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Paper on the Internal Capital Adequacy Assessment Process (ICAAP) for Smaller Institutions

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1 Introduction

1. This paper provides recommendations for smaller institutions (credit institutions and investment firms[1]) on how they might approach the internal Capital Adequacy Assessment Process (ICAAP). The paper provides more detail about how smaller institutions could comply with the guidelines formulated by CEBS in its "Guidelines on the Application of the Supervisory Review Process under Pillar 2 ("Guidelines"), published on 25 January 2006. The paper also provides recommendations to supervisors on how they might approach the SREP for these institutions.

2. The recommendations in this paper are without prejudice to the approaches that may be considered or adopted by larger institutions.

3. The paper relates only to issues concerning how to calculate the internal capital need in Pillar 2.

4. The paper focuses mainly on elaborating Guidelines on ICAAP 6 to 10 in the Guidelines, which are subject to the principle of proportionality. For the avoidance of doubt, smaller institution should also adopt Guidelines on ICAAP 1 to 5 in the Guidelines. The supervisory authorities agree that the Internal Governance guidelines in the Guidelines have been drafted with larger institutions in mind and that the principle of proportionality must also be applied in this respect. For example, IG 14 requires 'as a minimum' three internal control functions which should be independent from each other. For smaller institutions, it may be impractical to deliver full segregation and independence of these functions, for example, because of the limited number of staff or because certain functions are undertaken on a part-time basis. The supervisory authorities agree that it is possible for smaller firms to comply with the IG guidelines without necessarily achieving 'full segregation and independence' of these functions, provided their internal organisation is adequate to achieve the purpose of the IG guidelines, which is to ensure that an institution's management body is explicitly and transparently responsible for its business strategy, organisation and internal control.

5. The approaches to ICAAP described in these recommendations are not exhaustive. The recommendations are instead to be seen as a 'toolkit' from which institutions and supervisors can collect ideas on how to approach the ICAAP in Pillar 2. This paper has been prepared by CEBS with the sole purpose of offering suggestions which might be helpful to institutions in designing their ICAAPs and to supervisors when performing SREP and to stimulate the industry's own debate. Institutions remain responsible for designing an ICAAP that is appropriate to their circumstances.

[1] For the avoidance of doubt, this paper only applies to those investment firms which are subject to the Capital Requirements Directive.

1.1 Proportionality and scope of application

6. The Guidelines state that the ICAAP should be proportionate to the nature, scale and complexity of the activities of the institution. This implies that the concept of proportionality will have a particular influence on the structure and complexity of the ICAAP of smaller institutions.

7. For the purpose of these recommendations, an institution would usually be considered as a smaller institution if it meets most or all of the following criteria:

   - its activities are non-complex and focus on a limited product range;
   - it has a relatively small market share;
   - it does not adopt or use any of the IRB, AMA and internal models related to market risk which are approved by supervisors;
   - it mainly operates inside the national territory and has none or only limited international activities. However, the supervisory authorities recognise that some small investment firms conduct more extensive cross-border activities or service foreign clients; and
   - it describes itself as a smaller institution in its own assessment.

   However, the ultimate decision whether an institution should be considered as a smaller institution in the sense of this paper rests with the supervisory authorities.

2 Smaller institutions and ICAAP

2.1 ICAAP requirements

2.1.1 General requirements

8. The Capital Requirements Directive includes basic requirements for all institutions to have robust governance arrangements and effective processes for managing all risks. It also requires all institutions to have in place sound, effective and complete strategies and processes to assess and maintain adequate capital, having considered the nature and level of their risks in a forward-looking manner.

9. The management body of the institution is responsible for structuring the ICAAP and assessing the institution's internal capital need. The smaller institutions bear the responsibility for setting targets of adequate internal capital need in a way which is consistent with their risk profile and operating environment. This remains the case even if the ICAAP is outsourced to any extent in accordance with CEBS' Standards on

Outsourcing[2]. The institution must further be able to explain and demonstrate how the ICAAP meets supervisory requirements. Regardless of the choice of ICAAP structure and assessment methodology, the ICAAP should be based on the Guidelines on ICAAP 1 to 10 laid down in the Guidelines.

10. The ICAAP should capture all the material risk to which the institution is exposed including all Pillar 1 risks, risk not fully captured under Pillar 1, Pillar 2 risks, and risk factors external to the institution.

2.1.2 Requirements for smaller institutions

11. Smaller institutions are also expected to conduct capital planning and capital adequacy assessment relative to their entire risk profile considering institution-specific characteristics and uncertainties. A suitable ICAAP can be seen as one of the key internal management processes for the management body. The development of an ICAAP aims to enhance risk awareness, maintain good risk assessments in smaller institutions and a sufficient level of internal capital to meet unexpected losses.

12. The supervisory authorities expect that the smaller institutions will already conduct many of the thought processes required by the ICAAP as part of their usual budgeting and strategic planning processes.

13. Smaller institutions could comply with the criteria in the Guidelines by setting up an ICAAP which takes into consideration the appropriate risk areas including risk drivers from Annex 1 of the Guidelines. These risk areas and risk drivers should be considered as a reference source institutions can use to identify which risks they are exposed to. If the institution is exposed to risks not mentioned in Annex 1 of the Guidelines, it should ensure that internal capital – if appropriate - is allocated to capture such risks.

14. Smaller institutions should be mindful that capital is not the only mitigant available and that in many circumstances, risk can be addressed through adequate systems and controls. Indeed, the supervisory authorities acknowledge that for risks which are difficult or impossible to quantify the importance of qualitative provisions within the institution increases.

2.2 Methodology

15. There is no single "correct" process when setting up the ICAAP. Smaller institutions could, for example, adopt an ICAAP based on the Pillar 1 minimum capital requirement and assess extra capital proportionate to the non-Pillar 1 risk. Alternatively, smaller institutions could choose to adopt a building block approach, using different methodologies for the risk types under the different Pillars and then calculating a sum of the

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[2] CEBS Standards on Outsourcing, previously CEBS High-level Principles on Outsourcing, published for public consultation in April 2004.

resulting capital needs. As a further alternative, an institution might start with its actual capital (risk taking capacity) and break it down to all its material risks. The choice of methodology should clearly be commensurate with the institutions ability to collect the necessary information and to calculate the necessary inputs in a reliable manner.

16. Regardless which methodology a smaller institution decides to adopt, it needs to compare its actual and future capital with the actual and future internal capital need arising from the assessment. The actual calculation and allocation of internal capital always needs to be supplemented by sufficiently robust qualitative procedures, measures and provisions to identify, manage, control and monitor all risks.

17. The process an institution has chosen for its ICAAP will always consist of two parts. One part covers all steps necessary for calculating the risks (see examples in Paragraphs 18-20). The other part covers all steps necessary to calculate the actual capital (risk taking capacity). In order to compile this overall measure, the institution has to define which components of its balance sheet and/or P/L can be included into the calculation (i.e. which balance sheet and/or P/L components genuinely represent loss absorption capacity for the institution). Therefore the institution has to define a clear process for the calculation. As these two parts will always meet at the end of the ICAAP and have to be in balance, there is no procedure which says which part has to be calculated first.

2.2.1 Pillar 1 minimum capital requirement approach

18. An institution which chooses to use the Pillar 1 minimum capital requirement as the starting point has to consider what additional capital may be required to take account of those risks which are not included or fully captured by the Pillar 1 minimum capital requirement. This requires an assessment first of whether the Pillar 1 minimum capital requirement fully captures the Pillar 1 risks (credit risk, market risk and operational risk), and second, how much capital to allocate against the Pillar 2 risks and external factors.

2.2.2 Structured approach

19. An institution which chooses to use a structured approach will need to set the internal capital requirement at a starting point of zero capital and then build on capital due to all Pillar 1 and Pillar 2 risks and external factors. This methodology could be seen as a simple model for calculating economic capital and is not based on the Pillar 1 minimum capital requirement[3]. All material risk areas, including credit risk, market risk and operational risk, should be assessed and taken into consideration when assessing the internal capital need. A sensitivity analysis could form the starting point. The sensitivity analysis should be

[3] The institution should still calculate the pillar 1 minimum capital requirement, but the calculation is not used for the purpose of the ICAAP.

based on an exceptional but plausible scenario. Risks which are not included in the sensitivity analysis should also be considered in terms of the structured approach.

2.2.3 Allocation of risk-taking approach

20. An institution which chooses to use this method will start from its actual capital (risk-taking capacity) and compare this figure to its total risks. Thereby it breaks the capital down to all its material risks. This step in the process requires quantification or at least an estimation method for various risks. The amount of capital provided for each risk category is determined by the current and envisaged amount of risk in each category, a risk buffer and the risk appetite of the institution. The institution will decide which type of risk quantification/estimation method is suitable and sufficient for its particular use. If the allocated capital seems insufficient, either the risk has to be reduced or the capital has to be raised. The allocated amounts of the capital will therefore work as a limit system, which assists and facilitates the institution in balancing its risk-taking capacity and its risks. The actual calculation and allocation of capital always needs to be supplemented by sufficiently robust qualitative procedures, measures and provisions to identify, manage, control and monitor all risks.

21. After choosing its ICAAP methodology, the institution could take its thinking through the following steps in developing the ICAAP:

    (i) Risk identification

    A smaller institution could prepare a list of all material risks to which it is exposed; for that purpose it may find it useful to identify and consider its largest past losses and whether those losses are likely to recur. The identification of all material risk to which the institution is exposed should be conducted in a forward looking manner.

    It may also consider whether any of the risks referred to in Annex 1 of the Guidelines are applicable to it. However, it is likely that those risks identified in the list of all material risks will be conclusive for a smaller institution.

    (ii) Capital assessment

    For all the risks identified through the process above, a smaller institution could then consider how it would act, and the amount of capital that would be absorbed, in the event that one or more of the risks identified was to materialise.

    (iii) Forward capital planning

    A smaller institution could then consider how its capital need as calculated above might alter in line with its business plans over its strategic time horizon, and how it might respond to these changes. In doing so, a smaller institution may want to perform a sensitivity analysis to understand how sensitive its capital is to changes in internal and external factors such as business risks, and changes in business cycles.

(iv) ICAAP outcome

Finally, a smaller institution should document the ranges of capital required identified above and form an overall view on the amount of internal capital which it should hold.

2.3 Risk areas of focus according to the nature of activities of smaller credit institutions

22. The next section sets out risks which may be considered by smaller credit institutions. It provides examples of the types of risks which such institutions might typically face and should therefore consider in their ICAAP, as detailed in the section above. The definitions of risks are valid as laid down in Annex 1 of the Guidelines.

2.3.1 Concentration risk

23. Concentration risk resulting from concentrated loan portfolios could be a significant factor, especially for smaller institutions. If a credit institution chooses to use the minimum capital requirement as a starting point for its capital assessment, it should remember that, when assessing its exposure to concentration risk, the minimum capital requirement is calibrated on the assumption that an institution is a well-diversified internationally active institution, which usually does not apply to smaller institutions.

24. In assessing the degree of credit concentration, a credit institution should consider its degree of credit concentration to both individual counterparties and economic or geographic areas. Where the business of a credit institution is, by its nature, concentrated (for example, a specialised firm lending to one sector only, or where there is collateral concentration), it should consider the impact of adverse economic factors on the concentrated area and its impact on asset quality.[4]

2.3.2 Control/management risk

25. Control/management risk could be divided into risk due to control/management deficiencies and risk due control/management limitations. Control/management deficiencies relate to circumstances where institutions do not comply with minimum legal requirements. Control/management limitations relate to circumstances where the institutions comply with minimum legal requirements, but, due to structural reasons inherent in their size, have a limited capacity to set up sophisticated governance arrangements and systems and controls.

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[4] CEBS intends to publish guidance on Concentration Risk as an Annex to the Guidelines.

26. Control/management deficiencies should normally be addressed by using other risk mitigants than capital. In fact, the correct response must be to take action to resolve the problems.

27. Control/management risk due to control/management limitations could be a significant factor for smaller institutions. The concept of proportionality means that supervisors would not expect the same degree of sophistication of governance arrangements and controls that could be found in a larger institution. However, other things being equal, the overall risk profile may be higher in smaller institutions after taking into account the proportionate management and control environment (whether in relation to specific risks, or in general). Smaller institutions will also be expected to consider the risk resulting from control/management limitations in their internal capital assessment, if the application of other measures is deemed to be inadequate to address such limitations within an appropriate timeframe.

2.3.3 Credit risk

28. The Pillar 1 minimum requirement seeks to cover credit risk. However, the Standardised Approach might not reflect the full credit risk of the institution. Therefore it is important that the institution considers whether its credit risk is fully captured in the capital assessed by Pillar 1. For example, the institution should make sure that the capital assessment allocates internal capital for the weaker exposure classes where accounting standards do not require (or allow) that provisions are made and where the Pillar 1 approach used does not sufficiently reflect the risk of a particular portfolio.

2.3.4 Interest rate risk

29. A credit institution should assess the sensitivity of its financial position to adverse movements in interest rates. For instance, it should assess its sensitivity to interest rate risk arising from interest rate mismatches and maturity mismatches between assets and liabilities.[5]

2.3.5 Liquidity including raising new capital

30. When assessing the adequacy of its capital, a credit institution should also consider the sensitivity of its funding, in particular its ability to raise additional funding in times of economic stress. It should therefore consider whether its funding pool is sufficiently diversified. The possibility of raising new capital normally depends on whether the institution has a financially strong parent company and whether the institution is quoted or not. Smaller institutions which are unquoted and not listed at a stock exchange such as savings banks and cooperative banks may in some countries have a lower possibility of raising new capital and the cost of

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[5] CEBS intends to publish guidance on Interest Rate Risk in the Banking Book as an Annex to the Guidelines.

new funding will be relatively high. Subsidiaries with financially strong parent companies will normally have easy access to raise additional funding. But if the subsidiary is reliant solely on its parent to provide funding, the institution should take into consideration that its access to funds may be suddenly restricted if the parent's creditworthiness is downgraded.

2.3.6 Operational risk

31. Operational risk is largely expected to be covered by the Pillar 1 minimum requirement. However, there may be additional factors that should be taken into account. Performance may, in some instances, depend on key individuals, especially in smaller institutions. In developing its sensitivity analysis, a credit institution should therefore consider the impact of losing key individuals on its ability to operate normally, and on its revenues.

2.3.7 Strategic risk

32. A credit institution should assess the impact of its business plans on its capital over the time horizon which it uses in its business plans. It should assess the impact on its capital of diversifying its activities and the risk it runs of failing to manage that new business successfully.

2.3.8 Impact from external factors

33. Credit institutions should also be aware of any impact from external factors. However the supervisory authorities expect that the impacts from external factors are normally covered by credit risk, market risk, concentration risk and strategic risk.

2.4 Risk areas of focus according to the nature of activities of smaller investment firms

34. The next section sets out risks which may be considered by smaller investment firms. It provides examples of the types of risks which such institutions might typically face and should therefore consider in their ICAAP, as detailed in the section above. The definitions of risks are valid as laid down in Annex 1 of the Guidelines.

2.4.1 Fixed overheads requirements

35. For investment firms, the fixed overheads requirement (FOR) is important in the context of the minimum capital requirements. The FOR is a fixed limit based on a firm's fixed expenditure to enable the firm to wind down its business in a three-month period.

36. For investment firms in the sense of Article 20(2) of the Capital Requirements Directive[6], the minimum capital requirement is the higher of the sum of credit risk and market risk or the FOR.

37. For investment firms in the sense of Article 20(3) of the CRD, the minimum capital requirement is the sum of credit risk, market risk and the FOR.

38. The supervisory authorities agree that depending on the individual firm's circumstances, in a majority of cases the FOR may be a good approximation for the result of the ICAAP for investment firms in the sense of Article 20(2) of the CRD. However, given the FOR's dependence on the fixed overheads costs of the firm, the FOR will not always be a good approximation for the result of the ICAAP for investment firms in the sense of Article 20(2) of the CRD. For example, an investment firm with very high fixed overheads costs and very low risks may find that the FOR is higher than the ICAAP results. Conversely, an investment firm with very low overhead costs and high risks may find that the ICAAP result is higher than the FOR. Therefore, when building their ICAAP, these investment firms should focus on whether the FOR is appropriate as the ICAAP figure for the particular circumstances of their business. Equally, in conducting the SREP, the supervisory authorities will focus on whether the FOR is appropriate as the ICAAP figure for the particular circumstances of their business.

2.5 Risks common to smaller investment firms

39. The supervisory authorities consider that most smaller investment firms are likely to undertake the investment services and activities listed in Annex I, Section A (1) to (5) of MiFID (the 'relevant activities') and are less likely to engage in the activities listed in Annex I, Section A (6) to (8) of MiFID.

40. The following section lists key risks common to all smaller investment firms, and key risks to investment firms undertaking specific relevant activities. As most smaller investment firms undertake a number of these, they should consider all risks listed for the activities they are undertaking.

2.5.1 Concentration risk

41. Concentration risk resulting from large exposures to a limited number of counterparties, a large transaction, or to a single product type is significant for most smaller investment firms undertaking the relevant activities. For example, an investment firm relying on the income generated by a large, one-off corporate finance transaction may wish to consider the possibility of legal action arising from that transaction which could prevent the payment of that income. Equally, an investment firm

[6] The Capital Requirements Directive (CRD), which recasts Directives 2000/12/EEC and 93/6/EEC.

relying on a small number of advisory mandates should consider the possibility of losing these mandates which could force the firm out of business. Please also refer to the definition of concentration risk in Annex 1 of the Guidelines.

2.5.2 Operational risk

42. Just like large banks, all investment firms, including smaller ones, should consider the consequences of operational risk events occurring. For smaller investment firms particular risks may be, for example, the consequences of not abiding by conduct of business rules or the legal framework they are operating in. They will need to bear in mind the systems and controls, including compliance requirements, they have put in place to mitigate the risks, such as failing to comply fully with customer mandates, or the cost resulting from fraud or theft.

2.5.3 Impact of external factors

43. All smaller investment firms should consider the impact of external factors when assessing the adequacy of their capital. They should develop scenarios which relate to their strategic and business plans. These scenarios might consider, for example, the effect of a market downturn affecting transaction volumes, or the impact on the current level of capital should the firm restructure, enter a new market or launch a new product.

2.6 Further risks common to all smaller investment firms

44. Investment firms should also consider the following risks set out above for smaller credit institutions: credit risk (Paragraph 28), control/management risk (Paragraphs 25-27), interest rate risk (Paragraph 29), liquidity and raising new capital (Paragraph 30) and strategic risks (Paragraph 32). Investment firms should bear in mind that the impact of these risks may be slightly different due to their business activities.

2.6.1 Investment firms receiving and transmitting orders, and executing orders on behalf of clients (MiFID Annex I, Section A (1) and (2))

45. Investment firms undertaking these activities effectively carry out orders for their customers. They should therefore consider the legal risk of breaching their customer obligations, and the reputational risk of providing poor customer service.

2.6.2 Investment firms dealing on own account (MiFID Annex I, Section A 3))

46. Investment firms dealing on own account are exposed to market risk. If they engage in proprietary trading book activities, they have a direct

market risk exposure. However, if they act as agent to fulfil a customer order they are usually only exposed to market risk if the transaction does not clear or settle properly. Firms dealing on own account are also exposed to liquidity risk as large losses can potentially arise from trades in illiquid securities or assets, which are difficult to sell.

2.6.3 Investment firms undertaking portfolio management (MiFID Annex I, Section A (4))

47. Investment firms undertaking this activity should consider the legal risk of breaching their customer obligations, and the reputational risk of providing poor customer service. They are also exposed to performance risk as poor investment returns can affect their ability to generate income, both in the short term (for example, because they may not receive performance bonuses) and in the long term (for example, because they find it more difficult to retain or attract new business). If they take positions (whether as principal or agent) they should also consider potential market risks (see Paragraph 38 above).

2.6.4 Investment firms giving investment advice (MiFID Annex I, Section A (5))

48. Investment firms undertaking this activity should consider the legal risk of breaching their customer obligations, for example, by giving unsuitable advice, and the reputational risk of providing poor customer service.

3 Supervisory Authorities and SREP

3.1 The Supervisory Review and Evaluation Process (SREP)

49. The purpose of this section is to provide recommendations to supervisors on how to approach the SREP for smaller credit institutions and smaller investment firms, and how the SREP for these institutions relates to their ICAAP.

50. The Guidelines define the SREP as the process which supervisors use

- to review and evaluate
    - the firm's exposure to risk (a firm's risk profile);
    - the adequacy and reliability of the firm's ICAAP;
    - the adequacy of the institution's own funds and internal capital in relation to the assessment of its overall risk profile;
- to monitor ongoing compliance with standards laid down in the CRD; and

- to identify any weakness or inadequacies and necessary prudential measures.

51. In the SREP the supervisor has to be satisfied with the calculation of the internal capital as well as with the qualitative methods implemented by the institution for assessing and controlling risks.

52. This section does not cover the process of monitoring ongoing compliance with CRD standards.

3.2 The SREP and proportionality

53. The Guidelines state that the proportionality of the SREP means that the depth, frequency and intensity of the SREP will be determined by the potential risk that the institution poses to the supervisor's objectives. Given that supervisors have to interact with a broad spectrum of institutions in terms of size and complexity, this requires using a spectrum of different tools for supervision. For example, unlike very large and complex firms, smaller institutions may not be subject to continuous relationship between supervisors and management so that the supervisor's interaction with the firm may be more limited.

54. Supervisory authorities should apply this risk-based approach to the SREP. Accordingly, the supervisory authorities envisage that a simplified SREP approach may be adopted for smaller institutions. In these cases, the SREP may involve peer group analysis, random reviews, using standardised self-assessments and analysing a limited number of the most important risks these firms are exposed to on the basis of a sectoral analysis through desk-based supervision, rather than a full, tailored SREP for every individual smaller institution. Nevertheless, supervisory authorities will always reserve the right to review the ICAAP of an institution at any time, which includes the right to carry out on-site inspections or apply any other supervisory tool they deem appropriate in the circumstances, within their legal powers and responsibilities.

3.3 SREP for smaller investment firms

55. The prudential risks posed by smaller investment firms (other than own-account dealers) are typically limited, as, unlike banks, they are not deposit takers. Customers are generally well protected through conduct of business rules, including segregation of clients' assets, and through the overall requirements on organisational and control structures.

56. Therefore, consistent with the proportionality principle and risk-based supervision, the supervisory authorities may adopt a 'light-touch' SREP for smaller investment firms which is simplified further. Accordingly, rather than conduct a routine SREP for these firms, the supervisory authorities may use off-site, desk-top reviews of data provided by the firm, such as standardised self-assessments in the form of questionnaires, or horizontal work in relation to the whole sector, for example thematic work, peer group analyses and random review. The supervisory authorities may also seek to identify 'outliers' through their

usual risk assessment systems. Nevertheless, supervisory authorities will always reserve the right to review the ICAAP of a firm at any time which includes the right to carry out on-site inspections or apply any other supervisory tool they deem appropriate in the circumstances, within its legal powers and responsibilities.

57. Please refer to Paragraph 37 for a discussion of the relationship between the FOR and the ICAAP.