PILLAR 4
CONSULTANTS

How to draft a successful ICAAP 'TOP Tips and Guidance'

Investment firms classed under the IFPRU or BIPRU prudential categories are required to draft an ICAAP (Internal Capital Adequacy Assessment Process) at authorisation and update the ICAAP at least annually. Here are our top ten tips to drafting and updating a successful ICAAP based on our Consultants years of experience working with investment firms and understanding the Regulator's expectations.

Out top ten tips:

- **Prepare accurate financial forecasts:** Start the ICAAP process by preparing robust 3-5-year financial projections (Balance Sheet, Income Statement, and Cash Flow). For firms that are forecast to post net losses, it possible, it is recommended to forecast projections until you get to at least two years of profitability. Ensure the numbers all tally up and that the Balance Sheet balances.

- **Understand your capital requirements:** For IFPRU and BIPRU firms, the capital requirements comprise of the following:
  - **Pillar 1 (Mandated through CRD for BIPRU firms and CRDIV/CRR for IFPRU firms)**
    - Firms must meet the Pillar 1 variable capital requirement at all times along with meeting their base capital requirement (EUR50K, EUR125K, EUR730K)
    - Pillar 1 variable is calculated as Credit + Market + Operational risk capital for Full Scope IFPRU730K firms (active Market risk takers)
    - Pillar 1 variable is calculated as the higher of (Credit+ Market risk capital); and the Fixed Overhead Requirement for BIPRU50K, IFPRU50K, and IFPRU125K firms
  - **Pillar 2 Capital Requirement (Don't forget about Pillar 2)**
    - Pillar 2 is the firm's own assessments of its risks and quantification of capital outside mandatory Pillar 1, mandated through regulation. Some firms use a Risk Register for Pillar 2 quantification others may use more complex risk models
    - If Pillar 2 capital requirements exceed Pillar 1, firms should undertake what's called a Pillar 2 add-on to Pillar 1. For example, if Pillar 1 Credit risk is £300K and Pillar 2 Credit risk is £400K, the capital requirement will be £400K (£300K under Pillar 1 plus a £100K Pillar 2 add-on)
    - Some firms, especially platform or IT heavy business models, may decide to allocate wind down costs under Pillar 2
  - **Individual Capital Guidance (Not always issued by the Regulator)**
    - Not all firms receive Individual Capital Guidance (ICG) from the Regulator but if you do, you will have to ensure that you meet any additional requirements over Pillar 1. Sometimes ICG can be issued prior to authorisation whilst at other times it is done as part of a SREP (Supervisory Review and Evaluation process). For example, several CFD Brokers/Dealers received ICG from the FCA in 2018 as part of a supervisory review of the CFD sector
  - **Capital buffers (SME firms generally exempt)**
    - Generally, small and medium sized firms are unlikely to be in scope of any regulatory mandated capital buffers. However, firms may decide to hold capital buffers as part of best practice.

- CRDIV buffers- these only apply to IFPRU 730K Full Scope firms (active Market risk takers) and there are two types of CRDIV buffers
  - **Capital Conservation Buffer (CCoB)-** calculated as 2.5% of Total Risk Exposure Amount (TREA), to be met with CET 1 capital
  - **Countercyclical Capital Buffer (CCyB-)** calculated as CET 1 capital equal to TREA multiplied by the weighted average of the countercyclical buffer rates that apply to exposures in the jurisdictions where the firm's relevant credit exposures are located
- **IFPRU and BIPRU Firms**
  - Capital Planning Buffer- held as a result of stress tests to ensure that a firm continues to meet capital requirements during periods of stress
  - Liquid assets buffer- generally doesn't apply to small and medium firms but applies to firms that conduct an ILAAP (Internal Liquidity Adequacy Assessment Process) or similar detailed liquidity assessment. Firms in scope of the liquid assets buffer requirement are required to maintain adequate liquidity resources of high-quality assets

- **Assess exposure to Credit Risk:** Conduct Credit risk calculations in line with the Capital Requirement Regulations (CRR). Generally, all assets that are not deducted from own funds (such as intangibles and goodwill) must be risk weighted and assessed for credit risk in line with the CRR.

Small and Medium sized firms tend to use the Standardised Approach to Credit Risk as laid down in the CRR. Larger firms such as large Banks sometimes develop Internal Ratings which they use with Regulatory approval.

- **Don't forget Counterparty Credit Risk:** Counterparty Credit risk is a subset of credit risk that could arise on over the counter derivative trades. Counterparty credit risk only arises where the investment firm is counterparty to a trade for example when trading on a matched principal basis or principal basis. Matched principal brokers will be exposed to counterparty credit risk on both sides of a transaction, the client side and the liquidity provider. Note that a Credit Valuation Adjustment (CVA) has to be calculated and included in Pillar 1 associated with the mid-market valuation of Counterparty Credit Risk.

Small and Medium sized firms tend to use either of three methods to quantify counterparty credit risk: mark to market, original exposure, or the standardised approach

- **Quantify Market risk in the Trading Book:** Carefully analyse trading book risks and conduct Market risk assessments in line with regulations for the instruments in scope. Generally, Market risk will fall within one of four categories depending on the characteristics of the financial instruments; these
are equities, debt instruments, foreign exchange, and commodities. Equities
and debt instruments are exposed to both specific and generic risk. Foreign exchange risk can arise both on the trading book on fx positions such as fx futures, forwards, or CFDs, as well as spot-fx exposure on the Balance sheet due to operating assets outside the reporting currency. Several methods for calculating Market risk are awarded through the regulations and firms should carefully select the most suitable that is allowed by the Regulator.

- **Calculate the FOR correctly:** Make sure you calculate the 'Fixed Overhead Requirement' correctly. Generally, investment firms that are not IFPRU730K Full Scope will use the Fixed Overhead Requirement as a proxy for Operational risk in their Pillar 1 variable calculations. The FOR is calculated by taking a quarter of the previous year fixed overhead costs or based on business projections where a firm has not traded a full year. Several deductions are allowed as per the EBA technical standards, as below:
    - fully discretionary staff bonuses.
    - Employees', directors', and partners' shares in profits, to the extent that they are fully discretionary.
    - Other appropriations of profits and other variable remuneration, to the extent that they are fully discretionary.
    - Shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue, and where the payment of the commission and fees payable is contingent upon the actual receipt of the commission and fees receivable.
    - Fees, brokerage, and other charges paid to clearing houses, exchanges, and intermediate brokers for the purposes of executing, registering, or clearing transactions.
    - Fees to tied agents in the sense of point 25 of Article 4 of Directive 2004/39/EC of the European Parliament and of the Council5, where applicable, notwithstanding the provisions of paragraph 3.
    - Interest paid to customers on client money.
    - Non-recurring expenses from non-ordinary activities

- **Calculate your Capital Resources (also known as own funds):** Capital resources (own funds) comprise of Common Equity Tier 1, Additional Tier 1, Tier 1, and Tier 2 capital. Make sure you make any mandatory asset deductions (current year losses, intangibles, goodwill, certain deferred taxes, etc) from own funds in line with the regulations. Such deductions can make a significant difference on own funds for some firms such as firms posting current year losses or those heavily invested in platform developments costs or other intangible assets. For most firms' own funds will be made up of share capital and retained earnings or losses.

- **Capital Resources (Own Funds) vs. Capital Requirements:** Make sure that the firm has adequate capital resources (own funds) to meet its Pillar 1 capital requirement, any capital buffers (if applicable), and Pillar 2 capital requirements of the firm. Some firms may receive Individual Capital guidance (ICG) from the Regulator following a detailed ICAAP review. Such firms should ensure that they meet ICG.

Watch out for retained and current year losses. These will reduce your own funds

- **Stress tests:** Don't forgot to stress test your base case (business as usual) financial forecasts and carefully select stress scenarios that are relevant at a micro and macro level. IFPRU and BIPRU Firms should also conduct SYSC 20 Reverse Stress tests (exemptions available for BIPRU firms).

- **Don't forgot about Liquidity:** Liquidity risk focuses on cash flows, profitability, solvency, and asset and liability management, among other aspects. Most small and medium sized IFPRU and BIPRU firms will only be in scope of BIPRU 12.1 to BIPRU12.4 which has less stringent requirements to an ILAS BIPRU Firm that has to undertake a detailed Liquidity Risk assessment and typically document an ILAAP or similar document. When looking at Liquidity, firms should look at the asset and liability management aspects of the firm and focus on the following areas mandated through the regulations.
    - pricing liquidity risk.
    - intra-day management of liquidity.
    - management of collateral.
    - management of liquidity across legal entities, business lines and currencies; and
    - funding diversification and market access.

  Firms should conduct liquidity stress tests and establish the need for liquidity buffers. Firms should also document a stringent Contingency Funding Plan to address action to be taken when a firm runs into liquidity stress.

Most small and medium sized IFPRU and BIPRU firms will be exempt from the detailed liquidity rules and reporting requirements such as CRR part six LCR and NSFR requirements. All firms are still however required to have a documented Liquidity Adequacy Assessment including Liquidity Stress Tests and a Contingency Funding Plan

The EBA in conjunction with ESMA is working on a new prudential regime for Investment Firms. Please refer to our articles on the IFD/IFR set to go live in June 2021, replacing the CRD/CRDIV/CRR for most Small and Medium sized Investment Firms.