

INVESTMENT FUNDS ALERT

IMPLEMENTATION OF THE U.K. FINANCIAL SERVICES AUTHORITY'S INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS



INTRODUCTION

The following note is of interest to those investment advisors with regulated offices in the U.K.

On 1 January 2007, the Financial Services Authority (FSA) implemented the provisions of the EU Capital Requirements Directive by issuing the GENPRU and BIPRU sourcebooks, bringing into effect rules regarding, among other things, capital adequacy, risk management and reporting requirements. In particular, the new rules introduced the concept of an Internal Capital Adequacy Assessment Process (ICAAP), by which firms are expected to assess the key risks attributable to the firm's operations, their risk management procedures, and what, if any, capital the firm needs to set aside on account of these risks.

The first year following the introduction of GENPRU and BIPRU was a "transitional phase," during which ICAAPs were optional but not required. However, as of 1 January 2008, the transitional provisions have ceased to apply, and firms regulated by the FSA are now subject to the full ICAAP regime.

This note is intended to provide basic guidance on the ICAAP requirements, in particular:

1. what is an ICAAP;
2. how to prepare an ICAAP document;
3. what else do firms need to consider; and
4. where to find further information.

WHAT IS AN ICAAP?

An ICAAP is an internal risk management process. The purpose of an ICAAP is to inform a firm's senior management of the ongoing assessment of the firm's risks, how the firm intends to mitigate those risks and how much current and future capital is necessary having considered

other mitigating factors. In addition, the document produced by a firm to record its ICAAP (ICAAP Document) will form the basis of how the firm explains its internal capital adequacy assessment process to the FSA.

The obligation to conduct an ICAAP includes requirements on a firm to:

1. carry out regular assessments of financial resources, capital resources and internal capital, to ensure these are adequate to cover the nature and level of risks to which the firm is or might be exposed;
2. identify the major sources of risk to the firm's ability to meet its liabilities as they fall due;
3. conduct stress and scenario tests;
4. ensure that the processes, strategies and systems outlined in a firm's ICAAP, and as required by the GENPRU and BIPRU regimes, are both comprehensive and proportionate to the nature, scale and complexity of the firm's activities; and
5. produce an ICAAP Document.

As of 1 January 2008, most regulated investment managers and advisors are required to prepare and document their ICAAP. Responsibility for structuring the ICAAP and assessing the firm's internal capital requirement lies with the firm's senior management. A firm should ensure that its ICAAP forms an integral part of the firm's management process and decision-making culture.

HOW TO PREPARE AN ICAAP

An ICAAP is intended to be a practical tool, and as such it should address the key risks that are specific to the firm's operations and how effective are the risk management procedures which are employed by the firm. It is incumbent on the firm to provide evidence of risk consideration, for example through board minutes detailing the issues discussed and conclusions drawn.

The process of carrying out the ICAAP must be proportional to the complexity of the business. In ascending order of complexity, examples of how to go about preparing an ICAAP might include the following:

1. Informal discussions between fund managers or senior partners in the firm.
2. Internal questionnaire addressing each area of potential risk and the likelihood of it occurring in relation to the firm's operations.
3. Tasking specific risk management professionals or committees within the firm with responsibility for the ICAAP.
4. Engaging external advisors and consultants.

Whatever procedures are followed, the firm should consider the major risk scenarios, in both qualitative and quantitative terms, and assess the adequacy and flexibility of its systems and controls to accommodate both present and future business plans. As a good basis for risk consideration, and a useful starting point for the ICAAP Document, firms should produce a matrix setting out the categories of risk and how these are managed. The complexity of this matrix will also vary depending on the firm's business. A sample ICAAP matrix may be found in AIMA's Guidance Note on the FSA's

Internal Capital Adequacy Assessment Process (although note that every firm needs to assess its individual risks, and the matrix will need to be amended accordingly).

Finally, the firm must produce an ICAAP Document. Although a firm need not, as a matter of course, submit this to the FSA, the FSA may request a copy of the firm's ICAAP at any time for its review, and larger firms in particular should expect this to happen regularly.

Since the ICAAP is a new requirement, there is no current industry standard ICAAP Document. However, the FSA does provide a sample document for smaller firms on their website entitled "ICAAP submission - suggested format," and it would be prudent to use this document as a starting point for producing a firm's own ICAAP Document.

WHAT ELSE DO FIRMS NEED TO CONSIDER?

The following is a summary of certain additional considerations, but should not be considered a comprehensive list.

- An ICAAP is an EU requirement. Accordingly, the FSA will not grant a waiver from the requirement to produce an ICAAP.
- Firms which report to the FSA on a group basis should be able to rely on their group's ICAAP.
- A firm's ICAAP should be subject to review at least annually, or more frequently if the situation warrants.
- All firms which are required to have an ICAAP will be subject to the FSA's next review stage, the Supervisory Review and Evaluation Process (SREP). The SREP will be used by the FSA to review and evaluate firms' exposure to risk, and the adequacy and reliability of their ICAAP. Having already prepared its ICAAP, a firm will be better placed to deal with the SREP. Further information regarding the SREP may be found on the FSA's website.

WHERE TO FIND FURTHER INFORMATION

Further information regarding ICAAPs can be found at the following websites:

- AIMA's Guidance Note on the FSA's Internal Capital Adequacy Assessment Process, including sample ICAAP matrix: <http://www.aima.org/uploads/AIMAGuidanceNoteonICAAP.pdf>
- FSA's CRD bulletin: http://www.fsa.gov.uk/pubs/international/CRD_bulletin6_inv.pdf
- FSA's suggested ICAAP template (for smaller firms): http://www.fsa.gov.uk/pages/about/what/international/pdf/icaap_smaller.pdf
- FSA handbook regarding GENPRU <http://fsahandbook.info/FSA/html/handbook/GENPRU>, and BIPRU <http://fsahandbook.info/FSA/html/handbook/BIPRU>

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