

FAS update - March 09



Capital Adequacy under the CRD Pillar 2 & Pillar 3 Requirements

Introduction

The Capital Requirements Directive (CRD) that came into force on 1 January 2008 introduced a new prudential framework for banks and building societies and certain types of investment firms, with an aim of relating capital requirements more closely to the risks they face. This introduced a pillar approach to capital requirements.

Pillar 1 deals with the minimum capital requirements regarding credit, market and operational risk and encompasses the base and variable capital requirements.

Pillar 2 requires firms to assess their need for additional capital not covered by Pillar 1. This is done by producing an Individual Capital Adequacy Assessment Process (ICAAP) document.

Pillar 3 deals with disclosure requirements and aims to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

The requirements of each pillar are expanded on below.

Pillar 1

Previously, firms only had to consider their exposures to credit and market

risk in order to arrive at the minimum amounts of capital the FSA believed they should hold.

Under Pillar 1, the rules were revised, and the capital requirements updated to include operational risk.

However, the operational risk requirements only apply to full scope firms and banks.

The capital requirement for a limited licence firm is the higher of the base capital requirement (€50K), the fixed overhead requirement or the sum of the credit and market risk.

The capital requirement for a full scope firm is the higher of the base capital requirement (€730K) and the sum of the credit, market and operational risk.

The capital requirement for a bank is the higher of €5M and the sum of the credit, market and operational risk.

Pillar 2

The CRD recognised that the Pillar 1 requirements might not cover all the risks facing a business.

Pillar 2 was therefore introduced to ensure that all firms consider all the risks facing their business and to identify whether they need additional capital to cover these risks over that required in pillar 1.

The ICAAP document is designed to show all relevant information neces-

sary for a firm's management and the FSA to make an informed decision on the appropriate capital level and risk management approach.

ICAAP (Internal Capital Adequacy Assessment Process)

Firms are now required to:

- Carry out regular assessments of the amounts and type of capital it considers adequate to cover the nature and level of risks to which it is or might be exposed
- Identify their 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 required and used in its ICAAP are both comprehensive and proportionate to the nature, scale and complexity of the firm's activities
- Document its ICAAP

The FSA have produced a document containing a suggested format for small investment firms – typically those BIPRU 50K Limited Licence Firms with simple structures (see Appendix I).

The assessments of capital and risks for firms should as a minimum be carried out annually.

If major events such as the recent turmoil in the credit markets occur, or alternatively, firm specific events which would affect the amount of capital needed or the risks facing the firm, then the ICAAP should be reviewed more frequently to ensure it deals accurately with the new trading conditions.

For BIPRU 50K firms, there is no requirement for the ICAAP to be submitted to the FSA, but it can be requested on demand.

The ICAAP for these firms will instead be assessed via the FSA019 Pillar 2 Information form to be submitted on GABRIEL.

This form (see Appendix 2) is intended to be used as part of the FSA's risk assessment of a firm and allow it to reduce supervisory time by identifying those firms with a risk profile requiring additional individual or thematic work.

The form links directly to a firm's ICAAP document and pulls together the most important facts and figures to enable the FSA to perform a quick review.

The FSA019 must be submitted by 2nd March for firms with a 31 December year end. The FSA will then conduct a review of submissions and follow up with those firms it identifies as outliers.

Pillar 3

Pillar 3 complements the minimum capital requirements in pillar 1 and the supervisory review process in pillar 2.

Its aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on a firm's capital, risk exposures and risk assessment processes.

The FSA is adopting a risk based approach to monitoring and enforcing firms' compliance with the market discipline disclosure requirements.

For most firms that fall under CRD, the requirements for Pillar 3 came into force on 1 January 2008.

The exact date that firms should publish Pillar 3 disclosures is not prescribed by the FSA and is left to the discretion of management. The disclosures should be updated at least annually or more often if it is deemed necessary.

The materiality concept applies, and the FSA allow certain disclosures to be omitted if management believe them to be immaterial.

The FSA also does not expect disclosures to be made if the information is considered as confidential by management.

There is a requirement however to disclose that information has been omitted and the grounds on which it has not been disclosed.

The location of the disclosures is also not prescribed. Typically firms will choose either to publish them in their annual financial statements or on their website.

A document showing the necessary disclosures and a suggested format is shown in Appendix 3.

For firms with a 31 December year end, these disclosures would typically appear as part of the annual financial statements, or if preferred on the firm's website at the same time the annual financial statements are made publicly available.

APPENDIX 1: ICAAP FSA Suggested Format for Small Investment Form

Executive Summary

The purpose of this section is to provide an overview of the firm's ICAAP methodology and results. It may typically include the following:

- confirmation that the firm has adequate capital for its size and complexity of business;
- confirmation that all the firm's regulated entities are covered by the assessment;
- if the firm is a member of a group, confirmation of the type of group (e.g. limited licence, limited activity or full scope) and if all firms in the group are not of the same type, what are the different types;
- material risks identified by the firm and whether these risks are within the firm's risk appetite;
- the findings of the ICAAP analysis:
 - the amount of capital the firm considers that it should hold compared to its capital resource requirement (CRR) 'pillar 1' calculation;
 - the adequacy of the firm's risk management process;
 - whether the firm has adequate resources over its planning horizon taking into account the dividend policy and the potential impact of an economic downturn;
- clarification of the BIPRU approach that the firm has adopted for credit, market and operational risk (if applicable);
- a table itemising components of the Pillar 1 (to be provided for comparison purposes) and the Pillar 2 capital figures (see below)

- commentary on any major issues where further analysis / work and decisions are required;
- a description of the review, challenge and approval process of the ICAAP by the firm and its governing body.

Background – the ICAAP Process

This section should provide a high level overview of the firm's ICAAP process pulling together the firm's risk management framework, business planning and capital management. It should cover relevant policies, procedures and systems used by the firm to identify, manage and monitor its risks in accordance with its risk appetite.

Statement of risk appetite

This section should provide a high level overview of the firm's risk appetite statement and set out the frequency of review by the firm's senior management and approval by its governing body.

Business strategy

This section should include a high level summary of the firm's business / corporate plan which should provide an indication of the forward view of the firm's business (e.g. growth plans, new product lines, new market / distribution channels etc.) Specific details on the firm's business model can be provided by way of appendices as appropriate.

Material risks

This section should provide a concise description of the firm's identification process of risks and how the firm assesses which risks are deemed to be material.

As a starting point this section should follow the FSA guidance and terminology of the key risks to be considered as part of an ICAAP.

If the firm uses Professional Indemnity Insurance (PII), the firm needs to adequately assess whether there is any gap in the coverage, whether the insurer is a good credit risk,

payment history and whether the insurer has sufficient liquidity to survive the period between submitting a claim and it being settled.

For an asset management firm, see BIPRU 2.2.61 and for a securities firm, see BIPRU 2.2.66 to 2.2.70

Capital planning and stress and scenario tests

This section should provide details on the firm's projections of its capital resources and capital requirements.

These projections may include a forward projection of 3 to 5 years (or a shorter time period if more appropriate) and should be consistent with the firm's business plan. This initial projection would form the 'base case' for the capital planning analysis. A projection of past and forecasted income streams would also be useful.

This information should provide an indication of the level of capital planning, management and cashflow analysis.

This section should include a statement of the firm's operating philosophy on capital management and how this links up with the firm's ICAAP.

Using the base case as a starting point the firm should use stress tests to consider how it would perform under stressed conditions. This section would set out the stress tests undertaken and the extent to which the stressed conditions that the firm has selected meet the FSA's definition of a severe recession or relevant business downturn / event, i.e. of a severity that occurs once in a 25 year period.

The firm should provide an indication of how it would manage its business and capital alongside meeting its minimum regulatory requirements, the firm's total capital held can not be less than the minimum Pillar I figure. Where mitigating actions are relied upon, the results of the stress tests

	Pillar 1 (optional)	ICAAP
	Minimum capital	Firm's pillar 2 capital
Credit risk		
Market risk		
Operational risk		
Fixed overhead requirement (FOR)		
Pillar 1 total		
Pillar 2 risk X		
Pillar 2 risk Y		
Pillar 2 risk Z		
Pillar 2 total		
Adjustments		
Additional capital to cover stress testing		
ICAAP total		
Current total capital		
Surplus		

Table for itemising components of the Pillar 1 and Pillar 2 capital figures

should be provided on both gross and net of controls and credible manageable actions. The details of the stress test such as the methodology and assumptions used should be included in an appendix.

There is guidance with respect to stress tests for asset managers and securities firms which can be found in **BIPRU 2.2.65** and **2.2.66** respectively.

Management actions following the stress and scenario tests should be articulated and the following should be considered:

- quantitative impact of management actions;
- sensitivity analysis / testing of management actions; and
- justifications for why these mitigating actions are realistic.

Challenge and adoption of the ICAAP

This section should 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.

The ICAAP document should be maintained and owned by the firm's Board / equivalent decision making body. The document's purpose is to inform the Board of the ongoing assessment of the firm's $\triangle \downarrow \nabla \nearrow \nabla$, how the firm intends to mitigate those risks and how much current and future capital is necessary having considered other mitigating factors.

This section should include the senior management and governing body review and sign-off procedures. If used, details should be provided of any reliance on external suppliers of economic scenario models or consultants. Copies of reports obtained from external reviewers or internal audits should be referred to in a separate appendix.

This section should also include a brief description of how the ICAAP is used by the firm including how it is embedded in the firm's decision making process.

Details of any future refinements to the firm's ICAAP (including any work-in-progress) and any relevant information that would help the FSA when they review the ICAAP should be included.

(Continued on page 5)

**APPENDIX 2 – FSA019
PILLAR 2 INFORMATION
FORM**

FSA019 Pillar 2 information				
1	Does GENPRU 1.2 apply to your firm?	B yes/no <input type="text"/>		
If so, please answer all the following questions:				
2	What is the internal capital amount that you consider adequate for the nature, scale and complexity of your firm's activities in line with its Internal Capital Adequacy Assessment Process (ICAAP)?	000s <input type="text"/>		
3	What is the actual amount of internal capital your firm holds at the accounting reference date?	<input type="text"/>		
4	Have you documented your ICAAP?	yes/no <input type="text"/>		
5	When did you last review the ICAAP?	dd/mm/yy <input type="text"/>		
6	Have your external auditors audited your firm's financial statement in the 12 months?	yes/no/not applicable <input type="text"/>		
7	If so, has any audit opinion you received in the last year been qualified in any respect?	<input type="text"/>		
8	What is the ratio of dealing errors in relation to the total number of transactions your firm has undertaken in the past 12 months?	% <input type="text"/>		
9	Have you considered your firm's risk appetite when developing its ICAAP?	yes/no <input type="text"/>		
10	In your ICAAP, have you considered the impact of an economic downturn on:			
11	· your firm's financial position?	<input type="text"/>		
	· your business plans?	<input type="text"/>		
Is the firm exposed to the risks listed below? And if so, what amount of internal capital have you allocated to each of them?				
		yes/no 000s A B		
12	· market risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
13	· credit risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
14	· operational risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
15	· liquidity risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
16	· securitisation risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
17	· insurance risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
18	· pension obligation risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
19	· concentration risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
20	· residual risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
21	· business risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
22	· interest rate risk	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
23	· other	<table border="1" style="width: 100%;"><tr><td style="width: 50%;"><input type="text"/></td><td style="width: 50%;"><input type="text"/></td></tr></table>	<input type="text"/>	<input type="text"/>
<input type="text"/>	<input type="text"/>			
FSA019 continued				
24	Does your firm have any professional indemnity insurance cover?	yes/no <input type="text"/>		
25	If so, What is the limit of the indemnity in the aggregate?	000s <input type="text"/>		
26	What is the greatest deductible for any single claim?	<input type="text"/> rating		

27	What is the credit rating of the lead underwriter?	<input type="text"/>
		yes/no
28	In your firm's ICAAP, do you take account of the results of the stress tests set out in BIPRU 4.3.39R and BIPRU 4.3.40R?	<input type="text"/>
29	Does your firm deduct illiquid assets as set out in GENPRU 2.2.17R to 2.2.19R?	<input type="text"/>
30	Does your firm have sufficient liquidity to meet your liabilities as they fall due in the circumstances of an orderly wind-down?	<input type="text"/>
		000s
31	Report the amount of <i>illiquid assets</i> .	<input type="text"/>
		yes/no
32	Do you use credit risk mitigation techniques?	<input type="text"/>
33	If so, have you considered in your ICAAP the fact that those techniques may not fully work as anticipated?	<input type="text"/>
34	Have you securitised assets in the last 12 months?	<input type="text"/>
35	Do you use an internal model as described in BIPRU 7.10 to calculate regulatory market risk?	<input type="text"/>
36	If so, have you taken the results of the market risk stress tests in your ICAAP into account ?	<input type="text"/>
		000s
37	Report the result of a 200 basis point shock to interest rates on your firm's economic value.	<input type="text"/>
		yes/no
38	Does the result of the above stress test exceed 20% of your economic value?	<input type="text"/>
39	Would the valuation adjustments required under GENPRU 1.3.35G enable you to sell or hedge out your firm's positions within a short period without incurring material losses under normal market conditions?	<input type="text"/>

APPENDIX 3 – FSA Suggested Format for Pillar 3 Disclosures

Background and Overview

This section should include the following:

- A brief account of the purpose of the Pillar 3 disclosures
- An explanation that it is the application of CRD and Basel II to the firm that requires it to make the Pillar 3 disclosures
- A statement that the rules provide that the firm may omit one or more of the required disclosures if it believes that the information is immaterial, including the definition of materiality
- A statement that the firm is also allowed to omit one or more disclosures where it believes that the information is regarded as confidential, including a definition of confidential information
- Confirmation that the firm has made the disclosures in accordance with BIPRU 11
- A statement confirming where the disclosures are to be published, and a website address if the disclosures are made online

Scope of Application

This section should provide a summary of the disclosures the firm will be making and under which BIPRU 11 rules.

Details of any waiver applicable to the firm should be disclosed here.

The firm must also disclose the basis on which it is preparing the disclosures i.e. an individual basis, as part of a UK consolidation group etc.

If the firm reports on a group consolidated basis, it should list the subsidiaries that the disclosures apply to

and give a breakdown of the group structure.

If applicable, this section should also confirm that there are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities when due between the parent company and its subsidiaries.

Risk Management

Firms should disclose here their risk management objectives and policies for each separate category of risk.

These disclosures must include:

- The strategies and processes to manage those risks
- The structure and organisation of the relevant risk management function or other appropriate arrangements
- The scope and nature of risk reporting and measurement systems
- The policies for hedging and mitigating risk; and the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants

A firm may choose to include here much of the risk assessment section from their ICAAP, as well as the considerations of the material risks faced by the firm and how it mitigates them.

Capital Resources

This section should include:

- Summary information on the terms and conditions of the main features of all capital resources items and components thereof
- Tier 1 capital resources, with separate disclosures of all positive items and deductions
- The total amount of tier two capital and tier three capital resources
- Deductions from tier one and

tier two capital resources

- Total capital resources net of deductions

Firms should have already considered this for their ICAAP, so again much of this can be taken from that document.

A table would be the best format here to show the breakdown of regulatory capital held by the firm.

Compliance with BIPRU 3, 4, 6, 7 and 10

This section should disclose:

- A summary of the firm's approach to assessing the adequacy of its internal capital to support current and future activities
- For a firm calculating risk weighted exposure amounts in accordance with the standardised approach to credit risk, 8% of the risk weighted exposure amounts for each of the standardised credit risk exposure classes
- For a firm calculating risk weighted exposure amounts in accordance with the IRB approach, 8% of the risk weighted exposure amounts for each of the IRB exposure classes
- In respect of its trading book business (not applicable for limited licence firms) minimum capital requirements for:
 - Interest rate PRR
 - Equity PRR
 - Option PRR
 - Collective investment schemes PRR
 - Counterparty risk capital component
 - Concentration risk capital component
- In respect of all its business activities, minimum capital requirements for:

- Commodity PRR
- Foreign currency PRR
- Operational risk capital requirement

It is also a requirement for firms to refer directly to the three core risks underpinning CRD – namely market, credit and operational risk.

For operational risk, disclosure of the approaches for the assessment of the operational risk capital requirement that the firm qualifies for is also needed.

For firms applying credit risk mitigation techniques, the following disclosures also need to be made:

- Policies and processes for, and an indication of the extent to which the entity makes use of, on and off balance sheet netting
- The policies for collateral valuation and management
- A description of the main types of collateral taken by the firm
- The main types of guarantor
- Information about market risk or credit risk concentration

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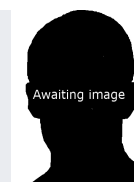
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