



Guernsey Financial Services Commission

Our Pillar 2 assessment: the SREP framework

June 2008

1 The Supervisor Review and Evaluation Process ('SREP')

In our review, we consider the quality of the firm's assessment of the quantitative and qualitative elements of their Internal Capital Adequacy Assessment Process ('ICAAP'). The ICAAP and SREP form two integral, and mutually complementary, parts of the overall supervisory review process that Pillar 2 represents. We set out in detail below the Commission's SREP framework. This is further illustrated in a flowchart attached as appendix 1 to this document.

1.1 Internal planning

Typically we will hold an internal planning meeting to provide challenge and approval for the structure and the scope of the Pillar 2 assessment.

1.2 The submission request letter

We will write to the firm to tell them what information we will need to carry out the SREP and to propose the timescales for the review (in certain cases we may agree the timescales with a firm over the telephone and confirm the agreed timing via email). Once the firm has received the letter, we will discuss its contents with them and agree timescales.

We normally allow two months for the firm to submit the ICAAP to us but this may be shorter, depending on how far the firm has progressed on its ICAAP.

Note 1.2a

Late or inadequate ICAAP submissions

There may be instances where firms fail to submit an ICAAP of adequate quality or where there are significant gaps in information. Normally we will try to work with the firm to resolve any difficulties. Where the prospect of receiving an adequate ICAAP is remote, we may still give the firm its Individual Capital Guidance ('ICG'). But, we will have to base the ICG on our view of the firm, taking into account our existing knowledge of it and any information that we have access to. However, we do not envisage needing in practice to resort to this approach.

1.3 High-level review

Once we have received the ICAAP submission, a senior analyst will check it for completeness compared to previously issued Commission guidance on layout and content by undertaking a high-level review. In particular, we will look for areas that require further examination or a more detailed explanation from the firm. We will also review any existing information we have that is specific to the firm and relevant to its ICAAP.

1.4 Written questions and / or discussions with the firm

Building on the high-level review, we will prepare several main questions for the firm as part of our initial feedback on the ICAAP. We may want to hold face-to-face discussions to explore areas of relevance or to provide further background and evidence to supplement the ICAAP submission. If one or more on-site visits are scheduled, we will notify the firm of the main issues that we plan to discuss before each visit so they can prepare in advance and ensure that appropriate staff are available.

1.5 Detailed review - quantitative and qualitative stages

Following discussions with the firm, we will carry out a more detailed review of the firm's ICAAP and related material. At this stage, we may want to hold further discussions with the firm. These will usually be arranged over the telephone or by email.

The structure of this dialogue should embrace the following four elements (see appendix 2 on page 7):

- i. Element 1 – Pillar 1 risks (credit, market and operational)
- ii. Element 2 – Risks not fully captured under Pillar 1 (for example, securitisation risk or residual risk in CRM). Also risks specifically covered by Pillar 2 (for example, interest rate, concentration, liquidity, reputational or strategic risk).
- iii. Element 3 – Methodological approach to determine Pillar 2 capital.
- iv. Element 4 – External factors, where not already considered under one of the above.

The detailed review will consider both the quantitative and qualitative aspects of the ICAAP and both stages will run concurrently.

During the quantitative stage of the detailed review, we will consider the firm's assessment of the business as usual elements of their ICAAP. This will involve a robust review and assessment of the firm's Pillar 1 & Pillar 2 risks. We will consider and assess the methodology and accuracy of the calculation of Pillar 1 risks and how those other risks not fully captured under Pillar 1 are included and quantified within the ICAAP (for example reputational risk, interest rate risk, strategic risk etc.).

Finally under the quantitative stage of the detailed review, we will assess how future changes in a firm's balance sheet can affect its future capital requirements. (This is covered by risk element 4 – see appendix 2 on page 7).

In summary a firm's ICAAP should cover the following key areas¹:

- chart the future of the firm based on its business plan; —
- subject that plan to economic stress tests and shocks including a downturn scenario(s);
- measure the financial impact of such scenario(s) on its business plan and the level of required capital both gross and net of the effect of management action (if preferred);
- identify how future capital needs (as required under the above scenarios) will be funded; and

¹ See guidance issued by the GFSC "High level principles on Pillar 2 and revision of supervisory returns" in June 2007 and additional guidance issued in October 2007 entitled "The Internal Capital Adequacy Assessment Process "ICAAP" and the supervisory review".

1.5 Detailed review - quantitative and qualitative stages (continued)

- be based on the firm's current controls, but assuming, as one type of scenario, a failure of a major control or set of controls to the extent of a major operational occurrence.

If we have made any capital adjustments after our quantitative review (the four elements) the resulting figure is called 'Intermediate Capital'. If we agree with the firm's ICAAP capital requirement, intermediate capital will be the same as the ICAAP capital requirement. Otherwise the difference reflects the degree to which our view differs from that in the firm's ICAAP along with our reasons for those differences.

The second stage of the detailed review is the qualitative assessment of the firm's oversight and governance. The Commission, as part of the review, will take account of any relevant information obtained from off-site reviews such as Section 36c returns, on-site examinations, prudential returns, meetings, media coverage and other research.

Subject to a more formalised approach in future by the Commission in assessing each firm's corporate governance regime and overall risk management practices, which will in time form part of the overall SREP framework, the Commission will consider imposing capital add-ons. This would be where the Commission feels a firm has failed to adequately and prudently address Pillar 2 risks which are relevant to the firm within their ICAAP or in relation to when the Commission conducts its peer comparison.

The resulting figure after adjustment, if any, is called Individual Capital Guidance – provisional. The provisional ICG must be validated through the internal validation panel process before it becomes final.

1.6 Sharing our provisional ICG with the firm - and the firm's response

Usually we will communicate to the firm's senior management the key conclusions of the SREP and our provisional ICG before the final validation panel meeting. This gives them an opportunity to have their comments considered by the panel. At this stage, we will highlight what we think are strengths and weaknesses in the firm's ICAAP - including a discussion of the detailed figures as well as broader issues.

Any proposed prudential measures would be discussed as part of these meetings with management. The prudential measures available to the Commission include:

- Requiring an institution to hold own funds and or Tier 1 capital above minimum level required by Pillar 1, and/or imposing other limitations on own funds.
- Requiring the institution to improve its internal control and risk management framework.
- Requiring the institution to apply a specific provisioning policy or treatment of assets in terms of own funds requirements.
- Restricting or limiting the business, operations or network of the institution.
- Requiring the institution to reduce the risk inherent in its activities, products or systems.

1.6 Sharing our provisional ICG with the firm - and the firm's response (continued)

The final decision on which measures, if any, to use will be taken by the Commission after dialogue with the firm. The measures will be reflective of the severity and underlying causes of the situation.

1.7 The final validation panel

The SREP review team will set out their conclusions and recommendations in a Panel Pack which presents their findings to the ICG validation panel for review and moderation. The panel considers the key issues for each firm in a sector-specific context to ensure broad consistency of the ICG, and makes the final decisions on capital requirements.

One of the best means of demonstrating that an ICG is fair and reasonable is through comparison with a firm's peers. The Panel Pack, therefore, sets out peer-group comparison of information, as well as a summary of the capital adjustments proposed.

1.8 The ICG letter

Following the internal validation of the ICG, we will write to the firm's management to feed back the results of our assessment. This letter formally tells the firm the ICG we consider to be appropriate. It will include reasons for any capital adjustments to their ICAAP, should the ICG be set higher. It will also identify, where appropriate, what actions the firm can take to reduce the level of these capital adjustments.

1.9 Ongoing monitoring of ICG

We aim to give ICG within six months of receipt of ICAAP. Once the SREP is completed and ICG has been given, the next complete review of the ICAAP should coincide with the anniversary of the issuance of the ICG.

However, we will consider on an ongoing basis, but more formally once a year, whether the circumstances of the firm have changed. If any of the key assumptions underpinning the firm's ICAAP change or a firm's risk profile alters and, as a result, the ICG no longer adequately reflects the underlying risks, then re-assessment may be necessary. In any event, and consistent with the firm's obligations, we would expect the firm to notify us of any such changes.

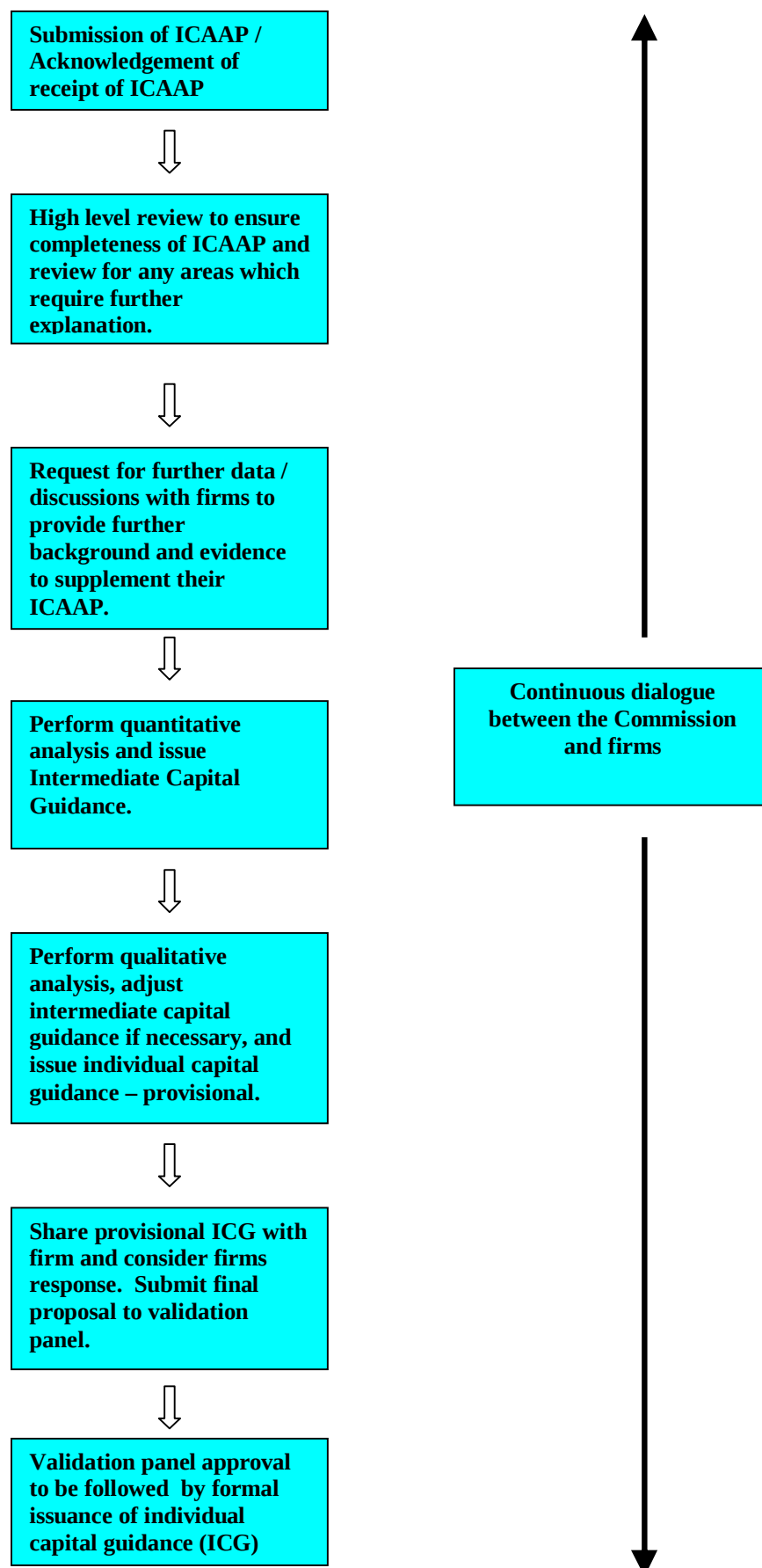
As this is the first year carrying out a SREP it is envisaged that this will be a stand alone review process. In future years, after the review process has become embedded it may be possible to combine the SREP with other supervisory areas of regulation, such as a more formalised approach by the Commission in assessing each firm's corporate governance regime and overall risk management practices. This will in time form part of the overall SREP framework which may affect the methodology used by the Commission in arriving at ICG. We will invite feedback on the initial process after we have completed one full cycle of reviews. We will also invite feedback on any proposed changes the Commission may wish to introduce to the SREP framework regarding the methodology of arriving at ICG.

Any queries relating to the information contained in this paper should be addressed in the first instance to:

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Appendix 1 – Supervisor Review and Evaluation Process



Appendix 2 – Supervisory review using a structured approach

