Agenda

• Introduction
  Lorraine Bay, Partner

• Capital, liquidity and recovery plan
  Giovanni Giro, Senior Manager

• Wind-down planning
  James Eldridge, Director

• Insights from the Regulator
  Andrew Jacobs, Director

• Conclusion
  Lorraine Bay, Partner
Capital, liquidity and recovery plan

Giovanni Giro
Introduction

1. Capital adequacy and ICAAP

2. Liquidity and contingency funding plan

3. Recovery and resolution plan

Recommended best practice
1. ICAAP

- Internal Capital Adequacy Assessment Process.
- Purpose: assess risks and calculate regulatory capital
- Key stages in the process:
  - Identify regulatory requirements and follow guidance
  - Business model and strategy (incl. group)
  - Risk appetite statement and risk assessment
  - Stress testing and scenarios analysis (incl. wind-down)
  - Review and challenge from senior management
- Pillar 2 capital determines actual risk-based capital requirement
- Allows senior management to monitor capital level and risk management
- Demonstrates firm's capital adequacy to the FCA
Application

- All firms subject to MiFID and CAD/CRD including:
  - BIPRU firms (portfolio managers)
  - IFPRU investment firm (brokers, investment banks)
  - CRR firms (UK banks and dual-regulated firms)
  - CPMI (AIFMs and UCITS managers doing MiFID business)
Risk management framework

- Establish and maintain a comprehensive risk matrix tailored to the firm’s specific business

- The purpose of a risk framework is to support the ICAAP process by:
  
  - Analysing all risk types and describing specific trigger events
  - Assessing impact and probability of each risk
  - Identifying any mitigating measures
  - Evaluating the need of any capital allocation to cover the risks
  - Providing realistic assessment of Pillar 2 capital requirements
Risk appetite

- Risk appetite statement represents:
  - maximum level of acceptable risk in each area
  - matrix of risk grading and benchmarks
  - tolerance levels

**Insufficient or poor statement**

- high level terms such as ‘risk-averse’, ‘conservative’ and ‘low’
- commitment to meet Pillar 1 requirements

**Acceptable statement**

- quantitative measures (tolerated loss)
- breakdown across business lines and risk types.
Stress testing and scenario analysis

- Test the firm’s resilience in stressful conditions
- Events occurring over a protracted period of time
- Sudden and severe events
- Imaginative assumptions and various scenarios
- Consider firm-specific and macro-economic events
- Include combined scenarios
- Wind-down scenario
Challenge and adoption of the ICAAP

- Senior management must be involved in the review and challenge
- Testing and control process applied to ICAAP models and calculations
- Description of reliance on external suppliers or reviewers
- Details of any internal audit reviews
- Use of the ICAAP
- Sign off procedures
Common pitfalls

- Insufficient explanation of methodology and conclusions
- Inadequate consideration given to group and contagion risk
- Pillar 2 capital ‘forced’ into Pillar 1
- Poor articulation of risk appetite and disjoint from business objectives
- Insufficient analysis of operational risk and quantification of impact
- Scenarios not sufficiently varied and lack of combined testing
- Insufficient assumptions in reverse stress testing
- Lack of challenge from senior management
### Best practice

- Board and senior management actively engaged in the process
- Stress testing all business, all risks at different levels of severity
- Clearly documented workings and outcome
- Circumstances and events occurring over 3-5 years
- Sudden and severe events
- Combination of different scenarios
- Worst-case scenarios as the most severe but plausible
- Include liquidity stress tests
2. Liquidity and Contingency Funding Plan

- Banks, BIPRU firms, IFPRU firms, CPMIIs must “meet their liabilities as they fall due”
- Contingency Funding Plan (CFP) for handling liquidity crises
- Stress test availability of funds and reliability of funding sources
- Risks:
  - Wholesale secured and unsecured funding risk
  - Retail funding risk
  - Intra-day liquidity risk
  - Intra-group liquidity risk
  - Cross-currency liquidity risk
  - Off-balance sheet liquidity risk
  - Funding diversification risk
<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Solutions</th>
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<tbody>
<tr>
<td>Recession</td>
<td>Reduce expenses</td>
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<tr>
<td>Large loss event</td>
<td>Sell assets</td>
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<tr>
<td>Counterparty into default / liquidation</td>
<td>Injection of cash</td>
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<tr>
<td>Custodian Bank into default / liquidation</td>
<td>Subordinated loan</td>
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<tr>
<td>Combined macro and firm-specific scenario</td>
<td>Financial support from shareholders or directors</td>
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<td></td>
<td>Financial support from group</td>
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</tbody>
</table>
Common pitfalls

- Underestimating liquidity requirement
- Overreliance on group support
- Lack of forecast of unexpected liabilities
- Overreliance on recurring debtors
- Insufficient stress testing of liquidity risk
## Best practice

<table>
<thead>
<tr>
<th>Best Practice</th>
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<tbody>
<tr>
<td>Review liquidity and cash positions daily</td>
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<td>Manage cashflow on a timely basis</td>
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<tr>
<td>Monitor sources of funding regularly</td>
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<tr>
<td>Test availability of sources of funding</td>
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<td>Regular review of CFP</td>
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<tr>
<td>Rely on firm’s own resources</td>
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<tr>
<td>Identify risks and complete stress testing</td>
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3. Recovery and Resolution Plan

- Maintain recovery plan outlining credible recovery actions to restore business to stable and sustainable condition in case of severe stress.

- **Scope:**
  - Banks
  - IFPRU 730k investment firms
  - Groups that contain one of the above

- More stringent requirements for significant IFPRU firms

- Resolution plan only when required by the regulator
RP structure

- Recovery plan summary
- Governance information
- Strategic analysis
- Recovery scenarios and options
- Communication and disclosure
- Preparatory measures
Recovery plan process

- Specific and quantifiable recovery indicators in each scenario
- Recovery plan to provide solutions after stress testing
- Explain how recovery options can be implemented effectively
- Include macro-economic and idiosyncratic recovery scenarios
- Internal and external communication strategy
- Governance of escalation and authorisation process
Common pitfalls

- Single event scenarios
- Recovery options based on same solution
- Absence of early warning indicators
- Delayed submission to regulator
- Stress test assumptions different from ICAAP and CFP
- Confusion with wind down plan
Best practice

- Indicators calibrated to give early warning of a stress event
- Stress scenarios linked to risks and risk appetite
- Analysis by risk area (capital, liquidity, profitability)
- Scenarios to follow up from early warning signals
- Consistency with ICAAP and liquidity policy/CFP
- Consider multiple and varied recovery options
- Imaginative stress testing (no parent support, slow sale of assets)
- Wind-down plan if recovery option is not sufficient
FCA’s approach and our conclusion

- Expects firms to review ICAAP annually and upon material changes
- FCA intensified SREP reviews and issuing of ICG
- Combined reviews of ICAAP, RRP and Wind down plan
- Requested resubmission of Recovery Plan
- Requested ICAAP prior to Part 4a authorisation
- Thematic work on regulatory reporting (COREP)

Overall recommendations:

- Maintain effective processes from startup to wind down
- ICAAP, CFP, RRP and wind down to be addressed consistently
- Prioritise focus on prudential requirements
Wind-down planning

James Eldridge
Wind-down planning

• In wind-down planning, a firm considers how it could close down its regulated business in an orderly manner, including under stressed conditions

• Helps firms cease regulated activity with minimal adverse impact on clients, counterparties and the wider market

• The governing body of the firm:
  – Identifies the steps and resources it needs to wind down its business, especially in a resource-stressed situation
  – Evaluates the potential risks and impact of a wind-down and considers how to mitigate them
Key elements of a wind down plan

- Scenarios
- Making a decision to wind down
- Operational analysis
- Impact assessment
- Resource assessment
- Communications plan
- Client monies and custody assets
- Groups of firms
Benefits of a detailed wind down plan

- Enhanced risk management
- Understanding of how financial stress can arise and its effects
- Avoid breaching capital requirements
- Avoid insolvency
- Mitigate risks of action against directors in an insolvency
- Maximise outcome for clients, creditors and investors
Insights from the Regulator

Andrew Jacobs
Key areas of regulatory focus in relation to prudential matters
Regulatory focus spans all stages of the business lifecycle

- **Authorisation**
  - Capital and Liquidity Management

- **Trading**
  - Ongoing Risk Management and Reporting

- **Failure**
  - Recovery, Resolution and Wind-down
Capital and Liquidity Management

• Recurring themes:

• Stress testing and reverse stress testing
  – incomplete compliance with SYSC 20
  – CRD IV Pillar 2 summary and stress testing observations

• Inadequate quantification of areas of risk:
  – Credit risk
  – Liquidity Risk
  – Counterparty risk
  – Concentration risk
  – Market risk
Regulatory returns & risk management

- The importance of the ICAAP cannot be overstated
- Close attention is being paid to regulatory reporting, particularly in respect of COREP
  - Large exposures reporting
- Thematic reviews initiated, or outlined in respect of COREP, ICAAPs and related to the Recovery and Resolution Directive (RRD)
Recovery, Resolution and Wind-down

Recovery & Resolution

- Recovery Planning
  Feedback issued in May 2016

- A number of findings relayed in initial feedback, relating to:
  - Indicators
  - Scenarios
  - Options
  - Communication strategy
  - A number of broader findings

Wind-down

- Covered in GC 16/5
  - feedback given to firms about whether the failure of a firm is consistent with the FCA’s statutory objectives.
Implications for Firms

- Individual Capital Guidance level increasing Pillar 1 own funds requirement
- Addition of scalars pertaining to specific areas of concern
- Capital levels fixed until the next Supervisory Review and Evaluation (SREP) – 36 months
- Firms required to undertake a prescribed Remediation Plan
Conclusion

- Scrutiny is set to intensify in all prudential areas and all aspect of prudential matters
- The evidence of governance & oversight
- It’s not something that firm’s can afford to get wrong
- It’s certainly not something to be left to chance if you are part of a thematic review
Conclusion

Lorraine Bay
Questions or comments?
Moore Stephens FS seminar programme

Dates to be confirmed imminently and details will be publicised nearer the time:

Jan 2017 – Looking back, Looking forward
Feb 2017 – MiFID II: 12 month countdown
Mar 2017 – Senior Managers & Certification Regime
Apr 2017 – FCA Business Plan & Risk Outlook
Helping to keep up-to-date

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