

136

Financial Services Authority

Individual Capital Adequacy Standards

May 2002



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The Financial Services Authority invites comments on this Consultation Paper. Please send your comments to reach us by 31 August 2002.

You can send your comments electronically using the form on the FSA's website (www.fsa.gov.uk/pubs/cp/cp136_response.html).

Alternatively, you can send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

1 Executive summary

- 1.1 This Consultation Paper (CP) seeks comments on the draft framework for individual capital adequacy standards (ICAS) for authorised firms. The proposals are particularly relevant to deposit-takers, insurers and investment firms with permission to take principal positions. Some elements of the proposals are also relevant to all firms who are subject to our prudential requirements. We intend that any rules and guidance derived from this framework will form part of the *‘Integrated Prudential Sourcebook’* (PSB) and the *‘Supervision Manual’*.
- 1.2 We have stated in previous publications¹ that we intend to develop a new framework within which individual capital standards could be determined for a wider range of firms than currently, and which fits with our New Regulator framework. This CP is the first step towards developing such a framework. The purpose of the ICAS framework is to reduce the probability of consumers suffering loss, or markets being disrupted, as a result of prudential failure. It does this by seeking to ensure that the amount of capital held by a firm is commensurate with the risk associated with its business profile and its systems and controls environment.
- 1.3 Condition 4 of the Threshold Conditions for Authorisation requires us to ensure that authorised firms hold adequate resources for their regulated activities. This is reiterated in Principle 4 of our Principles for Businesses and proposed rules within Chapter 4 of the Application and General Requirements (PRAG) element of the draft PSB (see Annex C). The framework proposed in this CP builds on these requirements. The framework is not designed to replace the rules and guidance within the rest of the PSB, but to add further guidance on how firms may assess ‘adequate resources’ and how we may satisfy ourselves that the firm’s assessment is appropriate.

1 Within Consultation Paper 31 *‘The FSA’s approach to setting prudential standards’* (November 1999), Consultation Paper 97 *‘Integrated Prudential Sourcebook’* (June 2001) and our Policy Statement *‘Individual Capital Ratios for Banks’* (July 2001).

- 1.4 Prudential capital is the subject of a number of international minimum standards. While these minimum standards may generate adequate capital for some of the firms to which they apply, they cannot, by definition, be relied on to do so for all of them – a fact that is well-recognised in international discussions. In the past, this has been dealt with in different ways in the various financial industry sectors (see paragraph 3.4 for details). This paper proposes a more harmonised approach within which the appropriate capital levels can be determined for individual firms. In doing so, it provides our initial thinking on how we are minded to implement, for deposit-takers and investment firms, the capital elements of the Supervisory Review – or so called Pillar 2 – of the current review of the Basel Capital Accord and the parallel EU process. In the case of insurers, the approach will need, in due course, to reflect EU developments under the ‘Solvency II’ exercise.
- 1.5 The proposed ICAS framework is a risk-based process that includes two key elements:
- an **Internal Capital Assessment (ICA)** to address business and systems and controls risks not adequately captured in the minimum capital requirements in the PSB. This element would be a self-assessment by firms within PRU categories 1, 2 and 3 (i.e. deposit-takers, insurers and principal position takers). This would be based on rules and guidance to be included within the PSB; and
 - a supervisory tool, known as a **Supplementary Capital Assessment (SCA)**, by which means we may advise or require a firm to hold additional capital in response to specific systems and controls related concerns, or to business risks not adequately captured by its ICA. The SCA would be part of our regulatory toolkit and would be available for us to use for all categories of firm regardless of business type. The framework does, however, recognise that capital is not the only tool, or indeed always the most appropriate tool, to deal with systems and controls issues.
- 1.6 The main benefits of this proposed framework are that it meets our overall aims of:
- reducing the probability of prudential failure in a cost efficient way;
 - creating greater transparency in the setting of regulatory capital standards; and
 - promoting a strong culture of risk management.
- 1.7 The single framework aims to retain sufficient flexibility to avoid the pitfalls arising from a “one size fits all” approach. The self-assessment process would require firms to assess their own capital needs and incentivise management to strengthen controls. There will also be benefits to us as it aligns our prudential supervision more closely with our risk assessment framework.

- 1.8 It is too early to estimate the potential impact these proposals would have on the capital of a given firm or sector. But within this CP (see Annex B) we have aimed to indicate the basis of how we would propose to calibrate the detailed framework.
- 1.9 We estimate that the ICA will apply to 1,750 firms. We believe that for the 350 deposit-takers, where individual capital ratios already exist, the average required level of capital should not increase. In the case of the 900 insurers, and 500 principal position-takers, we would expect to see some increase in the overall average amount of required, if not actual, capital. A very small minority of the remaining 7,250 firms may be subject to increased capital requirements under the SCA.
- 1.10 This paper contains the following chapters:
- Chapter 2 provides an introduction;
 - Chapter 3 provides an overview of the framework, the background, the implementation and enforcement issues and the anticipated impact on capital;
 - Chapter 4 is a more detailed description of the ICA;
 - Chapter 5 is a more detailed description of the SCA; and
 - Chapter 6 discusses the proposed framework's compatibility with our statutory objectives.

Next Steps

- 1.11 Comments on this consultation will be used in developing the framework. We plan to issue a second CP in 2003 that will include draft rules and guidance and further detail of the proposed framework. To achieve this, we request that all comments on this paper reach us by 31 August 2002.

2 Introduction

Purpose of this Consultation Paper

- 2.1 This Consultation Paper (CP) seeks comments on the draft framework for determining individual capital adequacy standards (ICAS) for authorised firms. Any rules and guidance derived from this framework will form part of the *‘Integrated Prudential Sourcebook’* (PSB) and the *‘Supervision Manual’*.

Context

- 2.2 Within CP 31 *‘The FSA’s approach to setting prudential standards’*, (November 1999), CP 97 *‘Integrated Prudential Sourcebook’* (June 2001), and our Policy Statement *‘Individual Capital Ratios for Banks’* (July 2001), we stated our intention to develop a new framework within which individual capital standards could be determined for a wider range of firms than currently, while reflecting our new risk assessment methodology. This CP is the first step towards developing such a framework. And in doing so, it provides our initial thinking on how we are minded to implement, for deposit-takers and investment firms, the capital elements of the Supervisory Review – or so called Pillar 2 – part of the proposed new Basel Capital Accord and parallel EU proposals. In the case of insurers, the approach will need in due course to reflect EU developments under the ‘Solvency II’ exercise.
- 2.3 The framework proposed within this CP is consistent with the approach in our publications on the New Regulator framework. These set out our new approach to regulation under the *‘Financial Services and Markets Act 2000’* (the Act). In particular, this framework will:
- aim to ensure that prudential standards are cost-effective and proportionate to the risks run by firms;
 - take into account the impact on customers and markets of a failure to meet the standards by different types of firm; and

- set out a framework within which firms apply their own procedures to determine the appropriate amount of capital for them to hold.

Background

- 2.4 In line with the PSB as a whole, this draft framework aims to ensure that authorised firms have adequate financial resources and appropriate risk management systems and controls. The framework in CP97 was designed to generate minimum capital requirements for firms to mitigate the risk of prudential failure. In this CP, we have built on this base so that the amount of capital held by a business is commensurate with the risk associated with its business profile and its systems and controls environment.
- 2.5 The proposed framework will form the basis of the rules and guidance that we would expect firms to apply in assessing their capital requirement. We are, as yet, not in a position to present the framework in sufficient detail to enable firms to determine the actual level of capital that would be required under such a framework. Instead we are consulting on the broad outline of how such an approach might work. We shall continue to develop the ICAS framework in light of comments received as a result of this paper and of developments in international capital adequacy standards. The more detailed framework arising from this development, and any draft rules and guidance as a result of it, will be proposed within a second CP on this subject next year.
- 2.6 Sections 155 and 157 of the Act require us to consult on draft rules and on any guidance which we propose to give to authorised person generally (or to a class of regulated person) about those rules. When we consult on draft rules or guidance we must also, under sections 155 (2) and 157 (3), publish a cost benefit analysis (CBA), an explanation of the purpose of those rules and why we consider them to be compatible with our general duties under section 2 of the Act. We do not include any draft rules or guidance in this paper, but these would eventually follow. So, we consider it appropriate to consult at this early stage on the basics of this framework and, in doing so, we have included, as Annex B to this paper, a CBA that was undertaken in the development of this proposal.
- 2.7 In relation to our regulatory objectives in section 2 of the Act, the purpose of the proposed framework within this CP is to promote both:
- consumer protection – by reducing the probability that consumers suffer a loss as a result of prudential failure. We aim to do so by seeking to ensure that the amount of capital held by a firm is commensurate with the risk associated with the business profile and systems and controls environment within that firm; and

- market confidence – by addressing the risk that prudential failure, i.e. the inability of a firm to meet its obligations as they fall due, damages confidence in the financial system in the UK. This might lead to adverse effects for the financial sector and potentially the wider economy, for example through reduced market liquidity.

2.8 We are seeking to address the following risks to our objectives (RTOs) that we identified within our ‘New Regulator’ framework:¹

- RTO 1 – the impact of financial failure on market confidence;
- RTO 2 – the impact of misconduct or mismanagement on market confidence; and
- RTO 8 – the impact on consumers of financial failure.

But, as we have made clear in our publications on the New Regulator framework, in developing the ICAS framework we recognise that a zero failure regime is neither achievable in practice, nor desirable in theory.

2.9 In Chapter 6, we discuss in more detail how the ICAS may help us to meet our statutory objectives and strategic aims.

Scope

2.10 This CP applies to all firms subject to our prudential regulations. The framework proposed has two key elements:

- the Internal Capital Assessment (ICA); and
- the Supplementary Capital Assessment (SCA).

These two elements are set out in more detail in Chapters 4 & 5 respectively.

2.11 The ICA will apply to all firms in PRU categories² 1, 2 or 3. It therefore applies specifically to:

- deposit-taking institutions;³
- insurance firms (including friendly societies and the Society of Lloyd’s) and;
- firms with permission to take principal positions.

1 ‘A New Regulator for the New Millennium’ (January 2000) and the updates ‘Building a New Regulator: Progress Report’ (December 2000 and February 2002)

2 The PRU categories were defined in CP97 in the PRAG 1 chapter.

3 The minimum capital requirements for credit unions are included within Chapter 8 of the draft ‘Credit union sourcebook’ (CRED) contained within CP107. While credit unions will not be subject to the ICA, in line with paragraph 2.13 they may be subject to an SCA on an exceptions basis.

2.12 Within this paper, we have referred to PRU category 3 firms as those with permission to take principal positions. In line with PRAG 1.3.8R, for the purpose of this framework a PRU category 3 firm is defined as a firm that has a Part IV permission that includes dealing as principal in securities and contractually-based investments except where:

- a) the firm holds positions in securities and contractually-based investments solely as a result of its failure to match investors' orders precisely; and
- b) such positions are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question; and
- c) the total market value of all such positions is no more than 15% of the firm's Tier One capital resources (before deductions – see PRCA 2.4.3R in CP97); and
- d) where the firm is not a PRU Category 1 or 2 firm.

So, for example, securities firms would be included within PRU Category 3, while fund managers would typically be excluded from this category (assuming, of course, that they fell within the above exclusion).

2.13 The SCA would be part of our regulatory toolkit and would be available for supervisors to use for all prudentially regulated firms regardless of business type. A supervisory judgement to use the tool would be taken within our wider risk-based framework in the usual way; there would be no presumption that any given category or type of firm would be automatically subject to an SCA. The application of the ICA and the SCA is summarised in the table below.

Prudential Category	Internal Capital Assessment	Supplementary Capital Assessment *
1	✓	✓
2	✓	✓
3	✓	✓
4	–	✓
5	–	✓
Others	–	✓

* – if deemed appropriate

2.14 As with the other sections of the PSB, this CP does not apply to:

- UK branches of EEA firms, i.e. firms authorised to carry out financial services business covered by the relevant EU directives by a regulator in another EEA member state; and

- certain overseas firms, i.e. firms authorised in a non-EEA country who carry out regulated activities in the UK through a branch and where the firm is subject to equivalent standards in its home country.

Q1: Is the scope of application of the proposed framework clear?

Relationship to current international work

2.15 This CP is being published against a background of wide-ranging international discussions on prudential standards:

- the Basel Committee on Banking Supervision is reviewing its Capital Accord. This includes revisions to the capital adequacy treatment of credit risk, new proposals on operational risk, the introduction of supervisory review under ‘Pillar 2’, and a market discipline element under ‘Pillar 3’;
- parallel work is being conducted in the European Union on the standards that apply to credit institutions and investment firms;
- the European Union is also reviewing the solvency margin requirements for insurance companies – the EU’s Solvency II review – and whether solvency margin requirements should be introduced for reinsurance companies; and
- the European Union is drawing up a new framework for the prudential regulation of financial conglomerates and published last year a draft directive addressing the strengthening of supervision arrangements in this area.

2.16 In the course of preparing this CP we have aimed, as far as possible, to anticipate the expected outcomes of these developments. As noted above, in the case of deposit-takers and principal position-takers, the ICAS would be the vehicle for implementing the capital adequacy element of Pillar 2 of the new Basel Capital Accord and of the parallel EU directives. While the relevant international standards are not yet complete, and therefore we cannot be sure of the final outcome, we do not at this stage believe that for these firms the framework proposed is superequivalent to (set higher than) the anticipated international requirements in this area.

2.17 In the case of insurance firms, our proposal to implement a new prudential regime while the timing and outcome of EU discussions are assessed means that it is likely that implementation of this framework would result in the UK being superequivalent to the EU minimum requirements. However, the EU minimum is widely regarded (both internationally and in the domestic market) as inadequate, and this has historically been addressed in different ways by different regulators. It is therefore difficult to assess precisely what the relative impact on the UK competitive position would be.

- 2.18 As these international standards evolve, we may need to include further changes to the ICAS framework that have not been included within this paper. These changes and a more detailed draft of the rules and guidance that will underlie this framework will be included in future CPs. It is likely that the effect of revised international standards will be to extend and develop the concepts within this paper rather than to change significantly the methodology involved.

Q2: Have the interactions between this proposed framework and international standards been made clear?

Timetable

- 2.19 The ICAS framework will be an integral part of both the PSB and the *'Supervision Manual'*. In CP115 *'Integrated Prudential Sourcebook – timetable for implementation'*, issued in November 2001, we indicated the timing issues facing the implementation of the PSB. These included the delay to the new Basel Capital Accord and the parallel EU process.
- 2.20 Given the uncertain timetables for the international standards referred to above, we said in CP115 that we planned to implement parts of the PSB as originally timetabled and to delay some parts to be implemented alongside these international standards. We now intend that the framework proposed within this CP be implemented as far as possible in line with that timetable and, therefore, that this framework will be in two parts. The framework for insurance firms will be implemented in 2004 and the implementation of the framework for other firms will occur in line with the full implementation of the PSB. We do not propose to delay implementation of this framework until Solvency II is complete.
- 2.21 This proposed timing should:
- minimise the number of firms which would otherwise be subject to a multiple step change arising from the implementation of this framework; and
 - allow enough time to finalise and implement the material in this consultation.
- 2.22 The envisaged timetable for the ICAS and related projects is therefore as follows:

Initiative	Current position
Integrated Prudential Sourcebook (PSB)	<p>We published CP97 <i>'Integrated Prudential Sourcebook'</i> in June 2001 and CP115 <i>'Timetable for implementation'</i> in November 2001. Although we are not in a position to offer full feedback on CPs 97 and 115 (see below), there were no objections to our proposals in CP115 to implement in 2004 at least the provisions relating to insurance (see below) and (for all firms) systems and controls. We will decide on other candidates for initial implementation shortly, in the light of the extension of our scope to include mortgage and general insurance intermediaries announced in December 2001 and of EU developments (see below).</p> <p>As proposed in CP115, we will implement the capital adequacy material in CP97 applicable to banks and most investment firms when we implement the Basel Capital Accord and related EU legislation (see below).</p> <p>We published CP128 (on liquidity risk systems and controls) in March 2002 and plan to issue a CP on operational risk systems and controls in August 2002.</p> <p>We plan to publish a feedback statement on CP97 and CP115, and details of our implementation plans, in August 2002.</p>
Individual capital adequacy standards (ICAS)	<p>In CP97, we set out proposals for the minimum capital requirements for firms. These will be updated to reflect a range of international initiatives as well as various insurance initiatives (see below). This CP, Individual Capital Adequacy Standards (May 2002), proposes an outline framework through which risk-based individual capital standards can be determined for a wider range of firms.</p> <p>We plan to implement this framework for insurers in 2004 (see below) and to consult on the detailed framework for other sectors in line with the full implementation of the PSB.</p>
Basel 2/CAD 3	<p>The Basel Committee on Banking Supervision (BCBS) is developing a revised Capital Accord (referred to as 'Basel 2'). A parallel process in Europe is developing new capital adequacy directive requirements (referred to as 'CAD 3'). These initiatives propose a three pillar approach: Pillar 1 provides minimum capital requirements, Pillar 2 covers the supervisory review process (including the need, in some cases, to set capital requirements above the Pillar 1 minimum), and Pillar 3 addresses market discipline through enhanced market disclosure. We expect to publish a statement in mid-2002 that will set out our overall approach to the implementation of Basel2/CAD3. The BCBS and the EU expect to publish their respective third (and final) consultation papers in the first half of 2003. We will issue a series of CPs, including a consultation on the PSB rules and guidance during 2003-4. We aim to implement these requirements in line with the common Basel/EU implementation timetable by the end of 2006.</p>

The prudential regime for insurance firms (including friendly societies)	<p>We propose to implement a comprehensive new regime for insurance firms in 2004. This regime will be developed to incorporate the EU directive for solvency margin rules for insurance firms (known as Solvency I) and will be implemented in 2004. It is too early to indicate the content and timing of any further EU legislation on solvency margins for insurance firms (Solvency II). We have committed to implementing a new prudential regime for insurance firms before the Solvency II would be implemented but will review our prudential rules to reflect any new EU requirements at that date. In order to achieve this we are planning the following publications:</p> <p>May 2002: Discussion Paper on regulatory reporting (see below);</p> <p>August 2002: CP and feedback statement on CP 97 responses; policy proposals on enhanced Pillar 1 capital requirements and stress and scenario testing; revised PSB text except as below;</p> <p>Late 2002: CP with detailed proposals and PSB (and SUP) text on regulatory reporting, stress and scenario testing guidance, capital (Pillar 1) and terminal bonus and other life reserving matters;</p> <p>Late 2002: CP on transitional arrangements and implications for Interim Prudential Sourcebooks for insurers and for friendly societies, including the permitted links regime;</p> <p>Early 2003: Feedback Statement and final PSB text, except on regulatory reporting;</p> <p>Late 2003: Feedback Statement and final text on remaining matters including permitted links and the application of ICAS (see above).</p> <p>Implementation: 2004 (timetable to be determined).</p>
Regulatory reporting	<p>We are publishing a Discussion Paper in May 2002, examining how to improve the broader regulatory reporting environment. As part of this discussion, we will examine the wider aspects of the information that we will need to meet our objectives and how best we can satisfy these needs on a cross-sector basis. The second part of this paper will be insurance-focussed. It will examine the current regulatory reporting framework for insurers and put forward various options that could be developed in constructing a new reporting environment. This Discussion Paper will be followed by a Consultation Paper late in 2002 that will propose a framework for insurance firms' regulatory reporting. Wider reporting needs for other sectors will be developed during the course of this year.</p>
Harnessing Market Forces	<p>We are currently undertaking a project that is examining ways in which we can harness market forces to help us to achieve our statutory objectives. Amongst other things, this project is looking at the potential use of market signals to focus on possible risks to our objectives and at possible disclosures by us of information to enhance transparency and thereby help the operation of market forces.</p>

International Accounting Standards (IAS)	In the EU, it is proposed that International Financial Reporting Standards (IFRS) will become mandatory for all listed firms by 2005. However, some key insurance aspects are under review, in particular the measurement of insurance liabilities, the fair value concept for insurance contracts, and other accounting issues relating to investments and reinsurance. The existence of such a standard may help insurance supervisors in their efforts to approach certain aspects of insurance regulation in ways that are consistent both between countries and with the regulation of the banking and securities sectors.
EU developments	<p>Within the above policy development projects, we will continue to incorporate other recent and prospective EU developments, which include:</p> <ul style="list-style-type: none"> • UCITS Directive- adopted December 2001 and must be implemented by February 2004; • Insurance Mediation Directive- expected to be adopted in summer 2002, for implementation by 2004; • Conglomerates Directive- expected to be adopted in summer 2002, for implementation in 2005; and • Investment Services Directive: further EU Commission proposals published in March 2002.

Q3: Is the above timetable sensible given the uncertain timing of the various international initiatives?

- 2.23 We shall keep timetables under review and, if necessary, consult again at key milestones.

The consultation process

- 2.24 We are publishing this CP in hard copy form and making it available at our website (<http://www.fsa.gov.uk>) and on our monthly CD-ROM issue. We are bringing it to the attention of both the firms that will have to comply with it and, through representative consumer groups, to financial services' consumers. We expect to talk to trade associations and professional associations about the draft material, following their help in informal discussions at earlier stages.

Who can respond?

- 2.25 We welcome responses from anyone with an interest in the way the ICAS framework will affect them or in the interests they represent. We need your responses to reach us no later than 31 August 2002. An early response would be particularly welcome if it concerns substantial matters. Throughout this CP, we have highlighted questions on which we are particularly keen to receive your views and these are summarised in Annex A.

3 Overview of the ICAS Framework

- 3.1 This chapter is an overview of the Individual Capital Adequacy Standards (ICAS) framework. It begins with a brief background to how this proposed framework would fit into the *'FSA Handbook'* and how individual capital standards are currently set for firms. It then gives a summary of the components of the framework, which are explained in more detail in Chapters 4 and 5.

Background

- 3.2 Condition 4 of the Threshold Conditions for Authorisation requires us to ensure that authorised firms hold adequate resources for their regulated activities; this is reiterated in Principle 4 of our Principles for Businesses. In CP97, the Integrated Prudential Sourcebook (the PSB), we set out minimum financial resources standards (within Chapter 4 of the Application and General Requirements (PRAG) element (see Annex C), and Chapter 1 of the Capital element (PRCA)). PRAG 4 requires a firm to maintain overall financial resources that are adequate, on reasonable assumptions, to ensure that there is no significant risk of the firm not being able to meet liabilities to customers. We also proposed that firms should carry out stress and scenario tests on the robustness of their assumptions. The feedback on CP97 was generally supportive of these proposals, although some respondents called for additional guidance on the application of stress and scenarios testing and the interaction with 'adequate' financial resources.
- 3.3 The determination of the adequacy of financial resources comprises a number of key elements including capital and liquidity. This CP focuses on the capital adequacy element of financial resources, supplementing the rules and guidance consulted upon in CP97, and sets out a single framework within which firms may determine the amount of capital they must hold to satisfy the requirements of PRAG 4. We recognise that the relative importance of capital as a mitigant against prudential failure varies between types of firms, and this

has been taken into account both within this framework and in the development of other related initiatives.¹

- 3.4 In the past, the determination of adequate capital has been addressed by prudential standards in different ways:
- by setting capital requirements at, or above, the EU minimum for all firms on an individual, risk-focused, basis (banks and building societies);
 - by setting capital expectations for most firms above the international minimum on an informal basis (insurance companies); and
 - by setting capital requirements above the minimum on an exceptions basis (investment business firms).
- 3.5 We believe that for those classes of firm which face significant prudential risks, determining capital requirements on an individual basis is an effective and efficient way of mitigating prudential failure. Our definition of capital in this context is proposed in CP97; we do not intend to develop this definition within this CP.

Outline of the ICAS Framework

- 3.6 We propose that the ICAS framework should include two risk-focussed elements:
- a) an Internal Capital Assessment (ICA) to address business and systems and controls risks not adequately captured in the minimum capital requirements. These additional capital requirements would be determined on a firm by firm basis for PRU categories 1, 2 and 3 (i.e. deposit-takers, insurers and principal position takers). The main process for achieving this would be through self-certification by the firms themselves, in one of two ways:
 - i) the firm's own assessment of its capital needs based on the rules and guidance to be included in the PSB; or
 - ii) if certain pre-conditions are met, the firm may use an estimate of its capital requirement as determined by its own economic capital model, supplementing it with capital add-ons where the model does not adequately cover the risks identified within this framework; and
 - b) a supervisory tool, known as a Supplementary Capital Assessment (SCA), by which means a firm may be advised or required by us to hold additional capital in response to specific systems and controls related concerns or for exceptional business risks not adequately captured by its ICA. The SCA would be part of our regulatory toolkit within the Supervision Manual and would be available for us to use for all prudentially regulated firms regardless

of

¹ These include CP128: 'Liquidity risk in the Integrated Prudential sourcebook: Systems and Controls chapter' and the various initiatives for insurance firms indicated in the table in paragraph 2.22.

business type. A supervisory judgement to use the tool would be taken within our wider risk-based framework. As part of this judgement we would need to determine whether the additional capital requirement was an appropriate mitigant or incentive to address the risks identified, or whether another action would be a better response.

- 3.7 The ICA and the SCA are explained in more detail in chapters 4 and 5 respectively.
- 3.8 In line with the PSB, we propose to adopt a risk-based structure for the ICAS. So, the draft rules and guidance arising from this framework will be aligned with the risk-specific chapters in the PSB:²
- capital;
 - credit risk;
 - market risk;
 - operational risk; and
 - insurance risk.

Q4: Is it appropriate to align the framework to the risks identified in CP97?

Q5: Is it appropriate that the ICA should be a self-assessment by the firm?

Q6: Is the inclusion of the SCA as a supervisory tool sensible?

Implementation and enforcement issues

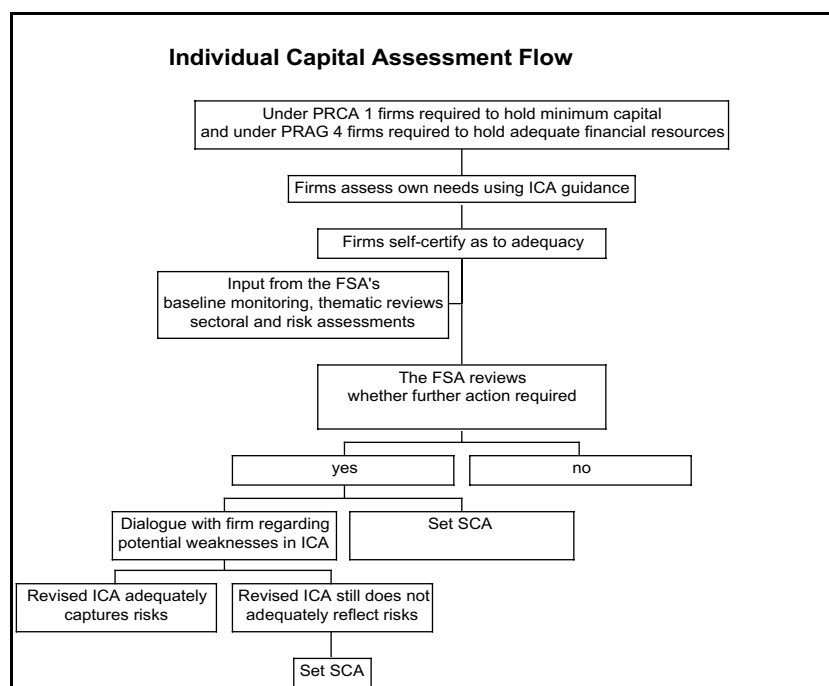
- 3.9 The overall aim of the ICAS framework is for senior management to determine a minimum level of capital that is appropriate to the business risks and systems and controls environment of their firm. Firms would be expected to review the internal assessment regularly and to implement policies and procedures to prevent a breach of that minimum level.
- 3.10 The senior management of the firm would be required to certify to us that they consider that, on the basis of all information and guidance available to them, the capital they hold is sufficient to mitigate the business and control risks that they have identified.
- 3.11 Our monitoring of firms' self-certification will be consistent with our New Regulator framework.³ As such the resources devoted to our monitoring or

2 Liquidity risk is the basis of a separate consultation (see CP128: '*Liquidity risk in the Integrated Prudential source-book: Systems and Controls chapter*' for further details)

3 Further detail on this framework can be found in our publication 'Building the new regulator, Progress report 2' (February 2002).

verification of a firm's ICA will be in line with our assessment of the firm's risk to our objectives.

- 3.12 In practice, this is likely to mean that a firm that we have identified as posing a high risk to our objectives under our risk assessment framework should expect to have a close and continuing dialogue with their supervisor as part of its finalisation of, and our monitoring and verification of, its ICA. At the other end of the spectrum, for firms that we have assessed as posing a low risk to our objectives, our monitoring of firms' compliance with these requirements will form part of our regular risk assessment, baseline monitoring and sectoral reviews or thematic work. In all cases our focus on the ICA will form a subset of, rather than in addition to, our overall risk assessment framework.
- 3.13 We would hope that the output of the ICA would result in an agreed level of capital for the firm. However, where we determine that there are systems and control weaknesses and/or business risks that have not been adequately reflected in the ICA, we may require firms to hold additional capital by setting a SCA. We would expect that the need for such a requirement would be exceptional. If, in due course, we found that SCAs were being set routinely for a large number of firms, this would signal a fault in the way the ICA was operating.
- 3.14 The diagram below summarises the interaction between the ICA and the SCA. The use of the SCA is discussed in more detail in Chapter 5.



- 3.15 As explained in paragraph 3.2 above, the ICAS framework builds on Condition 4 of the Threshold Conditions, Principle 4, and PRAG 4. A failure to follow the guidance on the ICA element of the framework may be taken into account when considering compliance with PRAG 4, Principle 4 and ultimately of the Threshold Conditions. SYSC 3.2.6R requires a firm to take reasonable care to maintain effective systems and controls for compliance with these regulatory requirements. If the firm's capital falls below the ICA, it could also call into question the effectiveness of the firm's risk management procedures. We have a range of tools (as set out within the supervision and enforcement manuals of the *FSA Handbook*) to use in response to such breaches of requirements.
- 3.16 The SCA would be set either as individual guidance or as an own initiative variation of a firm's Part IV permission under s45 of the Act. This decision would be made on a case by case basis. The relevant process will be set out within the *Supervision Manual*.

Q7: Have the legal obligations of firms under this framework been made clear?

Rules, evidential provisions and guidance

- 3.17 This CP does not include any draft Handbook text. However, as we develop the framework, we will seek to ensure an appropriate balance of rules, evidential provisions and guidance. Mindful of industry concerns that requirements in this area should not be overly prescriptive, we anticipate that the bulk of the text will be in the form of evidential provisions and guidance. But there will be some areas where the framework will require new rules or a modification of existing PSB rules. In particular, rules will:
- require firms to undertake their own capital adequacy assessment and to keep this assessment under review;
 - require firms to document their assessment in order to support their view;
 - require firms to hold capital in accordance with their self-assessment; and
 - require firms, on an annual basis, to certify that they have followed this framework and notify us of their self-assessment.
- 3.18 The proposed text for the rules and other material referred to above will be included within a later CP.

Impact on total capital

- 3.19 While it is too early to quantify the potential impact of these proposals on a given firm or sector, we can indicate the basis on which we would propose to calibrate the detailed framework. It is important to stress that there is no presumption that all firms will be required to hold more than the minimum capital level, as given by both international and UK standards, as a result of this framework.
- 3.20 In the case of the deposit-taking sector, where individual capital ratios already exist, we do not anticipate that, on average, that this framework will result in an overall increase in capital. The new Basel Accord and equivalent EU directives should deliver an improved risk-based capital requirement under 'Pillar 1', we would expect, on average, the ICAS framework to generate fewer (in both number and size) additional capital requirements than are currently generated under the existing approaches. The impact of the Pillar 1 requirements on these firms will be mixed; where the new Accord and equivalent EU directives deliver a lower level of capital (e.g. where a bank has a well diversified retail book) we will not seek routinely to reverse this capital saving through the ICAS. Notwithstanding our intention, we will need to fulfil our international obligations, particularly in respect of Pillar 2 of the new Basel Accord and any direct capital charge that may arise from it, for instance in the case of procyclicality (see paragraph 4.24). In calibrating the new framework, we would take account of the impact on overall capital of the revisions to the Pillar 1 and any quantitative Pillar 2 requirements of the framework.
- 3.21 For those firms in sectors which have not previously been subject to an individual capital requirement (i.e. investment firms and insurance companies), we expect that, on average, the overall level of regulatory capital will increase above the current minimum required as a result of the application of the ICA, but will on average remain within the actual level of capital held. Calibration for these sectors will be more difficult. Where possible we will aim to ensure that similar risks attract equivalent capital charges. So, for example, we would aim to calibrate the level of capital that investment firms are required to hold against market risk by reference to that currently applied to deposit-takers.
- 3.22 Further discussion of the potential impact on capital is included within the cost benefit analysis in Annex B.

Application to groups

- 3.23 We recognise that the proposals in this paper raise questions regarding their application to groups. For deposit-takers the current process has generally

been to apply common individual capital requirements at the solo and group levels. However this approach may not be appropriate for all types of groups and in particular raises the following questions:

- Where groups include banking, investment and insurance entities, how will the differing approaches fit together?
- How does the framework apply to integrated groups?
- Should the approach to determining group capital requirements vary according to consolidation techniques adopted (accounting consolidation, deduction and aggregation)?

3.24 The Financial Conglomerates Directive is seeking to address the current gap in EU legislation on consolidated supervision to capture groups consisting of different sectors of the financial industry. Further work will determine how the ICAS framework should apply to such cross-sector groups keeping in mind these international developments. Similarly, further work is required to develop our approach to consolidated groups (integrated and non-integrated) within our new risk assessment methodology.

4 Internal capital assessment

- 4.1 This chapter explains the ICA in more detail, highlighting how it would apply to firms in the different sectors.

Introduction

- 4.2 The ICA is a risk-focussed process designed to address business and systems and controls risks not adequately captured in the minimum capital requirements. In doing so, it provides a framework within which to determine the level of capital a firm needs to meet the adequacy of financial resources rule within PRAG 4. The main process for achieving this would be through self-certification by the firm, using one of two methods:
- i) the firm's own internally-generated assessment of its capital needs based on rules and guidance included in the PSB; or
 - ii) if certain pre-conditions are met, the firm may use an estimate of its capital requirement as determined by its own economic capital model, supplementing it with capital add-ons where the model does not adequately cover the risks identified within this framework.

Scope of application

- 4.3 The ICA would apply to deposit-takers, insurers and investment firms with permission to deal as principal (PRU categories 1, 2 and 3, see paragraphs 2.11 and 2.12).
- 4.4 There would be no specific requirement for an ICA by client asset holders, advisers or arrangers (PRU categories 4 & 5), nor any other prudentially regulated firm (e.g. credit unions and mortgage lenders). However, these firms would still be subject to the minimum capital requirements as set out in the

PSB (PRCA 1.4.1R), or the relevant specialist sourcebooks, and to a Supplementary Capital Assessment where required (see Chapter 5).

Designing the ICA

- 4.5 In designing the ICA, we propose to take as our starting point the relevant minimum capital requirements, anticipating where possible the outcome of the current international discussions on Basel and EU directives. We will then assess the extent to which the basic framework captures all of the relevant business and system and control risks, i.e. we will assess the degree of ‘model fit’ in the base capital framework. Where the base framework does not capture a risk at all, or where it fails to capture a risk adequately, we would seek to include an additional capital requirement within the ICA. This cannot be a mechanical process and will require a significant degree of judgement.
- 4.6 The degree to which the relevant minimum standards can be said to be truly risk-based varies considerably, and we will need to take this into account in developing the ICA. In practice, this is likely to mean adopting a slightly different approach for insurers – where the relevant EU directive requirements are not specifically risk-based.
- 4.7 In practice, we would expect the differing starting points to result in parallel approaches:
- for deposit-takers and investment firms, the international minimum 8 percent capital ratio will form the basis. Numerical percentage add-ons (to the 8 percent) will be generated within the ICA to reflect business risks not specifically covered within the base model (i.e. lack of model fit), and systems and control weaknesses. These add-ons may be generated by qualitative measures or quantitative measures (e.g. using stress tests); and
 - for insurers, as part of the wider range of initiatives to develop a comprehensive regime for insurers (see the table in paragraph 2.22), we are seeking to develop an enhanced ‘Pillar 1’ capital requirement. The ICAS framework for insurers may then build on this new base requirement using a range of stress and scenario tests (discussed in more detail in paragraphs 4.40 to 4.46 below).
- 4.8 We recognise that the industry would prefer that any new framework should not be purely additive, but that some offset should be allowed where the base model generates an overly penal capital charge relative to the underlying risk. While we cannot, at this stage, commit to providing for such an approach, we will give this full consideration as we take the detailed development forward. Of course, we would not allow a capital level to be set below the minimum permitted by either our own minimum standards (as proposed in CP97) or by international standards.

- 4.9 Within this CP we are generally seeking feedback on the ICAS framework itself and not on the detail within each risk-specific module. As the ICAS framework will include elements that are derived from EU directives, we cannot, until those directives are further advanced, finalise the detail or calibrate the framework. As such, we have not included, in this CP, enough detail for a firm to work out the effect of the implementation of this proposed framework on its capital requirement. We have included below, so far as is possible, an outline of what we expect to be included within each module of the framework to help you understand how the ICAS framework might work.

Risk-based approach

- 4.10 Once fully developed, the ICA guidance should enable firms to generate capital add-ons that capture business and system and control risks not adequately reflected within the minimum requirements. We propose to align this material to the relevant risk modules within the PSB as explained below. For each module, we will aim to cover two main areas: to address risks not adequately captured in the minimum capital requirements (model fit); and to capture additional supervisory responsibilities arising under Pillar 2 of the new Basel Accord (or the EU equivalent) e.g. procyclicality (see paragraph 4.24)

High level systems and controls

- 4.11 The aim of this module is to set out guidance within which firms could self-assess the amount of capital add-on that is required for any identified weaknesses in systems and controls. It would not propose rules and guidance on the adequacy of systems and controls as these are set in Chapter 3 of *Principles for Businesses* (PRIN) and *Senior Management Arrangements, Systems and Controls* (SYSC) parts of the *FSA Handbook* and in other sections of the PSB.
- 4.12 The adequacy of systems and controls is fundamental to the reliance that firms can place on their assessment of capital requirements. We have, therefore, sought to include those factors that increase the risk of a firm's prudential failure in this module. We acknowledge that adequate systems and controls vary with the scale, nature and complexity of the activities carried on by firms and therefore we do not propose prescriptive rules or guidance within this module.
- 4.13 We also acknowledge that capital is not the only (or in some cases the best) mitigant against prudential risk from systems and controls weaknesses. But it does have a role to play both directly (through mitigating risk) and indirectly

(by providing appropriate incentives to firms to put in place strong risk management systems).

4.14 Our aim is to provide a series of objective questions and tests that a firm would have to consider in order to assess its capital requirement. In developing this framework, we will seek to align these tests with our new risk assessment framework. This will help to ensure transparency between the ICA and our risk assessment process. So, for example, where our risk assessment had identified control weaknesses, we would expect these to be reflected in a firm's ICA. The firm would be required to self-certify that:

- it has followed our guidance when conducting these tests or specify where it has taken its own view;
- senior management has approved its results; and
- it has considered all internal and external information on its business and control environment.

The questions and tests would cover:

- group structure;
- risk management;
- policies, procedures and controls;
- management information;
- information technology;
- compliance;
- internal audit;
- outsourcing/third party providers;
- business continuity;
- corporate governance;
- allocation and definition of management responsibilities; and
- human resources.

4.15 For each of these categories we propose to develop guidance that firms would consider in their self-assessment. We acknowledge that this would not be applicable to all firms but firms should consider the guidance as examples of weaknesses for each criterion. Illustrations of such examples are in Annex D.

4.16 In our final guidance, we plan to include a range of capital add-ons for each criterion and guidance for firms as to what capital add-on should be applied.

- 4.17 We propose to set an upper limit to the possible add-on. This is for two reasons:
- there are diminishing returns in risk mitigation from a capital requirement above a certain level; and
 - at a certain level of systems and controls weakness, we would determine that the firm is no longer satisfying the rule SYSC 3.1.1R to have appropriate systems and controls.
- 4.18 To promote consistency of application, this guidance will be designed to reduce the degree of subjective judgement needed by firms, although, as noted above, it is not our intention that this should be reduced to a purely mechanical process. We will seek to verify/corroborate a firm's scoring as part of our regular risk-based supervisory approach including through the use of evidence obtained as part of our risk-assessment program or from external audit reports.
- Q8: Is it clear how we would expect firms to self-assess the amount of capital they should include within their ICA for systems and controls?
- Q9: Does this framework provide enough incentives to ensure that the ICA will be carried out properly? What other incentives might be used?
- Q10: Does this framework propose an appropriate balance in the level of prescription and transparency?

Capital

- 4.19 Most of this framework deals with the amount of capital held. However, in the past, where we have set individual capital requirements, we have considered both the quality of the firm's underlying capital and its access to future capital. We believe that these factors are important when measuring the overall adequacy of capital as a mitigant against prudential failure.
- 4.20 Therefore, this module would contain criteria against which firms would measure the quality of their capital. The factors that would be covered are likely to include:
- the extent to which a firm can demonstrate that it has access to capital from outside the group;
 - the extent to which a firm can demonstrate that it has access to capital from parent/associated undertakings;

- whether a firm has experienced persistent shortfalls in its internal or regulatory capital limits in the past; and
- whether the firm has experienced repeated downgrading by credit agencies.

Credit Risk

- 4.21 As mentioned in Chapter 7 of CP97 ‘Credit Risk (PRCR)’, the developments arising from the Basel Committee and EU reviews will have a significant impact on the content of the base model in the various chapters of the credit risk chapter in the PSB. In addition, we propose that the most appropriate method of implementing certain elements of the new EU directive requirements on Supervisory Review would be through the framework proposed within this paper. These credit risk elements of the new Basel Accord and associated EU directives would apply to firms in PRU categories 1 and 3 and not to insurance firms (see paragraph 4.27).
- 4.22 The specific credit risk elements that we anticipate that we may be required by the new Basel Accord or the new EU Capital Adequacy Directive to cover are:
- concentration of exposures risk (or granularity, explained below in 4.23); and
 - procyclicality (explained below in 4.24).

Concentration of exposures risk (or granularity)

- 4.23 The current draft PSB addresses concentration risk in its simplest form – the risk of loss to the firm on the failure of a single exposure. The concept of granularity is the risk that arises where such single counterparty exposures are inter-related. For example, credit exposures to counterparties that are active in the same geographical or business sector, where macroeconomic factors affecting that region or sector could have an impact on all counterparties in that sector.

Procyclicality

- 4.24 One of the criticisms made in response to the Basel Committee’s earlier proposals to revise its Accord was that, particularly under the more sensitive internal ratings-based approach, the resulting capital requirements would be excessively procyclical. In the event of an economic downturn, capital charges would increase to reflect the decline in credit ratings at a time when revenue is likely to be reducing and when additional capital funding would be harder to raise. This effect, which has been termed ‘procyclicality’, does not exist under the current Basel Accord (other than any cyclical effects on bad debt

provisioning) as the risk weightings applied are not sensitive to changes in credit ratings.

- 4.25 The prudential impact of this effect is that, in good economic conditions, firms should ensure that they hold enough capital in anticipation of such uncertainties.
- 4.26 Any requirements designed to address procyclicality will be derived mainly from EU directives and the new Basel Accord. At present there are several options that may be considered to minimise the effect of procyclicality. These include:
- a requirement for firms to take a more long-term assessment of a counterparty's probability of default; or
 - a requirement for firms to stress-test their capital adequacy models to ensure that they have adequate capital to fulfil the requirements of the PSB even after a downgrading of their loan portfolios. The firm would usually hold capital to the full amount of potential capital needs identified by this test.

Credit risk in insurance firms

- 4.27 The existing base capital requirements for insurance firms are split between credit risk arising from underwriting activities and the credit risk arising from investment activity. It is proposed that the former should follow the method proposed for insurance risk (see paragraph 4.40); and the latter will be dealt with by some form of stress or resilience test to reflect the resulting risk to firms' financial positions.

Market Risk

- 4.28 While international developments from the Basel Committee and EU reviews will have a more limited impact on the market risk module, we do expect, for deposit-takers and principal position takers, the Supervisory Review to give rise to some new requirements in this area. In particular, the Basel Committee has recognised that interest rate risk within the banking book is a potentially significant risk that would be mitigated by holding an appropriate amount of capital.
- 4.29 A sudden and unanticipated movement in interest rates can have an impact on a firm's capital resources. The extent of this potential impact demonstrates the relative effectiveness of a firm's policy on managing its interest rate exposure on its long-term assets and/or liabilities (including the banking book). We recognise the role of a firm's own internal systems and controls in managing this risk. There is a strong argument for firms to hold capital to mitigate

interest rate risk. The second consultation paper issued by the Basel Committee proposed that a firm should be required to:

- implement systems and controls so that it could undertake regular monitoring of its exposure to market shifts through internal stress tests, using a methodology consistent with the process it is using for determining the capital required to be held against market and credit risk in its trading book;
- include within its stress tests the scenario of a movement in interest rates of 200 basis points or its equivalent; and
- where the firm's economic value falls by more than 20% of the sum of the firm's Tier 1 and Tier 2 capital as a result of this test, include this excess as a Pillar 2 capital requirement.

Market risk in insurance firms

- 4.30 We propose that insurance firms would also probably be subject to a stress and scenario test in determining their capital requirement for market risk (in line with the existing equity resilience tests). The resilience test concept has been used for many years in the life sector and requires the firm to calculate the impact on both assets and liabilities caused by specific equity, market or interest rate movements.
- 4.31 Such tests allow firms with good asset liability matching or risk management procedures to take credit for such matching when calculating their required capital. The current resilience test for insurers is denoted as a liability rather than a capital requirement. However, under the proposed framework, unless specifically prohibited by EU directives, we propose that this would be a capital rather than a liability item.

Operational risk

- 4.32 We recognise that, in designing the operational risk module of the ICAS framework, we will need to be alert to the potential overlap between the requirement for appropriate systems and controls outlined in SYSC 3.1.1R and PRAG 6.3, and the more specific operational risk requirements set out in PROR . There is also an overlap between the operational risk requirements within the new Basel Accord and EU directive and the systems and controls and operational risk modules. For insurance firms, there is also a limited overlap with the Solvency I operational risk charge for unit-linked funds. We have sought to minimise these overlaps, but will need to keep this under review as the Basel and EU requirements are finalised.

4.33 For the purpose of designing capital requirements, the Basel Committee has defined operational risk as ‘the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’. As a result, firms subject to the Basel Accord and parallel EU directives will be subject to a ‘Pillar 1’ operational risk charge that would be included within the minimum capital requirement to be contained within the PSB. The ICAS framework proposed within this CP would seek to address the elements of operational risk that are not adequately addressed within the minimum Pillar 1 charge and the elements of operational risk that insurance firms should assess within their ICA. These include:

- residual risk;
- strategy risk; and
- legal and litigation risks.

Residual risk (including documentary risk)

4.34 In all situations where a firm seeks risk mitigation, there is still a risk that the actual effect of the mitigation will be diminished. For example, ineffective collateral arrangements, delays on payments under guarantee arrangements, and failure of legal documentation supporting new structured products, may all detract from a firm’s efforts to mitigate its risks. Firms can, therefore, never be entirely certain that they will not be left with some residual exposure. We believe that this residual risk needs to be taken into account as part of the capital assessment process.

Litigation and legal risks

4.35 The failure of a firm to hold sufficient capital to mitigate legal risk arising from its normal business operations may also lead to prudential failure.

Strategic risk

4.36 The failure of a firm to have a fully worked up and agreed business strategy, or the failure to follow that strategy, gives rise to significant prudential risk. While additional capital is not of itself a long-term substitute for implementing a sound business strategy, an additional cushion of capital does mitigate the risk in the shorter term, for example, where a firm is seeking to develop and/or implement a new strategy.

Insurance risk

- 4.37 For many classes of insurance, there is considerable uncertainty regarding the incidence and severity of claims and even the eventual cost of settling claims that have been reported. In many cases there is further uncertainty arising from assets and liabilities not being closely matched. Reliance on reinsurance can also produce potential risk related to the failure of the counterparty. The nature of insurance business, particularly long-tail insurance business, means that it can be many years before the full financial impact of business written is known. Therefore the 'reserving' for expected losses and the capital buffer for unexpected losses are important when considering prudential risks in insurance firms. This capital buffer acts as a solvency margin.
- 4.38 The EU has decided to revisit the existing solvency margin rules for insurance companies. This process is being pursued in two parts. Under the first part, known as 'Solvency I', two directives were passed in February 2002 that will change slightly the solvency margin regime for life and non-life insurance firms. The second part, known as 'Solvency II', is likely to lead to enhanced risk-based capital requirements for insurance firms and to underlying regulatory valuation principles. In the longer term, the IASB's international accounting standard (for the valuation of assets and liabilities) will also have an impact, for companies accounts purposes, on the capital adequacy regime for insurers. It will draw out more clearly how much capital is genuine on a realistic basis and how much is a 'buffer' within asset or liability valuations.
- 4.39 It is too early to indicate the content and timing of new EU legislation. As a result of the Baird report¹ and the Tiner review,² we have also committed to reviewing the minimum capital requirement for firms ahead of the implementation of the EU Solvency II review (see the table in paragraph 2.22).
- 4.40 Therefore, within this module, we propose the use of an enhanced framework for firms to determine how much capital they will need to satisfy the requirement to hold adequate financial resources. We propose three elements to this framework:
- an enhanced Pillar 1;
 - stress and scenarios tests (see paragraph 4.45); and
 - capital add-ons to reflect operational risk and systems and controls weaknesses.

1 *'The Regulation of Equitable Life – an independent report'*, prepared by Ronnie Baird, Director, Quality Assurance and Internal Audit, FSA, assisted by Norton Rose and PricewaterhouseCoopers, published on 16 October 2001 and available on www.hm-treasury.gov.uk.

2 *'The future regulation of insurers- Report submitted by the Board of the Financial Services Authority to the Economic Secretary of the Treasury'* (November 2001).

- 4.41 We will consult separately on the implementation of any new EU directives at a later date but would hope to implement this framework in 2004.
- 4.42 Many failures in the insurance industry have been attributed to operational risk. Therefore, in line with the other firms that would be affected by the ICAS framework, we propose that, as part of the ICA, insurance firms should assess their exposure to operational and to systems and controls risk as explained earlier in this chapter.
- 4.43 There are several possibilities for the assessment of financial resources by insurance firms. The alternatives include a formula-based approach and a stress and scenario-based approach, or a combination of both.
- 4.44 The formula-based approach would be akin to an updated or expanded version of the current EU requirement. We intend to introduce an enhanced 'Pillar 1' requirement for insurance firms on this basis. However, for the ICA, stress and scenario testing is the best way to encourage firms to identify, manage and capture the risks that are specific to their balance sheet and that are not captured within the minimum capital requirement.
- 4.45 This stress and scenario approach is consistent with the requirements of the other parts of the PSB. We would require firms to include the assumptions made and the results of these stress tests within their regulatory reporting, together with an explanation of how much capital they have selected to hold as a result of these tests.
- 4.46 We are at present reviewing the options regarding the stress and scenario testing. In particular, we are considering the costs and benefits of the level of prescriptiveness in the scenarios. The options are:
- i) To allow firms to set their own stress and scenario tests. This may be too subjective and difficult to supervise and would lead to a wide variation between firms as to the nature of the tests and the extent to which the tests are applied.
 - ii) To develop broad minimum criteria which firms must use for stress and scenario tests. This would be similar to the approach used by two or three regulators internationally, in particular the DCAT system in Canada, the new risk-based approach in Australia and the catastrophe scenarios used by Lloyd's of London. In the UK life sector, this approach is already used to assess market risk by the use of specific prescribed scenarios or levels of stress for market movements. This approach has the advantage of allowing greater comparison between firms and a more efficient approach to supervision, as well as setting a minimum level for compliance by firms. The disadvantage of this approach is that it would not be able to cover all the specific risks within a firm and might discourage firms from adopting a truly risk-based approach to financial resources management.

iii) To move to a full internal model approach, building on the use of stochastic models.³ Use of stochastic models is at an early stage of development so this option is unlikely to be practicable for any but the most sophisticated firms. However, if the IASB's proposals for the valuation of insurance contracts develop along the lines currently proposed, the firms that would most benefit from the use of such models (e.g. firms where there is optionality in insurance contracts) will need to do some form of stochastic modelling for financial statements purposes. Consequently, use of such models for regulatory purposes would need to be revisited as accounting developments progress.

Q11: Is it clear how this framework is intended for work for insurance firms?

Q12: Have we captured all the appropriate risks within the proposed ICAS framework? If not, what other risks should be included?

Economic capital models

- 4.47 Where a firm has a suitably adapted and accurate economic capital model, this should be a more appropriate mechanism for a firm to manage and mitigate certain elements of prudential risk than generic rules and guidance would allow. Therefore, we propose that where an economic capital model is being used by a firm and is based upon the rules and guidelines to be proposed within this framework and other relevant PSB rules, its output may be used as a substitute for determining capital in certain aspects of this guidance.
- 4.48 Economic capital is a firm's own assessment of the aggregate amount of capital that is required as a buffer for its unexpected losses due to its credit, market and operational risks. Economic capital is calculated by identifying and measuring all risks as precisely as possible on an individual exposure and then on an aggregated basis. Since the value of the capital required is a variable that is determined by, amongst other factors, the level of confidence (the probability of an outcome within a certain volatility), a firm using an economic capital model should be mindful of the external credit rating to which it aspires to as part of its strategy.
- 4.49 Some firms have been using such a model as a measure for determining the relative and risk-weighted returns on investments or business divisions. It has, therefore, been used as a management information tool in assessing the most efficient allocation of capital across a firm but it is not generally being used to

³ Models, based on probabilities, that predict how key financial parameters interact with each other over time and generate a distribution of outcomes based on simulations of those parameters in the future.

determine how much capital a firm should hold overall for either business or regulatory purposes. We would therefore expect that initially very few firms would adopt this approach.

- 4.50 The effective maintenance and monitoring of an economic capital model should enhance the operational management of the firm since the senior management would be able to map where their capital requirements were being adversely affected by business risks.
- 4.51 Firms wishing to use their own internal assessment of economic capital to derive all, or part, of their ICA would need to meet certain qualification or 'entry' criteria. These entry criteria may be, in part, based on existing standards for use of such models e.g. VaR. Other criteria that might be considered are:
- the extent of use of the economic capital model within the firm's capital management policy;
 - whether and what sort of quantitative and qualitative data should be used within the model;
 - the nature of any training or staff requirements;
 - the confidence levels that should be set and whether these should be linked to a firm's corporate strategy;
 - the time horizons that should be set for the different types of business that the firm could do; and
 - the extent of any historic data used and the extent to which the firms had carried out back testing of the model.
- 4.52 Firms wishing to use their economic capital model would be required to self-certify to us that all of the relevant criteria had been met.
- 4.53 We recognise that firms would not necessarily consider all the risks that we propose in the ICA within their own economic capital model; this should not, of itself, rule out the use of internal models. To maintain the integrity of the model, the firm would be allowed to use the output. However it would be required to supplement the model with its assessment, based on the guidance given within this framework, of the additional capital required for each risk, or a specific subsection of a risk (e.g. procyclicality or litigation risk), not covered by their model.

Q13: Is it appropriate to allow firms to use their economic capital models?

Q14: What criteria, both quantitative and qualitative, would be appropriate in determining whether to allow the use of an economic capital model?

5 Supplementary capital assessment

Introduction

- 5.1 The Supplementary Capital Assessment (SCA) would be a supervisory tool designed to address specific concerns concerning a firm's systems and controls or business risks which have not been adequately addressed, where applicable, by the ICA.
- 5.2 This remedial or preventative tool would form part of the regulatory toolkit and would be available for supervisors to use for all prudentially regulated firms. A supervisory judgement to use the tool would be taken within the wider risk-based framework in the usual way. There would be no presumption that any given category or type of firm would be subject to an SCA, or that additional capital would always be the most efficient tool to address the concerns. Indeed we would consider it a failure of the ICAS framework if an SCA were set for the majority of firms within the scope of the ICA.

Scope of application

- 5.3 Whereas the ICA would apply only to PRU category 1, 2 and 3 firms, the SCA would be available for us to apply to all prudentially-regulated firms. We propose that the SCA may be used by us as a tool to increase capital requirements where we determine that a firm has systems and controls weaknesses and where the risk arising from these weaknesses can sensibly be mitigated by an increase in capital held. For firms in PRU categories 1, 2 and 3, the SCA may also be used to address deficiencies identified in an ICA as a result of unusual business risks not properly covered by the guidance. However in this latter case, it is expected that the firm would identify that risk itself and incorporate it within its ICA.

- 5.4 An SCA could therefore be applied as an addition to the total capital resources requirement where issues of concern are widespread and have an impact across the business or where concerns are specific to an area of business, or as a requirement against a specific risk. For life insurance companies, the SCA may be applied directly to the capital requirement but it may be preferable to reflect the uncertainty arising from the risk through an adjustment to the technical reserves. For PRU categories 4 and 5, the SCA would be applied to the total capital resources requirement.
- 5.5 The SCA might, in exceptional circumstances, form a continuing requirement in addition to the ICA. But it is more likely to be a short-term measure until the firm has addressed the systems and controls issues that required the setting of an SCA.
- 5.6 The SCA could act as a continuing requirement for PRU category 1, 2 or 3 firms using an internal economic capital model as part of their ICA and where we determine that there is an increased control risk associated with a firm's ability to manage its internal model appropriately.
- 5.7 If a firm has significant difficulty in setting an appropriate ICA, this, in itself, suggests an increased likelihood of operational or systems and controls risk within the firm and may therefore necessitate the setting of an SCA.
- 5.8 For PRU category 4 firms (client asset holders), we might use the SCA as a short-term measure where we have reason to doubt the strength of the segregation controls. The requirement would apply until the segregation controls were corrected.
- 5.9 For PRU category 5 and other firms we might use the SCA either as a continuing requirement or a short term measure depending on the nature of concerns, for example as a short-term measure where we have concerns about the control environment surrounding the management of decentralised operations.

Basis for setting a Supplementary Capital Assessment

- 5.10 An SCA would be set on the basis of evidence we have obtained of risks that a firm has not adequately addressed within its setting of an ICA for firms in PRU categories 1, 2 or 3, or within the minimum capital requirement for other firms. Annex E provides more examples of business and systems and controls risks that may give rise to an SCA.

Guidance on setting a Supplementary Capital Assessment

- 5.11 We will include further detail on the setting of an SCA in the PSB and our Supervision Manual. However, consistency in the context of the SCA cannot mean a mechanical process that automatically generates a given value of SCA. The appropriate supervisory response to risks identified would depend on, amongst other factors, a firm's specific business profile, organisational structure, size, whether it is a member of a group, and how that group is organised.
- 5.12 It is important that this element of the ICAS framework is applied in a fair and justifiable way and that decisions are made on a timely basis and backed-up by valid reasoning. Key factors we would consider when setting, revising or removing an SCA are that:
- the SCA may be related to the cost of correcting the internal control weakness or the issue of concern;
 - the reasons for the application of an SCA would be communicated to the firm;
 - there would be an upper limit to the SCA, above which capital would no longer be considered an appropriate tool to address serious concerns. Supervisory judgement would be required to determine the point at which an SCA becomes ineffective and other tools (including limitation of activity, own initiative variation of permission etc) are necessary;
 - the SCA would be removed when a firm can satisfy us that the weaknesses identified have been addressed; and
 - the effectiveness of the SCA tool would be kept under review and we expect our internal guidance for quantifying SCAs to develop over time.

Q15: Is it clear how and why we would set an SCA?

Q16: Has the interaction between the ICA and the SCA been made clear?

Q17: What other factors should be considered when deciding whether to set an SCA, or the appropriate level of SCA to set?

6 Compatibility with our objectives and general duties under the Act

Introduction and statement of purpose

- 6.1 This chapter explains why we believe that the proposed framework in this CP is compatible with our general duties under section 2 of the Act. The requirement for this Compatibility Statement is set out in section 155 (2) (c) of the Act. In presenting the proposals set out in this CP, we are satisfied that they are compatible with the general duties conferred upon us.
- 6.2 We explain the purpose of the ICAS framework within Chapter 2 of this CP. Further detail of the options considered in the development of the framework and the rationale for the option chosen are given in the CBA in Annex B.

Compatibility with the statutory objectives

- 6.3 This CP is aimed principally at meeting our market confidence and consumer protection objectives. However the other two statutory objectives are also relevant.
- 6.4 **Market Confidence.** This objective requires us, when setting new rules and requirements, to consider whether market confidence will be maintained in the financial system as a whole.
- 6.5 One of the key objectives of the ICAS framework is to reduce the probability of market disruption caused by the prudential failure of a single firm or a group of firms. It aims to achieve this in two ways:
- by seeking to ensure that the amount of capital held by a business is commensurate with the risk associated with the business profile and systems and control environment within that firm; and
 - by providing appropriate incentives for senior management to develop strong risk management controls.

- 6.6 In developing the framework, we have sought to ensure that individual capital standards are set appropriately for those firms where prudential failure (either singly or collectively) is most likely to have an adverse impact on market confidence – i.e. for deposit-takers, insurers and principal position takers. We do not propose to set bespoke capital standards routinely for investment firms that hold client assets, advise or arrange, or for any other prudentially-regulated firms.
- 6.7 In line with the development of the PSB, we aim to give both firms and consumers a clear understanding of what we can and cannot achieve. We acknowledge that it is impossible and, in any case, undesirable to seek to develop rules and guidance that would prevent the prudential failure of all firms. The ICAS framework does not therefore aim to generate a zero failure regime; rather it seeks to ensure that firms identify an adequate level of capital to hold that is proportional to the business and systems and controls risks within that firm.
- 6.8 *The protection of customers.* In assessing the appropriate degree of consumer protection, we are required to consider four specific matters:
- the differing degrees of risk involved in different kinds of investment or other transactions;
 - the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;
 - the needs that consumers may have for advice and accurate information; and
 - the general principle that consumers should take responsibility for their own decisions.

The framework in this CP is relevant primarily to the first two of these.

- 6.9 As with market confidence, the ICAS framework aims to protect consumers by seeking to ensure that the amount of capital held by a business is commensurate with the risk associated with the business profile and systems and control environment within that firm; and by providing appropriate incentives for senior management to develop strong risk management controls.
- 6.10 Similarly, when developing the scope of application of the framework we have sought to ensure that the ICAS yields bespoke capital standards for those firms where prudential failure is most likely to result in direct losses to consumers, and where capital is an appropriate tool to mitigate that risk. This is discussed in detail in paragraphs 24-29 of Annex B.
- 6.11 *Public awareness.* The rules and guidance proposed within this paper are not specifically aimed at promoting public awareness. However, we believe that a single framework, within which capital levels are determined on an individual

firm basis for a range of firms on a transparent basis, should promote greater understanding within the financial services industry and by the public.

- 6.12 ***The reduction of financial crime.*** The ICAS framework does not seek to address financial crime directly; this risk is addressed more specifically in the *Money Laundering Sourcebook*. However, the ICA will require firms to make an assessment of the overall strength of their systems and controls – including aspects that may be important in the reduction of financial crime, for example, segregation of duties.

Compatibility with the need to have regard to the principles of good regulation

- 6.13 Under section 2 (3) of the Act, we must have regard, in carrying out our general functions, to the specific matters set out below.

The need to use our resources in the most efficient and economic way

- 6.14 The ICAS framework has been designed to be firmly embedded within our new risk-based approach to regulation. As such, the resources devoted to the monitoring and/or verification of firms' application of the ICA will be in line with the overall resourcing model. The practical implications of this are discussed in paragraph 3.12.

The responsibilities of those who manage the affairs of authorised persons

- 6.15 The ICAS framework – and in particular the ICA – is designed to promote the concept that senior management should take responsibility for assessing the appropriate level of regulatory capital to hold. We have proposed two possible options for achieving this:
- through a firm's own internally-generated assessment of its capital needs in line with the guidance to be included in the PSB; or
 - if certain pre-conditions are met, a firm may use its own economic capital model.
- 6.16 Although we are yet to consult on our proposed rules and guidance for this framework, we will aim to avoid detailed, prescriptive requirements to the extent that doing so is consistent with both the need to clarify how firms should assess 'adequate financial resources' and our obligation to implement EU directives.
- 6.17 We believe that the self-assessment process under the ICA, together with the supervisory tool provided under the SCA, should provide appropriate

incentives for the senior management of firms to identify and manage their business and systems and controls risks.

The principle that a burden or a restriction should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction

- 6.18 We have included a CBA as Annex B to this paper. This sets out the options considered and decisions made in the development of the proposed framework. We believe that the attached CBA demonstrates that the costs arising from the implementation of this framework would be proportionate to the benefits.
- 6.19 Respondents to this CP are invited to identify any areas where they think that we have not identified significant new and additional costs and to provide quantitative information to enable us to carry out further analysis. We will include a more specific CBA in future consultations when we propose draft Handbook text.

Q18: Do you consider the analysis in Annex B to be a fair estimate of the benefits and incremental costs of the framework? If not, please provide specific alternatives.

The desirability of facilitating innovation in connection with regulated activities

- 6.20 We recognise that the proposed framework will have an impact on a wide range of firms. In designing the ICAS we have therefore sought to avoid an overly prescriptive approach. As such, the single framework aims to retain sufficient flexibility to avoid the pitfalls arising from a “one size fits all” approach. It aims to promote the development of strong risk management techniques; and, in particular, the inclusion in the ICA of the possibility of using economic capital models is designed to facilitate innovation in those firms with more sophisticated approaches to allocating capital.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

- 6.21 The proposed framework anticipates the expected outcomes of international developments. In particular, in the case of deposit-takers and investment firms, the ICAS would be the vehicle for implementing the capital adequacy element of the Supervisory Review (or ‘Pillar 2’) of the new Basel Accord and parallel EU directive. We do not believe that for these firms the framework proposed will be superequivalent to the anticipated international requirements in this area. We do not expect these proposals to have an adverse impact on the UK’s competitive position in these sectors.

- 6.22 In the case of insurance companies, uncertainty about the timing and outcome of international discussions means that it is possible that implementation of this framework and an interim insurance prudential regime could result in the UK being superequivalent to the EU minimum requirements. While it is possible that in setting prudential standards above the international minimum in this way firms might choose to relocate or undertake business abroad, the current EU minimum requirements are widely regarded (both internationally and in the domestic market) as being imprudently low, and this has historically been addressed in different ways by different regulators. It is difficult, at this time, to assess precisely what the impact on the UK competitive position will be.

The need to minimise the adverse effects on competition that may arise from anything done in the discharge of the FSA's functions

- 6.23 The limitations of the proposed approach have arisen where we have had to differentiate between the guidance set for insurance and other firms. This is a result of different international minimum standards and a different basis of financial resources. We have aimed to minimise adverse effects on competition between firms by aligning the framework with firms' permitted activities through the PRU categories of firm. We have also sought to align the underlying approach to mitigating each risk.
- 6.24 This framework will not operate at an individual product level. As such, it does not seek to address any underlying differences which exist in the base or 'Pillar 1' treatment of individual products. This might lead to some unequal prudential treatment of such risks between firms. We are currently undertaking other projects investigating the impact of this.

The desirability of facilitating competition between those who are subject to any form of regulation by us

- 6.25 In the past, the setting of bespoke capital requirements above the minimum has been dealt with in different ways in the various financial industry sectors. By developing a single framework within which bespoke capital standards can be determined in a flexible and transparent way, we will seek to contribute to a levelling of playing fields across sectors such that, so far as possible and appropriate, similar risks attract equivalent capital treatment.
- 6.26 Since the framework will generate capital requirements which are tailored to the risk profile of a firm (i.e. the higher the risk profile of a firm and/or the poorer its systems and controls, the more capital it will be required to hold), and is sufficiently flexible to accommodate a wide range of firm types and levels of sophistication, it should not penalise any one sector, type, or size of firm. It should also be able to accommodate market developments.

The most appropriate way for us to meet our regulatory objectives

- 6.27 We are required to set out clearly why we think our standards are not just one appropriate way to meet our obligations, but are the most appropriate way.
- 6.28 We have considered alternative approaches to meeting our objective of reducing the probability that consumers suffer loss, or markets are disrupted, as a result of prudential failure, while still having regard to the principles of good regulation. The options that were considered as part of the development of this proposed framework are fully explained within Annex B. This explains in detail how well each of these identified options complies with our statutory objectives and therefore why the framework proposed was chosen.
- 6.29 In summary, the framework proposed is the most appropriate mechanism by which to achieve our objectives because:
- it emphasises the need for a firm's senior management to assess, monitor and mitigate the risks within the firm and to determine the adequate level of capital the firm should hold as a result. The firm's senior management are in the best position to gauge the risks facing their firm and to quantify the effect of those risks on its financial resources;
 - the development of a single harmonised approach should level the playing fields across sectors (as compared with the current differentiated approaches);
 - the framework increases the transparency to each firm of the link between regulatory capital limits and the business and systems and controls risks within a firm, thereby giving firms an incentive to improve their risk management procedures;
 - it generates bespoke capital standards that are tailored to the specific business risk profile and systems and controls environment within each firm;
 - it is flexible enough to apply to a wide range of firm types, sizes and levels of sophistication;
 - it promotes innovation in the area of risk management, for example by allowing firms to make use of their internal economic capital models;
 - it allows us to concentrate our resources on assessing firms' risk management procedures and, through the analysis of stress tests, to take a more forward looking approach to risk assessment; and
 - the SCA allows for capital to be used as a regulatory tool, for example where the ICA does not appear to address adequately all of the business or systems and controls risks that we identify. In particular, the SCA may

be used (on a wide range of firms) to give firms an incentive to address systems and controls weaknesses and so reduce the prudential risk within a firm.

6.30 We believe that this is the most cost-effective approach because:

- it will reduce the cost of maintaining different prudential standards for different sectors, for both firms and for us, thereby saving on the maintenance of separate sourcebooks in the future;
- where possible, the framework builds on firms' internal approaches to identifying and managing risk, thereby bringing regulatory capital requirements more closely into line with how prudent firms run their businesses;
- the framework is aligned with our new risk-based approach to regulation. This should ensure a more efficient allocation of resources to the monitoring of capital adequacy standards. In particular the onus will be on senior management to conduct and support their own capital assessment. We will monitor compliance with the ICAS using the information gathered under our risk assessment framework and through baseline monitoring. This will release resources to enable us to target the risks to our objectives arising from individual firms or from market developments more effectively;
- the framework builds on existing minimum standards and has been designed in anticipation of further developments in international standards. The implementation costs of future additional rule changes to firms has therefore been minimised; and
- it develops the stress testing requirements included within the draft PSB and is based on procedures that we believe management should undertake as a matter of course in the running of their firms.

List of questions in this Consultation paper

Chapter 2. Introduction

- Q1: Is the scope of application of the proposed framework clear?
- Q2: Have the interactions between this proposed framework and international standards been made clear?
- Q3: Is the above timetable sensible given the uncertain timing of the various international initiatives?

Chapter 3. Overview

- Q4: Is it appropriate to align risks covered within this chapter to the risks identified in CP97?
- Q5: Is it appropriate that the ICA be a self-assessment by the firm?
- Q6: Is the inclusion of the SCA as a supervisory tool sensible?
- Q7: Have the legal obligations of firms under this framework been made clear?

Chapter 4. Internal Capital Assessment

- Q8: Is it clear how we would expect firms to self-assess the amount of capital they should include within their ICA for systems and controls?

- Q9: Does this framework provide enough incentives to ensure that the ICA will be carried out properly? What other incentives might be used?
- Q10: Does this framework propose an appropriate balance in the level of prescription and transparency?
- Q11: Is it clear how this framework is intended for work for insurance firms?
- Q12: Have we captured all the appropriate risks within the proposed ICAS framework? If not, what other risks should be included?
- Q13: Is it appropriate to allow firms to use their economic capital models?
- Q14: What criteria, both quantitative and qualitative, would be appropriate in determining whether to allow the use of an economic capital model?

Chapter 5. Supplementary Capital Assessment

- Q15: Is it clear how and why we would set an SCA?
- Q16: Has the interaction between the ICA and the SCA been made clear?
- Q17: What other factors should be considered when deciding whether to set an SCA, or the appropriate level of SCA to set?

Chapter 6. Compatibility with the FSA's objectives and general duties under the Act

- Q18: Do you consider the analysis given in Annex B to be a fair estimate of the benefits and incremental costs of the framework? If not, please provide specific alternatives.

Cost benefit analysis

Purpose

- B1 A Cost Benefit Analysis (CBA) analyses benefits and assesses, in quantitative terms where possible and in qualitative terms where not, the costs and/or benefits of a proposed policy.
- B2 CP97 included a CBA of setting minimum capital requirements across a range of categories of firms. This CBA assesses the costs and benefits of introducing a new framework for determining individual capital requirements.

Introduction

- B3 Currently, individual capital requirements are only applied routinely to deposit-taking firms. We said in CP31 and CP97 that we intended to apply variable capital standards to a wide range of firms. We are carrying this out by developing a new framework (proposed in this CP) to apply to a wide range of firms, to reflect the risk assessment methodology which we have developed as part of the new regulator work.
- B4 We are aiming for variable capital assessments that reflect better the risks which firms run and those to our objectives from prudential failure. This approach may result in some firms being required to hold more capital resources. The approach will have benefits for consumers and markets. There will be costs and benefits to firms required to carry out individual capital assessments. There will also be initial set up costs for firms and to us in implementing the new framework.
- B5 We have aimed, as far as possible, to anticipate changes to the international approach (e.g. Basel Pillar 2); minimise the adverse effects on competition in

the market; and retain the competitive position of the UK. The changes proposed in this CP aim to:

- increase consumer protection and secure market confidence;
- harmonise the regulatory treatment of firms;
- meet new international standards;
- enable greater transparency in the framework for setting regulatory capital; and
- remove either a disproportionate regulatory burden or an impediment to efficient competition.

Background

B6 Minimum standards generate adequate capital for some of the firms to which they apply. However, they cannot be relied on to do so for all of them. For example, the current regulatory capital model for deposit-takers (which implements the Basel Accord and relevant EU directives) does not fully capture the risks of these firms. To overcome this and the similar situation for investment and insurance firms, capital requirements for the different authorisations are currently set in different ways:

- banks and building societies have capital requirements set at, or above, the international standard for all members of the authorised population on an individual, risk-focussed basis. These ratios can be increased in light of significant business and control risks. Banks and building societies are currently the only firms we regulate to have individual capital standards set on such a routine basis;
- additional capital requirements for investment business firms are set on an exception basis using a Secondary Requirement. In the past, this tool has been used in a small number of cases to address unusual or exceptional systems and control issues and high levels of business risk; and
- there has been no similar mechanism for the setting of individual capital requirements within insurance companies. However, firms are expected to hold capital in excess of the minimum required by Solvency Margin Requirements. Furthermore, in practice, weaknesses in systems and controls have been more likely to result in a limit on the extent or nature of any regulated business carried out through a limitation on permission.

Basis of proposed new framework

B7 We proposed in CP97 that all firms should be required to take their own view as to the adequacy of their financial resources in order to meet the risks inherent in their business. The senior management of a firm will be able to make a better-informed judgement of the risks in their firm, and so, if necessary, of the need to hold more financial resources than the minimum. Together with the requirements in CP97 on senior management's responsibilities, the following criteria were set to help develop the individual capital standards framework:

- to be consistent with our statutory objectives and principles of good regulation, and with requirements laid down in international minimum standards and EU directives;
- to be implemented in a manner consistent with our new risk assessment framework;
- to be suitable for firms mainly subject to a regime of baseline monitoring, but allow for adjustments to the output of the methodology in the case of firms subject to a closer supervisory relationship;
- to be transparent and consistent with the Act;
- to be consistent with the cost-effective use of the resources available for supervision in the future, and capable of easy and rapid updating if required;
- to be applicable to groups as well as solo entities; and
- to be applicable to new as well as existing authorisations.

B8 The following aims were also identified:

- the framework should separate out business risk (e.g. market, credit, operational, legal risk, financial soundness, strategy, nature of customers, products and services) and control risk (systems and controls, organisation, board, management and staff) to allow flexibility in how each of these elements is addressed;
- the framework should seek ways of setting firm specific capital requirements to address business risk, if minimum capital requirements do not fully address all the risks for certain types of firm (namely, deposit-takers, insurers and principal position takers);
- the framework should recognise that the routine application of additional capital requirements is not an efficient or effective way of addressing the residual risks for client asset holders, where the risks are more appropriately addressed through other means (systems and controls, client asset rules);

- in addressing control risk, the framework should allow for additional capital requirements to be applied irrespective of firm type, but there should be no presumption that capital is the only or best tool; and
- the framework should as far as possible encourage firms' senior management to take responsibility for the identification, management and capital allocation in respect of risks.

B9 It should be noted that under any methodology adopted, firms would not be able to set capital below an acceptable minimum requirement.

Outline of proposals

B10 In developing the framework, we considered a number of options:

- 1) only applying minimum standards (driven by directives and similar standards);
- 2) a regulatory tool allowing capital requirements to be set above the minimum financial resources requirement for firms with a particularly high risk profile and/or unusual levels of operational risk, on a case by case basis;
- 3) requiring all firms to carry out stress tests to determine the adequacy of overall financial resources (PRAG 4.3.2R). We would then review the stress tests and their results and respond accordingly;
- 4) a system that would link a number of discrete capital requirement levels to the firm's ability to carry out certain kinds of business; and
- 5) individual capital requirements would be determined for all firms, following a detailed assessment of the risks being run by the firm concerned.

Option 1

B11 The PSB will contain minimum standards for capital, generally driven by directives or other international standards. But applying only these standards would be particularly unsatisfactory where the minimum standards deliver low capital requirements relative to the risks posed by some firms. Other regulatory tools would have to be used to address this, but these might not be as efficient or effective as the setting of individual capital standards. So, this option would thus fail to meet criterion 1 (consistency with statutory objectives and principles of good regulation) although all the other criteria would be met.

B12 Some firms may choose voluntarily to hold additional levels of capital above the minimum. However, this option would not have the benefit of requiring

senior management to ensure that the financial resources of the firm reflect the risks.

Option 2

- B13 Under this option, a supervisory tool would be used to set individual capital requirements above the minimum for firms with a particularly high business risk profile or unusually serious system and control weaknesses.
- B14 While this approach would probably meet most of the criteria identified above, it is less clear that it would be consistent with criterion 1 (consistency with statutory objectives and principles of good regulation). As with option 1, the key concern is that under the new risk assessment framework the practical result of using this option is likely to be that firms that we assess as having a low risk to our statutory objectives would be set a capital requirement equal to the minimum. However, as discussed above, one of the key drivers for developing the new framework is the view that, in most cases, minimum requirements do not adequately reflect the risks being run by the institutions concerned. Nonetheless, this approach could provide a useful basis for developing a capital requirement framework for specific systems and controls concerns and exceptional business risk.

Option 3

- B15 This option starts with the proposed requirement in CP97 for firms to carry out stress tests to determine the adequacy of overall financial resources. Based on the stress tests and other internal assessments, the firm would then be required to make a judgement about the amount of capital to hold. We would review the results, and if we did not accept the firm's estimate we could respond accordingly.
- B16 This approach fits well with our overall philosophy that primary responsibility for maintaining sound capital lies with the firm's management. So, it goes some way to meeting criteria 1, 4, 5, 6 and 7. While it is not automatically compatible with the new risk assessment framework, it could be made more so – for example, firms assessed as having a high risk to our objectives could be subject to varying degrees of scrutiny, while lower risk firms would be subject only to an automated peer group review.
- B17 A weakness of this approach is that it may not deal satisfactorily with poor management or systems and controls. So, on its own, this option may fail criterion 1 (consistency with statutory objectives and principles of good regulation). However, it is a promising basis for further development.

Option 4

- B18 An approach to setting capital requirements used in the US has been to design a system containing a number of discrete capital requirement levels. These are linked to mandatory actions by supervisors and to the firms' abilities to carry out certain kinds of business. The best known example of this is the regime for banks in the US Federal Deposit Insurance Corporation Improvement Act.¹ This has five zones of banks, ranging from well capitalised (requiring, amongst other things, a risk asset ratio greater than 10 percent) to critically under-capitalised (when the equity to assets ratio falls below 2 percent). The authorities are required to take specific action if a bank falls out of the well-capitalised category and brokered deposits may only be taken by well-capitalised banks. For example, for a bank falling into zone 3 (undercapitalised with risk asset ratio less than 8 percent) the authorities would take the following mandatory actions: suspend dividend and management fees, require capital restoration plan, restrict asset growth, approval required for new activities and acquisitions and no brokered deposits. Further discretionary provisions to restrict activities would also be available to the authorities.
- B19 To make this approach operable in the UK, we would need to tie together our enforcement actions and variations in permission (preventing firms from carrying out certain kinds of business). This would require a different approach to both these topics from the one that we have adopted so far (following the usual consultations), which is predicated on a flexible, case-by-case approach to both these issues.
- B20 Although this option is likely to meet criteria 1, 4, 6 and 7, it would fail to meet criteria 2, 3 and 5 given the level of supervisory intervention required for firms assessed as having a low risk to our statutory objectives.

Option 5

- B21 Current and pre-N2 practice in the deposit-taking area has been to set an individual capital requirement at or above the minimum for all firms after our detailed assessment of the risks being run by the firm concerned. This process has been well documented in the Policy Statement '*Individual Capital Ratios for banks*' recently released (www.fsa.gov.uk/pubs/policy/pscapitalratios.pdf) and the Building Societies Commission's Methodology for Threshold Solvency Ratios for building societies ('*Interim Prudential Sourcebook for Building Societies*').

1 Source: '*FDICIA after five years: a review and evaluation*' (Benston and Kaufman)

- B22 This option would probably meet criteria 1, 4, 6 and 7. But it would probably fail to meet criteria 2 (consistency with risk assessment framework), 3 (consistency with baseline monitoring) and 5 (consistency with resource availability). This reflects the significant resource input required from us for such an approach.

Proposed new framework

- B23 As the above analysis shows, none of the options in isolation meet the required success criteria. However, a combination of options 2, 3 and 5 was thought to be the best fit with the criteria and so they formed the basis for further development. These approaches were then combined and developed to ensure that all criteria were met and that the concerns highlighted above were addressed. In doing so the framework was split into two key elements:
- i) an Internal Capital Assessment ('ICA') to address business and systems and controls risks. This would be determined on a firm by firm basis for PRU categories 1, 2 and 3 (i.e. deposit-takers, insurers and principal position takers). It would take the form of self-certification by the firms themselves (followed by a review by the FSA), using one of two methods (internally generated using our guidance or based on the firm's own economic model with appropriate supplements, where necessary); and
 - ii) a supervisory tool available to use for all categories of firm, known as a Supplementary Capital Assessment ('SCA'), whereby a firm may be required to hold additional capital in response to specific systems and controls related concerns, or exceptional business risks not adequately captured by the ICA.

Scope of the ICA

- B24 As noted above, it is proposed that the scope of the ICA be limited to PRU category 1, 2 and 3 firms. Below is a brief outline of our general approach to the application of prudential standards and to how the scope of the ICA was determined.
- B25 In developing CP97, we identified three key types of firm (PRAG 1.3.2G):
- those whose business includes activities which normally involve a direct creditor relationship with consumers and where consumers may become unsecured creditors should the firm become insolvent; and whose insolvency may also have particularly damaging effects on market confidence. These are the firms in PRU categories 1, 2 and 3.
 - Those which hold assets on behalf of consumers but which do not undertake activities which normally involve a direct creditor relationship

with consumers (who are protected in the first instance by our client assets rules). These are the firms in PRU category 4.

- Those whose business is confined to activities which do not normally involve a direct creditor relationship with consumers and who do not hold assets on behalf of consumers; these firms are less likely than others to give rise to consumer loss in the event of insolvency. These are the firms in PRU category 5.

- B26 It is widely accepted that for firms falling into the first category above (deposit-takers, insurers and principal position takers), minimum capital requirements do not fully address all the risks. So, it is proposed that these firms be included in the scope of the ICA.
- B27 The decision to include or exclude the second type of firm (client asset holders) was not as clear-cut. In determining whether to include PRU category 4 firms in the scope of the ICA we considered:
- that for PRU category 4 firms, the risk of consumer loss is mitigated by the adoption of client asset rules;
 - concerns about the adequacy of compliance with client asset rules should not be addressed by long-term capital requirements. The risk is that capital could be seen as a substitute for proper client money systems and controls;
 - that it is recognised that the greater a firm's capital, the greater the financial resources to make good any client money shortfall. However, in practice, it is recognised that it would be unacceptably costly to increase capital to such a degree as to cover any potential client money losses; and
 - setting individual capital requirements on an exceptions basis is widely regarded as an important and effective tool for the supervision of investment firms. Such capital requirements provide a strong incentive for firms to address specific business or systems and controls concerns.
- B28 We concluded that for client asset holders the key mitigants are systems and controls and specifically the client asset regulations. We do not believe that to set individual capital requirements for PRU category 4 firms routinely above the minimum would be an effective use of resources. However, a key advantage of the capital requirement tool is that it provides a strong incentive for firms to address exceptional business risk and systems and controls issues. So, we propose that a capital tool should be available to apply to category 4 firms, on an exception basis. We believe the SCA would more effectively meet this need for PRU category 4 firms.
- B29 Similarly, given the nature of the risks run by PRU category 5 firms, it was not felt appropriate to include these firms within the scope of the ICA. Systems

and controls and Conduct of Business rules are more efficient ways of mitigating the risk of loss to consumers through mis-selling for PRU category 5 firms. Routinely setting capital requirements above the minimum would not be an effective use of our resources. However, we believe that it is appropriate to keep the possibility of using capital as a regulatory tool and the SCA would meet this need.

The market impact analysis

- B30 In performing the CBA, we consider the possible impact of individual capital requirements on: direct costs and benefits to us, capital costs to firms, compliance costs to firms. The impact on competition is discussed in Chapter 6.

Direct costs and benefits to the FSA

- B31 A significant component in the cost of implementation is our own costs. The main cost will be in the training of staff in the new framework and supervisory tools. Around 800 supervisory staff will need to be trained on the proposed standards. In total, we expect that around 800 days (including training preparation time) will be necessary. At a cost of £400 each, this amounts to a total one-off cost of £320,000. This would have to be considered against the savings made by a simplified and more risk-based means of setting regulatory capital for banks in line with our 'New Regulator' framework.
- B32 The cost of administering the new framework on a continuing basis is expected to be lower than at present, in particular for supervising deposit-taking firms, since the responsibility for determining the ICA will lie primarily with the senior management of the firm. In resource terms, the new framework compares favourably with current procedures and is also suitable for low risk firms. The amount of supervisory resource dedicated to those deposit-taking firms that are assessed under our risk assessment process as having a low risk to our objectives will, on average, be reduced.

Costs to firms

- B33 We believe the costs to firms fall into two main elements: the cost of capital resources and the practical costs associated with the implementation of the new framework. Each is considered in more detail below.

Cost of capital resources

- B34 At this stage of developing the framework it is too early to perform a detailed cost analysis. So, we have aimed to set out an indication of overall effects of

the proposed framework. It is helpful to consider the effect on capital resources by splitting this section into three categories: the regulatory minimum, individual capital requirements above minimum, and actual capital held or senior management view of capital required.

- B35 The estimated number of firms in each PRU category is shown in the table below.²

Table 1: Number of firms in each PRU category (Jan 2002)

Category	Number of firms
1	350
2	900
3	500
4	800
5 & others ³	6,450
Total	9,000

Regulatory minimum

- B36 Based on the above figures, we estimate that around 7,250 firms will not be subject to the ICA and so will not be required routinely to hold capital above the regulatory minimum. However, a small proportion of these may be required to hold additional capital under the SCA on a case-by-case basis.

Individual capital requirement above minimum

- B37 For the firms in PRU categories 1, 2 and 3, the changes proposed in this CP are likely to affect sectors in different ways. Table 2 divides the application of the ICA framework into its component parts (market risk, credit risk, insurance risk etc) for each type of firm.

2 We are currently combining our legacy systems and data into one system and have not yet allocated firms to PRU categories. In the absence of this information we have extracted information from the new systems on a permissions basis. Following our grandfathering process for permissions, we have noted that a larger number of firms (1,000) than we expected have permission for “dealing as principal” and could therefore be included in PRU category 3. But many of these will be excluded from PRU category 3 as described in paragraph 2.12. We estimate that the number of firms in PRU category 3 after adjustment to exclude the above exemptions is approximately 400-500.

3 For completeness, we have also included those firms which are currently subject to a specialist sourcebook, but for which we may wish to keep the option of using the SCA.

Table 2: Components of the Initial Capital Assessment

ICA Component	Impact on PRU Category			
	1	2	3	4 & 5
High level systems and controls risk	✓	✓	✓	–
Capital	✓	✓	✓	–
Credit risk (model fit)	✓	✓	✓	–
Credit risk (Basel 2 specific e.g. concentration risk/procyclicality/residual risk)	✓		✓	–
Market risk (model fit)	✓	✓	✓	–
Market risk (Basel 2 specific e.g. interest rate risk in the banking book)	✓		✓	–
Insurance risk		✓		–
Operational risk	✓	✓	✓	–

B38 This table illustrates where firms are likely to be affected to a greater (✓) or lesser (✓) degree by the proposed framework.

B39 In practice we expect the effect on firms to be that:

- In the case of the 350 or so PRU category 1 firms, where individual capital ratios already exist, we do not anticipate that, on average, any overall increase in capital will result from the application of this framework. Since the new Basel Accord and equivalent EU directives should deliver an improved risk sensitive capital requirement under ‘Pillar 1’, we would expect the ICAS framework to generate, on average, lower additional capital requirements than are currently generated under the existing approaches. We recognise that the impact of the Pillar 1 requirements on these firms will be mixed: where the new Accord and equivalent EU directives deliver a lower level of capital, we will not seek to reverse this capital saving routinely through the ICAS. Our rules and guidance in respect of this effect will be mainly derived from EU directives and the new Basel Accord.
- In the case of PRU category 2 (accounting for around 900 firms) and PRU category 3 (accounting for around 500 firms) firms, which have not generally been subject to an individual capital requirement (i.e. insurance and investment firms), we expect that on average the overall level of required capital will increase above the current minimum required as a result of the application of the ICA, but will on average remain within the actual level of capital currently held. Calibration for these sectors will be more difficult. Where possible we will aim to ensure that similar risks attract equivalent capital charges across sectors.

- B40 In the course of preparing this CP we have considered the potential impact of developments in international standards on capital requirements, and how these could eventually be incorporated within this framework. In due course we may need to include further changes to the ICAS framework. These changes, and a more detailed draft of the rules and guidance that will underlie this framework, will be included in a future CP.

Actual capital held or senior management view of capital required

- B41 Many firms hold capital resources significantly above the regulatory requirement. We estimate that almost a half of banks and around three-quarters of ex-SFA regulated firms hold 50 percent or more excess capital. The figures for insurers show that over half (for both life and non-life) of firms hold 200 percent or more excess over the minimum. The reason firms choose to hold excess capital vary, but may include market discipline (e.g. a wish to attain a given rating), and a decision to hold a given buffer of capital above regulatory requirements to accommodate volatility. It is therefore difficult to assess what impact this framework may have on the amount of excess capital firms choose to hold; we recognise that even where a new regulatory requirement is well below the amount of actual capital held, this does not necessarily mean that there will be zero additional capital cost to the firm.

Implementation costs for firms

- B43 In this section we attempt to identify and to quantify the costs to firms of implementing the proposed standards. The costs have been split between ICA and SCA, with the main costs relating to the ICA. Although costs will differ by firm, almost all firms are likely to incur such costs to a degree, if only in determining the application of new standards. Firms in PRU categories 1, 2 and 3 will have the highest costs as more material within this framework applies to them. Firms in PRU categories 4 and 5 will still be subject to parts of the framework (SCA) but it may be that the effect on these firms is minimal.

SCA

- B44 We believe that the SCA will initially require minimal implementation costs following the introduction of the overall framework. For example, we expect management and staff to be aware of the purpose and implications of an SCA and the types of situations where we could set an SCA.
- B45 In contrast, the continuing costs where an SCA has been determined will vary. For example, the costs associated with us setting an SCA include the costs of capital and the costs of addressing the weaknesses identified (which depend on the nature of the concerns). These costs can only be determined on a case

by case basis. Our basis for setting the capital requirement for an SCA is given in Chapter 5.

ICA

- B46 We expect that the costs of the ICA will vary depending on the approach taken by the firm to performing the assessment (i.e. internally generated using our guidance, or based on the firm's own economic capital model with supplements where necessary using our guidance). Firms using their own economic models are expected to face lower implementation costs.
- B47 In broad terms, most firms will have to go through a process which involves the analysis of policy changes to determine their application and an assessment of impact (changes to existing compliance calculations, systems changes including appropriate testing, documentation and audit etc.). Clearly all these stages have costs.
- B48 We think that there are six main issues surrounding the implementation of the ICA framework:
- Methodology – PRU category 1, 2 and 3 firms will be required to determine their approach to the ICA.
 - IT systems – the specialised software packages that would enable firms to undertake the stress and scenario tests that are proposed. As the ability to undertake such stress tests has already been identified as a requirement under PRAG 4 of the PSB, the additional costs involved will be from running the specific scenarios identified and in interpreting the output.
 - Interfacing – there may be additional costs from the need to review the collating of data from the front and back office systems into a form that is appropriate for carrying out the tests required by this framework.
 - Staff training – all personnel whose functions directly deliver compliance with prudential standards will have to be trained in the new requirements.
 - Other staff time – other staff apart from compliance staff will also need to understand the basics of the rules and requirements to produce sufficient data and data interpretation for the framework. Systems and processes will need to be designed and implemented to carry out and maintain their ICA in-house. For firms with offices or head offices overseas, there may be a need to liaise with foreign associates or regulators.
 - Consultancy expenditure – specialist advice in the design or implementation of software or interfacing may be required by some firms. The additional costs of adapting systems to run the stress tests and scenarios proposed in this CP are considered separately from the costs of

design and implementation of the original systems necessary as a result of the implementation of the PSB.

- B49 In seeking to estimate these costs we have used a simplified approach, based on an assumption that the resources spent on updating and adapting systems and controls are dependent on a firm's category. We have analysed expenditure of different types and estimated a composite level of expenditure for each category of firm. The actual costs to each firm will depend on the complexity of their business, their current ability to measure their risk exposure through their IT infrastructure, the level of expertise they have and the associated need to use external consultants. In our view, the numbers shown represent a prudent estimate of the actual costs to a 'typical firm' for each category.
- B50 We have assumed that the IT and systems changes necessary as a result of the proposed framework are to be taken in isolation from a firm's other IT programs. In practice, firms review their systems and controls on a regular basis and operate a program for the updating and improving of IT systems. By combining adaptation of the proposed changes with such internal processes, incremental compliance costs from the implementation of the ICAS framework can be reduced significantly.

Table 3: Estimated implementation cost per firm

	PRU Category					
	1&3		2		4&5	
	Days	Cost £	Days	Cost £	Days	Cost £
IT systems & interfacing	–	20,000	–	30,000	–	
Training (£450)	6	2,700	6	2,700	1	450
Staff time (£450)	24	10,800	24	10,800	1	450
Consultancy (£1,000)	10	10,000	12	12,000	–	
Total		43,500		55,500		900

- B51 We have assumed that:
- Some investment firms and deposit-takers will have existing stress/scenario systems and processes that may require minor additions as a result of this framework. We also assume that insurance firms may not have specific risk management processes covering such tests and so could face higher costs. We are aware that the cost of implementing systems will

vary depending on the use of bespoke or off-the-shelf systems. Given these differences we have roughly estimated this cost.

- The average prudential compliance department at PRU category 1, 2 and 3 firms has two compliance officers who are directly affected by the implementation of the individual capital requirements framework.
- Each of these staff would require three days of training in the framework proposed and in the practical implications for the firm.
- A further 24 days a year will be taken up on the assessment of each of these firms' prudential capital requirement throughout the year and in reporting that requirement to us.
- Each firm may require specialist consultancy advice in redesigning their systems to capture the requisite data for the stress and scenario tests contained within this framework.
- Staff and consultancy time is assumed to cost £450 and £1,000 per day respectively.

B52 We have assumed that PRU category 4 & 5 firms will be affected only by an SCA. As this is a supervisory tool that will be used within our wider regulatory framework, we believe that it will not be applied to most of these firms. So, we have estimated that only one day will be needed for each of these firms in respect of them understanding this framework and how it may affect them. We have allowed for one day's work for each firm as a prudent estimate of the amount of time these firms will give to these requirements and the costs of any discussion with us.

B53 Multiplying these 'typical costs' by the population in each category gives the total implementation costs arising from this framework. As shown below this figure is estimated to be £115 million. If we adjust PRU category 3 to exclude the estimated 500 firms which we believe would in fact fall into category 4 or 5 (see paragraph 34), this estimate would be reduced to below £100 million.

Table 4: Estimated implementation cost per sector

Category	Typical Cost (£)	Number of firms	Subtotal (£)
PRU 1	43,500	350	15,225K
PRU 2	55,500	900	49,950K
PRU 3	43,500	1,000	43,500K
PRU 4	900	300	270K
PRU 5 + Others	900	6,450	5,805K
TOTAL			114,750K

Analysis of the benefits

- B54 ***Market Confidence.*** One of the key objectives of the ICAS framework is to reduce the probability of market disruption caused by the prudential failure of a single firm or a group of firms. It aims to achieve this in two ways:
- by seeking to ensure that the amount of capital held by a business is commensurate with the risk associated with the business profile and systems and control environment within that firm; and
 - by providing appropriate incentives for senior management to develop strong risk management controls.
- B55 ***The protection of customers.*** As with market confidence, the ICAS framework aims to protect consumers by seeking to ensure that the amount of capital held by a business is commensurate with the risk associated with the business profile and systems and control environment within that firm; and by providing appropriate incentives for senior management to develop strong risk management controls.
- B56 ***Public awareness.*** The rules and guidance proposed within this paper are not specifically aimed at promoting public awareness. However, we believe that a single transparent framework within which capital levels are determined on an individual firm basis for a range of firms in a transparent way, should promote greater understanding within the financial services industry and by the public.
- B57 ***The reduction of financial crime.*** The ICAS framework does not seek to address financial crime directly; this risk is addressed more specifically in the Money Laundering Sourcebook. However, the ICA will require firms to make an assessment of the overall strength of their systems and controls – including aspects that may be important in the reduction of financial crime e.g. segregation of duties. The ICAS framework does, therefore, provide some incentives that might help reduce financial crime.
- B58 We have outlined in this CP how we have sought to integrate the framework proposed into the rest of the PSB. We have done this by matching the requirements to the risks identified in the PSB and by setting a single set of standards addressing each risk.
- B59 As with the rest of the PSB, one of the key benefits from this proposed framework will be the reduced cost to firms of applying an integrated set of rules and guidance in the setting of regulatory capital. While we recognise that certain limitations apply (e.g. arising from the different EU directive requirements, which apply to the different sectors), the development of a single harmonised approach should also level the playing fields across sectors (as compared with the current differentiated approaches).

- B60 The most noticeable gain for this proposed framework is that firms will be able to move towards a more risk-focused capital requirement, thereby increasing a firm's understanding as to how and why regulatory capital is derived. It is our belief that this transparency will encourage firms to improve their risk monitoring and measuring to manage their risk and capital requirements. This will have the additional benefits of encouraging firms to strengthen controls and systems where appropriate, especially in risk and management information reporting.
- B61 The process should generate a bespoke capital standard that is tailored to the specific business risk profile and systems and control environment within a firm. At the same time, it is, we hope, sufficiently flexible to apply to a wide range of firm types, sizes and levels of sophistication. In particular, it should promote innovation in the area of risk management e.g. by allowing firms to make more use of their internal economic capital models.
- B62 When developing the scope of application of the framework we sought to ensure that the ICAS framework yields bespoke capital standards for those firms where prudential failure is most likely to result in market confidence issues and direct losses to consumers, and where capital is an appropriate tool to mitigate that risk.
- B63 The key direct benefits to ourselves are the reduced cost of maintaining different capital frameworks for different sectors; and concentrating our resources on assessing firms' risk management procedures and, through the analysis of stress tests, taking a more forward looking approach.

Summary and conclusion

- B64 We do not expect overall capital resources to change significantly from present levels. However, we do expect some redistribution of regulatory capital between firms. This will ensure that capital resources requirements reflect better the risks to our objectives. Whilst there are costs attached to the implementation of such a framework, we believe these are outweighed by the benefits.

Extracts from CP97

PRAC 1

- 1.3.1 R** A firm must maintain at all times capital resources equal to or in excess of its capital resources requirements.
- 1.3.5 G** (extract) The capital resources requirements are determined both by reference to our assessments of the risks presented by different types of firm and by the EU directive requirements.
- 1.3.6 G** (extract) The FSA may impose a higher capital requirement than the minimum requirement set out in this chapter as part of the firm's Part IV permission.

PRAG 4

- 4.3.1 R** A firm must maintain overall financial resources adequate, on reasonable assumptions, to ensure that there is no significant risk that liabilities to customers cannot be met as they fall due.
- 4.3.2 R** For the purposes of determining the adequacy of its overall financial resources, a firm in PRU categories 1, 2, 3, 4A and 4B must carry out appropriate stress and scenario tests including taking reasonable steps:
- 1) to identify realistic adverse scenarios in which any of, or any realistic combination of, market, credit, insurance, operational, group or other losses or risks might occur or crystallise; and
 - 2) to ensure that in the event of each scenario, it would still have adequate financial resources to meet liabilities to customers.

List of illustrations of questions for assessing high-level systems and controls capital requirement

Risk Management

Are there any new or existing products that have not been considered within the risk identification and mitigation program?

Is there any evidence that the firm does not have an appropriate separate risk assessment function responsible for assessing the risks that the firm faces?

Is there any evidence that suggests that the risk management function is not staffed by an appropriate number of experienced, skilled and independent staff?

Policies Procedures and Controls

Is there any evidence to suggest that the firm does not maintain adequate and up to date policies and procedural manuals?

Is there any evidence from internal or external audit reports that there are weaknesses in the firm's procedures for monitoring compliance with these manuals?

Management Information

Is there any evidence from internal or external audit reports that show weaknesses in the adequacy, scope, accuracy or timeliness of financial and management reporting?

Is there any evidence from internal or external audit reports that show weaknesses in the adequacy, scope, accuracy or timeliness of the budgeting process?

Information Technology

Is there any evidence from internal or external audit reports that the controls surrounding IT resources, prioritisation, planning and development are not adequate?

Is there any evidence from internal or external audit reports that show weaknesses in the adequacy of controls surrounding the development, testing and implementation of new hardware and software?

Is there any evidence from internal or external audit reports that show weaknesses in the ability of the IT infrastructure to cope with the current or projected/budgeted volumes of business?

Internal Audit

Is there any evidence that suggests that the internal audit function is not staffed by an appropriate number of experienced, skilled and independent staff?

Outsourcing/ Third Party Providers

Is there any evidence from internal or external audit reports or from historical problems that show weaknesses in the relationship with third party contractors?

Does the firm have appropriate plans to ensure that it can continue to function and meet its regulatory obligations in the event of an unforeseen interruption? Are these plans updated and tested regularly?

Corporate Governance

Does the board meet regularly?

Do all directors bring an independent judgement to bear on issues of strategy, performance, resources and standards of conduct?

Are there non-executives on the board?

Is there a senior non-executive director?

Do non-executives constitute not less than one third of the board?

Human Resources

Is there any evidence from internal or external advisor reports that there are skills shortages in key business or control areas or is this evidenced by excessive reliance on part-time staff and/or high rates of turnover of staff?

Examples of business and systems and control risk weaknesses that might lead to a SCA

Examples of business risk situations are listed below (Note: this list is not intended to be exhaustive).

- Inadequate strategic plan in terms of its appropriateness to the business, including risk appetite.
- Unusual risk profile in terms of concentration/diversification of customers /products/ services.
- Increased risk of loss due to default of large counterparty or deterioration in credit quality of significant exposures.
- Increased risk arising from insurance company's underwriting, including the setting of premiums commensurate to risk, purchase of reinsurance etc.
- The uncertainty resulting from changes in market conditions such as market product prices, volatility, market liquidity, interest rates and foreign exchange rates.
- Risk that the firm's contractual agreements are not enforceable under applicable law, including the risk that the nature of the product/service may render the firm particularly vulnerable to litigation.

Examples of systems and control risk situations are listed below (Note: this list is not intended to be exhaustive). The risks have been grouped in line with FSA's risk assessment framework for risk group: Internal Systems and Controls.

Risk management

- Inadequate assessment of the risk of certain business activities, whether on or off balance sheet.
- Inadequate risk management systems in place to identify, measure, monitor and control the risk of the business in an appropriate and timely manner (including credit, market, operational, insurance and legal risk).

Policies, Procedures and Controls

- Significant business activities supported by outdated systems, controls and procedures.
- Commencement of complex new business activities without sufficient regard to supporting systems and controls infrastructure.
- Inadequate integration plans for systems and controls following a hostile takeover, merger or acquisition of significant sized business.
- Inadequate definition of responsibilities of key front office and back office staff.
- The absence or failure of key control activities such as segregation of duties, approvals, verifications, reconciliations and reviews of operating performance.
- Inadequate policies, procedures and controls to ensure soundness and safeguarding of client assets.
- Client money segregation undertaken by untrained staff within an inadequate or ineffective systems and controls framework.
- Insurance companies (PRU category 2) having inadequate controls on claim payments, resulting in claims being paid for which the firm is not liable.

Management Information

- Lack of management understanding, review and authorisation procedures over high-risk business activities.
- Inadequate management information in terms of accuracy, relevance, timeliness and ineffective distribution.
- Lack of adequate management oversight and accountability and failure to develop a strong control culture.
- Inadequate communication of information between levels of management within the firm, particularly in relation to the upward communication of problems.
- Inadequate information on insurance claims, making estimates of outstanding liabilities (and rate setting) more uncertain than normal.
- Inadequate analysis of insurance business (timing and quality) by potential rating factors of claims and business written, so that the rates charged may be inappropriate.

IT Systems

- Poor controls over IT infrastructure, including adequacy of resources, procedures for implementation and procurement, effectiveness of security framework etc and inadequate consideration as to whether the IT infrastructure is an adequate platform on which to run the business.
- Commencement of complex new business activities without sufficient regard to supporting systems and controls infrastructure.
- Key integration plans for systems following a hostile takeover, merger or acquisition of a significant-sized business.

Financial and Regulatory Reporting and Accounting Policies

- Poor controls over the adequacy, accuracy, relevance and timeliness of financial and regulatory reporting, including appropriate application of accounting policies.
- Inadequate policies, procedures and controls to ensure financial integrity and soundness and safeguarding client assets.

Compliance

- Compliance function inadequately resourced and trained, inappropriate structure and reporting lines and unclear mandate.

Internal Audit

- Internal audit department lacking independence, quality and experience of staff and inadequate or ineffective audit programs and other monitoring activities. It is recognised that not all the firms that we regulate will have an internal audit department.

Outsourcing/Third Party Providers

- Inadequate selection procedures, legal arrangements, monitoring and contingency plans in relation to key outsourcing or third party providers.

Business Continuity

- Inadequate and out-dated business continuity arrangements.

Other

- Mis-selling of life insurance and other products giving rise to large potential liabilities, and, until an investigation is carried out, the potential financial impact cannot be quantified. Once the potential liabilities, from compensations fines and the costs of the investigation, have been quantified, the additional provisions and the impact on capital can be estimated.

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