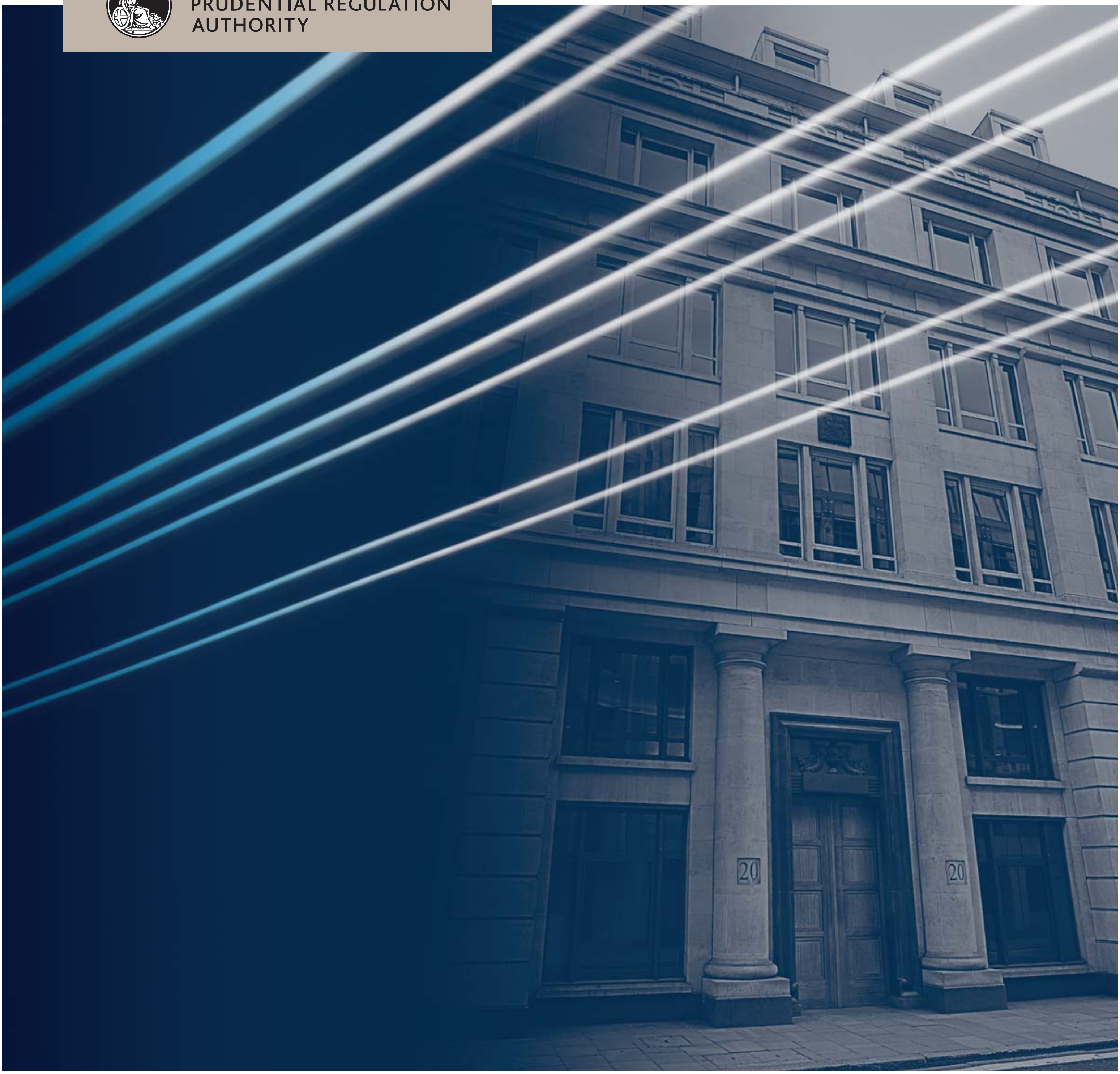
Supervisory Statement | SS5/13

The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)

December 2013

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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1 Introduction

1.1 This supervisory statement is aimed at firms to which CRD IV[1] applies.

1.2 The purpose of this supervisory statement is to set out the expectations that the Prudential Regulation Authority (PRA) has in relation to the Internal Capital Adequacy Assessment Process (ICAAP) and the requirements set out in the PRA Rulebook in the Internal Capital Adequacy Assessment rules.

1.3 It provides further detail in relation to the high-level expectations outlined in *The PRA's approach to banking supervision*.[2]

1.4 The PRA will review a firm's ICAAP as part of its Supervisory Review and Evaluation Process (SREP), and this supervisory statement also sets out some of the factors that the PRA will take into consideration during the SREP.

1.5 In addition, this supervisory statement sets out the PRA's expectations with regard to firms' coverage and treatment of interest rate risk arising in the non-trading book, group risk and operational risk and foreign currency lending to unhedged retail and SME borrowers.

2 Expectations of firms undertaking an ICAAP

2.1 A firm must carry out an ICAAP in accordance with the PRA's ICAAP rules. These include requirements on the firm to undertake a regular assessment of the amounts, types and distribution of capital that it considers adequate to cover the level and nature of the risks to which it is or might be exposed. This assessment should cover the major sources of risks to the firm's ability to meet its liabilities as they fall due and incorporate stress testing and scenario analysis. The ICAAP should be documented and updated annually by the firm 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.

2.2 The PRA expects firms in the first instance to take responsibility for ensuring that the capital they have is adequate, with the ICAAP being an integral part of meeting this expectation. The PRA expects the ICAAP to be the responsibility of a firm's governing body, that it is reviewed and signed off by the governing body, and that it is used as an integral part of the firm's management process and decision-making culture. The processes and systems used to produce the ICAAP should ensure that the assessment of the adequacy of a firm's financial resources is reported to its governing body and senior management as often as is necessary.

2.3 The ICAAP, and internal processes and systems supporting it, should be proportionate to the nature, scale and complexity of the activities of a firm, as set out in Internal Capital Adequacy Assessment 3.3 in the PRA's Rulebook. Where a firm has identified risks as not being material, it should be able to provide evidence of the assessment process that determined this and discuss why that conclusion has been reached.

2.4 Liquidity risk should also be assessed, including in relation to potential losses arising from the liquidation of assets and increases in the cost of funding during periods of stress. The requirements in relation to liquidity risk may be found in BIPRU 12.

2.5 As outlined in the supervisory statement on stress testing, the PRA expects firms to develop a framework for stress testing, scenario analysis and capital management that captures the full range of risks to which they are exposed and enables these risks to be assessed against a range of plausible yet severe scenarios. The ICAAP should outline how stress testing supports capital planning for the firm.

2.6 Where a firm uses a model to aid its assessment of the level of adequate capital, it should be appropriately conservative and should contribute to prudent risk management and measurement. The firm should expect the PRA to investigate the structure, parameterisation and governance of the model, and the PRA will seek reassurance that the firm understands the attributes, outputs and limitations of the model, and that it has the appropriate skills and expertise to operate, maintain and develop the model.

3 The SREP

3.1 The SREP is a process by which the PRA will, taking into account the nature, scale and complexity of a firm's activities:

- review the arrangements, strategies, processes and mechanisms implemented by a firm to comply with its regulatory requirements laid down in PRA rules and the CRR;
- evaluate the risks to which the firm is or might be exposed;
- assess the risks that the firm poses to the financial system; and
- evaluate the further risks revealed by stress testing.

3.2 As part of its SREP, the PRA will review the firm's ICAAP and have regard to the risks outlined in the overall Pillar 2 rule in Internal Capital Adequacy Assessment 3.1, the governance arrangements of the firm, its corporate culture and values, and the ability of members of the management body to perform their duties. The degree of involvement of the governing body

(1) The Capital Requirements Directive (2013/36/EU) (CRD) and the Capital Requirements Regulation (575/2013) (CRR), jointly 'CRD IV'.
(2) www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx.

of the firm will be taken into account by the PRA when assessing the ICAAP, as will the appropriateness of the internal processes and systems for supporting and producing the ICAAP.

3.3 When the PRA reviews an ICAAP as part of the SREP, it does so in order to determine whether all of the material risks have been identified and that the amount and quality of capital identified by the firm is sufficient to cover the nature and level of the risks to which it is or might be exposed.

3.4 The SREP will also consider:

(a) the results of stress tests carried out in accordance with the CRR by firms that use the Internal Ratings-Based (IRB) approach or internal models for market risk capital requirements;

(b) the exposure to and management of concentration risk by firms, including their compliance with the requirements set out in Part Four of the CRR and Chapter 6 of the ICAAP rules;

(c) the robustness, suitability and manner of application of policies and procedures implemented by firms for the management of the residual risk associated with the use of credit risk mitigation techniques;

(d) the extent to which the capital held by a firm in respect of assets which it has securitised is adequate, having regard to the economic substance of the transaction, including the degree of risk transfer achieved;

(e) the exposure to and management of liquidity risk by firms, including the development of alternative scenario analyses, the management of risk mitigants (including the level, composition and quality of liquidity buffers), and effective contingency plans;

(f) the impact of diversification effects and how such effects are factored into firms' risk measurement system;

(g) the geographical location of firms' exposures;

(h) the exposure of firms to the risk of excessive leverage;

(i) whether a firm has provided implicit support to a securitisation; and

(j) the exposure to and management of foreign currency lending risk to unhedged retail and SME borrowers by firms, in line with the European Banking Authority's Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP).[1]

3.5 The PRA will also assess as part of the SREP the risks that the firm poses to the financial system.

3.6 The PRA may need to request further information and meet with the governing body and other representatives of a firm in order to evaluate fully the comprehensiveness of the ICAAP. The management of the firm, including the governing body, should therefore be prepared to discuss all aspects of the ICAAP, covering both quantitative and qualitative components. Additionally, the PRA will consider the business model of the firm and the advocated rationale for the model, as well as the firm's expectations regarding the future market and economic environment and how they might affect its business model.

3.7 The SREP will generally be the same across all types of firms, but will be proportionate given the nature, scale and complexity of a firm's activities. There may also be a different emphasis depending on the type of firm or its potential risk to the financial system. For example, banks and building societies may be more exposed to credit concentration risk and interest rate risk in the non-trading book, with investment firms being more likely to be exposed to market risk; these potentially different areas of emphasis will be reflected in the conduct of the SREP, where applicable, for relevant firms.

3.8 On the basis of the SREP, the PRA will determine whether the arrangements implemented by a firm and the capital held by it provide sound management and adequate coverage of its risks. If necessary, the PRA will require the firm to take appropriate actions or steps at an early stage to address any future potential failure to meet its prudential regulatory requirements.

4 The setting of Individual Capital Guidance (ICG) and the Capital Planning Buffer (CPB)

ICG

4.1 Following the SREP, including both a review of the ICAAP and any further interactions with a firm, the PRA will normally give the firm Individual Capital Guidance (ICG), advising the firm of the amount and quality of capital that the PRA considers the firm should hold to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1.

4.2 The PRA will give ICG on a consolidated basis to firms which must comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 on a consolidated basis. The PRA may decide not to give ICG on an individual basis to members of a group where firms are able to demonstrate that capital has been adequately allocated

(1) www.eba.europa.eu/documents/10180/535130/EBA-GL-2013-02+%28Guidelines+on+capital+measures+for+FX+lending%29.pdf/966f1ca0-7454-4003-a40a-e2fc98214fc1. Title I 'Subject matter, scope and definitions' of the EBA Guidelines, section 2, page 8, provides definitions of 'FX', FX lending', (ie 'foreign currency lending') and 'unhedged borrower'.

among subsidiaries and that there are no impediments to the transfer of capital within the group. This does not absolve individual firms or members of the group of their obligation to comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1, which applies to all firms on an individual basis whether or not it also applies to the firm on a consolidated basis.

4.3 Where the PRA gives ICG to a firm it will generally specify an amount of capital (Pillar 2A) that the firm should hold at all times in addition to the capital it must hold to comply with the CRR (Pillar 1). It will usually do so stating that the firm should hold capital of an amount at least equal to a specified percentage of that firm's capital requirement under the CRR, plus one or more static add-ons in relation to specific risks in accordance with the overall Pillar 2 rule in Internal Capital Adequacy Assessment 3.1. The PRA expects firms to meet Pillar 2A with at least 56% Common Equity Tier 1 (CET1) capital and no more than 44% in AT1 by 1 January 2015.

4.4 It is for firms to ensure that they comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. However, if a firm holds the level of capital recommended as its ICG that does not necessarily mean that it is complying with the overall financial adequacy rule. Deviation by a firm from the terms of the ICG given to it by the PRA does not automatically mean that the firm is in breach of the overall financial adequacy rule or that the PRA will consider that the firm is failing or is likely to fail to satisfy the Threshold Conditions (TCs). However, firms should expect the PRA to investigate whether any firm is failing or likely to fail to satisfy the TCs, with a view to taking further action as necessary.

4.5 The PRA does not expect a firm to meet the CRD IV buffers with any CET1 capital maintained to meet its ICG. If a firm agrees with its ICG, the PRA will expect the firm to apply for a requirement under Section 55M(5) of the Financial Services and Markets Act 2000 (FSMA) preventing the firm from meeting any of the CRD IV buffers that apply to it with any CET1 capital maintained to meet its ICG. The firm will normally be invited to apply for such a requirement at the same time as it is advised of its ICG. If the firm does not apply for such a requirement the PRA will consider using its powers under Section 55M(3) to impose one of its own initiative.

4.6 Where a firm is subject to the Basel 1 floor the PRA does not expect a firm to meet the CRD IV buffers with any CET1 maintained by the firm to meet the Basel 1 floor and will use its powers under Section 55M to prevent a firm from doing so. Where applicable to a firm, global and other systemically important institution buffers will also be set by the PRA using its powers under Section 55M of FSMA.

CPB

4.7 Following the SREP, the PRA may also notify the firm of an amount and quality of capital that it should hold as a Capital Planning Buffer (CPB), over and above the level of capital recommended as its ICG, and will generally do so at the same time as advising the firm of its ICG. The CPB, based on a firm-specific supervisory assessment, should be of sufficient amount and adequate quality to allow the firm to continue to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. This should be the case even in adverse circumstances, after allowing for realistic management actions that a firm could and would take in a stress scenario. Use of the CPB is not of itself a breach of capital requirements or the TCs. The automatic distribution constraints associated with the CRD IV buffers do not apply to the CPB.

4.8 The PRA may set a firm's CPB either as an amount of capital which it should hold from the time of the PRA's notification following the firm's SREP or, in exceptional cases, as a forward-looking target that a firm should build up over time. More information on setting the CPB is outlined in the supervisory statement on stress testing. Where the general stress and scenario testing rule, as part of the ICAAP rules, applies to a firm on consolidated basis the PRA may notify the firm that it should hold a group CPB.

4.9 Where the amount or quality of capital which the PRA considers a firm should hold to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 or as a CPB is different from that identified by the firm through its ICAAP, the PRA usually expects to discuss the difference with the firm and may consider the use of its powers under Section 166 of FSMA to assist in such circumstances.

4.10 If a firm considers that the ICG or the CPB advised to it by the PRA is inappropriate to its circumstances it should notify the PRA of this, consistent with Principle 11 (Relations with regulators). If, after discussion, the PRA and the firm do not agree on an adequate level of capital, the PRA may consider using its powers under Section 55M of FSMA to impose a requirement on the firm to hold capital in accordance with the PRA's view of the capital necessary to comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. In deciding whether it should use its powers under Section 55M of FSMA, the PRA will take into account the amount and quality of the capital that the firm should hold for its CPB.

5 Failure to meet ICG and use of the CPB

5.1 The PRA expects every firm to hold at least the level of capital advised to it via its ICG at all times. If a firm's capital has fallen or is expected to fall below that level it should inform the PRA as soon as practicable (even if the firm has not accepted the ICG given by the PRA), explaining why this has happened or is expected to happen. The firm will also be expected to discuss the actions that it intends to take to increase its capital and/or reduce its risks (and therefore capital requirements), and any potential modification that it considers should be made to the ICG.

5.2 Where this has happened, the PRA may ask a firm for alternative and more detailed proposals or further assessments of capital adequacy and risks faced by the firm. The PRA will seek to agree with the firm appropriate timescales and the scope for any such additional work.

5.3 Where a firm has a CPB in place, it should only use that buffer to absorb losses or meet increased capital 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.

5.4 Consistent with Principle 11, a firm should notify the PRA as early as possible in advance where it has identified that it would need to use its CPB (even if the firm has not accepted the PRA's assessment of the amount or quality of the capital required for the CPB). The firm's notification should state as a minimum:

- what adverse circumstances are likely to force the firm to draw down its CPB;
- how the CPB will be used up in line with the firm's capital planning projections; and
- what plan is in place for the eventual restoration of the CPB.

5.5 Following discussions with the firm, the PRA may put in place additional reporting arrangements to monitor the firm's use of its CPB in accordance with the plan agreed to restore that buffer. The PRA may also identify specific trigger points as the CPB is being used up by the firm, which may lead to additional supervisory actions.

5.6 Where a firm's CPB is being drawn down due to circumstances other than those arising from a deteriorating external environment or periods of stress (eg macroeconomic downturns or financial/market shocks), or firm-specific circumstances (eg poor planning), the PRA may ask the firm for more detailed plans to restore its CPB. In light of the relevant circumstances, the PRA may consider taking other remedial actions, which may include using its powers under Section 55M of FSMA to require the firm to take specified action to restore its CPB within an appropriate timeframe.

5.7 Where a firm has started to use its CPB in circumstances where it was not possible to notify the PRA in advance, it should notify the PRA and provide information about the cause, the current and projected usage of the buffer, and its eventual restoration as soon as practicable afterwards.

6 Interest rate risk in the non-trading book

6.1 Firms must have appropriate systems and processes, proportionate to the nature, scale and complexity of their business, to evaluate and manage interest rate risk in the non-trading book. Examples of interest rate risk in the non-trading book include:

- the mismatch of repricing of assets and liabilities and off balance sheet short and long-term positions (termed 'repricing risk');
- hedging exposure to one interest rate with exposure to a rate which reprices under slightly different conditions ('basis risk');
- the uncertainties of occurrence of transactions, eg where actual transactions do not equal those that were expected in the future ('pipeline risk'); and
- consumers redeeming fixed rate products when market rates change ('optionality risk').

6.2 The systems and processes should allow the firm to include:

- the ability to measure the exposure and sensitivity of the firm's activities, if material, to repricing risk, yield curve risk, basis risk and risks arising from embedded optionality (eg pipeline risk, prepayment risk) as well as changes in assumptions (eg those about customer behaviour);

- consideration as to whether a purely static analysis of the impact on its current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation approach; and

- scenarios in which different interest rate paths are computed and in which some of the assumptions (eg about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate level.

6.3 Under Internal Capital Adequacy Assessment 13.1, a firm is required to make a written record of its assessments made under those rules. A firm's record of its approach to evaluating and managing interest rate risk as it affects the firm's non-trading activities should cover the following issues:

- the internal definition of the boundary between 'banking book' and 'trading activities';
- the definition of economic value and its consistency with the method used to value assets and liabilities (eg discounted cash flows);
- the size and the form of the different shocks to be used for internal calculations;

- the use of a dynamic and/or static approach in the application of interest rate shocks;
- the treatment of commonly called 'pipeline transactions' (including any related hedging);
- the aggregation of multi-currency interest rate exposures;
- the inclusion (or not) of non-interest bearing assets and liabilities (including capital and reserves);
- the treatment of current and savings accounts (ie the maturity attached to exposures without a contractual maturity);
- the treatment of fixed rate assets (liabilities) where customers still have a right to repay (withdraw) early;
- the extent to which sensitivities to small shocks can be scaled up on a linear basis without material loss of accuracy (ie covering both convexity generally and the non-linearity of pay-off associated with explicit option products);
- the degree of granularity employed (for example offsets within a time bucket); and
- whether all future cash flows or only principal balances are included.

6.4 In accordance with Internal Capital Adequacy Assessment 9.2, a firm should apply a 200 basis point shock in both directions to each major currency exposure. The PRA will periodically review whether the level of the shock is appropriate in light of changing circumstances, in particular the general level of interest rates (for instance, during periods of very low interest rates) and their volatility. The level of shock required may also be changed in accordance with EBA guidelines. A firm's internal systems should, therefore, be flexible enough to compute its sensitivity to any standardised shock that is prescribed. If a 200 basis point shock would imply negative interest rates, or if such a shock would otherwise be considered inappropriate, the PRA will consider adjusting the requirements accordingly.

6.5 Alongside the requirement to monitor and evaluate the potential impact of changes in interest rates on economic value, the PRA expects firms to monitor the potential impact on earnings volatility. This should be assessed on an appropriate timeframe of three to five years, and factor in the firm's forward-looking view of product volumes, based on its proposed business model, and the projected path of interest rates.

7 Group risk

7.1 Under SYSC 12.1.8R a firm is required to have adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing its own exposure to group risk, including sound administrative and accounting procedures.

8 Operational risk

8.1 In meeting the general standard referred to in Internal Capital Adequacy Assessment 10.1, a firm that undertakes market-related activities should be able to demonstrate to the PRA:

- in the case of a firm calculating its capital requirement for operational risk using the basic indicator approach or standardised approach, that it has considered; or

- in the case of a firm with an Advanced Measurement Approach (AMA) permission, compliance with

the Committee of European Banking Supervisors' *Guidelines on the management of operational risk in market-related activities*,(1) published in October 2010.

8.2 In meeting the general standards referred to in Internal Capital Adequacy Assessment 10.1, a firm with an AMA approval should be able to demonstrate to the appropriate regulator that it has considered and complies with Section III of the European Banking Authority's *Guidelines on the Advanced Measurement Approach (AMA) — Extensions and Changes*,(2) published in January 2012.

8.3 The matters dealt with in a business continuity plan should include:

(a) resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;
(b) the recovery priorities for the firm's operations;
(c) communication arrangements for internal and external concerned parties (including the PRA, clients and the press);
(d) escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;
(e) processes to validate the integrity of information affected by the disruption; and
(f) regular testing of the business continuity plan in an appropriate and proportionate manner.

9 Foreign currency lending to unhedged retail and SME borrowers

9.1 Foreign currency lending is defined in the EBA Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP).(3)

(1) www.eba.europa.eu/regulation-and-policy/operational-risk/guidelines-on-the-management-of-operational-risk-in-market-related-activities.
(2) www.eba.europa.eu/-/guidelines-on-ama-extensions-and-chang-1.
(3) www.eba.europa.eu/documents/10180/535130/EBA-GL-2013-02+%28Guidelines+on+capital+measures+for+FX+lending%29.pdf/966f1ca0-7454-4003-a40a-e2fc98214fc1. Title I 'Subject matter, scope and definitions' of the EBA Guidelines, section 2, page 8, provides definitions of 'FX', 'FX lending', (ie 'foreign currency lending') and 'unhedged borrower'.

9.2 As part of its obligations under Internal Capital Adequacy Assessment 3.1 a firm that lends in foreign currency to unhedged retail and SME borrowers should determine whether it meets the thresholds of materiality in Title II, section 1 paragraph 9 of the European Banking Authority's Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP). Where a firm meets the threshold it should notify the PRA and reflect the risk in its ICAAP.