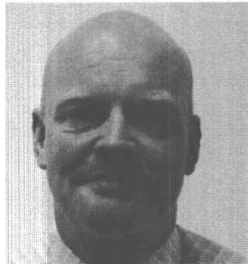


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A new directive could mean that investment management firms will have to set aside significantly higher amounts of cash depending on how clients are assessed. Driven by the FSA, it will be rigidly enforced – so what are the key elements of the Internal Capital Adequacy Assessment Process?

Reining in risk



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On 1 Jan, 2007, the Capital Requirements Directive was implemented in the UK by the Financial Services Authority (FSA). This is an amendment to its own systems and controls rules, and includes the require-

ment for firms to undertake an Internal Capital Adequacy Assessment Process (ICAAP). Most investment management firms must undertake this by 1 Jan, 2008.

The ICAAP must be completed by all firms that make investment management decisions. This includes any whose FSA permissions include the ability to manage investments and make discretionary investment decisions, whether they use them or not.

So now is another good time for every firm to look at its permissions and ask itself whether it really provides all the services it is allowed to. If, for example,

a firm is providing investment advice alone, and this is confirmed by its permissions, it will not need to complete an ICAAP whether or not it is subject to MiFID requirements.

■ Listing the risks

An ICAAP is the process by which a firm's senior management considers their business risks. It requires the documentation of what these key risks are, details of how they are managed, and consideration of any capital that might need to be set aside to adequately mitigate them.

Where a firm identifies additional capital needs through the ICAAP, this

becomes the firm's new minimum capital requirement. There may be some temptation for firms to pay only a passing regard to this, as the last thing many of them want is a higher capital requirement than they already have.

But the FSA requires firms to put in place risk management arrangements to meet their obligations. Periodically, they are expected to review the strategies and policies put in place for taking up, managing, monitoring and mitigating the risks the firm is, or might be, exposed to, including those posed by the macroeconomic environment in which it operates.

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The ICAAP provides a framework for achieving these requirements as well as validating the amount of capital that is in place to meet the risks of the firm.

■ Detailed analysis

This means the FSA will look at ICAAP as a fundamental part of the way the business is run and controlled. And scrutinised it certainly will be.

Even the smallest investment management firms will be required to submit information of ICAAP to the FSA, which will look in detail at a broad range of firms' submissions, particularly those that appear to be at odds compared with their peers.

The impact of ICAAP should not be underestimated, as this is not just another regulatory return.

Central to the concept is the notion that a firm must use its findings in the running of its business and the FSA will expect to see evidence of this.

So those responsible for producing the ICAAP should not treat it as a one-off task but as a core management tool that needs continually to be challenged and updated.

As part of their oversight and governance arrangements, senior managers should also be looking at the ICAAP, the risks it identifies and the mitigation arrangements it proposes sufficiently often.

■ Preparing an ICAAP

The principal risk for asset management and securities

firms not using their balance sheet for investment business activities is the operational one. Firms will need to document their policies and processes to evaluate and manage the exposure to operational risk, including those that are low frequency but high severity.

The FSA defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk". It requires firms to develop a definition of operational risk appropriate to their business. But firms can adopt the FSA definition if it is appropriate.

An ICAAP should have a practical focus and address the key risks that are specific to a firm's operations, so it can be used to evaluate whether the amount of capital required by the FSA minimum capital standards is sufficient to mitigate the firm's risk.

Firms will need to assess if their risk management procedures are effective. To do this they need to consider the major risk scenarios, the controls in place to mitigate the risks and, at the extreme, the continuity and viability of the business (see 'ICAAP structure and process' box).

They will need to capture information to support their risk evaluation. This may be as simple as documenting the arrangements but may require a broader information capture process, such as a risk

identification meeting.

Firms should be proportionate about all of this, recognising that many investment firms have relatively small levels of balance sheet risk. Indeed, many risks are resolved by having sufficient resources to transfer the client obligations to another investment firm, or liquidate a portfolio or fund and return the money to the clients. In many group situations these obligations can simply be transferred outside the UK.

These closure arrangements are one of the key aspects of ICAAP since, in extreme risk situations, this may be the only realistic course of action for most firms.

■ Yearly examination

A firm's ICAAP will be subject to annual review by the FSA through its integrated reporting system. The questionnaire firms must submit will gather key data about their ICAAP that the FSA will initially analyse electronically.

We can expect the FSA to request a copy of the ICAAP document for desk-top review from a cross-sample of firms, and it may then request further information.

Larger firms will be subject to a Supervisory Review Evaluation Process, a detailed dialogue and challenge process; while medium-sized firms will be subject to a streamlined version of it.

Where the FSA is not satisfied with the assessment, it can provide individual

capital guidance requiring firms to hold more regulatory capital.

But the key for each firm is to remain proportionate in preparing its ICAAP. Firms must also remember that FSA requirements should be considered relative to the nature, scale and complexity of their business. For many investment management firms, this will mean a relatively straightforward process.

But firms must treat ICAAP seriously and ensure they get value from it by using it as one of the fundamental tools for managing the risks inherent in their businesses.

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PA SUMMARY

Each investment management firm must complete an Internal Capital Adequacy Assessment by 1 Jan, 2008.

Under the ICAAP, a firm's senior management must document its business risks and consider any capital that might need to be set aside to adequately mitigate them.

The ICAAP will be reviewed annually, with the possibility that the capital adequacy requirements could also change annually.

PA ICAAP STRUCTURE AND PROCESS

As the ICAAP is a new requirement, industry benchmarks are only just beginning to emerge. But the following list is a good starting point for firms thinking about how to structure their ICAAP and the content it requires.

- Executive summary
- Background
- Summary of current and projected financial and capital positions
- Capital adequacy
- Key sensitivities and future scenarios
- Aggregation and diversification
- Challenge and adoption of the ICAAP
- Use of ICAAP within the firm

Possible process for an investment management firm:

- Identify all material risks
- Explain likelihood and impact of such risks
- Set out risk mitigation plans
- Consider the adequacy of its closure provision
- Detail any professional indemnity insurance and consider its effectiveness
- Demonstrate the ICAAP is forward looking
- Conclude on whether the amount of capital is reasonable

Source: IMS Consulting

PA ICAAP: IMPACT ON INTERMEDIARIES

WHAT DOES THE ICAAP MEAN FOR INVESTMENT MANAGERS?

In theory, if an ICAAP identifies risks then a firm should consider holding more capital to cover them. But in practice, most risks will be better mitigated by a business or operational control. If that control is put in place, then holding extra capital would not be necessary. If capital is required, the amount for many firms is probably within the level of capital they currently maintain.

WILL HIGHER FEES BE NEEDED TO FINANCE ANY GREATER CAPITAL ADEQUACY REQUIREMENT?

There should not be higher fees as a consequence of ICAAP, because most firms use other controls to manage their risks. If firms do not

do so, and do not have enough existing capital in the business, then higher fees are theoretically possible. But those which do put up their fees are likely to find themselves at a competitive disadvantage, causing investors to switch firms. This gives them an incentive to manage their risks efficiently as well as effectively.

WHAT ABOUT INVESTOR CONFIDENCE?

A primary aim of the ICAAP is to improve investor confidence. Whether it is by capital or other means, investors should feel reassured by dealing with a firm that takes positive steps to manage the risks it faces.

Source: IMS Consulting