

Appendix 3

In this appendix as all the text is new it is not underlined in the usual manner.



The DFSA Rulebook

Supervision Module

(SUP)

6 IRAP, ICAAP and SREP

6.1 Application

- 6.1.1** (1) This chapter applies, subject to (2), to an Authorised Firm that is a Domestic Firm.
- (2) This chapter does not apply to an Authorised Firm that is:
- (a) in Category 4;
 - (b) a Protected Cell Company;
 - (c) a Captive Insurer; or
 - (d) an Authorised ISVP.
- (3) In this chapter and also in App2, App3 and App4 the term “Authorised Firm” is to be construed as meaning an Authorised Firm other than one that is specified in (2) unless expressly stated otherwise.
- 6.1.2** Where an Authorised Firm to which this chapter applies is part of a Financial Group, this chapter applies on a consolidated basis covering all the entities within the Financial Group.
- 6.1.3** In implementing the requirements prescribed in this chapter, an Authorised Firm must give due and appropriate regard to the provisions in App2, App3 and App4.

Guidance

If an Authorised Firm is part of a Group which is already subject to requirements similar to those prescribed in this chapter, the DFSA may consider a request for a waiver or modification in relation to the requirements of this chapter.

6.2 Overview

Guidance

1. These Rules are designed to implement key aspects of Pillar 2 of the revised framework of capital adequacy, commonly known as Basel II, published by the Basel Committee on Banking Supervision.
 2. An Authorised Firm is required to carry out an Internal Risk Assessment Process (IRAP). An IRAP is a comprehensive internal risk evaluation. More detail on the establishment of an IRAP and the manner of carrying out an IRAP assessment is provided in App2.
 3. An Authorised Firm other than one in Category 2 or 3 is also required to carry out an Internal Capital Adequacy Assessment Process (ICAAP). This process enables such an Authorised Firm to determine and maintain an adequate amount and quality of capital, relative to its risk profile. More detail on the establishment of an ICAAP and the manner of carrying out an ICAAP assessment is provided in App3.
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4. The documented results of IRAP and ICAAP assessments are required to be submitted to the DFSA. The DFSA then applies a process known as the Supervisory Review and Evaluation Process (SREP). As part of the SREP, the DFSA will evaluate the quality, completeness and consistency of the IRAP and, where applicable, the ICAAP of the Authorised Firm to form a view on the overall risk profile of the firm and whether the capital held by the firm is sufficient to deal with the risks. More detail concerning the SREP is provided in App4.
5. Following review of the IRAP and ICAAP of an Authorised Firm, the DFSA may engage in a dialogue with the firm to evaluate the assessment of risks and where relevant, additional capital which the DFSA considers that the firm should hold resulting from the IRAP, ICAAP or SREP.
6. Upon completing the SREP, the DFSA may impose an Individual Capital Requirement (ICR). The ICR may be imposed where the DFSA concludes that the firm should hold more capital to provide for its overall risks. Rules relating to the ICR are set out in chapter 2 of PIB and chapter 4 of PIN.

6.3 IRAP

6.3.1 An Authorised Firm must establish and maintain an Internal Risk Assessment Process (IRAP) which details the processes and procedures by which the Authorised Firm will identify, assess, aggregate and monitor the risks faced by the firm.

- 6.3.2**
- (1) An Authorised Firm must conduct an IRAP assessment at least annually giving due regard to the Guidance in App2.
 - (2) The IRAP assessment conducted by the Authorised Firm pursuant to (1) must be approved by its Governing Body and submitted to the DFSA within four months from the end of the Authorised Firm's financial year.
 - (3) In addition to (1), an Authorised Firm must conduct an IRAP assessment:
 - (a) whenever there is material change to the business, strategy, nature or scale of the activities of the Authorised Firm which may have a significant impact on its risk profile or adequacy of its Capital Resources or Adjusted Capital Resources, as applicable; or
 - (b) as and when required by the DFSA.
 - (4) An IRAP assessment conducted by the Authorised Firm pursuant to (3) must be approved by its Governing Body and submitted to the DFSA within two months, or such other period as may be specified by the DFSA, from the date of such material change or requirement.
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6.3.3 The results of an IRAP assessment must be documented by the Authorised Firm in writing and include details of:

- (a) the risks identified;
- (b) the Authorised Firm's strategies and plans to deal with those risks;
- (c) the Authorised Firm's assessment of the adequacy of its Capital Requirement as calculated using the PIB Rules, or its Minimum Capital Requirement as calculated using the PIN Rules, to address all the risks identified by its IRAP assessment;
- (d) in the case of an Authorised Firm other than an Insurer or a firm in Category 2 or 3, the details of any stress testing and scenario analysis carried out and the resultant impact on the Capital Requirement;
- (e) in the case of an Authorised Firm which is an Insurer, the details of any stress testing and scenario analysis carried out and the resultant impact on the Minimum Capital Requirement; and
- (f) any other relevant information, giving due regard to the Guidance in App2.

6.3.4 An Authorised Firm must retain the records of an IRAP assessment for at least six years.

6.4 ICAAP

6.4.1 An Authorised Firm, other than one in Category 2 or 3, must establish and maintain an Internal Capital Adequacy Assessment Process (ICAAP) which details the processes and procedures by which the firm will assess and maintain adequate capital resources in relation to the risks faced by it.

6.4.2 (1) An Authorised Firm, other than one in Category 2 or 3, must conduct an ICAAP assessment at least annually giving due regard to the Guidance in App3.

(2) The ICAAP assessment conducted by the Authorised Firm pursuant to (1) must be approved by its Governing Body and submitted to the DFSA within four months from the end of the Authorised Firm's financial year.

(3) In addition to (1), the Authorised Firm must conduct an ICAAP assessment:

- (a) whenever there is material change to the business, strategy, nature or scale of the activities of the Authorised Firm which may have a significant impact on its risk profile or adequacy of its Capital Resources or Adjusted Capital Resources, as applicable; or
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(b) as and when required by the DFSA.

- (4) The ICAAP assessment conducted by the Authorised Firm pursuant to (3) must be approved by its Governing Body and submitted to the DFSA within two months from the date of such material change or requirement.

6.4.3 An Authorised Firm must ensure that an ICAAP assessment is documented in writing and includes details of:

- (a) the calculations and models used in the determination of the level of capital requirements which it considers will be adequate to cover all the risks identified by its IRAP assessment;
- (b) the Authorised Firm's strategies and plans to ensure availability of the level of capital determined by the ICAAP;
- (c) specifications of any models used in the ICAAP, including the underlying assumptions, parameters, and results of back-testing; and
- (d) any other relevant information, giving due and appropriate regard to the Guidance in App3.

6.4.4 An Authorised Firm must retain the records of an ICAAP assessment for at least six years.

6.5 SREP

Guidance

1. The DFSA may conduct a Supervisory Review and Evaluation Process (SREP) to review and evaluate the assessments carried out by an Authorised Firm under its IRAP and ICAAP. App4 contains guidance in relation to a SREP.
2. The DFSA may engage with an Authorised Firm in a dialogue where, following an SREP, the DFSA considers that it is or may be appropriate to impose an Individual Capital Requirement (ICR) on the firm.
3. It is important that an Authorised Firm cooperates in an open manner with the DFSA in the course of its conduct of the dialogue.

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App2 INTERNAL RISK ASSESSMENT PROCESS (IRAP)

Guidance

Application

1. This Guidance is relevant to an Authorised Firm as defined in Rule 6.1.1 (3) in regard to an IRAP.
2. An Authorised Firm to which an ICAAP is relevant should read this Guidance together with App3.
3. The following Guidance generally assumes that the Rules relating to capital adequacy in the PIB or PIN modules apply to an Authorised Firm on a solo basis. However, the Guidance is to be read as also applying where the capital adequacy requirements in these modules apply to the Financial Group of an Authorised Firm on a consolidated basis.

Purpose of the IRAP

4. The IRAP is an internal process of an Authorised Firm which enables it to identify, assess, aggregate and monitor its risks adequately. The objective of the IRAP is to develop a comprehensive and detailed risk profile for the firm. The IRAP should help the firm to ensure that sound risk management systems are in place, address any weaknesses in its risk management framework, and maintain adequate internal capital relative to its risk profile.
 5. An Authorised Firm should ensure that the IRAP forms an integral part of the firm's risk management framework and decision-making processes. The IRAP should cover all activities of the Authorised Firm and should be proportionate to the nature and complexity of the firm's activities.
 6. The Authorised Firm should be able to demonstrate to the DFSA that its internal risk assessment is comprehensive and adequate relative to the nature of risks posed by its business activities and its operating environment. The IRAP should be subject to adequate internal controls and reviews by internal audit to ensure the integrity and objectivity of the process. The IRAP should consider the quality and effectiveness of the Authorised Firm's risk management framework while determining its risk profile.
 7. The IRAP should:
 - a. identify and outline all related parties of the Authorised Firm, and list the types of transactions that occur between those related parties and the firm;
 - b. identify the most significant risks to which the firm is exposed, which should, at a minimum, include the risks identified in guidance note No. 10;
 - c. identify each of the firm's major business lines and prepare a comprehensive list of the major risks to which each of the business is exposed;
 - d. identify the controls and risk management measures used to address the risks referred to in b. and c. and assess the strength of such controls and systems; and
 - e. consider the impact of an economic or industry downturn on its future earnings taking into account its business plans.
 8. In the case of an Authorised Firm other than one in Category 2 or 3, the IRAP should, in addition to the aforementioned factors:
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- a. estimate, with the aid of historical data, where available, the range and distribution of possible losses which might arise from each of those risks and consider using stress tests to provide risk estimates;
 - b. consider the extent to which the firm's Capital Requirement or Minimum Capital Requirement, as applicable, adequately addresses the type of risks referred to under guidance note No. 7 (b) and (c); and
 - c. estimate the expected change in the firm's risk profile on the basis of projections of the firm's business activities for the next 3 to 5 years.
9. If the firm's IRAP is based on this Guidance, it may enable the DFSA more easily to review the IRAP as part of its SREP. However, the DFSA may decide to rely on an IRAP that is not consistent with the elements of this Guidance, owing to specific reasons and/or circumstances which necessitate an alternative approach.

Guidance on risks to be covered as part of the IRAP

10. An Authorised Firm should consider the following risks, where relevant, in its IRAP:
- a. credit risk, including large exposures and concentration risks;
 - b. market risk;
 - c. liquidity risk;
 - d. for Islamic Financial Business involving PSIAs, displaced commercial risk;
 - e. interest rate risk in the non-trading book ;
 - f. operational risk;
 - g. internal controls and systems;
 - h. reputational risk; and
 - i. for Insurers only, underwriting risk, insurance risk, and claims reserving risk.
11. This guidance is merely an indicative list of risk categories, which does not preclude an Authorised Firm from assessing other risks that it considers significant (for example, securitisation risks and residual risks). Likewise, certain categories of risks might not be relevant to all Authorised Firms completing the IRAP. In this case, the IRAP should clearly indicate why the risk is considered minimal or not relevant. The IRAP should also consider all risks arising from any non-regulated activities of the Authorised Firm, if they are seen as material to the risk profile of the firm.

Specific Guidance relevant to asset management and brokerage operations

12. The DFSA expects an Authorised Firm involved in Managing Assets to have in place adequate controls to mitigate the risk of failing to perform its contractual obligations to its Clients. Past claims and compensation may provide a useful indication for the firm to assess its sensitivity to future legal action.
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App3 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS (ICAAP)

Guidance

Application

1. This Guidance is relevant to an Authorised Firm as defined in Rule 6.1.1(3) other than one in Category 2 or 3.
2. This Guidance should be read in conjunction with App2.

Purpose and process of the ICAAP

3. The ICAAP is an internal process of an Authorised Firm which enables it to determine and maintain the amount and quality of capital that is adequate in relation to the Authorised Firm's risk profile as assessed in the IRAP. Authorised Firms are encouraged to maintain capital over and above the regulatory minimum capital. The ICAAP, in conjunction with the IRAP, should be embedded in the Authorised Firm's business and organisational processes.
 4. When assessing its capital needs, an Authorised Firm should take into account the impact of economic cycles, and sensitivity to other external risks and factors. For larger or more complex institutions, this may mean developing appropriate stress testing and scenario testing framework.
 5. The DFSA does not prescribe any specific approach for the ICAAP and consequently an Authorised Firm can choose to implement an ICAAP which is proportionate to the nature, size and complexity of the business activities.
 6. In completing an ICAAP, an Authorised Firm should:
 - a. estimate the amount of capital required to absorb potential losses, if any, for the significant risks identified in the IRAP (particularly risks which lead to financial losses);
 - b. perform reasonable and proportionate sensitivity tests to analyse the impact of variation in the risk parameters of significant risks identified in the IRAP on the profitability and the capital position of the Authorised Firm;
 - c. estimate, using the range and distribution of possible losses estimated from historical data, the level of capital required to reasonably cover likely losses;
 - d. estimate the capital resources required to address potential variation in the Authorised Firm's Capital Requirement or in the case of an Insurer, the Insurer's Minimum Capital Requirement arising from planned growth in business levels or any significant deviation in growth from plans;
 - e. document the ranges of capital required for each of the factors identified above and enable the Governing Body and the senior management to form an overall view on the amount and quality of capital which that Authorised Firm should hold.
 7. The DFSA does not require an Authorised Firm to implement ICAAP through sophisticated models and the DFSA has no prescribed approach for developing an internal capital model for the firm's ICAAP assessment. However, an Authorised Firm should be able to demonstrate:
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- a. the confidence levels set and whether these are linked to its corporate strategy;
 - b. the time horizons set for the different types of business that it undertakes;
 - c. the extent of historic data used and back-testing carried out;
 - d. that it has in place a process to verify the correctness of the model's outputs; and
 - e. that it has the skills and resources to operate, maintain and develop the model.
8. If an Authorised Firm's internal model makes explicit or implicit assumptions in relation to correlations within or between risk types, or in relation to diversification benefits between business lines, the firm should be able to explain to the DFSA, with the support of empirical evidence, the basis of those assumptions. An Authorised Firm's model should also reflect the past experience of both the firm and the sectors in which it operates.
9. The assumptions required to aggregate risks modelled and the confidence levels adopted should be considered by the Authorised Firm's senior management. An Authorised Firm should also consider whether any relevant risks, including systems and control risks, are not captured by the model.
10. An Authorised Firm using an internal capital model should validate the assumptions of the model through a comprehensive stress testing programme. In particular this validation should:
- a. test correlation assumptions (where risks are aggregated in this way) using combined stresses and scenario analyses;
 - b. use stress tests to identify the extent to which the firm's risk models omit non-linear effects, for instance the behaviour of derivatives in market risk models; and
 - c. consider not just the effect of parallel shifts in interest rate curves, but also the effect of curves becoming steeper or flatter.
11. Any internal assessment of capital adequacy should address diversification benefits and transferability of capital resources between members of the Financial Group. It should also describe the distribution of the capital required by the Financial Group across all entities including the Authorised Firm.
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App4 SUPERVISORY REVIEW AND ASSESSMENT PROCESS (SREP)

Guidance

Application

1. This Guidance is relevant to an Authorised Firm as defined in Rule 6.1.1 (3) for the purpose described under section 6.5.

Introduction

2. This Guidance covers the evaluation criteria and methodology that the DFSA may use when reviewing and evaluating the IRAP and ICAAP of an Authorised Firm.
3. An SREP of an IRAP and an ICAAP forms an integral part of the overall supervisory approach of the DFSA. An SREP is expected to enable assessment of the effectiveness, completeness and quality of an IRAP and ICAAP in relation to the overall risk profile of the Authorised Firm. It leverages from information collected and assessments carried out as part of the wider supervisory regime, including desk-based reviews, on-site risk assessments, discussions with firms management, and reviews completed by internal and external auditors.
4. The SREP is structured to provide consistency of treatment across Authorised Firms taking into consideration the differences in risk profiles, business strategies and management. An essential element of the SREP is the qualitative assessment of each type of risk and its management within the overall context of the firm's internal governance.
5. The DFSA's assessment of the individual risk profile of an Authorised Firm will provide the context for evaluation of the firm's IRAP and/or ICAAP. The evaluation in turn will be used by the DFSA to augment its understanding of the overall risk profile of a firm. The DFSA might involve the firm in a formalised discussion of risks and capital adequacy, which might lead to a requirement for additional capital.

Supervisory Review and Evaluation Process (SREP)

6. The SREP may be used as a regulatory tool for Authorised Firms which are required to perform an IRAP and/or ICAAP. The SREP for each Authorised Firm will be proportionate in terms of the size, scale and complexity of its business and its impact on financial sector stability. The DFSA will cooperate actively with other supervisory authorities whenever an Authorised Firm is part of a group and is prudentially regulated on a consolidated basis.
 7. The SREP evaluation cycle will be determined in the discretion of the DFSA and be based on the risk assessment, developments in the risk profile and changes in the Authorised Firm's strategy or products. The SREP is as far as possible aligned with the risk assessment process to ensure that a recent risk assessment is available for the SREP evaluation process.
 8. It is envisaged that the DFSA will use a range of supervisory tools of qualitative or quantitative nature to perform the SREP. The SREP is not intended as, and should not constitute, a parallel or secondary IRAP or ICAAP. Its purpose is to evaluate the quality, completeness and consistency of the IRAP or ICAAP of the Authorised Firm.
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Review of the IRAP and ICAAP Assessment

9. Upon receipt of an IRAP or ICAAP the DFSA would normally:
 - a. subject the data provided to an initial analysis for completeness and accuracy followed by a more detailed comparison with the relevant data held on file at the DFSA about the Authorised Firm;
 - b. determine if there are material changes compared with previous submissions;
 - c. determine if the submitted data contains indicators of a possible material change in the firm's risk profile;
 - d. address and discuss any information gaps or anomalies with the firm; and
 - e. form an assessment about content and quality of the submission which will be integrated into the overall supervisory approach.

Evaluation of the IRAP and ICAAP

10. The SREP evaluation of the IRAP and where applicable the ICAAP covers all activities of an Authorised Firm and takes all relevant data collected during the supervisory process into account. The SREP evaluation process will use desk based reviews, firm visits and meetings to arrive at a final view.
 11. As part of the SREP, the DFSA will consider:
 - a. the completeness of the IRAP and where applicable the ICAAP by ensuring that it covers all business areas, internal governance and all risk categories of the Authorised Firm;
 - b. the soundness and quality of the IRAP and where applicable the ICAAP process in relation to the firm's size, business complexity and risk profile;
 - c. soundness of qualitative calibration and quantitative methodology whenever employed by the firm;
 - d. execution of the IRAP and where applicable the ICAAP in terms of consistency, quality and documentation;
 - e. adequacy of internal controls and quality assurance processes on the IRAP and where applicable the ICAAP; and
 - f. adequacy of management information and whether the management had responded adequately and in a timely manner to such information.
 12. Based on the SREP, the DFSA will form an assessment which will be communicated to the Authorised Firm and flow into the overall supervisory approach. The action required resulting from the IRAP and ICAAP will be communicated to the firm as part of a risk mitigation programme.
 13. In cases where the DFSA is not in agreement with the results of the Authorised Firm's ICAAP results, the DFSA will involve the firm in a dialogue to reconcile any difference in view to arrive at a consensus estimate of the capital level required to address all risks identified either by the firm or by the DFSA in its SREP. Such an estimate will be specified by the DFSA as the ICR for the firm. Where consensus is not possible the DFSA is not prevented from imposing an ICR on a firm. Such a decision by the DFSA is appealable to the Regulatory Appeals Committee.
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