

## Chapter 2

# Supervisory processes and governance

## 2.1 Application and purpose

[Note: On 19 December 2014, the EBA published “Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)”, EBA/GL/2014/13. The FCA has confirmed its intention to make every effort to comply with these guidelines.]

### Application

2.1.1

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■ IFPRU 2 applies in the following manner:

- (1) to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*; and
- (2) the *general stress and scenario testing rule* (and related rules and guidance) applies only to a *significant IFPRU firm*.

### Purpose

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This chapter implements certain provisions of CRD relating to governance and contains *guidance* related to Section III of Chapter 2, Title VII of CRD (Supervisory review and evaluation process).

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This section amplifies Principle 4, under which a *firm* must maintain adequate financial resources. It is concerned with the adequacy of the financial resources that a *firm* needs to hold in order to meet its liabilities as they fall due. These resources include both capital and liquidity resources.

2.1.4

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This section has *rules* requiring a *firm* to identify and assess risks to its ability to meet its liabilities as they fall due, how it intends to deal with those risks, and the amount and nature of financial resources that the *firm* considers necessary. ■ IFPRU 2.2.43 R (Documentation of risk assessment) provides that a firm should document that assessment. The FCA will review that assessment as part of its own assessment of the adequacy of a *firm's* capital under its supervisory review and evaluation process (*SREP*). When forming a view of any *individual capital guidance* to be given to the *firm*, the FCA will also review the regulator's risk assessment and any other issues arising from day-to-day supervision.

2.1.5

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This section has *rules* requiring a *firm* to carry out appropriate stress tests and scenario analyses for the risks it has previously identified and to establish the amount of financial resources and internal capital needed in each of the circumstances and events considered in that analyses. The FCA

will consider, as part of its *SREP*, whether the *firm* should hold a *capital planning buffer* and the amount and quality of that buffer. The *capital planning buffer* is an amount separate, though related to, the *individual capital guidance* in so far as its purpose is to ensure that a *firm* is able to continue to meet the *overall financial adequacy rule* throughout the relevant capital planning period in the face of adverse circumstances, after allowing for realistic management actions. Therefore, when forming its view on a *firm's capital planning buffer*, the *FCA* will take into account the assessment made in relation to the *firm's ICG*.

### 2.1.6

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This section has *rules* on the individual, *sub-consolidated basis* and *consolidated basis* application of:

- (1) the *ICAAP rules* in ■ IFPRU 2.2.45R to ■ IFPRU 2.2.49R (Level of application: *ICAAP rules*);
- (2) the *risk control rules* in ■ IFPRU 2.2.58R to ■ IFPRU 2.2.60R (Level of application: *risk control rules*); and
- (3) the overall financial adequacy rule in ■ IFPRU 2.2.61R to ■ IFPRU 2.2.63R (Level of application: overall financial adequacy rule).

## 2.2 Internal capital adequacy assessment process

### Adequacy of financial resources

- 2.2.1 **R** A *firm* must, at all times, maintain overall financial resources and internal capital, including *own funds* and liquidity resources which are adequate both as to amount and quality to ensure there is no significant risk that its liabilities cannot be met as they fall due.
- 2.2.2 **G** ■ BIPRU 12 contains *rules* and *guidance* relating to the adequacy of a *firm's* liquidity resources. In assessing the adequacy of its liquidity resources, a *firm* should do so by reference to the *overall liquidity adequacy rule*, rather than the *overall financial adequacy rule*.
- 2.2.3 **G** The effective management of prudential risk relies on the adequacy of a *firm's* financial resources, systems and controls. These need to be assessed in relation to all the activities of the *firm* and the risks to which they give rise, and so this chapter applies to a *firm* for the whole of its business. For a *collective portfolio management investment firm*, this means that this section also applies to its activities in relation to the management of *AIFs* and/or *UCITS*.
- 2.2.4 **G** The liabilities referred to in the *overall financial adequacy rule*:
- (1) include:
    - (a) a *firm's* contingent and prospective liabilities;
    - (b) liabilities or costs that arise in scenarios where the *firm* is a going concern and those where the *firm* ceases to be a going concern;
    - (c) claims that could be made against a *firm*, which ought to be paid in accordance with fair treatment of *customers*, even if such claims could not be legally enforced; and
    - (d) claims on insurance that a *firm* has made or is in the course of making; and
  - (2) exclude liabilities that might arise from transactions that a *firm* has not entered into and which it could avoid (e.g. by taking realistic management actions such as ceasing to transact new business after a suitable period of time has elapsed).

2.2.5 **G** In the light of **IFPRU 2.2.4 G**, a *firm* should make its assessment of adequate financial resources on realistic valuation bases for assets and liabilities, taking into account the actual amounts and timing of cash flows under realistic adverse projections.

2.2.6 **G** Risks may be addressed through holding capital to absorb losses that unexpectedly materialise. The ability to pay liabilities as they fall due also requires liquidity. Therefore, in assessing the adequacy of a *firm's* financial resources, both capital and liquidity needs should be considered. A *firm* should also consider the quality of its financial resources, such as the loss-absorbency of different types of capital and the time required to liquidate different types of asset.

**Strategies, processes and systems**.....

2.2.7 **R** A *firm* must have in place sound, effective and comprehensive strategies, processes and systems:

- (1) to assess and maintain, on an ongoing basis, the amounts, types and distribution of financial resources, *own funds* and internal capital that it considers adequate to cover:
  - (a) the nature and level of the risks to which it is, or might be, exposed;
  - (b) the risk in the *overall financial adequacy rule*;
  - (c) the risk that the *firm* might not be able to meet the obligations in Part Three of the *UK CRR* (Capital Requirements) in the future; and
- (2) that enable it to identify and manage the major sources of risks referred to in (1), including the major sources of risk in each of the following categories where they are relevant to the *firm* given the nature and scale of its business:
  - (a) credit and counterparty risk;
  - (b) *market risk*;
  - (c) *liquidity risk*;
  - (d) *operational risk*;
  - (e) concentration risk;
  - (f) residual risk;
  - (g) *securitisation risk*;
  - (h) business risk;
  - (i) interest rate risk, including interest-rate risk in the *non-trading book*;
  - (j) *risk of excessive leverage*;
  - (k) pension obligation risk; and
  - (l) group risk.

[Note: article 73 first paragraph and article 74(1) of *CRD*]

## 2.2.8

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- (1) This *rule* defines some of the terms used in the *overall Pillar 2 rule*.
- (2) Residual risk means the risk that *credit risk mitigation* techniques used by the *firm* prove less effective than expected.
- (3) *Securitisation* risk includes the risk that the *own funds* held by a *firm* for assets which it has *securitised* are inadequate having regard to the economic substance of the transaction, including the degree of risk transfer achieved.
- (4) Business risk means any risk to a *firm* arising from:
  - (a) changes in its business, including:
    - (i) the acute risk to earnings posed by falling or volatile income;
    - (ii) the broader risk of a *firm's* business model or strategy proving inappropriate due to macro-economic, geopolitical, industry, regulatory or other factors; and
    - (iii) the risk that a *firm* may not be able to carry out its business plan and desired strategy; and
  - (b) its remuneration policy (see also the *Remuneration Code* which applies to *IFPRU investment firms* and the detailed application of which is set out in ■ SYSC 19A.1).
- (5) Pension obligation risk is the risk to a *firm* caused by its contractual or other liabilities to, or with respect to, a pension scheme (whether established for its employees or those of a related *company* or otherwise). It also means the risk that the *firm* will make payments or other contribution to, or with respect to, a pension scheme because of a moral obligation or because the *firm* considers that it needs to do so for some other reason.
- (6) Interest-rate risk in the *non-trading book* means:
  - (a) risks related to the mismatch of re-pricing of assets and liabilities and off balance sheet short- and long-term positions ("re-pricing risk");
  - (b) risks arising from hedging exposure to one interest rate with exposure to a rate which re-prices under slightly different conditions ("basis risk");
  - (c) risk related to the uncertainties of occurrence of transactions, for example, when expected future transactions do not equal the actual transactions ("pipeline risk"); and
  - (d) risks arising from consumers redeeming fixed rate products when market rates change ("optionality risk").
- (7) Group risk is the risk that the financial position of a *firm* may be adversely affected by its relationships (financial or non-financial) with other entities in the same *group* or by risks which may affect the financial position of the whole *group* (eg, reputational contagion).

## 2.2.9

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- (1) This paragraph gives *guidance* on some of the terms used in the *overall Pillar 2 rule*.

- (2) In a narrow sense, business risk is the risk to a *firm* that it suffers losses because its income falls or is volatile relative to its fixed cost base. However, in a broader sense, it is exposure to a wide range of macro-economic, geopolitical, industry, regulatory and other external risks that might deflect a *firm* from its desired strategy and business plan. ■ IFPRU 2.3.47 G to ■ IFPRU 2.3.54 G provides further *guidance* on business risk.
- (3) Interest-rate risk in the *non-trading book* is explained in ■ IFPRU 2.3.39 G (Interest rate risk in the non-trading book).

**2.2.10** **G** In the *overall Pillar 2 rule*, internal capital refers to the financial resources of a *firm* which it treats as being held against the risks listed in the *overall Pillar 2 rule*. The obligation in that *rule* to assess the distribution of such capital refers, in relation to a *firm* making an assessment on an individual basis, for example, to the need to take account of circumstances where part of a *firm's* financial resources are held by a *branch* of that *firm* which are subject to restrictions on its ability to transfer that capital. An assessment of internal capital distribution might also take account of such of a *firm's* financial resources as may be ring-fenced in the event of its insolvency.

**2.2.11** **R** As part of its obligations under the *overall Pillar 2 rule*, a *firm* must identify separately the amount of *common equity tier 1 capital*, *additional tier 1 capital* and *tier 2 capital* and each category of capital (if any) that is not eligible to form part of its *own funds* which it considers adequate for the purposes described in the *overall Pillar 2 rule*.

**2.2.12** **R** The processes, strategies and systems required by the *overall Pillar 2 rule* must be comprehensive and proportionate to the nature, scale and complexity of the *firm's* activities.  
 [Note: article 73 second paragraph (part) of CRD]

**2.2.13** **R** A *firm* must:

- (1) carry out regularly the assessments required by the *overall Pillar 2 rule*; and
- (2) carry out regular assessments of the processes, strategies and systems required by the *overall Pillar 2 rule* to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the *firm's* activities.

[Note: article 73 second paragraph (part) of CRD]

**2.2.14** **R** As part of its obligations under the *overall Pillar 2 rule*, a *firm* must :

- (1) make an assessment of the *firm-wide* impact of the risks identified in line with that *rule*, to which end a *firm* must aggregate the risks across its various business lines and units, taking appropriate account of the correlation between risks;

- (2) take into account the stress tests that the *firm* is required to carry out as follows:
  - (a) (for a *significant IFPRU firm*) under the *general stress and scenario testing rule* (including ■ SYSC 20 (Reverse stress testing));
  - (b) (except a *firm* in (a)) under ■ SYSC 20 (Reverse stress testing); and any stress tests that the *firm* is required to carry out under the *UK CRR*;
- (3) have processes and systems that:
  - (a) include an assessment of how the *firm* intends to deal with each of the major sources of risk identified in line with ■ IFPRU 2.2.7 R (2); and
  - (b) take account of the impact of the diversification effects and how such effects are factored into the *firm's* systems for measuring and managing risks.

**2.2.15** G Certain risks, such as systems and controls weaknesses, may not be adequately addressed by, for example, holding additional capital and a more appropriate response would be to rectify the weakness. In such circumstances, the amount of financial resources required to address these risks might be zero. However, a *firm* should consider whether holding additional capital might be an appropriate response until the identified weaknesses are rectified. A *firm*, should, in line with ■ IFPRU 2.2.43 R to ■ IFPRU 2.2.44 R (Documentation of risk assessments), document the approaches taken to manage these risks.

**2.2.16** G

- (1) A *firm* should:
  - (a) carry out assessments of the sort described in the *overall Pillar 2 rule* and ■ IFPRU 2.2.13R on an ongoing basis; and
  - (b) document the assessments in (a), in line with ■ IFPRU 2.2.43R to ■ IFPRU 2.2.44R (Documentation of risk assessments), at least annually, or more frequently if changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of financial resources is no longer adequate.
- (2) The appropriateness of the internal process, and the degree of involvement of *senior management* in the process, will be taken into account by the *FCA* when reviewing a *firm's* assessment as part of the *FCA's* own assessment of the adequacy of a *firm's* financial resources and internal capital. The processes and systems should ensure that the assessment of the adequacy of a *firm's* financial resources and internal capital is reported to its *senior management* as often as is necessary.

**Credit and counterparty risk**

**2.2.17** R A *firm* must base credit-granting on sound and well-defined criteria and clearly establish the process for approving, amending, renewing and re-financing credits.

[Note: article 79(a) of *CRD*]



2.2.18 **R** A *firm* must have internal methodologies that:

- (1) enable it to assess the credit risk of exposures to individual obligors, securities or *securitisation positions* and credit risk at the portfolio level;
- (2) do not rely solely or mechanistically on external credit ratings;
- (3) where its *own funds requirements* under Part Three of the *UK CRR* (Capital Requirements) are based on a rating by an *ECAI* or based on the fact that an exposure is unrated, enable the *firm* to consider other relevant information for assessing its allocation of financial resources and internal capital.

[Note: article 79(b) of *CRD*]

2.2.19 **R** A *firm* must operate through effective systems the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions.

[Note: article 79(c) of *CRD*]

2.2.20 **R** A *firm* must adequately diversify credit portfolios given its target markets and overall credit strategy.

[Note: article 79(d) of *CRD*]

**Residual risk**

2.2.21 **R** A *firm* must address and control, by means which include written policies and procedures, residual risk (see ■ IFPRU 2.2.8 R (2) and ■ IFPRU 2.3.41 G).

[Note: article 80 of *CRD*]

**Concentration risk**

2.2.22 **R** A *firm* must address and control, by means which include written policies and procedures, the concentration risk arising from:

- (1) exposures to each counterparty, including central counterparties, groups of connected counterparties and counterparties in the same economic sector, geographic region or from the same activity or commodity;
- (2) the application of *credit risk mitigation* techniques; and
- (3) risks associated with large indirect credit exposures, such as a single collateral issuer.

[Note: article 81 of *CRD*]

2.2.23 **R** In ■ IFPRU 2.2.22 R, the processes, strategies and systems relating to concentration risk must include those necessary to ensure compliance with Part Four of the *UK CRR* (Large exposures).

**Securitisation risk**

2.2.24 **R** A *firm* must evaluate and address through appropriate policies and procedures the risks arising from *securitisation* transactions in relation to which a *firm* is investor, *originator* or *sponsor*, including reputational risks, to ensure, in particular, that the economic substance of the transaction is fully reflected in risk assessment and management decisions.  
 [Note: article 82(1) of CRD]

2.2.25 **R** A *firm* which is an *originator* of a revolving *securitisation* transaction involving early amortisation provisions must have liquidity plans to address the implications of both scheduled and early amortisation.  
 [Note: article 82(2) of CRD]

**Market risk**

2.2.26 **R** A *firm* must implement policies and processes for the identification measurement and management of all material sources and effects of *market risks*.  
 [Note: article 83(1) of CRD]

2.2.27 **R** A *firm* must take measures against the risk of a shortage of liquidity if the short position falls due before the long position.  
 [Note: article 83(2) of CRD]

2.2.28 **R**

- (1) A *firm's* financial resources and internal capital must be adequate for material *market risk* that are not subject to an *own funds requirement* under Part Three of the *UK CRR* (Capital Requirements).
- (2) A *firm* which has, in calculating *own funds requirements* for position risk in accordance with Part Three, Title IV, Chapter 2 of the *UK CRR* (Own funds requirements for position risk), netted off its positions in one or more of the equities constituting a stock-index against one or more positions in the stock index future or other stock-index product, must have adequate financial resources and internal capital to cover the basis risk of loss caused by the future's or other product's value not moving fully in line with that of its constituent equities. A *firm* must also have such adequate financial resources and internal capital where it holds opposite positions in stock-index futures which are not identical in respect of either their maturity or their composition or both.
- (3) A *firm* using the treatment in article 345 of the *UK CRR* (Underwriting: Reduction of net positions) must ensure that it holds sufficient financial resources and internal capital against the risk of loss which exists between the time of the initial commitment and the following working day.

[Note: article 83(3) of CRD]

2.2.29 **R** As part of its obligations under the *overall Pillar 2 rule*, a *firm* must consider whether the value adjustments and provisions taken for *positions* and portfolios in the *trading book* enable the *firm* to sell or hedge out its

positions within a short period without incurring material losses under normal market conditions.

[Note: article 98(4) of CRD]

**Interest risk arising from non-trading book activities**

2.2.30 **R** A firm must implement systems to identify, evaluate and manage the risk arising from potential changes in interest rates that affect a firm's non-trading activities.

[Note: article 84 of CRD]

- 2.2.31 **R**
- (1) As part of its obligations under the overall Pillar 2 rule, a firm must carry out an evaluation of its exposure to the interest-rate risk arising from its non-trading activities.
  - (2) The evaluation under (1) must cover the effect of a sudden and unexpected parallel change in interest rates of 200 basis points in both directions.
  - (3) A firm must immediately notify the FCA if any evaluation under this rule suggests that, as a result of the change in interest rates described in (2), the economic value of the firm would decline by more than 20% of its own funds.
  - (4) A firm must carry out the evaluation under (1) as frequently as necessary for it to be reasonably satisfied that it has at all times a sufficient understanding of the degree to which it is exposed to the risks referred to in (1) and the nature of that exposure. In any case it must carry out those evaluations no less frequently than once a year.

[Note: article 98(5) of CRD]

**Operational risk**

2.2.32 **R** A firm must implement policies and processes to evaluate and manage the exposure to operational risk, including model risk and to cover low-frequency high severity events. Without prejudice to the definition of operational risk, a firm must articulate what constitutes operational risk for the purposes of those policies and procedures.

[Note: article 85(1) of CRD]

2.2.33 **R** A firm must have adequate contingency and business continuity plans in place aimed at ensuring that, in the case of a severe business disruption, the firm is able to operate on an ongoing basis and that any losses are limited.

[Note: article 85(2) of CRD]

**Risk of excessive leverage**

2.2.34 **R** (1) A firm must have policies and procedures in place for the identification, management and monitoring of the risk of excessive leverage.

- (2) Those policies and procedures must include, as an indicator for the *risk of excessive leverage*, the leverage ratio determined in accordance with article 429 of the *UK CRR* (Calculation of the leverage ratio) and mismatches between assets and obligations.

[Note: article 87(1) of *CRD*]

**2.2.35** **R** A *firm* must address the *risk of excessive leverage* in a precautionary manner by taking due account of potential increases in that risk caused by reductions of the *firm's own funds* through expected or realised losses, depending on the applicable accounting rules. To that end, a *firm* must be able to withstand a range of different stress events with respect to the *risk of excessive leverage*.

[Note: article 87(2) of *CRD*]

### General stress and scenario testing

**2.2.36** **R** The *general stress and scenario testing rule* in **IFPRU 2.2.37 R** and related *rules and guidance* apply to a *significant IFPRU firm*.

- 2.2.37** **R**
- (1) As part of its obligation under the *overall Pillar 2 rule*, a *firm* that is a *significant IFPRU firm* must:
    - (a) for the major sources of risk identified in line with IFPRU 2.2.7R(2), carry out stress tests and scenario analyses that are appropriate to the nature, scale and complexity of those major sources of risk and to the nature, scale and complexity of the *firm's* business; and
    - (b) carry out the reverse stress testing under **SYSC 20** (Reverse stress testing).
  - (2) In carrying out the stress tests and scenario analyses in (1), a *firm* must identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile and consider the exposure of the *firm* to those circumstances, including:
    - (a) circumstances and events occurring over a protracted period of time;
    - (b) sudden and severe events, such as market shocks or other similar events; and
    - (c) some combination of the circumstances and events described in (a) and (b), which may include a sudden and severe market event followed by an economic recession.
  - (3) In carrying out the stress tests and scenario analyses in (1), the *firm* must estimate the financial resources that it would need in order to continue to meet the *overall financial adequacy rule* and the *own funds requirements* under the obligations laid down in Part Three of the *UK CRR* (Capital requirements) in the adverse circumstances being considered.
  - (4) In carrying out the stress tests and scenario analyses in (1), the *firm* must assess how risks aggregate across business lines or units, any

material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

- (5) A *firm* must carry out the stress tests and scenario analyses at least annually, unless:
  - (a) it is notified by the *FCA* to carry out more frequent or ad-hoc stress tests and scenario analyses; or
  - (b) the nature, scale and complexity of the major sources of risk identified by it under the *overall Pillar 2 rule* make it appropriate to carry out more frequent stress tests and scenario analyses.
- (6) A *firm* must report to the *FCA* the results of the stress tests and scenario analysis annually and not later than six *months* after its annual reporting date.

[Note: article 100 of *CRD*]

2.2.38 **G** To comply with the *general stress and scenario testing rule*, a *firm* should undertake a broad range of stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on an individual portfolio, as well as a *firm-wide* level.

2.2.39 **G** A *firm* with an IRB permission which has any material credit *exposures* excluded from its IRB models should also include these *exposures* in its stress and scenario testing to meet its obligations under the *general stress and scenario testing rule*. A *firm* without IRB permission should conduct analyses to assess risks to the credit quality of its counterparties, including any protection sellers, considering both on and off-balance sheet exposures.

2.2.40 **G** In carrying out the stress tests and scenario analyses under **■ IFPRU 2.2.37 R (1)**, a *firm* should also consider any impact of the adverse circumstances on its *own funds*. In particular, a *firm* should consider the capital ratios in article 92 of the *UK CRR* (Own funds requirements) where its *common equity tier 1 capital* and *additional tier 1 capital* is eroded by the event.

2.2.41 **G** A *firm* should assign adequate resources, including IT systems, to stress testing and scenario analysis, taking into account the stress testing techniques used, in order to accommodate different and changing stress tests at an appropriate level of granularity.

2.2.42 **G** For the purpose of **■ IFPRU 2.2.37 R (5)**, a *firm* should consider whether the nature of the major sources of risks identified by it, in line with **■ IFPRU 2.2.7 R (2)** (Main requirement relating to risk strategies, processes and systems), and their possible impact on its financial resources suggest that such tests and analyses should be carried out more frequently. For instance, a sudden change in the economic outlook may prompt a *firm* to revise the parameters of some of its stress tests and scenario analyses. Similarly, if a *firm* has recently become exposed to a particular sectoral concentration, it may wish to add some stress tests and scenario analyses to reflect that concentration.

**Documentation of risk assessments**

**2.2.43** **R** A *firm* must make a written record of the assessments required under this chapter. These assessments include those carried out on a consolidated basis and on an individual basis. In particular, it must make a written record of:

- (1) the major sources of risk identified in accordance with the *overall Pillar 2 rule*;
- (2) how it intends to deal with those risks; and
- (3) details of the stress tests and scenario analyses carried out, including any assumptions made in relation to scenario design and the resulting financial resources estimated to be required in accordance with the *general stress and scenario testing rule*.

**2.2.44** **R** A *firm* must maintain the records in **IFPRU 2.2.43 R** for at least three years.

**Level of application: ICAAP rules**

**2.2.45** **R** A *firm* must apply the *ICAAP rules* on an individual basis if it is not:

- (1) a *subsidiary undertaking* of a *parent undertaking* incorporated in, or formed under the law of any part of, the *United Kingdom*; and
- (2) a *parent undertaking*.

**2.2.46** **R** A *firm* that is not a member of a *FCA consolidation group* must apply the *ICAAP rules* on an individual basis.  
 [Note: article 108(1) of *CRD*]

**2.2.47** **R** A *firm* which is a *UK parent institution* must comply with the *ICAAP rules* on a *consolidated basis*.  
 [Note: article 108(2) of *CRD*]

**2.2.48** **R** A *firm* controlled by a *UK parent financial holding company* or a *UK parent mixed financial holding company* must comply with the *ICAAP rules* on the basis of the *consolidated situation* of that holding company, if the *FCA* is responsible for supervision of the *firm* on a *consolidated basis* under article 4B of the *UK CRR*.  
 [Note: article 108(3) of *CRD*]

**2.2.49** **R** A *firm* that is a *subsidiary* must apply the *ICAAP rules* on a *sub-consolidated basis* if the *firm*, or the *parent undertaking* where it is a *financial holding company* or *mixed financial holding company*, have an *institution* or *financial institution* or an *asset management company* as a *subsidiary* in a *third country* or hold a *participation* in such an *undertaking* as members of a *non-UK sub-group*.  
 [Note: article 108(4) of *CRD*]

**Extent and manner of prudential consolidation**

- 2.2.50 **R** If the *ICAAP rules* apply to a *firm* on a *consolidated basis*, the *firm* must carry out consolidation to the extent and in the manner prescribed in Part One, Title II, Chapter 2, section 2 of the *UK CRR* (Methods for prudential consolidation) and ■ IFPRU 8.1(Prudential consolidation).
- 2.2.51 **R** For the purpose of the *ICAAP rules* as they apply on a *consolidated basis* or on a *sub-consolidated basis*:
- (1) the *firm* must ensure that the *FCA consolidation group* has the processes, strategies and systems required by the *overall Pillar 2 rule*;
  - (2) the risks to which the *overall Pillar 2 rule* and the *general stress and scenario testing rule* refer are those risks as they apply to each member of the *FCA consolidation group*;
  - (3) the reference in the *overall Pillar 2 rule* to amounts and types of financial resources, *own funds* and internal capital (referred to in this *rule* as resources) must be read as being to the amounts and types that the *firm* considers should be held by the members of the *FCA consolidation group*;
  - (4) other references to resources must be read as being to resources of the members of the *FCA consolidation group*;
  - (5) the reference in the *overall Pillar 2 rule* to the distribution of resources must be read as including a reference to the distribution between members of the *FCA consolidation group*; and
  - (6) the reference in the *overall Pillar 2 rule* to the *overall financial adequacy rule* must be read as being to that *rule* as adjusted under ■ IFPRU 2.2.63 R (Application of the *overall financial adequacy rule* on a consolidated basis).
- 2.2.52 **R**
- (1) This *rule* relates to the assessment of the amounts, types and distribution of financial resources, *own funds* and internal capital (referred to in this *rule* as "resources") under the *overall Pillar 2 rule* as applied on a *consolidated basis* and to the assessment of diversification effects as referred to in ■ IFPRU 2.2.14 R (3)(b) as applied on a *consolidated basis*.
  - (2) A *firm* must be able to explain how it has aggregated the risks referred to in the *overall Pillar 2 rule* and the financial resources, *own funds* and internal capital required by each member of the *FCA consolidation group* and how it has taken into account any diversification benefits for the group in question.
  - (3) In particular, to the extent that the transferability of resources affects the assessment in (2), a *significant IFPRU firm* must be able to explain how it is satisfied that resources are transferable between members of the group in question in the stressed cases and the scenarios referred to in the *general stress and scenario testing rule*.

- 2.2.53** **R** (1) A *firm* must allocate the total amount of financial resources, *own funds* and internal capital identified as necessary under the *overall Pillar 2 rule* (as applied on a consolidated basis) between different parts of the *FCA consolidation group*. ■ IFPRU 2.2.11 R (Identifying different tiers of capital) does not apply to this allocation
- (2) The *firm* must carry out the allocation in (1) in a way that adequately reflects the nature, level and distribution of the risks to which the group is subject and the effect of any diversification benefits.
- 2.2.54** **R** A *firm* must also allocate the total amount of financial resources, *own funds* and internal capital (referred to in this *rule* as "resources") identified as necessary under the *overall Pillar 2 rule* as applied on a *consolidated basis* or *sub-consolidated basis* between each *firm* which is a member of the *FCA consolidation group* on the following basis:
- (1) the amount allocated to each *firm* must be decided on the basis of the principles in ■ IFPRU 2.2.53 R (2); and
- (2) if the process in (1) were carried out for each group member, the total so allocated would equal the total amount of resources identified as necessary under the *overall Pillar 2 rule*, as applied on a *consolidated basis* or *sub-consolidated basis*.
- 2.2.55** **G** A *firm* to which the *ICAAP rules* apply on a *consolidated basis* need not prepare a *consolidated basis* assessment if such an assessment has been prepared by another member of its *FCA consolidation group*. In such cases, a *firm* may adopt such an assessment as its own. A *firm* nevertheless remains responsible for the assessment.
- 2.2.56** **G** The purpose of ■ IFPRU 2.2.52 R to ■ IFPRU 2.2.55 G is to enable the *FCA* to assess the extent, if any, to which a *firm's* assessment, calculated on a *consolidated basis*, is lower than it would be if each separate legal entity were to assess the amount of capital it would require to mitigate its risks (to the same level of confidence) were it not part of a group subject to consolidated supervision under Part One, Title II, Chapter 2 of the *UK CRR* (Prudential consolidation). The reason the *FCA* wishes to make this assessment is so that individual capital guidance which it gives is fair and comparable between different *firms* and groups. Group diversification benefits which a *firm* might assert exist can be a material consideration in a capital adequacy assessment. Understanding the methods used to aggregate the different risks (eg, the correlation assumptions) is crucial to a proper evaluation of such benefits.
- 2.2.57** **G** Whereas a single legal entity can generally use its capital to absorb losses wherever they arise, there are often practical and legal restrictions on the ability of a group to do so. For instance:
- (1) capital which is held by overseas regulated *firms* may not be capable of being remitted to a *firm* in the *UK* which has suffered a loss;
- (2) a *firm* which is, or likely to become, insolvent may be obliged to look to the interests of its creditors first before transferring capital to other group *companies*; and



(3) a parent *company* may have to balance the interests of its shareholders against the protection of the creditors of a *subsidiary* which is, or might become, insolvent and may, rationally, conclude that a *subsidiary* should be allowed to fail rather than provide capital to support it.

**Level of application: risk control rules**

2.2.58 **R** The *risk control rules* apply to a *firm* on an individual basis whether or not they also apply to the firm on a *consolidated basis*.

[Note: article 109(1) of CRD]

2.2.59 **R** Where a *firm* is a member of a *FCA consolidation group* or a *non-UK sub-group*, the *firm* must ensure that the risk management processes and internal control mechanisms at those levels comply with the obligations set out in the *risk control rules* on a *consolidated basis* (or a *sub-consolidated basis*).

[Note: article 109(2) of CRD]

2.2.60 **R** Compliance with the obligations in **IFPRU 2.2.59 R** must enable the *FCA consolidation group* or the *non-UK sub-group* to have arrangements, processes and mechanisms that are consistent, well integrated and ensure that data relevant to the purpose of supervision can be produced.

[Note: article 109(2) of CRD]

**Level of application: overall financial adequacy rule**

2.2.61 **R** The *overall financial adequacy rule* applies to a *firm* on an individual basis, whether or not it also applies to the firm on a *consolidated basis* or *sub-consolidated basis*.

2.2.62 **R** The *overall financial adequacy rule* applies to a *firm* on a *consolidated basis* if the *ICAAP rules* apply to it on a *consolidated basis* and applies to a *firm* on a *sub-consolidated basis* if the *ICAAP rules* apply to it on a *sub-consolidated basis*.

2.2.63 **R** When the *overall financial adequacy rule* applies on a *consolidated basis* or *sub-consolidated basis*, the *firm* must ensure that at all times its *FCA consolidation group* maintains overall financial resources and internal capital, including *own funds* and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that the liabilities of any members of its *FCA consolidation group* cannot be met as they fall due.

**Additional guidance on stress tests and scenario analyses**

2.2.64 **G** The *general stress and scenario testing rule* requires a *firm* to carry out stress tests and scenario analyses as part of its obligations under the *overall Pillar 2 rule*. Both stress tests and scenario analyses are undertaken by a *firm* to further a better understanding of the vulnerabilities that it faces under adverse conditions. They are based on the analysis of the impact of a range

of events of varying nature, severity and duration. These events can be financial, operational or legal or relate to any other risk that might have an economic impact on the *firm*.

**2.2.65** **G** Stress testing typically refers to shifting the values of individual parameters that affect the financial position of a *firm* and determining the effect on the *firm's* financial position.

**2.2.66** **G** Scenario analysis typically refers to a wider range of parameters being varied at the same time. Scenario analyses often examine the impact of adverse events on the *firm's* financial position, for example, simultaneous movements in a number of risk categories affecting all of a *firm's* business operations, such as business volumes, investment values and interest rate movements.

**2.2.67** **G** There are three broad purposes of stress testing and scenario analysis:

- (1) it can be used as a means of quantifying how much capital might be absorbed if an adverse event or events occurs (ie, a simple 'what if' approach to estimating exposure to risks), this might be a proportionate approach to risk management for an unsophisticated business;
- (2) it can be used to provide a check on the outputs and accuracy of risk models, particularly in identifying non-linear effects when aggregating risks; and
- (3) it can be used to explore the sensitivities in longer term business plans and how capital needs might change over time

**2.2.68** **G** One of the main purposes of stress tests and scenario analyses under the *general stress and scenario testing rule* is to test the adequacy of overall financial resources. Scenarios need only be identified, and their impact assessed, in so far as this facilitates that purpose. In particular, the nature, depth and detail of the analysis depend, in part, upon the *firm's* capital strength and the robustness of its risk prevention and risk mitigation measures.

**2.2.69** **G** Both stress testing and scenario analyses are forward-looking analysis techniques which seek to anticipate possible losses that might occur if an identified risk crystallises. In applying them, a *firm* should decide how far forward to look. This should depend upon:

- (1) how quickly it would be able to identify events or changes in circumstances that might lead to a risk crystallising resulting in a loss; and
- (2) after it has identified the event or circumstance, how quickly and effectively it could act to prevent or mitigate any loss resulting from the risk crystallising and to reduce exposure to any further adverse event or change in circumstance.

- 2.2.70 **G** Where a *firm* is exposed to *market risk*, the time horizon over which stress tests and scenario analyses should be carried out will depend on, among other things, the maturity and liquidity of the *positions* stressed. For example, for the *market risk* arising from the holding of investments, this will depend upon:
- (1) the extent to which there is a regular, open and transparent market in those assets, which would allow fluctuations in the value of the investment to be more readily and quickly identified; and
  - (2) the extent to which the market in those assets is sufficiently liquid (and would remain liquid in the changed circumstances contemplated in the stress test or scenario analysis) to allow the *firm*, if needed, to sell, hedge or otherwise mitigate the risks relating to its holding so as to prevent or reduce exposure to future price fluctuations. In devising stress tests and scenario analyses for *market risk*, a *firm* should also take into account the following:
    - (a) the *general stress and scenario testing rule* should include a regular programme of stress testing and scenario analysis of its trading book positions, both at the trading desk level and on a *firm-wide* basis, with the results of these tests being reviewed by *senior management* and reflected in the policies and limits the *firm* sets;
    - (b) the *firm's* stress testing programme should be comprehensive in both risk and *firm* coverage, and appropriate to the size and complexity of trading book positions held;
    - (c) for the purpose of **IFPRU 2.2.37 R (5)(b)**, the frequency of stress testing of trading book positions should be determined by the nature of the *positions*;
    - (d) the stress testing should include shocks which reflect the nature of the portfolio and the time it could take to hedge out or manage risks under severe market conditions;
    - (e) the *firm* should have procedures in place to assess and respond to the results of the stress testing programme, in particular, stress testing should be used to evaluate the *firm's* capacity to absorb losses or to identify steps to be taken by the *firm* to reduce risk;
    - (f) as part of its stress testing programme, the *firm* should consider how prudent valuation requirements in article 105 of the *UK CRR* will be met in a stressed scenario.
- 2.2.71 **G** In identifying scenarios and assessing their impact, a *firm* should take into account, where material, how changes in circumstances might impact upon:
- (1) the nature, scale and mix of its future activities; and
  - (2) the behaviour of *counterparties*, and of the *firm* itself, including the exercise of choices (eg, options embedded in financial instruments or *contracts of insurance*).
- 2.2.72 **G** In determining whether it would have adequate financial resources in the event of each identified realistic adverse scenario, a *firm* should:

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- (1) only include financial resources that could reasonably be relied upon as being available in the circumstances of the identified scenario; and
- (2) take account of any legal or other restriction on the use of financial resources.

**Capital planning**

- (1) In identifying an appropriate range of adverse circumstances and events in accordance with ■ IFPRU 2.2.37 R (2):
  - (a) a *firm* will need to consider the cycles it is most exposed to and whether these are general economic cycles or specific to particular markets, sectors or industries;
  - (b) for the purposes of ■ IFPRU 2.2.37 R (2)(a), the amplitude and duration of the relevant cycle should include a severe downturn scenario based on forward-looking hypothetical events, calibrated against the most adverse movements in individual risk drivers experienced over a long historical period;
  - (c) the adverse scenarios considered should in general be acyclical and, accordingly, the scenario should not become more severe during a downturn and less severe during an upturn. However, the *FCA* does expect scenarios to be updated with relevant new economic data on a pragmatic basis to ensure that the scenario continues to be relevant; and
  - (d) the adverse scenarios considered should reflect a *firm's* risk tolerance of the adverse conditions through which it expects to remain a going concern.
- (2) In making the estimate required by ■ IFPRU 2.2.37 R (3), a *firm* should project its *own funds* and required *own funds* over a time horizon of three to five years, taking account of its business plan and the impact of relevant adverse scenarios. In making the estimate, the *firm* should consider both the *own funds* required to meet its *own funds requirements* and the *own funds* needed to meet the *overall financial adequacy rule*. Those projections should be made in a manner consistent with its risk management processes and systems in IFPRU 2.2.7R.
- (3) In projecting its financial position over the relevant time horizon, the *firm* should:
  - (a) reflect how its business plan would "flex" in response to the adverse events being considered, taking into account factors such as changing consumer demand and changes to new business assumptions;
  - (b) consider the potential impact on its stress testing of dynamic feedback effects and second order effects of the major sources of risk identified in accordance with ■ IFPRU 2.2.7 R (2);
  - (c) estimate the effects on the *firm's* financial position of the adverse event without adjusting for management actions;
  - (d) separately, identify any realistic management actions that the *firm* could, and would, take to mitigate the adverse effects of the stress scenario; and

- (e) estimate the effects of the stress scenario on the *firm's* financial position after taking account of realistic management actions.
- (4) A *firm* should identify any realistic management actions intended to maintain or restore its capital adequacy. These could include ceasing to transact new business after a suitable period, balance sheet shrinkage, restricting distribution of profits or raising additional capital. A *firm* should reflect management actions in its projections only where it could, and would, take such actions, taking account of factors such as market conditions in the stress scenario and its effects upon the *firm's* reputation with its counterparties and investors. The combined effect on capital and retained earnings should be estimated. To assess whether prospective management actions in a stress scenario would be realistic and to determine which actions the *firm* would and could take, the *firm* should take into account any pre-conditions that might affect the value of management actions as risk mitigants and analyse the difference between the estimates in (3)(c) and (3)(e) in sufficient detail to understand the implications of taking different management actions at different times, particularly where they represent a significant divergence from the *firm's* business plan.
- (5) The *firm* should document its stress testing and scenario analysis policies and procedures, as well as the results of its tests in accordance with ■ IFPRU 2.2.43 R to ■ IFPRU 2.2.44 R (Documentation of risk assessments). These records should be included within the *firm's* ICAAP submission document.
- (6) The FCA will review the *firm's* records in (5) as part of its SREP. The purpose of examining these is to enable the FCA to judge whether a *firm* will be able to continue to meet its *own funds requirements* and the *overall financial adequacy rule* throughout the projection period.
- (7) If, after taking account of realistic management actions, a *firm's* stress-testing management plan shows that the *firm's* projected *own funds* are less than those required to continue to meet its UK CRR or needed to continue to meet the *overall financial adequacy rule* over the projection period, the FCA may require the *firm* to set out additional countervailing measures and off-setting actions to reduce such difference or to restore the *firm's* capital adequacy after the stress event.
- (8) The *firm's* senior management or *governing body* should be actively involved and engaged in all relevant stages of the *firm's* stress testing and scenario analysis programme. This would include establishing an appropriate stress testing programme, reviewing the programme's implementation (including the design of scenarios) and challenging, approving and actioning the results of the stress tests.

2.2.74 **G** The FCA may formulate macroeconomic and financial market scenarios which a *firm* may use as an additional input to its ICAAP submission. In addition, the FCA may also ask a *firm* to apply specific scenarios directly in its ICAAP submission.

2.2.75 **G** A *firm* may consider scenarios in which expected future profits will provide capital reserves against future risks. However, it would only be appropriate

to take into account profits that can be foreseen with a reasonable degree of certainty as arising before the risk against which they are being held could possibly arise. In estimating future reserves, a *firm* should deduct future dividend payment estimates or other forms of profits distribution from projections of future profits.

- 2.2.76 **G** (1) Stress and scenario analyses should, in the first instance, be aligned with the risk appetite of the *firm*, as well as the nature, scale and complexity of its business and of the risks that it bears. The calibration of the stress and scenario analyses should be reconciled to a clear statement setting out the premise upon which the *firm's* internal capital assessment under the *overall Pillar 2 rule* is based.
- (2) In identifying adverse circumstances and events in line with **■ IFPRU 2.2.37 R (2)**, a *firm* should consider the results of any reverse stress testing conducted under **■ SYSC 20**. Reverse stress testing may be expected to provide useful information about the *firm's* vulnerabilities and variations around the most likely ruin scenarios for the purpose of meeting the *firm's* obligations under **■ IFPRU 2.2.37 R**. In addition, such comparison may help a *firm* to assess the sensitivity of its financial position to different stress calibrations.

- 2.2.77 **G** A *firm* should use the results of its stress testing and scenario analysis not only to assess capital needs, but also to decide if measures should be put in place to minimise the adverse effect on the *firm* if the risk covered by the stress or scenario test actually materialises. Such measures might be a contingency plan or might be more concrete risk mitigation steps.

**Pension obligation risk**

- 2.2.78 **G** This section contains guidance on the assessment required by **■ IFPRU 2.2.7 R (2)(k)** for a *firm* exposed to pension obligation risk as defined in **■ IFPRU 2.2.8 R (5)**.

- 2.2.79 **G** The focus of the risk assessment is on the *firm's* funding obligations towards the pension scheme, not of the pension scheme's risks themselves (i.e. the scheme's segregated assets and liabilities). A *firm* should include in its estimate of financial resources both its expected obligations to the pension scheme and any increase in obligations that may arise in a stress scenario.

- 2.2.80 **G** If a *firm* has a current funding obligation in excess of normal contributions or there is a risk that such a funding obligation will arise then, when calculating available capital resources, the *firm* should include these sources of risk as part of its:
- (1) stress tests and scenario analysis under **■ IFPRU 2.2.37R** and considering at least the scenarios in **■ IFPRU 2.2.81G**; and
  - (2) capital projections under **■ IFPRU 2.2.73G**.

2.2.81 **G** A *firm* may wish to consider the following scenarios:

- (1) one in which the *firm* gets into difficulties with an effect on its ability to fund the pension scheme; and
- (2) one in which the pension scheme position deteriorates (e.g. because either investment returns, or interest rate assumptions, or both, fall below expected returns or because of increases in life expectancy) with an effect on the *firm's* funding obligations; taking into account the management actions the *firm* could and would take.

2.2.82 **G** A *firm* is expected to determine where the scope of any stress test impacts upon its pension obligation risk and estimate how the relevant measure of pension obligation risk will change in that scenario. For example, in carrying out stress tests under **IFPRU 2.2.37 R**, a *firm* must consider how a stress scenario, such as an economic recession, would impact on the *firm's* current obligations towards its pension scheme and any potential increase in those obligations. Risks such as interest-rate risk or reduced investment returns may have a direct impact on a *firm's* financial position as well as an indirect impact resulting from an increase in the *firm's* pension scheme obligations. Both effects should be taken into account in a *firm's* estimate of financial resources under **IFPRU 2.2.7 R** (Overall Pillar 2 rule).

2.2.83 **G** A *firm* should consider issues such as:

- (1) the extent to which trustees of the pension scheme or a pension regulator (such as the one created under the Pensions Act 2004) can compel a certain level of contributions or a one-off payment in adverse financial situations or to meet the minimum legal requirements under the scheme's trust deed and rules or applicable laws relating to the pension scheme;
- (2) whether the valuation bases used to set pension scheme contribution rates are consistent with the *firm's* current business plans and anticipated changes in the workforce; and
- (3) which valuation basis is appropriate, given the expected investment return on scheme assets and actions the *firm* can take if those returns do not materialise.

2.2.84 **G** A *firm* should carry out analyses only to a degree of sophistication and complexity which is commensurate with the materiality of its pension risks.

**Group risk**

2.2.85 **G** This section contains additional guidance on the assessment required by **IFPRU 2.2.7 R (2)(I)** (Group risk).

2.2.86 **G** A *firm* should include in the written record in **IFPRU 2.2.43 R** (Documentation of risk assessments) a description of the broad business strategy of the *FCA consolidation group* or the *non-UK sub-group* of which it is a member, the group's view of its principal risks and its approach to measuring, managing and controlling the risks. This description should include the role of stress

testing, scenario analysis and contingency planning in managing risk on an individual basis and *consolidated basis*.

**2.2.87** **G** A *firm* should satisfy itself that the systems (including IT) of the *FCA consolidation group* or the *non-UK sub-group* of which it is a member are sufficiently sound to support the effective management and, where applicable, the quantification of the risks that could affect the *FCA consolidation group* or the *non-UK sub-group*, as the case may be.

**2.2.88** **G** In performing stress tests and scenario analyses, a *firm* should take into account the risk that its *group* may have to bring back on to its consolidated balance sheet the assets and liabilities of off-balance sheet entities as a result of reputational contagion, notwithstanding the appearance of legal risk transfer.

**2.2.89** **G** A *firm* should carry out stress tests and scenario analyses to a degree of sophistication which is commensurate with the complexity of its group and the nature of its *group* risk.





## 2.3 Supervisory review and evaluation process: internal capital adequacy standards

[**Note:** On 19 December 2014, the EBA published “Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)”, EBA/GL/2014/13. The FCA has confirmed its intention to make every effort to comply with these guidelines.]

### Purpose

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- (1) ■ IFPRU 2.3 sets out guidance on ■ IFPRU 2.2 (Adequacy of financial resources) so far as it applies to an *IFPRU investment firm*. In particular, *guidance* on how a *firm* should carry out its ICAAP, as well as some factors the FCA will take into consideration when undertaking a SREP. The terms ICAAP and SREP are explained in ■ IFPRU 2.3.3 G. ■ IFPRU 2.3.48 G to ■ IFPRU 2.3.52 R are *rules* that apply to a *firm* with an IRB permission.
- (2) ■ IFPRU 2.3 is mainly written on the basis that ■ IFPRU 2.2 (Adequacy of financial resources) applies to a *firm* on an individual basis. However, it is still relevant when ■ IFPRU 2.2 applies on a *consolidated basis*. When ■ IFPRU 2.2 applies on a *consolidated basis*, ■ IFPRU 2.3 should be read with appropriate adjustments.

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■ BIPRU 12 contains *rules* and *guidance* relating to the adequacy of a *firm's* liquidity resources and its assessment by the *firm* and the FCA.

### Meaning of capital

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For the purpose of ■ IFPRU 2.3, "capital" refers to a *firm's* financial resources, *own funds* and internal capital, all as referred to in the *overall Pillar 2 rule*.

### The ICAAP and the SREP: introduction

2.3.3

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The adequacy of a *firm's* capital needs to be assessed both by a *firm* and the FCA. This process involves:

- (1) an *internal capital adequacy assessment process (ICAAP)*, which a *firm* is obliged to carry out in accordance with the *ICAAP rules*; and
- (2) a supervisory review and evaluation process (*SREP*), which is conducted by the FCA.

**The ICAAP and the SREP: the ICAAP**

2.3.4

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The obligation to conduct an *ICAAP* includes requirements on a *firm* to:

- (1) carry out regularly assessments of the amounts, types and distribution of financial resources, *own funds* and internal capital that it considers adequate to cover the nature and level of the risks to which it is or might be exposed (■ IFPRU 2.2.1 R to ■ IFPRU 2.2.6 G (the *overall Pillar 2 rule* and related rules));
- (2) identify the major sources of risk to its ability to meet its liabilities as they fall due (the *overall Pillar 2 rule*);
- (3) conduct stress and scenario tests (the *general stress and scenario testing rule*, – including ■ SYSC 20 (Reverse stress testing) – if it is a *significant IFPRU firm*; or ■ SYSC 20 (Reverse stress testing) if it is not a *significant IFPRU firm*) taking into account, for a *firm* with an IRB permission, the stress test required by the *UK CRR*;
- (4) ensure that the processes, strategies and systems required by the *overall Pillar 2 rule* and used in its *ICAAP*, are both comprehensive and proportionate to the nature, scale and complexity of that *firm's* activities (■ IFPRU 2.2.12 R); and
- (5) document its *ICAAP* (■ IFPRU 2.2.43 R to ■ IFPRU 2.2.44 R (Documentation of risk assessments)).

2.3.5

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- (1) Where a *firm* is a member of a group, it should base its *ICAAP* on the consolidated financial position of the group. The group assessment should include information on:
  - (a) diversification benefits and transferability of resources between members of the group;
  - (b) the contribution of each member within the group to its overall risk profile; and
  - (c) an apportionment of the capital required by the group as a whole to the *firm* (■ IFPRU 2.2.45R to ■ IFPRU 2.2.57G (Application of ■ IFPRU 2.2 on an individual and consolidated basis)).
- (2) A *firm* may, instead of preparing the *ICAAP* itself, adopt as its *ICAAP* an assessment prepared by other group members.

2.3.6

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A *firm* should ensure that its *ICAAP* is:

- (1) the responsibility of the *firm's governing body*;
- (2) reported to the *firm's governing body*; and
- (3) forms an integral part of the *firm's* management process and decision-making culture.

**The ICAAP and the SREP: the SREP**

2.3.7

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The *FCA* will review a *firm's ICAAP*, including the results of the *firm's* stress tests carried out under *IFPRU* and the *UK CRR*, as part of its *SREP*. Provided

that the *FCA* is satisfied with the appropriateness of a *firm's* capital assessment, the *FCA* will take into account that *firm's* *ICAAP* and stress tests in its *SREP*. More material on stress tests for a *firm* with an *IRB* permission can be found in ■ IFPRU 2.3.50 R to ■ IFPRU 2.3.54 G.

- 2.3.8 **G** The *SREP* is a process under which the *FCA*:
- (1) reviews the arrangements, strategies, processes and mechanisms implemented by a *firm* to comply with *IFPRU*, *SYSC* and with requirements imposed by or under the *UK CRR* and wider *regulatory system* and evaluates the risks to which the *firm* is, or might be, exposed;
  - (2) determines whether the arrangements, strategies, processes and mechanisms implemented by the *firm* and the capital held by the *firm* ensures a sound management and coverage of the risks in (1); and
  - (3) (if necessary) requires the *firm* to take the necessary actions or steps at an early stage to address any failure to meet the requirements in (1).
- 2.3.9 **G** As part of its *SREP*, the *FCA* may ask a *firm* to provide it with the results of that *firm's* *ICAAP*, together with an explanation of the process used. Where appropriate, the *FCA* will ask for additional information on the *ICAAP*.
- 2.3.10 **G** As part of its *SREP*, the *FCA* will consider whether the amount and quality of capital which a *firm* should hold to meet its *own funds requirements* in the *UK CRR* is sufficient for that *firm* to comply with the *overall financial adequacy rule*.
- 2.3.11 **G** After completing a review as part of the *SREP*, the *FCA* will normally give that *firm* individual *guidance* (individual capital guidance), advising it of the amount and quality of capital which it should hold to meet the *overall financial adequacy rule*.
- 2.3.12 **G**
- (1) As part of its *SREP*, the *FCA* will also consider whether a *firm* should hold a *capital planning buffer* and the amount and quality of such *capital planning buffer*.
  - (2) In making these assessments, the *FCA* will have regard to the nature, scale and complexity of a *firm's* business and of the major sources of risks relevant to such business as referred to in the *general stress and scenario testing rule* and ■ *SYSC 20* (Reverse stress testing), and the extent to which the *firm* has used any of the capital buffers that are required of it under the *UK* legislation that implemented the *CRD*, as applicable.
  - (3) Accordingly, a *firm's* *capital planning buffer* should be of sufficient amount and adequate quality to allow the *firm* to continue to meet the *overall financial adequacy rule* in the face of adverse circumstances, after allowing for realistic management actions.

- 2.3.13** G After completing a review as part of the *SREP*, the *FCA* may notify the *firm* of the amount and quality of capital which it should hold as a *capital planning buffer* over and above the level of capital recommended as its *ICG*. The *FCA* may set a *firm's capital planning buffer* either as an amount and quality of capital which it should hold now (ie, at the time of the *FCA* notification following the *firm's SREP*) or, in exceptional cases, as a forward-looking target that the *firm* should build up over time.
- 2.3.14** G Where the amount or quality of capital which the *FCA* considers a *firm* should hold to meet the *overall financial adequacy rule* or as a *capital planning buffer* is not the same as that which results from a *firm's ICAAP*, the *FCA* usually expects to discuss any such difference with the *firm*. Where necessary, the *FCA* may consider the use of its powers under section 166 of the *Act* (Reports by skilled persons) to assist in such circumstances.
- 2.3.15** G If a *firm* considers that the individual capital guidance given to it is inappropriate to its circumstances it should, consistent with *Principle 11* (Relations with regulators), inform the *FCA* that it disagrees with that *guidance*. The *FCA* may reissue the individual capital guidance if, after discussion with the *firm*, the *FCA* concludes that the amount or quality of capital that the *firm* should hold to meet the *overall financial adequacy rule* is different from the amount or quality initially suggested by the *FCA*.
- 2.3.16** G If a *firm* disagrees with the *FCA's* assessment as to the amount or quality of *capital planning buffer* that it should hold, it should, consistent with *Principle 11* (Relations with regulators), notify the *FCA* of its disagreement. The *FCA* may reconsider its initial assessment if, after discussion with the *firm*, the *FCA* concludes that the amount or quality of capital that the *firm* should hold as *capital planning buffer* is different from the amount or quality initially suggested.
- 2.3.17** G The *FCA* will not give individual capital guidance to the effect that the amount of capital advised in that *guidance* is lower than the amount of capital which a *firm* should hold to meet its *own funds requirements*.
- 2.3.18** G If, after discussion, the *FCA* and a *firm* still do not agree on an adequate level of capital, the *FCA* may consider using its powers under section 55L of the *Act* on its own initiative to require the *firm* to hold capital in line with the *FCA's* view of the capital necessary to comply with the *overall financial adequacy rule*. In deciding whether it should use its powers under section 55L, the *FCA* will take into account the amount and quality of the *capital planning buffer* which the *firm* should hold as referred to in ■ IFPRU 2.3.13 G and ■ IFPRU 2.3.14 G. ■ SUP 7 provides further information about the *FCA's* powers under section 55L.

**The drafting of individual capital guidance and capital planning buffer**

- 2.3.19** G If the *FCA* gives individual capital guidance to a *firm*, the *FCA* will state what amount and quality of capital the *FCA* considers the *firm* needs to hold in order to comply with the *overall financial adequacy rule*. It will generally do so by saying that the *firm* should hold *own funds* of an amount which is at

least equal to a specified percentage of that *firm's total risk exposure amount* plus one or more static add-ons for specific risks, in line with the *overall Pillar 2 rule*.

2.3.20

G

Individual capital guidance may refer to two types of *own funds*:

- (1) General capital. It refers to total *common equity tier 1 capital* and *additional tier 1 capital* after applying deductions and prudential filters under the *UK CRR*.
- (2) Total capital. It refers to total *common equity tier 1 capital*, *additional tier 1 capital* and *tier 2 capital* after applying deductions and prudential filters under the *UK CRR*.

2.3.21

G

Where the *FCA* notifies a *firm* that it should hold a *capital planning buffer*, the notification will state what amount and quality of capital the *FCA* considers is adequate for the *firm* to hold. This will normally be notified to the *firm*, together with its individual capital guidance and expressed as a separate amount of *own funds* that the *firm* should hold in excess of the amount of *own funds* indicated as its individual capital guidance.

2.3.22

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For the purposes of ■ IFPRU 2.3.21 G, ■ IFPRU 2.3.20 G applies as it applies to individual capital guidance. References in those provisions to individual capital guidance should be read as if they were references to *capital planning buffer*. In relation to ■ IFPRU 2.2.62 R, where the *general stress and scenario testing rule* or ■ SYSC 20 (Reverse stress testing), as part of the *ICAAP rules*, applies to a *firm* on a *consolidated basis*, the *FCA* may notify the *firm* that it should hold a *group capital planning buffer*. In these cases, the *firm* should ensure that the group holds a *capital planning buffer* of sufficient amount and adequate quality to allow it to continue to meet the *overall financial adequacy rule* in the face of adverse circumstances, after allowing for realistic management actions.

**Failure to meet individual capital guidance and monitoring and reporting on the capital planning buffer**

2.3.23

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A *firm* continuing to hold capital in accordance with its individual capital guidance and its ability to carry on doing so is a fundamental part of the *FCA's* supervision of that *firm*. Therefore, if a *firm's own funds* have fallen, or are expected to fall, below the level advised in individual capital guidance, then, consistent with *Principle 11* (Relations with regulators), a *firm* should inform the *FCA* of this fact as soon as practicable, explaining why this has happened or is expected to happen and:

- (1) what action the *firm* intends to take to increase its own funds or to reduce its risks and hence its own funds requirements; or
- (2) what modification the *firm* considers should be made to the individual capital guidance which it has been given.

2.3.24

G

In the circumstance in ■ IFPRU 2.3.23 G, the *FCA* may ask a *firm* for alternative or more detailed proposals and plans or further assessments and analyses of capital adequacy and risks faced by the *firm*. The *FCA* will seek to agree with

- the firm appropriate timescales and scope for any such additional work, in the light of the circumstances which have arisen.
- 2.3.25** **G** If a *firm* has not accepted individual capital guidance given by the *FCA* it should, nevertheless, inform the *FCA* as soon as practicable if its *own funds* have fallen, or are expected to fall, below the level suggested by that individual capital guidance.
- 2.3.26** **G** Monitoring the use of a *firm's capital planning buffer* is also a fundamental part of the *FCA's* supervision of that *firm*. A *firm* should only use its *capital planning buffer* to absorb losses or meet increased own funds requirements if certain adverse circumstances materialise. These should be circumstances beyond the *firm's* normal and direct control, whether relating to a deteriorating external environment or periods of stress, such as macroeconomic downturns or financial/market shocks, or firm-specific circumstances.
- 2.3.27** **G** Consistent with *Principle 11* (Relations with regulators), a *firm* should notify the *FCA* as early as possible in advance where it has identified that it would need to use its *capital planning buffer*. The *firm's* notification should at least state:
- (1) what adverse circumstances are likely to force the *firm* to draw down its *capital planning buffer*;
  - (2) how the *capital planning buffer* will be used up in line with the *firm's* capital planning projections; and
  - (3) what plan is in place for the eventual restoration of the *capital planning buffer*.
- 2.3.28** **G** Following discussions with the *firm* on the items listed in **IFPRU 2.3.27 G**, the *FCA* may put in place additional reporting arrangements to monitor the *firm's* use of its *capital planning buffer* in accordance with the plan referred to in **IFPRU 2.3.27 G** (3). The *FCA* may also identify specific trigger points as the *capital planning buffer* is being used up by the *firm*, which could lead to additional supervisory actions.
- 2.3.29** **G** Where a *firm's capital planning buffer* is being drawn down due to circumstances other than those in **IFPRU 2.3.26 G**, such as poor planning or mismanagement, the *FCA* may ask the *firm* for more detailed plans for it to restore its *capital planning buffer*. In the light of the relevant circumstances, the *FCA* may consider taking other remedial actions, which may include using its powers under section 55L of the *Act* on its own initiative, to impose a *requirement* on a *firm*.
- 2.3.30** **G** A *firm* should inform the *FCA* where its *capital planning buffer* is likely to start being drawn down, even if it has not accepted the *FCA's* assessment as to the amount or quality of its *capital planning buffer*.

2.3.31 **G** Where a *firm* has started to use its *capital planning buffer* in circumstances where it was not possible to notify in advance, it should notify the *FCA* and provide the information referred to in **■ IFPRU 2.3.27 G** as soon as practicable afterwards.

2.3.32 **G** **■ IFPRU 2.3.23 G** to **■ IFPRU 2.3.31 G** also apply to individual capital guidance and to *capital planning buffer* on a *consolidated basis*.

**Proportionality of an ICAAP**

2.3.33 **G** **■ IFPRU 2.3.34 G** to **IFPRU 2.3.36G** set out what the *FCA* considers to be a proportional approach to preparing an *ICAAP* as referred to in **■ IFPRU 2.2.12 R** (The processes, strategies and systems required by the *overall Pillar 2 rule* should be comprehensive and proportionate), according to the relative degree of complexity of a *firm's* activities. If a *firm* adopts the appropriate approach, it may enable the *FCA* more easily to review a *firm's ICAAP* when the *FCA* undertakes its *SREP*. The *FCA* is also likely to place more reliance on an *ICAAP* which takes the appropriate form described in **■ IFPRU 2.3.34 G** to **■ IFPRU 2.3.36 G** than would otherwise be the case, although there may also be circumstances in which the *FCA* will be able to rely on an *ICAAP* that is not drawn up in that form.

2.3.34 **G**

- (1) This paragraph applies to a *firm* that is not a *significant IFPRU firm* (see **■ IFPRU 1.2.3 R**) whose activities are simple and primarily not credit-related.
- (2) In carrying out its *ICAAP* it could:
  - (a) identify and consider that *firm's* largest losses over the last three to five years and whether those losses are likely to recur;
  - (b) prepare a short list of the most significant risks to which that *firm* is exposed;
  - (c) consider how that *firm* would act, and the amount of capital that would be absorbed, in the event that each of the risks identified were to materialise;
  - (d) consider how that *firm's own funds requirements* might alter under the scenarios in (c) and how its *own funds requirements* might alter in line with its business plans for the next three to five years;
  - (e) consider whether any of the risks in the *overall Pillar 2 rule* is applicable to the *firm* (it is unlikely that any of those risks not already identified in (a) or (b) will apply to a *firm* whose activities are simple);
  - (f) document the ranges of capital required in the scenarios identified and form an overall view on the amount and quality of capital which that *firm* should hold, ensuring that its senior management is involved in arriving at that view; and
  - (g) (to determine the amount of capital that would be absorbed in the circumstances in (c)) carry out simple sensitivity tests where the *firm* analyses the impact of a shift in the key risk parameters identified in (b) on the earnings of the *firm*.

- (3) A *firm* is also expected to form a view on the consolidated amount of capital it should hold, as well as the capital required to be held for each of the individual risks identified under the *overall Pillar 2 rule*. For that purpose, it may conservatively sum the results of the individual tests performed in (2)(c). However, if the *firm* chooses to reduce that sum on the understanding that not all risks will materialise at the same time, then the *firm* should perform scenario tests that demonstrate that a reduction in capital is legitimate.
- (4) A *firm* should conduct stress tests and scenario analyses in accordance with ■ SYSC 20 (Reverse stress testing) to assess how that *firm's* capital and *own funds requirements* would alter and what that *firm's* reaction might be to a range of adverse scenarios, including operational and market events. Where relevant, a *firm* should also consider the impact of a severe economic or industry downturn on its future earnings, *own funds* and *own funds requirements*, taking into account its business plans. The downturn scenario should be based on forward-looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.

2.3.35

**G** For a *firm* that is a *significant IFPRU firm* (see ■ IFPRU 1.2.3 R) and whose activities are moderately complex, in carrying out its ICAAP, ■ IFPRU 2.3.34 G (2) to ■ IFPRU 2.3.34 G (4) apply. In addition, it could:

- (1) having consulted the management in each major business line, prepare a comprehensive list of the major risks to which the business is exposed;
- (2) estimate, with the aid of historical data, where available, the range and distribution of possible losses which might arise from each of those risks and consider using shock stress tests to provide risk estimates;
- (3) consider the extent to which that *firm's own funds requirements* adequately captures the risks identified in (1) and (2);
- (4) for areas in which the *own funds requirements* is either inadequate or does not address a risk, estimate the additional capital (if any) needed to protect that *firm* and its *customers*, in addition to any other risk mitigation action that *firm* plans to take;
- (5) consider the risk that that *firm's* own analyses of capital adequacy may be inaccurate and that it may suffer from management weaknesses, which affect the effectiveness of its risk management and mitigation;
- (6) project that *firm's* business activities forward in detail for one year and in less detail for the next three to five years and estimate how that *firm's* capital and *own funds requirements* would alter, assuming that business develops as expected;
- (7) assume that business does not develop as expected and consider how that *firm's* capital and *own funds requirements* would alter and what that *firm's* reaction to a range of adverse economic scenarios might be (see ■ IFPRU 2.2.7 R to ■ IFPRU 2.2.44 R (the *overall Pillar 2 rule* and related *rules* and *guidance*)). Where appropriate, the adverse



scenarios should consider the impact of market events that are instantaneous or occur over an extended period of time but which are nevertheless still co-dependent on movements in economic conditions;

- (8) document the results obtained from the analyses in (2), (4), (6) and (7) in a detailed report for that *firm's senior management* and, where relevant, its *governing body*; and
- (9) ensure that systems and processes are in place to review against performance the accuracy of the estimates made in (2), (4), (6) and (7).

2.3.36

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- (1) This paragraph applies to a proportional *ICAAP* in the case of a *firm* that is a *significant IFPRU firm* (see ■ IFPRU 1.2.3 R) whose activities are complex.
- (2) A proportional approach to that *firm's ICAAP* should cover the matters identified in ■ IFPRU 2.3.34 G and ■ IFPRU 2.3.35 G, but is likely also to involve the use of models, most of which will be integrated into its day-to-day management and operation.
- (3) Models of the kind referred to in (2) may be linked to generate an overall estimate of the amount of capital that a *firm* considers appropriate to hold for its business needs. For example, a *firm* is likely to use value-at-risk models for market risk (see Part Three, Title IV, Chapter 5 of the *UK CRR* (Use of internal models to calculate own funds requirements for market risk)), advanced modelling approaches for credit risk (see Part Three, Title II, Chapter 3 of the *UK CRR* (Internal Ratings Based Approach)) and, possibly, advanced measurement approaches for *operational risk* (see Part Three, Title III, Chapter 4 of the *UK CRR* (Advanced measurement approaches)). A *firm* might also use economic scenario generators to model stochastically its business forecasts and risks. A *firm* may also link such models to generate information on the economic capital desirable for that *firm*. A model which a *firm* uses to generate its target amount of economic capital is known as an economic capital model (ECM). Economic capital is the target amount of capital which maximises the return for a *firm's* stakeholders for a desired level of risk.
- (4) A *firm* is also likely to be part of a *group* and to be operating internationally. There is likely to be centralised control over the models used throughout the *group*, the assumptions made and their overall calibration.
- (5) The more a *firm* integrates into its business such economic capital modelling, the more it is likely to focus on managing risks for the benefit of its stakeholders. Consequently, ECMs may produce capital estimates that differ from the amount of capital needed for regulatory purposes. For the *FCA* to rely on the results of a *firm's* models, including ECMs, a *firm* should be able to explain the basis and results of its models and how the amount of capital produced reflects the amount of capital needed for regulatory purposes. Where they are not equal, the *FCA* will expect a *firm* to explain any differences. However, it may prove difficult to reconcile the outcome of a *firm's* modelling with the *FCA's* own assessment of the adequacy of that *firm's* capital. For example, when matters of judgment are

involved in arriving at a *firm's* capital assessment or the *FCA* relies on information which cannot be fully disclosed to the *firm* (eg, comparisons with the *firm's* peers). Nevertheless, a *firm* whose ECM produces a different amount of capital to that required for regulatory purposes is still obliged to comply with the *overall Pillar 2 rule*. A *firm* should, therefore, be able to explain to the *FCA* how the outcome of its ECM is adjusted so that it complies with the *overall financial adequacy rule* and the *overall Pillar 2 rule*.

- (6) Stress testing carried out under the *general stress and scenario testing rule* should provide senior management with a consolidated view of the amount of risk the *firm* is, or might be, exposed to under the chosen stress events. Senior management should be presented with information that considers the possibility of the risks materialising simultaneously in various proportions. For instance, it would be misrepresentative to simulate *market risk* stressed events without considering that, in those circumstances, *market counterparties* may be more likely to default. Accordingly, a *firm* could:
  - (a) carry out combined stress tests where assets and liabilities are individually subjected to simultaneous changes in two or more risk drivers; for instance, the change in value of each loan made by a *firm* may be estimated using simultaneous changes to both interest rates and stock market or property values;
  - (b) integrate the results of market and credit risk models, rather than aggregating the results of each model separately; and
  - (c) consider scenarios which include systemic effects on the *firm* of wider failures in the *firm's* market or systems upon which the *firm* depends and also any possible systemic effects caused by the *firm* itself suffering losses which affect other market participants which, in turn, exacerbate the *firm's* position.
- (7) Furthermore, if a complex *firm* uses an ECM it should validate the assumptions of the model through a comprehensive stress testing programme. In particular, this validation should:
  - (a) test correlation assumptions (where risks are aggregated in this way) using combined stresses and scenario analyses;
  - (b) use stress tests to identify the extent to which the *firm's* risk models omit non-linear effects, for instance the behaviour of derivatives in market risk models; and
  - (c) consider not just the effect of parallel shifts in interest-rate curves, but also the effect of curves becoming steeper or flatter.

**Guidance on risks to be covered in an ICAAP**

2.3.37

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■ IFPRU 2.3.37 G to ■ IFPRU 2.3.47 G set out *guidance* on some of the sources of risk identified in the *overall Pillar 2 rule*. ■ IFPRU 2.3.50 R to ■ IFPRU 2.3.54 G contain material relating to a *firm* with an IRB permission.

2.3.38

G

- (1) A *firm* may take into account factors other than those identified in the *overall Pillar 2 rule* when it assesses the level of capital it wishes to hold. These factors might include external rating goals, market reputation and its strategic goals. However, a *firm* should be able to distinguish, for the purpose of its dialogue with the *FCA*, between

capital it holds to comply with the *overall financial adequacy rule*, capital it holds as a *capital planning buffer* and capital held for other purposes.

(2) The calibration of the *own funds requirements* assumes that a *firm's* business is well diversified, well managed with assets matching its liabilities and good controls, and stable with no large, unusual or high risk transactions. A *firm* may find it helpful to assess the extent to which its business in fact differs from these assumptions and, therefore, what adjustments it might be reasonable for it to make to the *own funds requirements* to arrive at an adequate level of *own funds*.

**Interest-rate risk arising from non-trading book activities**

2.3.39 G A *firm* should assess its exposure to changes in interest rates, particularly risks arising from the effect of interest-rate changes on *non-trading book* activities that are not captured by the *own funds requirements*. In doing so, a *firm* may wish to use stress tests to determine the impact on its balance sheet of a change in market conditions.

**Securitisation risk**

2.3.40 G A *firm* should assess its exposure to risks transferred through the *securitisation* of assets should those transfers fail for whatever reason. A *firm* should consider the effect on its financial position of a *securitisation* arrangement failing to operate as anticipated or of the values and risks transferred not emerging as expected.

**Residual risk**

2.3.41 G A *firm* should assess its exposure to residual risks that may result from the partial performance or failure of *credit risk mitigation* techniques for reasons that are unconnected with their intrinsic value. This could result from, for instance, ineffective documentation, a delay in payment or the inability to realise payment from a guarantor in a timely manner. Given that residual risks can always be present, a *firm* should assess the appropriateness of its *own funds requirements* against its assumptions which underlie any risk mitigation measures it may have in place.

**Concentration risk**

2.3.42 G A *firm* should assess and monitor, in detail, its exposure to sectoral, geographic, liability and asset concentrations. The *FCA* considers that concentrations in these areas increase a *firm's* exposure to credit risk. Where a *firm* identifies such concentrations it should consider the adequacy of its *own funds requirements*.

**Liquidity risk**

2.3.43 G Under the *overall Pillar 2 rule*, a *firm* should consider its exposure to *liquidity risk* and assess its response should that risk materialise.

- 2.3.44 G When assessing *liquidity risk*, a *firm* should consider the extent to which there is a mismatch between assets and liabilities.
  
- 2.3.45 G A *firm* should also, when assessing *liquidity risk*, consider the amount of assets it holds in highly liquid, marketable forms that are available should unexpected cash flows lead to a liquidity problem. The price concession of liquidating assets is of prime concern when assessing such liquidity risk and should, therefore, be built into a *firm's ICAAP*.
  
- 2.3.46 G Some further areas to consider in developing the *liquidity risk* scenario might include:
  - (1) any mismatching between expected asset and liability cash flows;
  - (2) the inability to sell assets quickly;
  - (3) the extent to which a *firm's* assets have been pledged; and
  - (4) the possible need to reduce large asset positions at different levels of market liquidity and the related potential costs and timing constraints.

**Business risk: general**

- 2.3.47 G A *firm's own funds requirements*, being risk-sensitive, may vary as business cycles and economic conditions fluctuate over time. Deterioration in business or economic conditions could require a *firm* to raise capital or, alternatively, to contract its businesses at a time when market conditions are most unfavourable to raising capital. Such an effect is known as procyclicality.
  
- 2.3.48 G To reduce the impact of cyclical effects, a *firm* should aim to maintain an adequate *capital planning buffer* during an upturn in business and economic cycles such that it has sufficient capital available to protect itself in unfavourable market conditions.
  
- 2.3.49 G To assess its expected capital requirements over the economic and business cycles, a *firm* may wish to project forward its financial position taking account of its business strategy and expected growth, according to a range of assumptions regarding the economic or business environment which it faces. For example, an *ICAAP* should include an analysis of the impact that the actions of a *firm's* competitors might have on its performance, in order to see what changes in its environment the *firm* could sustain. Projections over a three- to five-year period would be appropriate in most circumstances. A *firm* may then calculate its projected *own funds requirements* and assess whether it could be met from expected financial resources. Additional *guidance* on capital planning over an economic and business cycle can be found in ■ IFPRU 2.2.73 G (Capital planning).

**Business risk: stress tests for firms using the IRB approach**

- 2.3.50 R A *firm* with an IRB permission must ensure that there is no significant risk of it being unable to meet its own funds requirements for credit risk under Part Three, Title II of the *UK CRR* (Capital requirements for credit risk) at all times

throughout an economic cycle, including the *own funds requirements* for credit risk indicated by any stress test carried out under article 177 of the *UK CRR* (Stress tests used in assessment of capital adequacy for a *firm* with an IRB permission) as being likely to apply in the scenario tested. To decide what *own funds* are, or will be, available to meet those credit risk requirements, a *firm* must exclude *own funds* that are likely to be required to meet its other capital requirements under the *UK CRR* at the relevant time. A *firm* must also be able to demonstrate to the *FCA*, at any time, that it is complying with this *rule*.

2.3.51 **R** ■ IFPRU 2.3.50 R applies to a *firm* on an individual basis if Part Three, Title II, Chapter 3 of the *UK CRR* (IRB approach) applies to it on an individual basis and applies on a *consolidated basis* if the *UK CRR* does.

2.3.52 **R** If ■ IFPRU 2.3.50 R applies to a *firm* on a *consolidated basis*, the following adjustments are made to ■ IFPRU 2.3.50 R in accordance with the general principles of Part One, Title II, Chapter 2 of the *UK CRR* (Prudential consolidation):

- (1) references to *own funds* are to the consolidated *own funds* of the *firm's FCA consolidation group* or, as the case may be, its *non-UK sub-group*; and
- (2) references to the capital requirements in Part Three of the *UK CRR* (Capital requirements) are to the consolidated capital requirements with respect to the *firm's FCA consolidation group* or, as the case may be, its *non-UK sub-group* under Part One, Title II, Chapter 2 of the *UK CRR* (Prudential consolidation).

2.3.53 **G** If a *firm's* current available *own funds* are less than the *own funds* requirements indicated by the stress test, that does not necessarily mean there is a breach of ■ IFPRU 2.3.50 R. The *firm* may wish to set out any countervailing effects and off-setting actions that can be demonstrated to the satisfaction of the *FCA* as being likely to reduce that difference. The *FCA* is only likely to consider a demonstration of such actions as credible if those actions are set out in a capital management plan based on the procedures in ■ IFPRU 2.2.73 G (Capital planning) and include a plan of the type referred to in ■ IFPRU 2.2.73 G (7) that has been approved by the *firm's senior management* or *governing body*.

2.3.54 **G** The countervailing factors and off-setting actions that a *firm* may rely on as referred to in ■ IFPRU 2.3.53 G include, but are not limited to, projected balance sheet shrinkage, growth in *own funds* resulting from retained profits between the date of the stress test and the projected start of the economic downturn, the possibility of raising new capital in a downturn, the ability to reduce dividend payments or other distributions, and the ability to allocate capital from other risks which can be shown to be negatively correlated with the *firm's* credit risk profile.

**Systems and controls**

2.3.55 **G** A *firm* may decide to hold additional capital to mitigate any weaknesses in its overall control environment. These weaknesses might be indicated by the following:

- (1) a failure by a *firm* to complete an assessment of its systems and controls to establish whether they comply with SYSC; or
- (2) a failure by a *firm's senior management* to approve its financial results; or
- (3) a failure by a *firm* to consider an analysis of relevant internal and external information on its business and control environment.

2.3.56 **G** In considering if there are any systems and control weaknesses, and their effect on the adequacy of the *own funds requirements*, a *firm* should be able to demonstrate to the FCA that all the issues identified in SYSC have been considered and that appropriate plans and procedures exist to deal adequately with adverse scenarios.

**Risks which may be considered according to the nature of the activities of a firm**

2.3.57 **G**

- (1) ■ IFPRU 2.3.58 G to ■ IFPRU 2.3.67 G set out *guidance* for:
  - (a) an asset management *firm*; and
  - (b) a securities *firm*;
- (2) ■ IFPRU 2.3.58 G to ■ IFPRU 2.3.67 G provide examples of the sorts of risks which such a *firm* might typically face and of stress tests or scenario analyses which it might carry out as part of its ICAAP.
- (3) The material on securities *firms* is also relevant to a commodities firm.

**An asset management firm**

2.3.58 **G** An asset manager is primarily exposed to *operational risk* and reputational risk.

2.3.59 **G** When assessing reputational risk, an asset manager should consider issues such as:

- (1) how poor performance can affect its ability to generate profits;
- (2) the effect on its financial position should one or more of its key fund managers leave that *firm*;
- (3) the effect on its financial position should it lose some of its largest customers; and
- (4) how poor customer services can affect its financial position; for example, a *firm* which has outsourced the management of customer accounts may want to consider the impact on its own reputation of the service provider failing to deliver the service.

**2.3.60** **G** As an asset manager's mandates become more complex, the risk of it failing to comply fully with the terms of its contracts increases. In the event of such failure, a *firm* can be exposed to substantial losses resulting from customers' claims and legal actions. Although the *FCA* would expect an asset manager to have adequate controls in place to mitigate that risk, it may also like to consider the potential cost to it if customers claim that it has not adhered to mandates. Past claims and compensation may provide a useful benchmark for an asset manager to assess its sensitivity to future legal action. In assessing the adequacy of its capital, an asset manager may, therefore, consider whether it could absorb the highest operational loss it has suffered over the last three to five years.

**2.3.61** **G** In relation to the issues identified in **IFPRU 2.3.60 G**, an asset manager should consider, for example:

- (1) the direct cost to it resulting from fraud or theft;
- (2) the direct cost arising from customers' claims and legal action in the future ? an asset manager could consider the impact on its financial position if a legal precedent were to encourage its customers to take legal action against it for failing to advise correctly on a certain type of product, the relevance of which is likely to depend on whether the asset manager is acting on a discretionary basis or solely as advisor; and
- (3) where it has obtained professional indemnity insurance, the deductibles and individual or aggregate limits on the sums insured.

**2.3.62** **G** The *FCA* expects an asset manager to consider the impact of economic factors on its ability to meet its liabilities as they fall due. Therefore, an asset manager should develop scenarios which relate to its strategic and business plan. An asset manager might consider:

- (1) the effect of a market downturn that affects both transaction volumes and the market values of assets in its funds - in assessing the impact of such a scenario, an asset manager may consider the extent to which it can remain profitable (eg, by rapidly scaling down its activities and reducing its costs);
- (2) the impact on current levels of capital if it plans to undertake a significant restructuring; and
- (3) the impact on current levels of capital if it plans to enter a new market or launch a new product ? it should assess the amount of capital it needs to hold when operating for the first time in a market in which it lacks expertise.

**A securities firm**

**2.3.63** **G** (1) A securities *firm* may consider the impact of the following situations on its capital levels when assessing its exposure to concentration risk:

- (a) the potential loss that could arise from large exposures to a single *counterparty*;

- (b) the potential loss that could arise from exposures to large transactions or to a product type; and
- (c) the potential loss resulting from a combination of events such as a sudden increase in volatility leaving a hitherto fully-margined client unable to meet the margin calls due to the large size of the underlying *position* and the subsequent difficulties involved in liquidating its *position*.

(2) An example of (1)(b) relates to a securities *firm* which relies on the income generated by a large, one-off corporate finance transaction. It may want to consider the possibility of legal action arising from that transaction which prevents the payment of its fees. Additionally, an underwriting *firm* may, as a matter of routine, commit to place a large amount of securities. Therefore, it may like to assess the impact of losses arising from a failure to place the securities successfully.

**2.3.64** G Where a securities *firm* deals in illiquid securities (eg, unlisted securities or securities listed on illiquid markets) or holds illiquid assets, potentially large losses can arise from trades that have failed to settle or because of large unrealised market losses. Therefore, a securities *firm* may consider the impact of *liquidity risk* on its exposure to:

- (1) credit risk; and
- (2) *market risk*.

**2.3.65** G Counterparty risk requirements only partially capture the risk of settlement failure, as the quantification of risk is only based on mark-to-market values and does not take account of the volatility of the securities over the settlement period. A securities *firm's* assessment of its exposure to counterparty risk should take into account:

- (1) whether it acts as arranger only or whether it also executes trades;
- (2) the types of execution venues which it uses - for example, the London Stock Exchange or a retail service provider (RSP) have more depth than *multilateral trading facilities*; and
- (3) whether it offers extended settlements and free delivery compared to delivery versus payment business.

**2.3.66** G A securities *firm* should also consider the impact of external factors on the levels of capital it needs to hold. Scenarios covering such external factors should relate to its strategy and business plan. A securities *firm* might wish to consider the following factors:

- (1) whether it plans to participate in a one-off transaction that might strain temporarily or permanently its capital;
- (2) whether the unevenness of its revenue suggests that it should hold a capital buffer. Such an assessment could be based, for instance, on an analysis of past revenue and the volatility of its capital;



- (3) how its income might alter as interest rates fluctuate where it is obliged to pay interest to its clients in excess of interest it earns on client money deposits;
- (4) how its capital would be affected by a market downturn. For instance, how sensitive that *firm* is to a sharp reduction of trading volumes;
- (5) how political and economic factors will affect that *firm's* business. For instance, a commodity firm may wish to consider the impact of a sharp increase in prices on initial margins and, consequently, on its liquidity;
- (6) whether it anticipates expanding its activities (eg, by offering clearing services) and, if so, the impact on its capital.

2.3.67 G A securities *firm* may also want to assess the impact of its internal credit limits on its levels of capital. For instance, a *firm* whose internal procedures authorise dealing without cash in the account, or without pre-set dealing limits, might consider more capital is required than if it operated stricter internal credit limits.

**Capital models**  
.....

2.3.68 G A *firm* may approach its assessment of adequate capital by developing a model, including an ECM (see ■ IFPRU 2.3.36 G), for some or all of its business risks. The assumptions required to aggregate risks modelled and the confidence levels adopted should be considered by a *firm's senior management*. A *firm* should also consider whether any relevant risks, including systems and control risks, are not captured by the model.

2.3.69 G A *firm* should not expect the *FCA* to accept as adequate any particular model that it develops, or automatically to reflect the results from the model in any individual capital guidance or *capital planning buffer*. However, the *FCA* will take into account the results of a sound and prudent model when giving individual capital guidance or when dealing with the *firm* in relation to its *capital planning buffer*.

2.3.70 G There is no prescribed approach as to how a *firm* should develop its internal capital model. However, a *firm* should be able to demonstrate:

- (1) the confidence levels set and whether these are linked to its corporate strategy;
- (2) the time horizons set for the different types of business that it undertakes;
- (3) the extent of historic data used and back-testing carried out;
- (4) that it has a process to verify the correctness of the model's outputs; and
- (5) that it has the skills and resources to operate, maintain and develop the model.

- 2.3.71** **G** In relation to the use of an ECM (see **IFPRU 2.3.36 G**), the *FCA* is likely to place more reliance on a *firm's ICAAP* if the *firm* provides the following information:
- (1) a comparison of the amount of capital that the ECM generates in respect of each of the risks captured in the *own funds requirements* before aggregation with the corresponding components of the *own funds requirements* calculation; and
  - (2) evidence that the *guidance* in **IFPRU 2.3.68 G** to **IFPRU 2.3.75 G** has been followed.
- 2.3.72** **G** If a *firm* adopts a top-down approach to developing its internal model, it should be able to allocate the outcome of the internal model to risks it has previously identified in relation to each separate legal entity, business unit or business activity, as appropriate. For a *firm* which is a member of a group, **IFPRU 2.2.54 R** (Application of **IFPRU 2.2** on an individual basis and consolidated basis) sets out how internal capital identified as necessary by that *firm's ICAAP* should be allocated.
- 2.3.73** **G** If a *firm's* internal model makes explicit or implicit assumptions in relation to correlations within or between risk types, or diversification benefits between business types, the *firm* should be able to explain to the *FCA*, with the support of empirical evidence, the basis of those assumptions.
- 2.3.74** **G** A *firm's* model should also reflect the past experience of both the *firm* and the sectors in which it operates.
- 2.3.75** **G** The values assigned to inputs into a *firm's* model should be derived either stochastically, by assuming the value of an item can follow an appropriate probability distribution and by selecting appropriate values at the tail of the distribution, or deterministically, using appropriate prudent assumptions. For options or guarantees which change in value significantly in certain economic or demographic circumstances, a stochastic approach would normally be appropriate.

## 2.4 Reporting of breaches

### 2.4.1

**R**

- (1) A *firm* must have appropriate procedures in place for its employees to report breaches internally through a specific, independent and autonomous channel.
- (2) The channel in (1) may be provided through arrangements provided for by social partners, subject to the Public Interest Disclosure Act 1998 and the Employment Rights Act 1996 to the extent that they apply.

[Note: article 71(3) of *CRD*]

### 2.4.2

**G**

■ SYSC 18 (Whistleblowing) contains requirements on *UK SMCR banking firms* and certain *insurers* (see ■ SYSC 18.1.1AR) in relation to the adoption and communication of appropriate internal procedures for handling *reportable concerns* as part of an effective risk management system. ■ SYSC 18.1.1CG provides that *firms* not otherwise subject to ■ SYSC 18 may nonetheless wish to adopt the provisions in that chapter as best practice.



## 2.5 Recovery and resolution plans

2.5.1 **R** [deleted]

2.5.2 **R** [deleted]