

Comment piece: Essential Risk Components of ICAAP

local knowledge global solutions

This comment piece looks at the Internal Capital Adequacy Assessment Process (ICAAP)

What is ICAAP?

The Internal Capital Adequacy Assessment Process (ICAAP) is an internal assessment of capital that a bank can conduct in order to cover the material risks to which it is exposed. The purpose of the ICAAP is to formalise a bank's approach to understanding its risk profile and the processes and systems it needs to have in place to assess, quantify, and monitor risks. It is aimed to achieve transparency and improved risk management in institutions, and thereby increased stability in the financial system.

Guiding Principles of ICAAP

Under Pillar II of the Basel II accord, the ICAAP should be guided by the following principles:

- **Risk-based:** ICAAP should be based on risk-management approaches.
- **Capital adequacy:** Every institution must have a process for assessing its capital adequacy relative to its risk profile; ICAAP design should specify the institution's capital policy.
- **Principle of proportionality:** The ICAAP's design should be proportional to a bank's size, risk level, and complexity;
- **Forward looking:** It should consider existing risks and possible future risks facing the bank;
- **An ongoing exercise:** The ICAAP is a dynamic and continuous process to ensure sufficient internal capital as business and market conditions change;
- **Have an evolving-nature:** The ICAAP should be continuously monitored and improved as needed for evolving business conditions and institutional complexity and experience.

ICAAP and Basel III

In the aftermath of the 2008 global financial crisis, to reinforce the stability of the financial system, policy makers and the Basel Committee have developed proposals to ensure that financial institutions maintain sufficient capital buffers. The December, 2009 proposal by the Basel Committee outlines fundamental changes and is already being called "Basel III" by the practitioners.

It includes a more restrictive definition of Tier one capital, use of leverage ratios, restrictions on discretionary distributions of earnings, and a "bottom-of-the-cycle" calibration for the Pillar I regulatory capital requirements.

While the jury is still out on 'Basel III' many have argued that these additional measures imply redundancies and likely to result in income and profit destruction per unit of capital base. Addressing the capital buffer problem within the Pillar II Internal Capital Adequacy Assessment Process (ICAAP) framework supplemented by conditional and forward looking stress testing and reverse stress testing simulations is a more flexible and preferred approach for banking risk managers.



Michael Henroid
Regional Solutions Manager,
FRSGlobal APJ

+65 6488 5019
Michael.Henroid@frsglobal.com

Essential Risk Components of ICAAP

ICAAP is dealing with all different types of financial and operational risks.

Credit risk (including counterparty credit risk, concentration risk, equity risk in the banking book, securitisation risk, country and transfer risk, residual risk from CRM strategies)

Market risk (interest rate risk, equity risk, commodities risk, foreign exchange risk)

Operational risk

Interest rate risk in the banking book

Liquidity risk

Other risks (including strategic risk, reputation risk, business risk, legal and compliance risk and more)

FRSGlobal solutions

FRSGlobal provides global risk analysis and regulatory compliance solutions on a unified platform through a combination of modules from **RegPro** and **RiskPro** that need to be employed in ICAAP analysis.

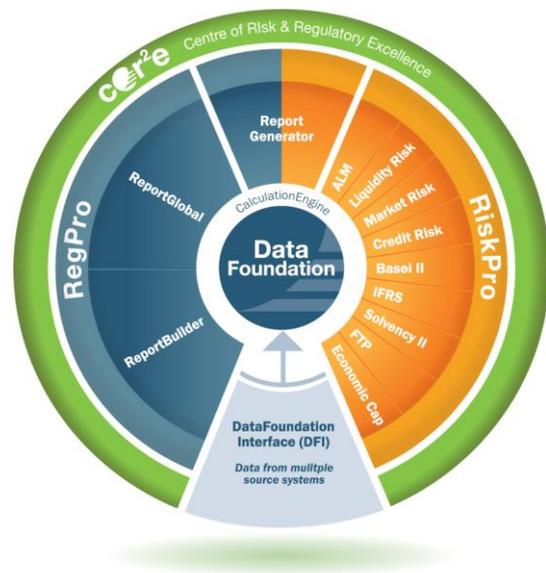
- The **RegPro** modules are designed to meet global regulatory reporting requirements
- The **RiskPro** modules are designed to meet risk management and profitability analysis and operational risk requirements
- FRSGlobal solutions share a unified platform with DataFoundation risk and regulatory data repository, and CalculationEngine for complex calculations.

RiskPro provides unified risk and profitability analysis. It covers a broad scope and depth of financial analysis, ensuring consistency of results and reducing the cost of analysis.

RiskPro has extensive financial product coverage, from saving accounts, complex loans, insurance instruments to exotic options and structured products.

RiskPro covers value and exposure analysis for all types of methods (fair value, nominal, NPV, observed value, amortised cost, various discounting methods etc), duration, key rate duration, sensitivity measures, various types of gap analysis, price and volatility shift, and VaR (parametric, historical simulation, Monte Carlo).

RiskPro solutions provide the user with the power of dynamic simulation – which allows evaluating potential decisions in a “*what-if*” environment, and as a consequence enables highly quantified strategic decisions to be made with confidence.



FRSGlobal's offering

This document is produced by the FRSGlobal Centre of Risk & Regulatory Excellence (CoR²E) team.

FRSGlobal is the only supplier of regulatory risk and compliance reporting, with coverage for 40+ countries. We provide over 1500 financial organisations – including 41 of the top 50 banking institutions – with enterprise risk and regulatory compliance reporting solutions that enable them to increase operational efficiency reduce costs and mitigate risks.

FRSGlobal customers receive software and rich regulatory content that is fully supported by the Regulatory Update Service. This ensures that the regulatory reports under subscription are kept fully up-to-date with regulators' requirements. This Service is facilitated by the FRSGlobal Centre of Risk and Regulatory Excellence (CoR²E) which monitors the changes that affect reporting requirements in more than 100 countries

The CoR²E group publishes a newsletter describing the latest regulatory developments. To subscribe, please register at www.frsglobal.com.