

*Industry Position Paper*

**Internal Capital Adequacy Assessment Process (ICAAP)**

**Introduction**

This paper on the internal capital adequacy assessment process, or ICAAP, is one in a series of industry position papers by the AMA Group<sup>1</sup> on business practices affecting the implementation of AMA in the United States.

**Background**

The July 2008 final supervisory guidance<sup>2</sup> published by the U.S. Federal Banking Supervisory Agencies describes standards for overall capital adequacy for firms that are required as a part of Pillar 2 of the U.S. implementation of Basel II. U.S. supervisors plan to apply these standards to any bank using the advanced approaches to Basel II. Part of this guidance document deals with the internal capital adequacy assessment process, or ICAAP, that each advanced approaches firm should have.

Firms have three main measures of capital:

- (1) Regulatory Minimum Capital Requirements, including:
  - a. Pillar 1 Capital Requirement: the estimate of minimum capital adequacy, based on separate assessments of credit, market and operational risks. This is required under Pillar 1;
  - b. Internal Capital Requirement: the internal estimate of capital adequacy, based not only on separate assessments of credit, market and operational risks, but also on other risks, such as liquidity risk, and on how all of these risks might interrelate materially. This is generated by the Internal Capital Adequacy Assessment Process (ICAAP) required under Pillar 2;

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<sup>1</sup> The Advanced Measurement Approaches Group (AMAG) was formed in 2005 by the RMA at the suggestion of the U.S. Inter-Agency Working Group on Operational Risk. The RMA – the Risk Management Association -- is a member-driven professional association whose purpose is to advance the use of sound risk management principles in the financial services industry.

The purpose of the AMAG is to share industry views on aspects of AMA implementation with the U.S. financial services federal regulatory agencies. The Group consists of senior operational risk management professionals working at financial service organizations throughout the United States. The AMAG is open to any financial institution regulated in the United States that is either mandated, opting in, or considering opting in to the Advanced Measurement Approaches under Basel. A senior officer responsible for operational risk management represents each member institution on the AMAG. Of the twenty or so US financial service institutions that are currently viewed as mandatory or opt-in Basel II institutions, sixteen were members of the AMAG at the time of this Survey; there were twelve members as of the time of this writing.

The names of AMAG members that agree with this Industry Position Paper are shown in the Attachment. Their institutions are listed for identification purposes. This paper does not necessarily represent the views of RMA's institutional membership at large, or the views of the individual financial service firms whose staff have participated in the AMAG.

Support for the AMAG is provided by RMA and Operational Risk Advisors LLC.

<sup>2</sup> Supervisory Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework (July 15, 2008).

- (2) Economic Capital: a measure of the amount of risk taken by parts of the bank and the bank as a whole that is used to manage the bank in various ways, including in particular risk adjusting performance measurement; and
- (3) Book Capital Level: the level of firm resources available for absorbing loss net of liabilities.

(1)(a) and (1)(b) are standards based on measures of risks; (2) is a management tool, also based on measures of risk; and (3) is the level of capital resources that a firm has recorded on its balance sheet. Under Pillar 1, regulators insist that (3) > (1)(a). Under Pillar 2, they insist that (3) > (1)(b) and they expect that (1)(b) > (1)(a), unless there is strong evidence to the contrary. Well run financial firms will want to have (3) > (2) and many firms actually use a higher standard of confidence for establishing (2) than regulators require for (1)(a) or (1)(b), often pushing the firm's capital resources well above the level of the two regulatory requirements.

In addition to the July 2008 document, regulators have made it clear in various industry presentations that they expect ICAAP to be documented and some have indicated that they expect the documentation to be comprehensive.

### **Industry Practices**

ICAAP is new in the United States, so there is no established range of industry practice to report at the time of this writing. AMA Group members have, however, expressed concerns about the additional burdens that ICAAP may impose on their institutions.

### **Industry Positions**

***Position 1: There is no general reason why the methodology used to estimate the contribution of operational risk to the Pillar 2 Internal Capital Requirement should be materially different from its contribution to the Pillar 1 Capital Requirement.***

Differences between operational and other types of risk: For market and credit risk, regulations prescribe in detail a standard methodology for calculating the Pillar 1 Capital Requirement, but they give firms much more leeway on how the ICAAP covers these two types of risk in the Internal Capital Requirement calculation. Some firms will use this latitude to adopt a scope, method and approach for the ICAAP that is quite different, to ensure as far as possible that result properly reflects their risk profile.

Operational risk is different. Because the AMA for estimating the Pillar 1 Capital Requirement is flexible, methodological differences are unlikely to be necessary to ensure the Internal Capital Requirement reflects the operational risk profile as well as possible. While differences in parameter choice – confidence intervals and time horizons for example – may arise and some differences in practice may affect the final number – such as mitigation practices – the regulatory insistence that AMA should reflect internal estimation practices means that it is unlikely there will be any material differences in methodology between ICAAP and Pillar 1 Capital.

Conservatism The July 2008 Guidance makes several references to “an appropriate level of conservatism” with a blanket requirement in paragraph 26 and individual examples added in the subsequent paragraphs. So far as capital requirements for operational risk are concerned, “an appropriate level of conservatism” is required in the estimation of the Minimum Capital Requirement under Pillar 1 and, the name of this standard notwithstanding, there is no rationale for adding extra capital over and above that minimum level.

Equally, there is no case for adding capital to that minimum requirement to ensure there is enough to “account for changes in a firm’s strategic direction, evolving economic conditions and volatility in the financial environment” (Para 36). All of these concerns should have been considered in Pillar 1 and, to the extent that they were judged to be material, they should have been addressed through some combination of BEICF, scenario analysis and stress testing.

*Scope of applicability* This principle applies to operational risk considered in isolation. It is quite possible that adjustments will be needed to take account of possible diversification and dependency effects between operational risk and other forms of risk during the ICAAP calculation – adjustments whose net effect may be to add or subtract from the sum of the individual capital requirements for the principal kinds of risk taken separately.

***Position 2: There is no general reason for firms to provide extra documentation for operational risk under ICAAP.***

*Thorough documentation under Pillar 1:* U.S. supervisors already require a good deal of documentation as part of a firm’s Pillar 1 qualification process - and regularly during exams. In this respect, they go far beyond the practice in most other banking jurisdictions. In preparation for Basel II they have asked for, and received, a great deal of documentation of operational risk management practices and capital estimation methods.

In accordance with those requirements, this documentation has been thorough, timely and complete. Once again, the fact the Minimum Capital Requirement and the Internal Capital Requirement will generally be the same, obviates the general need for any additional documentation. Of course, where issues outlined in the ICAAP regulation have not been addressed in the bank’s qualification documentation and where these issues are material, there may be a special need for additional documentation. Examples might be documenting the “linkage between capital adequacy and damage or potential damage to a bank’s reputation” (par 22), or in documenting a “description of the bank’s overall capital management process including the committees and individuals responsible” (par. 41). But it seems likely that these will be the exception, rather than the rule.

As written, much of U.S. ICAAP imposes a redundant and unnecessary burden on U.S. financial firms. A more effective and reasonable requirement, therefore, would be a scaled back version of ICAAP that would complement the already rigorous examination process in the U.S., not one that seems more reflective of other jurisdictions, where in some cases, regulators do not even visit their subject institutions. A key goal of U.S. ICAAP should be a mutually beneficial process for both the firms and their regulators.

**Attachment**

**AMAG Signatories**

Following are the AMAG member signatories to this Industry Position Paper on ICAAP:

BNY Mellon  
Comerica  
Goldman Sachs  
HSBC  
JP Morgan Chase  
Keycorp  
Morgan Stanley  
State Street  
SunTrust  
Union Bank of California  
Wells Fargo / Wachovia