Chapter 7

Governance and risk management

7

7.7 ICARA process: assessing and monitoring the adequacy of liquid assets

7.7.1 R This section applies to a *MIFIDPRU investment firm*.

7.7.2 R

(1) As part of its *ICARA process*, a *firm* must produce a reasonable estimate of the maximum amount of *liquid assets* that the *firm* would require to:

(a) fund its ongoing business operations during each quarter over the next 12 *months*; and

(b) ensure that the *firm* could be wound down in an orderly manner.

(2) The assessment in (1) must take into account any potential material harms that the *firm* has identified under MIFIDPRU 7.4.9R and been unable to reduce appropriately through its systems and controls.

(3) Without prejudice to the ongoing nature of the *ICARA process*, the *firm* must update the analysis in (1) immediately following any material change in the *firm's* business model or operating model.

(4) To produce the estimate in (1), the *firm* must ensure that it has in place reliable management information systems to provide timely and forward-looking information on its liquidity position.

7.7.3 G

(1) The *overall financial adequacy rule* requires a *firm* to hold adequate *liquid assets* to ensure that:

(a) the *firm* is able to remain financially viable throughout the economic cycle, with the ability to address any potential harm that may result from its ongoing activities; and

(b) the *firm's* business can be wound down in an orderly manner.

(2) To comply with the *overall financial adequacy rule*, a *firm* must therefore hold the sum of the *basic liquid assets requirement* and the higher of:

(a) the amount of *liquid assets* that the *firm* requires to fund its ongoing business operations, taking into account potential periods of financial stress during the economic cycle; or

(b) the additional amount of *liquid assets* that a *firm* would need to hold when commencing its wind-down process to ensure that the *firm* could be wound down in an orderly manner.

(3) The *firm* should use the analysis it produces under MIFIDPRU 7.7.2R to ensure that it complies with the *overall financial adequacy rule*.

(4) The *liquid assets threshold requirement* is the amount of *liquid assets* that a *firm* needs to hold at any given time to comply with the *overall financial adequacy rule*.

7.7.4 G

(1) When considering the *liquid assets* that are required to fund its ongoing business operations under MIFIDPRU 7.7.2R(1), a *firm* should consider, among other factors:

(a) the ordinary level of *liquid assets* that would typically be required to operate the *firm's* underlying business, taking into account any seasonal variations;

(b) any material harms that may realistically occur during the next 12 *months* and their potential impact on the *firm's* liquidity position;

(c) any *liquid assets* that a *firm* may need to use as collateral or to meet margining requirements; and

(d) any estimated gaps in funding, including during periods of severe but plausible stress.

(2) The *liquid assets* that a *firm* requires at any given time during the 12-*month* period in MIFIDPRU 7.7.2R(1) may fluctuate, depending on the timing of a *firm's* expected liabilities and the nature of its business. Therefore, a *firm* should divide the 12-*month* period into quarters and assess the highest amount of *liquid assets* that it would require in each quarter. The *FCA* accepts that forecasts of the *liquid assets* that a *firm* requires may become less accurate for later quarters, but expects *firms* to use a 12-*month* time horizon to ensure that adequate attention is given to potential harms and significant liquidity outflows that may occur during that period.

(3) As a *firm's* liquidity requirements are typically dynamic in nature, MIFIDPRU 7.7.2R requires a *firm* to update its *liquid assets* assessment where there has been a material change in the *firm's* business model or operating model. This ensures that the *firm* updates its liquidity analysis to reflect material changes in its circumstances that may affect the availability of *liquid assets* or the *firm's* liquidity requirements, while also assessing future needs over a rolling 12-*month* time horizon.

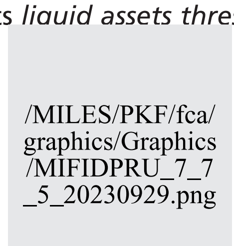
(4) As part of its reporting obligations under MIFIDPRU 9, a *firm* must report liquidity information to the *FCA* on a regular basis. The *FCA* will use this information to monitor both the *liquid assets* that the *firm* is holding and the *firm's* assessment of its *liquid assets threshold requirement*.

7.7.5 G

(1) A *firm's basic liquid assets requirement* provides a minimum level of *core liquid assets* that the *firm* must maintain at all times. The purpose of the *basic liquid assets requirement* is to ensure that the *firm* always has a minimum stock of *liquid assets* to fund the initial stages of its wind-down process if wind-down becomes necessary. The *firm* cannot, therefore, use the value of the *core liquid assets* that it holds to meet the *basic liquid assets requirement* as *liquid assets* for the liquidity needs of its ongoing business.

(2) The *basic liquid assets requirement* may, however, be insufficient to provide the *liquid assets* that the *firm* has assessed would be necessary to facilitate an orderly wind-down as part of its wind-down planning under ■ MIFIDPRU 7.5.7R. Therefore, the *firm* may identify that it needs to hold an additional amount of *liquid assets* to meet its funding needs as part of the wind-down process. This is not necessarily the whole amount of the *liquid assets* that would be required to fund the entire wind-down process, because in some circumstances, the *firm* may reasonably expect to generate additional *liquid assets* during wind-down. However, the *firm* should identify if it could have a funding gap during the wind-down process that the *firm* needs to cover by holding more liquid assets at the point that wind-down begins.

(3) The following diagram summarises the process that a *firm* should undertake to determine its *liquid assets threshold requirement*:



*When a *firm* assesses the amount of *liquid assets* it needs for ongoing operations, it cannot use the value of the *core liquid assets* held to meet the *basic liquid assets requirement* to fund those operations.

**The *basic liquid assets requirement* may be insufficient to provide the *liquid assets* that the *firm* has assessed would be necessary to facilitate an orderly wind-down. Therefore, the *firm* may identify that it needs to hold an additional amount of *liquid assets* (above the *basic liquid assets requirement*) to meet its funding needs to commence its wind-down process.The amount of additional *liquid assets* under assessment (B), therefore, does not include the amount of the *basic liquid assets requirement* (as explained in ■ MIFIDPRU 7.7.3G(2)(b)).

***Unless otherwise specified by the *FCA*.

(4) The following example illustrates how to determine the *firm's liquid assets threshold requirement* once assessment (A) and assessment (B) have been calculated:

(a) A *firm* has a *basic liquid assets requirement* of £1,000,000 under ■ MIFIDPRU 6.

(b) Through its *ICARA process*, the *firm* assesses that it needs a total amount of *liquid assets* of:

(i) £1,500,000 for ongoing operations under assessment (A); and

(ii) £5,000,000 for an orderly wind-down, which means that the *firm's* additional amount of *liquid assets* (above the *basic liquid assets requirement*) under assessment (B) is £4,000,000.

(c) As assessment (B) (£4,000,000) is higher than assessment (A) (£1,500,000), assessment (B) (£4,000,000) is added to the *firm's basic liquid assets requirement* of £1,000,000.

(d) The *firm's liquid assets threshold requirement* would, therefore, be £5,000,000 (the sum of the *basic liquid asset requirement* (£1,000,000) and assessment (B) (£4,000,000)).

7.7.6 R

(1) Subject to (2) and (3), a *firm* may hold the *liquid assets* necessary to comply with its *liquid assets threshold requirement* in any combination of:

(a) any *core liquid asset*, except trade receivables under MIFIDPRU 6.3.3R; or

(b) any *non-core liquid asset*, as defined in MIFIDPRU 7.7.8R, provided that the *firm* applies an appropriate haircut in accordance with MIFIDPRU 7.7.10R.

(2) This *rule* does not apply in relation to the *liquid assets* that a *firm* is holding to meet its *basic liquid assets requirement*, which must be *core liquid assets*.

(3) A *firm* may only use a *non-core liquid asset* for the purpose in (1) if the *firm* is satisfied that the asset can easily and promptly be converted into cash, even in stressed market conditions.

7.7.7 G

When considering whether a *non-core liquid asset* meets the requirement in MIFIDPRU 7.7.6R(3), a *firm* should take into account the following principles:

(1) low risk: assets that are less risky tend to have higher liquidity. High credit standing of the issuer and a low degree of subordination tends to increase an asset's liquidity. Low duration, low legal risk, low inflation risk and denomination in a convertible currency with low foreign exchange risk all tend to enhance an asset's liquidity;

(2) ease and certainty of valuation: an asset's liquidity tends to increase if market participants are more likely to agree on its valuation. Assets with more standardised, homogenous and simple structures tend to be more fungible, promoting liquidity. The pricing formula of a high-quality liquid asset should be easy to calculate and not depend on strong assumptions. The inputs into the pricing formula should also be publicly available. In practice, this should rule out the inclusion of most structured or exotic products;

(3) low correlation with risky assets: the stock of assets should not be subject to wrong-way (highly correlated) risk. For example, assets issued by financial institutions are more likely to be illiquid in times of liquidity stress in the financial sector;

(4) listed on a developed and recognised exchange: being listed tends to increase an asset's transparency and liquidity;

(5) active and sizable market: the asset should have an active market at all times. This means that:

(a) there should be historical evidence of market breadth and market depth. This could be demonstrated by low bid-ask spreads, high trading volumes, a large and diverse number of market participants, and the existence of a repo market. Diversity of market participants reduces market concentration and increases the reliability of the liquidity in the market; and

(b) there should be robust market infrastructure in place. The presence of multiple committed market makers increases liquidity as quotes will most likely be available for buying or selling the asset;

(6) low volatility: assets whose prices remain relatively stable and are less prone to sharp price declines over time will have a lower probability of triggering forced sales to meet liquidity requirements. Volatility of traded prices and spreads are simple proxy measures of market volatility. There should be historical evidence of relative stability of market terms (e.g. prices and haircuts) and volumes during stressed periods; and

(7) flight to quality: historically, the market has shown tendencies to move into these types of assets in a systemic crisis. The correlation between proxies of market liquidity and financial system stress is one simple measure that could be used.

7.7.8 R

(1) Except as specified in (2), the following assets are eligible as *non-core liquid assets*:

- (a) short-term deposits at a *credit institution* that does not have a *Part 4A permission* in the *UK* to *accept deposits*;
- (aa) short-term non-sterling deposits at a *UK credit institution*;
- (b) assets representing claims on, or guaranteed by, multilateral development banks and international organisations;
- (c) assets representing claims on, or guaranteed by, any *third country* central bank or government;
- *(d)* *financial instruments*; and
- (e) any other instrument eligible as collateral against the margin requirement of an *authorised central counterparty*.

(2) A *firm* must not treat any of the following as a *non-core liquid asset*:

- (a) any asset that belongs to a *client*;
- (b) any other asset that is encumbered; or
- (c) any asset issued by the *firm* or any of its affiliated entities, except a short-term deposit with an affiliated *credit institution*.

7.7.9 R

(1) For the purposes of MIFIDPRU 7.7.8R(2)(a), an asset may belong to a *client* even if the asset is held in the *firm's* own name. Examples of assets belonging to a *client* include money or other assets held under the *FCA's client asset rules*.

(2) For the purposes of MIFIDPRU 7.7.8R(2)(b), an asset may be encumbered if it is pledged as security or collateral, or subject to some other legal restriction (for example, due to regulatory or contractual requirements) which affects the *firm's* ability to liquidate, sell, transfer, or assign the asset.

7.7.10 R

A *firm* must apply an appropriate haircut to the value of a *non-core liquid asset* to reflect the potential loss of value when converting the asset into cash during stressed market conditions.

7.7.11 G The *FCA* considers that a minimum haircut of no less than that in the range specified in the table in ■ MIFIDPRU 7.7.12G is likely to be appropriate for the purposes of ■ MIFIDPRU 7.7.10R.

7.7.12 G This table belongs to ■ MIFIDPRU 7.7.11G.

Non-core liquid asset	Haircut
Short-term deposits at a *credit institution* that does not have *permission* in the *UK* to *accept deposits*	0%
Short-term non-sterling deposits at a *UK credit institution*	0%
Assets representing claims on, or guaranteed by, multilateral development banks or international organisations	0%
Assets representing claims on, or guaranteed by, any *third country* central bank or government	0% - 50%
Regulated covered bonds, or comparable covered bonds regulated in a *third country*	7% - 30%
Asset-backed securities eligible for 'STS' designation under the *Securitisation Regulation*, and backed by residential loans, personal loans, leases or commercial loans for purposes other than commercial real estate development, or comparable asset-backed securities regulated in a *third country*	25% - 35%
High quality corporate debt securities	15% - 50%
Shares that form part of a major stock index	50%
Financial instruments not covered above for which there is a liquid market as defined in article 42(1)(17) of *MiFIR* or article 42(1)(17) of *EU MiFIR*	55%
Other instruments eligible as collateral against the margin requirement of an *authorised central counterparty*	25% - 55%

7.7.13 G For the purposes of applying ■ MIFIDPRU 7.7.10R and ■ 7.7.11G to shares or units in a *CIU*:

(1) where a *firm* is aware of the exposures underlying the *CIU*, it may look through to the underlying exposures to assign an appropriate haircut;

(2) where a *firm* is not aware of the exposures underlying the *CIU*, it should assume that the *CIU* invests, up to the maximum amount allowed under its mandate, in the highest risk assets permissible; and

(3) in either case, a *firm* should consider applying an additional haircut to reflect any additional loss of value that could result from the underlying exposures being held through a *CIU*.

Requirement to notify the FCA of certain levels of liquid assets

7.7.14 R

(1) A *firm* must notify the *FCA* immediately in each case where:

(a) its *liquid assets* fall below its *liquid assets threshold requirement*; or

(b) its *liquid assets* fall below its *liquid assets wind-down trigger* or the *firm* considers that there is a reasonable likelihood that its *liquid assets* will fall below its *liquid assets wind-down trigger* in the foreseeable future.

(2) A notification under (1) must include the following information:

(a) a clear statement of the current level of the *firm's liquid assets* in comparison to:

(i) the *firm's liquid assets threshold requirement*; and

(ii) in the case of a notification under (1)(b), the *firm's liquid assets wind-down trigger*;

(b) an explanation of why the *firm's liquid assets* have reached the current level;

(c) in the case of a notification under (1)(a), an explanation of the recovery actions specified for the purposes of MIFIDPRU 7.5.5R(2)(b) and 7.5.6G that the *firm* has already taken or will take to restore compliance with its *liquid assets threshold requirement*; and

(d) in the case of a notification under (1)(b), the *firm's* intentions in relation to activating its wind-down plan.

(3) A *firm* must submit the notification in (1) through the *online notifications and applications system* using the form in MIFIDPRU 7 Annex 5R.

7.7.15 G

(1) The notification requirement in MIFIDPRU 7.7.14R does not replace a *firm's* obligations under:

(a) *Principle* 11 to disclose appropriately to the *FCA* anything relating to the *firm* of which the *FCA* would reasonably expect notice; or

(b) the general notification requirements in SUP 15.3.

(2) Where a *firm* has submitted a notification under MIFIDPRU 7.7.14R, the notification will generally discharge a *firm's* obligations under *Principle* 11 and the general notification requirements in SUP 15.3 in relation to the matters contained in the notification. However, a *firm* must still consider whether the *FCA* should be notified of developments before any of the notification indicators in MIFIDPRU 7.7.14R occur. In addition, *Principle* 11 and SUP 15.3 may require a *firm* to notify the *FCA* of additional material information that is not specifically referenced in MIFIDPRU 7.7.14R.

(3) A *MIFIDPRU investment firms* should notify the *FCA* at an early stage of any significant event which creates a material risk of a *firm* ceasing to hold adequate financial resources, even if the impact of that event has not yet fully materialised.

FCA approach to intervention in relation to liquid assets

7.7.16 G

(1) The table in MIFIDPRU 7.7.17G explains the interventions that the *FCA* would generally expect to make where a *MIFIDPRU investment firm* has breached, or there is evidence that the *firm* may be at risk of breaching, its *liquid assets* requirements. The table sets out the points at which the *FCA* would normally intervene and what actions it would normally take. Note that unlike for *own funds*, there is no *early warning indicator* requirement in relation to *liquid assets*.

(2) The *FCA* would generally expect that the interventions in the table would be cumulative – i.e. in a declining prudential situation, as the *firm* hits each intervention point in turn, the *FCA* would take some or all of the actions associated with that particular point. The actions are intended to be proportionate and progressively stronger responses to address the prudential concerns raised by each intervention point.

(3) However, if the *firm* experiences a sudden adverse event which causes the *firm* to hit multiple intervention points simultaneously, the *FCA* may immediately take the actions associated with the most severe point.

(4) The actions specified in the table do not prevent the *FCA* from taking alternative or additional actions in appropriate cases. The purpose of the table is to provide greater clarity for *firms* on the *FCA's* general expectations and approach to interventions, to assist *firms*' own planning and responses.

7.7.17 G

This table belongs to MIFIDPRU 7.7.16G.

Intervention point	Purpose	Potential FCA supervisory actions
Threshold requirement notification: *Firm* holding insufficient *liquid assets* to meet its *liquid assets threshold requirement*	The *liquid assets threshold requirement* is the amount of *liquid assets* that the *firm* needs at any point in time to comply with the *overall financial adequacy rule*. The *FCA* will monitor a *firm's* assessment of its *liquid assets threshold requirement* through the information that the *firm* provides under MIFIDPRU 9. This notification is intended to prompt the *firm* and the *FCA* to address the breach of *threshold conditions* in a timely manner. Where a *firm* has ceased to hold sufficient *liquid assets* to meet its *liquid assets threshold requirement*, the focus should be on restoring *liquid assets* to at least the level of the *liquid assets threshold requirement* and recovery of the *firm* (unless the *firm* chooses to	The *FCA* would normally expect that: (a) the *firm* will have considered taking the recovery actions identified under MIFIDPRU 7.5.5R(2)(a) and MIFIDPRU 7.5.6G before breaching its *liquid assets threshold requirement* and will be considering whether to take, or will have taken, any relevant recovery actions identified under MIFIDPRU 7.5.5R(2)(b); (b) the *firm's governing body* will regularly evaluate whether the *firm* should take additional actions to restore its level of *liquid assets* to at least the level of the *liquid assets threshold requirement*; and (c) the *FCA* will consider whether to request the *firm* to report additional information to the *FCA*. If, having considered the information provided by the *firm* about its proposed actions, the *FCA* reasonably considers that the *firm* may fail to restore its *liquid assets* to the level required by the *liquid assets*

Intervention point	Purpose	Potential FCA supervisory actions
	exit the market by voluntarily winding down). However, any proposed actions for recovery must be credible and achievable within a reasonable and realistic timeframe.	*threshold requirement* within a reasonable timeframe, the *FCA* may consider the following actions: (d) requesting that the *firm* cease making discretionary payments; (e) requesting that the *firm* cease taking on new business; (f) requesting that the *firm's parent undertaking* provides additional *liquid assets* for the *firm*; (g) where appropriate, inviting the *firm* or its *parent undertaking* to apply for a *requirement* under section 55L(5) or section 143K(1) of the *Act*, or imposing a *requirement* on the *FCA's* own initiative under section 55L(3) or section 143K(2) of the *Act*, in relation to (a) – (f) above; or (h) where appropriate, inviting the *firm* to apply for variation or cancellation of *permission* under section 55H of the *Act*, or varying or cancelling the *firm's permission* on the *FCA's* own initiative under section 55J of the *Act*. The *FCA* would also expect the *firm* to consider whether it is appropriate to trigger the *firm's* wind-down plan under MIFIDPRU 7.5.7R to ensure

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Intervention point	Purpose	Potential FCA supervisory actions	
		an orderly wind-down of its business. This may be the case where the *firm's* identified wind-down actions will require a reasonable length of time to execute, such as where the *firm* will need to transfer customers or close out its own positions.	
Wind-down trigger notification: *Firm's liquid assets* fall below its *liquid assets wind-down trigger*	The *liquid assets wind-down trigger* is an absolute minimum level of *liquid assets* that a *firm* must maintain at all times to provide the necessary financial resources to commence wind-down. This is equal to the *firm's basic liquid assets requirement* (or such higher amount as the *FCA* may have imposed for these purposes in a *requirement*).	The *FCA* would normally expect the following to occur:	
		(a)	the *firm's governing body* will make a formal decision to initiate the *firm's* wind-down plan, unless the *governing body* has a reasonable basis for determining that there is an imminent and credible likelihood of the *firm's* recovery; and
	In order to maximise the potential for an orderly wind-down, the *FCA* expects that *firms* that breach this trigger should normally commence winding down immediately unless the *firm's governing body* and the *FCA* determine that there is an imminent and credible likelihood of recovery.	(b)	where the *firm* decides to initiate its wind-down plan, the *FCA* will invite the *firm* to apply for a *requirement* under section 55L(5) of the *Act*, or will impose a *requirement* on the *FCA's* own initiative under section 55L(3) of the *Act*, that prevents the *firm* from taking on any new business.
		The *FCA* may consider the following additional actions if it has concerns that without these actions, the potential risk of harm to consumers or the markets is likely to increase:	

Intervention point	Purpose	Potential FCA supervisory actions
		(c) taking appropriate action to protect any *client money* or *client assets*, including, where appropriate, inviting the *firm* to apply for a *requirement* under section 55L(5) of the *Act*, or imposing a requirement on the *FCA's* own initiative under section 55L(3) of the *Act*, to achieve any necessary protection; and (d) where appropriate, inviting the *firm* to apply for variation or cancellation of *permission* under section 55H of the *Act*, or varying or cancelling the *firm's permission* on the *FCA's* own initiative under section 55J of the *Act*. If a *firm* refuses to commence an orderly wind-down despite its *governing body* or the *FCA* having concluded that there is no imminent and credible likelihood of recovery, the *FCA* will consider the full range of its supervisory powers. In particular, the *FCA* may use a combination of its own initiative powers under section 55L(3) and section 55J of the *Act* to: (e) prevent the *firm* from continuing to carry on any *regulated activities*; and (f) direct the *firm* to take appropriate actions to ensure the fair treatment and appropriate

Intervention point	Purpose	Potential FCA supervisory actions
		protection of *clients* and counterparties during any run-off period for its existing regulated business.