the ICAAPs.

Risk Advisors would **not** recommend that firms rely on the ICG being reduced in a downside scenario.