

Chapter 2

Supervisory processes and governance

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 *EU 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

R

- (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

G

- (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 *EU 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 *EU 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 *EU 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 *EU 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 *EU 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 *EU 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 *EU CRR* (Calculation of the leverage ratio) and mismatches between assets and obligations.

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

2.2.35

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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

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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 *EU 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 *EU 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 *parent institution in a Member State* 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 *parent financial holding company in a Member State* or a *parent mixed financial holding company in a Member State* 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 111 of *CRD*.
 [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-EEA 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 *EU 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 *EU 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-EEA 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-EEA 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 *EU 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 *EU 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-EEA 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*.

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A *firm* should satisfy itself that the systems (including IT) of the *FCA consolidation group* or the *non-EEA 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-EEA sub-group*, as the case may be.

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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.

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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.