



Financial Services Authority

# Our Pillar 2 assessment framework

May 2007



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## **Appendix 1** Territorial scope

# Foreword

The aim of this paper is to give firms an insight into what they can expect of our Pillar 2 process and how this will be applied proportionately according to the risks to our objectives. In particular, we set out how we will apply the Supervisory Review and Evaluation Process (SREP) when we review firms' Internal Capital Adequacy Assessment Processes (ICAAPs) under the relevant CRD<sup>1</sup> obligations. Our approach to Pillar 2 will be underpinned by the following key principles.

## Key principles

Our starting point is that the Pillar 1 minimum capital requirements are generally adequate for the credit, market and operational risks of 'well diversified international banks'. It may be necessary for additional capital to be held in Pillar 2 against these risks to the extent that individual firms do not fit into this stylised risk profile. Additional capital may also be appropriately held in Pillar 2 for those risks not captured at all by Pillar 1.

When we set regulatory capital requirements under Pillar 2:

- We make no distinction for the size of firms. However, a distinction will be made between firms acting as principals and those acting as agents. For firms which act as principals, where protection for the client is afforded through the existence of capital, the amount of capital held should be proportionate to the risks being run by the firm. For firms acting solely as agents, where the main protection is provided through client money arrangements, the role of variable capital requirements is less relevant: accordingly, the Pillar 1 minimum may be regarded as adequate where such firms have sound systems and controls and corporate governance arrangements. Where firms act both as principals and agents, a split approach may be necessary.
- Our reference point is the equivalent of a BBB rating. This is broadly the same calibration that we use for the purposes of Pillar 1. In applying this, we will consider international practice and the competitive position of UK firms.

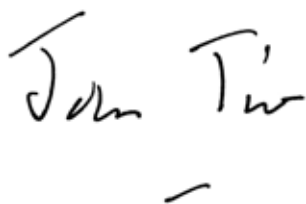
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<sup>1</sup> The Capital Requirements Directive (CRD) came into force on 1 January. It recasts two existing directives: the Banking Consolidation Directive (2006/48/EC) and the Capital Adequacy Directive (2006/49/EC).

However, this does not mean that we will be driven by the lowest common international denominator.

When we conduct a Pillar 2 review:

- We will not use it to claw back reductions resulting from the move to the Basel 2 framework for calculating Pillar 1 regulatory capital. For some firms, such as residential mortgage lenders, the Pillar 1 approach could result in marked reductions in the overall amount of regulatory capital required compared with the Basel 1 approach. This is an intended effect.
- We may include capital adjustments (up or down, subject to Pillar 1 remaining as the floor for regulatory capital) to reflect underlying weaknesses or strengths in governance, oversight, risk management and controls. We aim to apply any such capital adjustments in a transparent manner and explain our rationale so that firms know clearly what they have to do to address any concerns we have.
- We aim to take a top-down and risk-focused approach. When considering Pillar 2 outcomes, we will focus on material risks and issues. Where we consider a firm's ICAAP is soundly-based and produces reasonable outcomes in line with a particular peer group, it is more likely that we will be prepared to accept that assessment.
- We will be prepared to recognise some offsetting for 'unders and overs' between risks - mainly within Pillar 2 but also to a limited extent between Pillar 1 and Pillar 2 - where these are agreed with a firm's senior management. However, we will only consider limited diversification benefits on a case-by-case basis, and the onus will be on the firm to justify such claims. We will undertake further work during 2007/08 to assess industry practices specifically in this area and more generally on economic capital modelling.
- We expect firms to be able to demonstrate how they will meet their regulatory capital requirement through a three to five year period (or a shorter period if appropriate given the nature of the business). This should include the possibility of a severe economic downturn or business event occurring (such as might be experienced once in a 25 year period). However, this should not be taken to be an automatic requirement for a firm to hold capital upfront. What is important is that firms are able to demonstrate credible forward thinking (at an appropriately senior level) as to how they would raise such additional capital, or take other mitigating action. Where this forward thinking is credible and meets the capital requirements generated by the stress test, there is no need to make a capital adjustment.



John Tiner, Chief Executive

# 1 Summary

## 1.1 What is Pillar 2?

Pillar 2 is one of the three supervisory pillars originally set out in the revised Basel Accord. These were written into European Law through the CRD, and further developed in the Pillar 2 guidance issued by the Committee of European Banking Supervisors (CEBS).

Collectively Pillars 1, 2 and 3 form an overall framework for prudential supervision of banks, credit institutions and investment firms. The first pillar revises existing minimum regulatory capital standards for three major components of risk that firms face: credit, market and operational risk. The second pillar requires firms to assess the amount of internal capital they consider adequate to cover all of the risks to which they are, or likely to be, exposed. As the regulator, we will review these assessments and give individual guidance on the regulatory capital we consider it appropriate for firms to hold. Pillar 3, which is still in development, requires firms to publish key information about their underlying risks, models, controls and capital position, so that market forces are brought to bear in these areas.

Under Pillar 2:

- deposit takers and investment firms subject to the CRD will therefore have to develop and maintain an Internal Capital Adequacy Assessment Process (ICAAP); and
- supervisors will have to review and evaluate firms' ICAAPs as part of the Supervisory Review and Evaluation Process (SREP) – also known as the Pillar 2 review.

## 1.2 What is the Pillar 2 review?

The Pillar 2 review or SREP has been developed to help supervisors review and evaluate each firm's ICAAP, including its:

- exposure to risks (its risk profile);
- processes for identifying, measuring and controlling risks;

- capital requirements;
- capital resources; and
- ongoing compliance with standards laid down in the CRD.

Through the SREP we will seek to identify any weaknesses or inadequacies requiring a regulatory response so we can provide the firm with:

- Individual Capital Guidance (ICG) that reflects the amount of capital that we believe is adequate for its risk profile, strategy and capital resources;
- individual guidance reaffirming or amending any existing liquidity ratios, limits or behavioural concessions; and
- resultant prudential or other measures.

# 2 Overview

## 2.1 What are your firm's obligations under Pillar 2?

The ICAAP should include a detailed assessment of the various risks identified by your firm and the capital allocated to mitigate those risks. We will expect you to explain the interaction between the Pillar 1 minimum regulatory requirement and the Pillar 2 ICAAP, so that we can assess those risks. From this work (and other considerations) we will then decide the amount of regulatory capital your firm is required to hold.

## 2.2 What is Individual Capital Guidance and when do we use it?

Once we have completed the Pillar 2 review, we will tell your firm the amount of capital we think it needs to hold through Individual Capital Guidance (ICG). GENPRU 1.2.26 R requires a firm at all times to maintain overall financial resources (including capital resources and liquidity resources) which are adequate, both in terms of amount and quality, to ensure that there is no significant risk that it cannot meet its liabilities as they fall due.

Your firm's ICAAP should, therefore, take into account its current risks, as well as any planned growth in risks, and the impact of future events such as an economic downturn. The more your firm is able to demonstrate to our satisfaction that its ICAAP is thorough, objective and prudent — that it captures and quantifies all the risks to which it is exposed — the more we expect to align its ICG with the ICAAP. However, ICG may differ from a firm's ICAAP where, for example, our regulatory objectives differ from a firm's economic objectives.

### Note 2.2

If and when your firm anticipates problems meeting its ICG levels (or where ICG has not been given, your own ICAAP capital assessment), we would expect you to discuss this with your relationship manager/supervisor as soon as possible.

### **2.3 Structure and scope of the Pillar 2 review**

The intensity and depth of the Pillar 2 review will be proportionate to the nature, scale, complexity and systemic importance of a particular firm. So the more complex a firm is the greater the level of sophistication we would expect in its ICAAP, and the greater the intensity and depth of our SREP and vice versa. So our review will vary in line with the perceived risks each type of firm poses to our statutory objectives.

Whichever approach a firm adopts, the capital assessment processes should be embedded in the firm's business operations and decision-making processes.

### **2.4 The three levels of the SREP**

To allow supervisors to tailor the review, there are three levels of the SREP.

ARROW approach	SREP approach	Differences in the various approaches	Exceptions
Full ARROW	<p><u>Full review</u> – is for high impact firms (including standardised) and all other firms applying for advanced approaches (e.g. AIRB, AMA, FIRB). By full review, we mean a full assessment of the ICAAP.</p>	<ul style="list-style-type: none"> <li>• A detailed review drawing on any Pillar 1 waiver approval work that we may have undertaken.</li> <li>• Firm visits are expected.</li> <li>• The qualitative scaling factor is based on the existing ARROW Oversight and Governance risk group score as well as any additional information emerging from the SREP.</li> </ul>	<ul style="list-style-type: none"> <li>• Where capital assessment is straightforward and prudential soundness risk is low.</li> </ul>
ARROW Light	<p><u>Streamlined review</u> – is aimed at smaller relatively simple firms using standardised or Basic Indicator Approaches (BIA). For low impact firms we will use a portfolio benchmarking approach by industry.</p>	<ul style="list-style-type: none"> <li>• Typically desk based with no firm visits.</li> <li>• The qualitative scaling factor is based either solely on the ARROW ‘Oversight and Governance’ risk group score (L, ML, MH or H) with no further analysis necessary, or on peer group analysis particularly where ARROW scores are no longer current.</li> <li>• Generally there will be a greater emphasis on peer group comparisons in a streamlined review. As such, although there will be validation of reviews through the panel process, it is likely that they will be considered in batches through dedicated panel meetings.</li> </ul>	<ul style="list-style-type: none"> <li>• Where the level of prudential soundness risk is disproportionately high.</li> <li>• Where a review is being conducted at the same time as an ARROW assessment and the ARROW assessment includes on site visits, the SREP would be incorporated into these visits.</li> </ul>
Non-Relationship Managed Firms	<p><u>Questionnaire approach</u> – is designed for use only on non-relationship managed investment firms. Although all investment firms will have to complete the questionnaire, for relationship-managed investment firms it will be used as a means of prioritising streamlined reviews and for the high impact investment firms prioritising full reviews. The questionnaire will not be available until 2008.</p>	<ul style="list-style-type: none"> <li>• Typically we will not carry out firm specific reviews on non-relationship managed firms.</li> </ul>	<ul style="list-style-type: none"> <li>• ARROW Light firms and firms subject to thematic reviews may be subject to a very basic SREP.</li> </ul>

## **2.5 Timing for the SREP**

Ideally the SREP should be carried out at the same time as the ARROW risk assessment. For some of the largest firms, however, the ICAAP assessment may take place at a different time. Indeed, for those applying for a Basel 2 Pillar 1 Waiver, we will ask the firm to submit the ICAAP during the six months allowed for processing the waiver. As a result, we will aim to complete the SREP and give ICG before the first use of the waiver.

Where the main ARROW assessment and the SREP are carried out at different times, we will update whichever assessment is carried out first.

# 3 The Full Review

In general, we use the full review for higher impact firms (including standardised) as well as all other firms applying for advanced approaches whether Foundation Internal Ratings Based (FIRB), Advanced Internal Ratings Based (AIRB), or Advanced Measurement Approach (AMA).

In a full review, we consider the quality of the firm's assessment of the quantitative business-as-usual elements of their ICAAP – these are covered by risk elements 1 to 3<sup>2</sup>. Under element 4, we will consider whether the firm has adequately assessed its forward-looking external risks (such as the impact on capital of future changes in the portfolio, balance sheet or the effects of an economic downturn). Where the firm has failed to adequately assess the risks to which it is exposed or the capital, or other mitigation is inadequate, we may need to apply additional capital (capital adjustments) to the firm's ICAAP. The capital figure that results after any adjustments have been made is known as 'intermediate capital'. It will fully reflect the degree to which we think the firm's ICAAP has captured all the element 1 to 4 risks.

The final stage of the SREP is an assessment of the firm's oversight and governance. During this qualitative assessment we will scale up (or down) the intermediate capital figure. The output of this process is the ICG that we consider appropriate for the firm. This should be viewed in combination with other non-capital mitigants applied to the firm. The process is described in more detail in the following sections.

## 3.1 Internal planning

Typically, we will hold a planning validation panel to provide challenge and approval for the structure and the scope of the Pillar 2 assessment.

## 3.2 The submission request letter

We will write to the firm to tell them what information we need to carry out the SREP and to propose the timescales for the review (In certain cases we may agree the timescales with a firm over the telephone and a letter will not be necessary). Once the firm has received the letter, we will discuss its contents with them and agree timescales. We normally allow three months for the firm to submit the ICAAP to us.

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<sup>2</sup> As defined by the Committee for European Banking Supervision (CEBS)

The letter also contains an appendix which sets out a suggested format for the ICAAP submission. Firms may find this helpful. Although this structure is not compulsory, an ICAAP submission that follows this layout will help us in the SREP and enhance comparability between firms and sectors.

#### **Note 3.2a**

##### **Late or inadequate ICAAP submissions**

There may be instances where firms fail to submit an ICAAP of adequate quality or where there are significant gaps in information. Normally we will try to work with the firm to resolve any difficulties, but significant delays to the SREP are unacceptable. Where the prospect of receiving an adequate ICAAP is remote, we may still give the firm ICG. But, we will have to base the ICG on our view of the firm, taking into account our existing knowledge of it and any information that we have access to. In such circumstances, because a firm has managed this important piece of work poorly, this deficiency will be reflected in additional capital or other mitigants. The ARROW risk assessment will also fully reflect and record such a failing in the firm's governance of its ICAAP work.

### **3.3 High-level review**

Once we have received the ICAAP submission we will check it for completeness and undertake a high-level review. In particular, we will look for areas that require further examination or a more detailed explanation from the firm. We will also review any existing information we have that is specific to the firm and relevant to its ICAAP.

### **3.4 Written questions and / or discussions with the firm**

Building on the high-level review, we will prepare several main question areas for the firm. We may want to hold face-to-face discussions to explore areas of concern or to provide further background and evidence to supplement their ICAAP submission. If one or more on-site visits are scheduled, we will notify the firm of the main issues that we plan to discuss before each visit so they can prepare in advance and ensure that appropriate staff are available.

### **3.5 Detailed review**

Following discussions with the firm, we will carry out a more detailed review of the firm's ICAAP and related material. At this stage, we may want to hold further discussions with the firm. These will usually happen over the telephone or by email.

### **3.6 The quantitative review – elements 1 to 3**

Most firms – i.e. other than the larger banks – will only be exposed to a sub-set of the risks in elements 1 to 3, and the techniques used by firms to measure those risks may vary considerably. Our supervisors will use a series of 'risk cards' that set out the key questions we need to ask in our risk assessment and set out a work programme to help us do this.

The risk cards:

- describe individual risks;
- set out ways in which the firm might mitigate those risks; and
- describe good practice in the management of each risk.

#### **Note 3.6a**

If a firm has applied for (or has) advanced model approval, then the supervisor will liaise with our Risk Review Department (RRD) on the results of credit, market and operational risk model visits they may have undertaken. However, it is likely that it will still be necessary to organise separate visits to focus more broadly on economic capital and the assumptions that may underpin the firm's ICAAP.

### **3.7 The quantitative review – element 4**

Under element 4 we will assess how future changes in a firm's balance sheet can affect its future capital requirements.

Under element 4, a firm's ICAAP should:

- chart the future of the firm based on its business plan;
- subject that plan to stress tests and shocks including a downturn scenario(s) (at least equivalent to a recession of the kind expected to be experienced once in a 25 year period);
- measure the financial impact of such scenario(s) on its business plan and the level of required capital both gross and net of the effect of management actions; and
- identify how future capital needs (as required under the above scenarios) will be funded.

After we have made any capital adjustments under the four elements, the resulting figure is called 'Intermediate Capital'. If we agree with the firm's ICAAP, intermediate capital will be the same as the ICAAP. Otherwise it reflects the degree to which our view differs from that in the firm's ICAAP along with our reasons for those differences.

### **3.8 Internal governance, systems and controls**

The final stage of the full review is the qualitative assessment of the firm's oversight and governance – which may be used to apply a capital scaling factor to intermediate capital. This scaling factor is not an automatic adjustment and our supervisors will have some discretion over the scaling factor that they propose to the FSA's internal validation panel. The scaling factor proposed will also take into account the firm's peers and previous ICGs given.

The scalar is based on the ARROW score (Low, Medium Low, Medium High or High) for oversight and governance. So, before using that score we will decide

whether any new control risks have emerged in the SREP that need to be reflected in the ARROW scores and update them as appropriate.

The range of factors is set out in the following table. The scaling factor can modify the intermediate assessment upwards or downwards. The resulting figure will be the ‘provisional ICG’ that we consider appropriate for the firm. We are monitoring the calibration of the qualitative scalar as Pillar 2 reviews are carried out and may modify it as the new regime evolves.

ARROW aggregate oversight and governance score	Low	Medium Low	Medium High	High
Uplift/reduction to the intermediate capital	-10% to 0%	0%	10% to 25%	25% to 50%

For example, if the firm’s ARROW control score is ‘low’ then a supervisor has the option to reduce the intermediate assessment by a maximum of 10%, subject to meeting the Pillar 1 minimum. This reduction would reflect the highest standards of a firm’s governance and controls and the mitigating effect of this on its overall risk profile.

Once the scalar has been applied to the intermediate assessment the resulting number is the provisional ICG.

**Note 3.8a**

The capital scaling factor cannot reduce the provisional ICG below the Pillar 1 regulatory minimum.

The provisional ICG must be validated through the internal validation panel process before it becomes final.

**3.9 Discussing our initial conclusions with the firm**

Usually we will informally tell the firm’s senior management the key conclusions of the SREP before the validation panel meeting. This gives them a chance to have their comments considered by the panel. At this stage, we will highlight what we think are strengths and weaknesses in the firm’s ICAAP - including a discussion of detailed figures as well as broader issues.

**Note 3.9a**

The final feedback we give to the firm may change between this stage and the ICG notification letter as a result of discussions at the validation panel meeting.

**3.10 The final validation panel**

The supervisor will set out their conclusions and recommendations in a Panel Pack which presents their findings to the ICG validation panel for review and moderation. The panel considers the key issues for each firm in a sector-specific

context to ensure broad consistency of the ICG, and makes the final decisions on capital requirements and Risk Mitigation Programmes (RMPs).

One of the best means of demonstrating that an ICG is fair and reasonable is through comparison with a firm's peers. The Panel Pack, therefore, sets out peer-group-comparison information, as well as, a summary of the capital adjustments proposed.

In most cases the SREP will take place at the same time as the ARROW risk assessment and the ICG validation will form part of the ARROW validation process. However, there may be instances where the size and complexity of the SREP requires a separate ICG validation panel. In such cases the SREP validation panel will take place before ARROW validation so the outcome of the SREP can be reflected in the ARROW RMP.

### **3.11 The ICG letter**

Following the internal validation of the ICG, we will write to the firm's Board to feed back the results of our assessment. This letter formally tells the firm the ICG we consider to be appropriate. It will include reasons for any capital adjustments to their ICAAP, should the ICG be set higher. It will also identify, where appropriate, what actions the firm can take to reduce the level of these capital adjustments. Where the SREP is carried out alongside the ARROW risk assessment, we will send one letter to the firm which will include both the results of the ARROW risk assessment and the SREP.

#### **Note 3.11a**

When we give ICG to a firm we will express it in terms of regulatory capital. ICG will be subject to similar limits as regulatory capital, e.g. innovative tier 1 capital can be included up to a limit of 15% of total tier 1, and tier 2 up to 100% of tier 1. Our aim in expressing ICG using the regulatory definition is to allow comparability across all regulated firms.

Separate ICG may be given where tier 3 capital is available for the firm to use to meet certain risks.

### **3.12 Ongoing monitoring of ICG**

We aim to give ICG within six months of receipt of ICAAP. Once the SREP is completed and ICG has been given, the next complete review of the ICAAP should coincide with the next ARROW risk assessment. However, we will consider on an ongoing basis, but more formally once a year, whether the circumstances of the firm have changed. If any of the key assumptions underpinning the firm's ICAAP change or a firm's risk profile alters and, as a result, the ICG no longer adequately reflects the underlying risks, then re-assessment may be necessary. In any event, and consistent with the firm's obligations<sup>3</sup>, we would expect the firm to notify us of any such changes.

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3 under PRIN 11 – Relations with regulators

**Note 3.12a**

The ICG acts as a trigger point for our supervisory work and this will vary on a case-by-case basis and normally would not extend to modifying a firm's permissions. However, in most cases, we will ask the firm to set out a plan to restore adequate capital.

# 4 The streamlined review

The streamlined approach is more broadly focused than the full scope review. We are likely to accept or reject the whole ICAAP rather than make a series of adjustments on a risk-by-risk basis and there is generally greater emphasis on peer group comparisons. As such, although validation will take place, it is likely that the SREPs will be considered in batches and rather than through dedicated validation panels.

The streamlined review will also typically be desk based with no visits to the firm. However, where a SREP review is being conducted at the same time as an ARROW risk assessment (which includes onsite visits) the SREP would be incorporated into those visits.

## 4.1 When will we use it?

Typically we use the streamlined SREP when reviewing smaller firms with relatively simple business models. Like the full review, it should reflect the firm's business plan, identify all material risks including more severe market conditions, capture the amount of capital required and display adequate systems and controls including the executive level.

## 4.2 Risk identification

First, we will compare the firm's risk profile with its sector risks. The firm's ICAAP should clearly identify the risks faced by the firm. However, we may decide that the firm has missed risks that we consider relevant based on our knowledge of the firm/sector/peers.

The ICAAP should also contain an analysis of 'non-material' risks to which the firm is exposed.

### Note 4.2a

Key questions we will consider:

- Does the firm's ICAAP identify all material risks?
- Is the 'materiality threshold' acceptable?

### 4.3 Risk measurement

We will assess the adequacy of the firm's approach to risk measurement against the core Pillar 1 assumptions. In general, we expect the Pillar 1 minimum capital requirement to be:

- Appropriate for small investment firms in normal circumstances (i.e. the firm does not trade in unusual and/or high risk products, has good systems and controls in place, and is generally well diversified). This is underpinned by the assumption that the firm's risks are better addressed through our rules governing conduct of business rather than capital.
- Unlikely to be appropriate for small banks and building societies due to the direct risk posed to depositors and consumers in the event of their failure unless this risk has been mitigated in a way other than through additional capital buffers.

#### Note 4.3a

Some firms may choose to limit their losses using Professional Indemnity Insurance (PII) cover and, as such, PII cover can be regarded as an alternative to capital. Firms will often use PII to mitigate potentially large but low-probability losses (e.g. certain operational failures). Where firms have used PII cover, we will focus on its limitations (e.g. limits of the indemnity, exemptions, excess, credit quality of the provider and the cashflow implications of the settlement period should a claim be made).

#### Note 4.3b

The Pillar 1 minimum capital requirement does not capture certain types of risk very well, including liquidity risk for small investment firms, and concentration risk for small building societies. Therefore, we are likely to focus more intently on these risks during our review.

- The adequacy of the firm's risk measurement is also a function of their risk appetite. So we will need to understand the link between the capital the firm holds and its risk appetite.

### 4.4 Capital planning

As in the full SREP, we will need to ensure that the firm has taken into account its business plan when calculating its ICAAP and subject that plan to stresses and shocks.

#### **Note 4.4a**

Key questions we will consider

- Is the scenario severe enough? (We expect a once in 25-year type recession to be included)
- Will the firm be able to fund its strategy under the chosen scenario? (E.g. will the firm have access to additional capital in a recession?)
- If not, should the firm consider holding a capital buffer to serve that purpose?
- If the firm plans to use management actions (e.g. reducing its cost base, selling assets etc), have they demonstrated a willingness and ability to carry out those actions under the described scenario?

### **4.5 Governance, systems and controls**

We will need to ensure the firm's systems and controls are adequate to mitigate the risks identified, and that their capital management is integrated. We will use the relevant ARROW scores and/or peer group comparison to help us assess both the quality of their systems and controls as well as their high-level corporate governance. The ICAAP should detail the range of systems and controls that are already in place to mitigate the firm's risks.

#### **Note 4.5a**

Pillar 1 capital specifies a sufficient amount of regulatory capital for investment firms only when client money is safely segregated and conduct-of-business rules are effectively implemented and reliable. Consequently, we will pay special attention to these issues.

#### **Note 4.5b**

Key questions we will consider

- Is each material risk adequately monitored and controlled?
- Does the firm have a good risk-management culture?
- Is senior management closely involved in managing capital and designing the ICAAP?
- Is the firm generally good at keeping its losses under control and does it have a good track record in dealing with errors, customer claims, un-reconciled items etc?
- Is the firm good at segregating client money?

#### **4.6 Final validation and the ICG letter**

After the internal validation of the ICG, we will write to the firm's Board to formally notify them of our assessment.

#### **4.7 Ongoing monitoring of ICG**

We aim to give ICG within six months of receiving the ICAAP. See paragraph 3.12 for full details.

# 5 The questionnaire approach

## 5.1 When will we use the questionnaire approach?

All investment firms will submit the questionnaire as part of their electronic annual return. There are two categories of exceptions:

- investment firms with a credit institution within their group, and
- a very small number of investment firms that might have been granted waivers.

However, the questionnaire will not become part of the annual return until 2008. It will be part of the new-style Integrated Regulatory Reporting (IRR) returns.

When firms submit their returns, the questionnaire will first be processed electronically. The system will score the answers to about 30 questions relevant to Pillar 2. This will generate a report for each division highlighting outlying firms. From this report, each division/department will be able to decide how to follow up with firms likely to have inadequate risk-management processes or capital.

In such cases, we will do one of the following:

- write a warning letter to the relevant firms and see whether matters improve in the next year's questionnaire;
- include the firm in appropriate thematic review work;
- ask the firm to submit an ICAAP and then conduct a desk-top review or streamlined SREP;
- visit the firm to gather further information; or
- seek confirmation of the adequacy of risk management and capital soundness from the firm's auditors, or commission a s.166 report<sup>4</sup>.

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4 Financial Services and Markets Act (FSMA) section 166 report

## **5.2 What does the questionnaire cover?**

The questionnaire contains questions on the following areas:

- Which risks (from a full list of Pillar 1 and Pillar 2 risks) the firm considers it is exposed to.
- For each risk, how much capital the firm has allocated to it.
- Details of PII cover.
- Comparison of the Fixed Overheads Requirement (FOR) (where relevant) with liquidity and estimates of wind-down costs.
- The effect on the value of the firm of a 200 basis point movement in interest rates.

# Appendix 1

## Scope of application of the CRD

### Requirement to maintain adequate financial resources

All firms are required to comply with GENPRU 1.2.26 R (requirement to maintain adequate financial resources) on a solo basis. Where they are a member of a UK group<sup>5</sup> or UK sub-group they must also comply with this rule on a consolidated or sub-consolidated basis.

### Internal capital adequacy assessment process (ICAAP)

Firms that are members of a UK group are required to have an ICAAP that covers the business of the members of the UK group (unless they have been granted the investment firm consolidation waiver). The ICAAP must produce a capital assessment for the UK group, which is capable of allocation to the significant firms and business units in the UK group. This is not the same as requiring each firm to have a standalone ICAAP that produces a solo capital assessment, as the allocated group number may include diversification benefits.

Firms that are members of a sub-group of the UK group will be required to have an additional ICAAP at the level of that UK sub-group. The UK sub-group will be a subset of the firm's UK group, and so will also be covered within the UK group ICAAP. We will not perform a separate SREP of the UK sub-group but will consider it as part of our review of the overall UK group's ICAAP.

Firms that are not members of a UK group are required to have an ICAAP that covers the business of the solo firm.

UK groups or firms that are sub-groups or subsidiaries of global groups are still required to have an ICAAP for their UK business. This is the case for both EEA and non EEA groups.

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<sup>5</sup> A UK group and, where applicable, a UK sub-group are defined in BIPRU 8 of the Handbook – these are called a UK consolidation group and Non-EEA sub-group respectively.

Where a UK group or firm is a sub-group or subsidiary of a larger global group it may use the processes and systems of the global group to meet its UK obligations to have an ICAAP. Where a UK group or firm uses global systems these must be capable of identifying the risks in the UK group or firm and determining an amount of capital for the UK.

Each firm in a UK group that has been granted the investment firm consolidation waiver is required to have an ICAAP that covers the business of the solo firm. These types of group may use group systems and processes to produce an assessment for each individual firm.

## **Supervisory review and evaluation process (SREP)**

Under the SREP we will review a firm's ICAAP.

We will set ICG at the highest level that the ICAAP applies. Where we set group ICG this will usually also apply to the individual solo firms, although we also have the option to set different ICG for a firm at the solo level if we consider it appropriate to do so. Such an approach is likely to be the exception rather than the norm.

We will ask firms to explain in their ICAAP submission how the risks across the group have been aggregated to produce the overall group capital number; and how the group capital assessment has been allocated to the significant firms and business units. Our review will also consider the validity of any diversification benefits and the extent to which capital is transferable around a group. The results of this work will be used to inform the ICG we give to the group and solo firms.

For groups that have the investment firm consolidation waiver, we still supervise them on a consolidated basis, including asking them to report consolidated Pillar 1 numbers to us.

So, from a practical perspective, it makes sense for us to conduct the SREP on the basis of the UK group. We will, therefore, either review a single ICAAP submission showing disaggregated capital assessments or review separate ICAAP submissions, depending on the firm.

For those firms that are members of global groups we need to take account of the home/host issues. We also have to consider the extent to which an ICAAP applicable at the level of the parent group could be used to inform us about the UK business on an 'allocated' basis; and in such a case what (if any) additional information might be required to provide a full enough picture in relation to the UK business.



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