Pillar 1 & 2 – initial observations on ICAAP submissions

This note provides key messages for banks based on our own observations of ICAAPs received to date. While there were many strengths in the drafts received this note concentrates on the generic areas where development would be beneficial.

Key messages:

1. **Firms need to support the numbers and conclusions in their ICAAP with solid analysis.**

   Firms need to ensure that the Pillar 1 calculations make sense in terms of a 'narrative', for example, if the capital requirement under Basel II has increased why this is. What are the market drivers? This narrative needs to be in the ICAAP so as to give confidence that the overall capital position is right.

   Where firms add capital on for Pillar 2 risks, we need to understand how these numbers have been derived, and in particular, what methodological assumptions have been made. The latter, for example, may include assumptions as to whether future profits have been used to set against capital requirements or the assumptions made around risk correlation. Other assumptions might be around impact and probability.

   If capital is not a suitable or an appropriate mitigant, a summary of other mitigants should be included in the body of the ICAAP and the detailed analysis set out in the appendices. In the event that a firm believes that a risk is mitigated by effective controls, it needs to state explicitly what these controls are and why they are believed to be effective.

2. **Embedding the ICAAP (the 'use test') and senior management understanding.**

   Firms need to demonstrate that the ICAAP plays an integral part of the firm's processes and demonstrate that senior management are engaged in and support the ICAAP. Further, firms need to detail how they intend to use the ICAAP going forward and how, for example, KRIs and economic capital indicators / assumptions can be updated and presented to the senior management / the Board of directors on a periodic basis. We realise that it is still early days for the ICAAP but we need to see evidence that the firm has embraced the process for business rather than regulatory reasons. Evidence that management has, through the ICAAP, made the business more efficient or less risky needs to be brought to the fore as positive factors.

3. **Firms need to consider what additional capital, if any, is required under Pillar 2 for operational risk.**

   It should be noted that only firms who apply the AMA in Pillar 1, are 'protected' from the need for a Pillar 2 charge for operational risk. This is because (a) the simple operational risk pillar one charges are not risk sensitive and (b) in Guernsey, early results show that the Pillar 1 operational risk charge is proving to be small due to its predication on net income. Firms should also take into account point 9 below regarding PII when considering operational risk capital requirements.

4. **The ICAAP should clearly distinguish between a firm's regulatory capital, a firm's actual capital and the capital the firm needs to hold for business purposes.**

   We have noticed at times confusion on this issue and suggest that a clear articulation of the differences in the ICAAP, where they exist.

5. **Firms need to articulate their risk appetite.**

   A clear and concise articulation of the firm's appetite for risk is required. The risk appetite statement should have been discussed and approved at board level. We acknowledge that firms may find this a difficult exercise especially when it does not run off a quantitative model but would encourage firms to give due consideration to this section of the ICAAP. The risk appetite should match the firms operations and product range. It should not necessarily follow that all firms will have a low risk appetite. We would encourage firms to show how their appetite for risk correlates to profitability or the control structure. We have no problem with firms saying they want to take on more risk.

6. **Firms must analyse their concentration risk.**

   This includes geographical (regional) and product concentration e.g. mortgage book and wholesale counterparties.

7. **Firms must undertake adequate stress testing that is appropriate and relevant to their business**.

   Firms should apply a proportionate approach to stress testing depending on the scale and nature of their business, but all firms must conduct stress tests. We have seen several cases where the stress tests have not been sufficiently severe. Firms are reminded that the stress test should look at abnormal conditions - such as the current market turbulence.

8. **Firms should aim to keep the ICAAP relevant to a Guernsey perspective.**

   Within reason, firms should consider whether the layout and content of a group ICAAP is suitable as a template for use by a Guernsey subsidiary. Are those risks detailed within the group ICAAP relevant to the risks faced by the Guernsey subsidiary? Are the stress tests suitable enough to allow subsidiary companies to input their results into a group stress test (for example will a property crash in the U.K affect Guernsey housing market to the same extent)?

9. **Professional Indemnity Insurance (PII) analysis.**

   Firms need to conduct an adequate gap analysis of their PII (i.e. risks excluded or not adequately covered). We would generally expect firms to assess the financial strength of the underwriter. For firms to use PII to reduce the capital requirement to cover a specific risk there should be a close correlation between the risk which the PII covers and the scenario under review. Saying 'we have PII cover' is not adequate, especially as PII often protects board members rather then the firm itself. Issues such as exclusion clauses, ease of renewal and maturity options should also be considered. In general the Commission will need to see a persuasive case before allowing PII to act as an alternative to capital.

10. **Where banks have not started preparing their ICAAPs to date, they should consider using a quarter end where a form BSL/2 has been completed as a starting point.**

    This will ensure that Pillar 1 calculations are easily referenced from a completed BSL/2 form to a firm's ICAAP and should reduce the potential for any errors in the calculation.

11. **Firms should aim to keep the main body of the ICAAP short.**

    Generally speaking around 20-25 pages with additional pages being included in appendices. The executive summary should clearly detail how the final figures included within the ICAAP are derived from the work documented in the appendices. A well written ICAAP will demonstrate that firms own the ICAAP.

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

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