

ICAAP - Revolutionary in Spirit & Evolutionary in Approach

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ICAAP regulations if implemented in letter and spirit would fundamentally change the way banks plan and strategize their business

“All courses of action are risky, so prudence is not in avoiding danger (it’s impossible), but calculating risk and acting decisively.” *Niccolo Machiavelli*

As bankers across the world go back to their strategy tables to rework their risk management framework, they would do well to heed that advice. Given that not taking Risk is not an option, prudence is in understanding risks being taken, calculating and acting on them and that is what ICAAP (Internal Capital Adequacy Assessment Process) aims to do.

Given the current challenges facing the global financial services industry, ICAAP, which falls under Pillar II of the Basel regulatory framework, could not have been mandated at a more appropriate time. It provides banks with a valuable opportunity to understand and manage their risk canvas in a brand new and holistic manner. In fact, ICAAP is a quiet revolution, disguised as a regulation as it broadens and deepens the risk canvas of a bank.

Pillar II or ICAAP is the central pillar of the spirit of the Basel regulatory framework. Pillar I was a prescriptive approach that laid down specific and detailed rules; Pillar II, requires banks to think for themselves within a broad framework. It centers around the critical idea that banks face both quantitative risks such as concentration risk, liquidity risk or interest rate risk, as well as qualitative risks such as reputation risk, strategic risk or business risk in addition to the traditional Credit, Market and the more recent Operational Risks.

ICAAP expects banks to understand their entire risk universe and identify which of those are material based on their individual businesses, operations and future plans. It encourages banks to define their risk appetite, capture the essence of their risk profiles and choose appropriate approaches and risk systems to best manage their businesses and finally arrive at appropriate capital buffer.

While this may be a liberal and empowering approach, the challenge is that banks will have to defend their ICAAP to regulators in supervisory reviews. Thus, while the risk management and the Capital Planning process is internal, its defense will be external.

The ICAAP mandate also brings to life the complexities of the banking business; it provides a three dimensional effect to risk management. In implementing the new framework, banks will have to use a six-step process. Banks must state their risk appetite, identify risks that the business carries, assess which of those risks are material, quantify the risks, do capital planning, allocate capital to businesses, and have a risk reporting framework. It is important to note that each of these steps throw up several challenges, but if implemented well ICAAP offers great new opportunities for banks.

THE CHALLENGES AND OPPORTUNITIES - CAPTURED GRAPHICALLY BELOW

Figure 1: ICAAP – Challenges & Opportunities

ICAAP Process	Challenge	Opportunity (if done right)
Risk Appetite Statement	Hitherto rarely done as a formal process-largely attempted at a very high level & on adhoc basis	Change & formalize risk consciousness at the board level and integrate it closely to strategy
Risk Identification	Little of No experience in looking beyond the traditional three – Credit, Market & Operational Risks	Who listically understand the risks being assumed in business and the erefore be better prepared
Materiality Assessment	A new frontier – Not done before and no guidelines to assess materiality	Institution's real risk profile can be assessed Focused attention on Material Risks & their mitigation.
Risk Quantification	Quantification methods for the newer and qualitative risks still at a nascent stage	Score Cards can be a starting point- what can be measured can be managed better – Leads to Improved Risk Management
Capital Planning	Forward looking hence more demanding on forecasting capability & visualization of Stress Scenarios	Use Capital planning as a strategic instrument to integrate Risk & Capital into Business Operations and Planning
Risk Reporting & Monitoring	Move from static to dynamic & interactive reporting	Use systems for decision support in planning. Operations and strategy

In a nut shell every step of the process does throw up tough challenges, none of which can be trivialized. Having said that the bright side of the exercise is that if the process is implemented as envisaged would creates such huge opportunities that the effort is more than well worth it.

A crucial part of the ICAAP process is that it is forward looking. Banks cannot depend on history alone to assess future risks because of newer products, newer ways of doing business, shrinking of global financial borders, lack of standardization etc., the demand on banks to have great clarity about their proposed balance sheet and risks it entails as also its capacity to withstand stressed situations becomes critical.

This approach tests a bank's real capability to envision the risks of its future plans, including those of new strategic initiatives, new geographies and business lines.

ICAAP offers banks the opportunity to holistically understand their risk canvas and be better prepared in their business. It invites banks to plan business growth by balancing risk and return and move from forecasting just profit to economic profit, using risk-adjusted performance measures. Thus, ICAAP has with a single stroke changed the contours of business forecasting, profit planning and capital planning and made forecasting a cognitive and deliberate process.

Arguably, the biggest challenge in implementing ICAAP is the lack of guidelines on how to assess materiality, how to quantify newer and especially qualitative risks, or how to relate these risks to capital. Skills in these areas are in their infancy, especially since there are no clear regulatory guidelines. For example, can a bank numerically quantify reputation or strategy risk and decide how much capital is appropriate to be allocated to such risks? It is here that ICAAP's evolutionary nature comes into play – since banks, academicians and regulators are working hard in this area, over time there will be answers to both how to quantify risks and how to relate them to capital.

In this context, score cards can be a good way to assess materiality. The starting point is to break down these risks into their underlying indicators and then methodically building a score card. For example, reputation risk could include the risks of negative publicity, customer complaints or possible lawsuits, each with potential costs.

Stress Testing is an effective tool for capital planning and management. The skill lies in turning stress testing into an art, a craft and a science. Banks must institutionalize stress testing mechanisms that allow them to recreate historical scenarios as well as to create blue-sky, hypothetical ones. Making Stress Testing a mere statistical exercise defeats the purpose – it needs to be led by business thinking.

On the reporting front, Pillar II calls on banks to change their reporting systems from being static to being dynamic and interactive. Such systems must capture not just risk-related information at a micro level, but must be able to provide an aggregated view as well in the form of a set of dashboards/reports that give senior management an instant and continuously updated view of multiple factors including risk, capital positions, Stress Test results etc amongst other things. This gives banks the opportunity to set up robust, interactive reporting systems that provide decision support for risk planning, profit planning and capital planning, as well as for operations and strategy.

IMPLICATIONS FOR THE STAKE HOLDERS

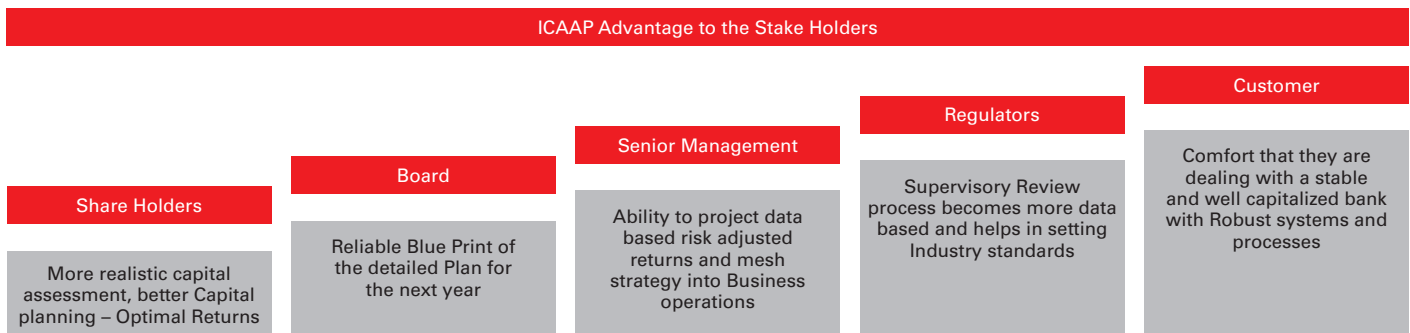
This paradigm shift has interesting implications for all stakeholders of the bank, both internal as well as external, and they are all learning on the go. First, the bank's board will now have to focus on making planning a forward looking process, it will have to define risk appetite in concrete terms and take responsibility for those definitions. ICAAP asks senior management to change their perspective from a historical one to a forward looking, futuristic and realistic one: predictive skills must be developed to formulate a future end state, which must then be worked backwards into actual plans, business operations and numbers.

Next, since auditors have now become the first line of defense ahead of regulatory reviews, they are scaling up their skills and will challenge business leaders on the projections and help them validate their plans in an entirely new way. Shareholders will know the optimum capital to be held against risks: too much capital means a loss of revenue, while too little capital is a risk in itself.

There are interesting implications for the external stakeholders too. Perhaps for the first time, the emphasis is on a dialogue between regulators and banks rather than a one-sided compliance measurement. Pillar II leaves a lot up to the individual bank in terms of assessment and quantification; by implication it also leaves a lot up to the judgment of the individual supervisor performing the regulatory review. Thus, regulators will be challenged to perform effective reviews without complete standardization. This problem will be more complex and manifold for global banks which are required to meet regulations in different countries, as well as for the regulators themselves. Thus both regulators and regulations will continue to evolve based on the actual supervisory experience.

The final set of stakeholders, the customers, will perhaps benefit most from ICAAP. They will be dealing with banks that have developed a more objective approach to business planning and a clear understanding of their risk-return equation, which can only make them more stable and robust organizations to deal with.

Figure 2:



CONCLUSION

ICAAP poses short-term challenges but at the same time, if done well, offers numerous opportunities. It invites banks to draw up a blueprint for the future and work towards it consciously. It asks banks to use planning and risk management as strategic instruments and mesh them with operations for optimal results. Thus, ICAAP has moved the realm of risk management away from a dusty corner into the entire being of a bank.



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