Actuaries Institute

Actuaries Managing Risk – Insights
ICAAP – Practical Insights from Banking Industry

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Introduction

- ICAAP (Internal Capital Adequacy Assessment Process) has been part of banking across the world for a number of years.
- Is key Pillar 2 disclosure.
- Different regulators have different views on the ICAAP. The FSA in the UK in particular has been very prescriptive.
- ICAAP has been introduced for insurers as part of the LAGIC framework by APRA. APRA has also taken the opportunity to align the requirements within the banking industry and introduced new standards and practice guide to assist this.

Key Considerations

- Separate summary of the process and reports on the outcomes of applying the process. (Although these can be combined).
- Stress testing and scenario testing are critical part of determination of adequacy.
- Needs to be forward looking.
- Triggers (and actions) to protect against downward movements in capital ratios.
- Board involvement in developing the ICAAP.
- Regular review and challenge of the ICAAP.

What should be in the ICAAP?

- What are the risks the institution is exposed to and how are they managed eg capital or other mitigants
- How is capital aggregated or diversified
- How is capital managed and used in business decision making
- What is the risk appetite and expected changes to risk profile.
- What is the current level of available capital and how does that relate to the capital required to meet the business' risks.
- What is the projected capital and capital requirement, both on a normal and downside/stressed basis.
- What controls and mitigants does the institution have in place to protect the capital position from declining too far e.g. triggers.

The ICAAP is an umbrella document that brings together all the aspects of the capital management process

- Risk Appetite Statement
- Capital Management Plan
- Stress Testing
- Strategic and Financial Plan

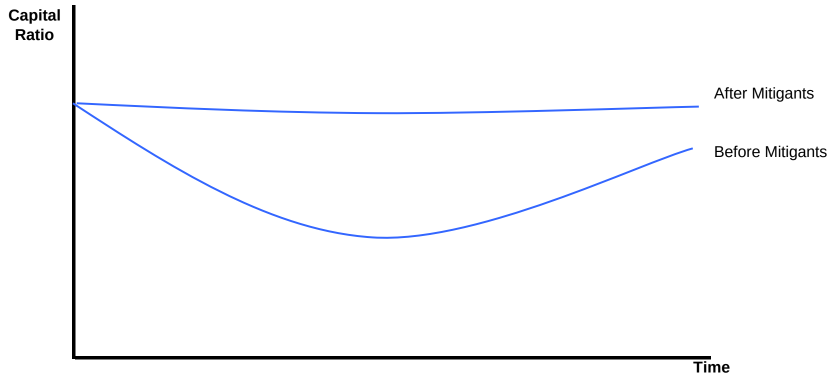
- Typically the ICAAP document is the only place people see all these come together as it's the intersection of Finance, Risk and Treasury.

This all sounds sensible, but in practice a number of key questions need to be asked.

- How easily can you do stress testing for a complex organisation?
- Do you have adequate capital models – in particular economic capital models that provide good information about concentration and diversification?
- Who does the ICAAP? Risk, Finance or Treasury?
- How do you get the board across it in enough detail but not confuse them?
- How is the ICAAP embedded in the business?

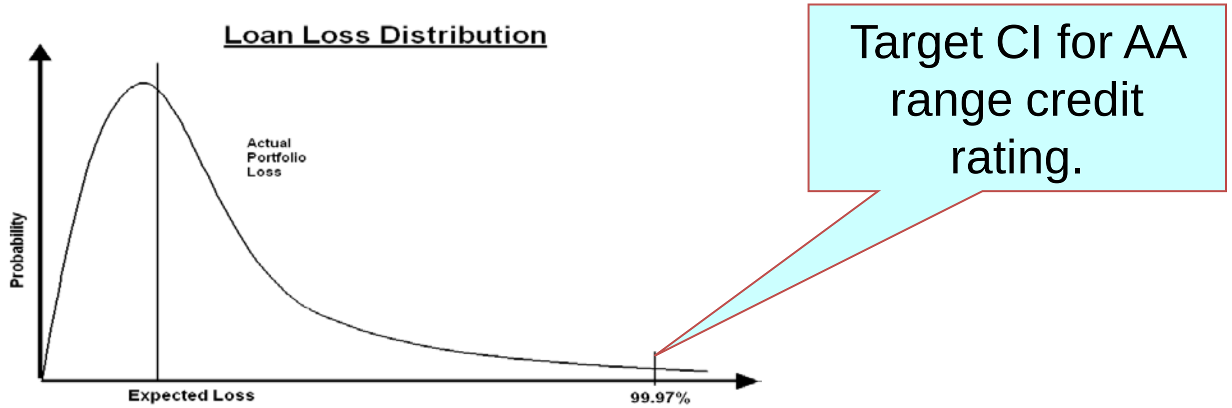
Stress and Scenario Testing

- Important to understand the adequacy of capital as well as the mitigants available eg repricing, raising capital, changes to dividend settings, shedding business, cutting bonuses etc.



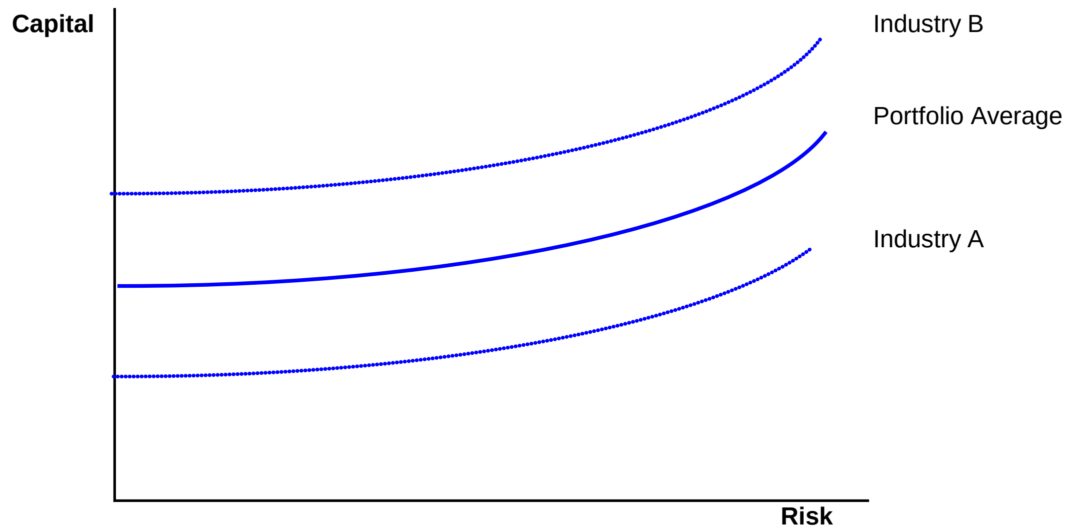
- This can be used to determine capital triggers where actions are required to restore the capital position.
- Should have severe tests but intermediate scenarios are critical as well.
- Do not underestimate the resources needed to do the stress testing.

Economic capital is a key part of the ICAAP

- Economic Capital set to confidence interval for target rating. Note Reg Capital assumes 99.9%
- 

- Reg Capital is also based on formulae and methods that while being risk based are limited by the form of the equations.

Economic capital measures diversification between customers and individual risks within a risk type.



This is important to determine concentration risks that regulatory capital does not capture, and whether additional capital is needed for this.

- Economic Capital captures additional risk types over the Pillar 1 risks. Including Business Risk and Pension Risk.
- Economic Capital allows for diversification between risks categories.