Chapter 7

Governance and risk management

Guidance on assessing potential harms that is potentially relevant to all firms

Purpose

1.1 G (1) This annex contains *guidance* on how a *MIFIDPRU investment firm* can assess the potential harms arising from its business as part of the *ICARA process*.

(2) This *guidance* is designed to be of relevance to all *firms*, but not every aspect of this *guidance* will be relevant to every *firm*. A *firm* should consider this *guidance* in light of its particular business model.

(3) A *firm's ICARA process* must be proportionate to the nature, scale and complexity of its activities. This *guidance* should be interpreted by reference to what is proportionate and appropriate for a particular *firm*.

General approach to assessing material potential harms

1.2 G (1) For the purposes of its *ICARA process*, a *firm* should identify potential harms by considering plausible hypothetical scenarios that may occur in relation to the activities that the *firm* carries on. The *firm* should also consider the possibility that certain scenarios may occur at the same time or that there may be a correlation between connected scenarios.

(2) A *firm* should generally estimate the nature and size of potential harms by using its own knowledge and experience.

(3) Where appropriate, a *firm* may use peer analysis to estimate potential harms. In this case, the *firm* should take into account any material differences between the *firm's* business and the business carried on by its peer, and to the extent that it is aware of them, any material differences in their respective systems and controls.

(4) A *firm* may, but is not required to, use statistical models to identify potential harms, but where it does, the *firm* should consider the following factors:

(a) the importance of ensuring that the statistical model is properly integrated into the *firm's* wider approach to mitigating risk under the *ICARA process* and appropriately takes into account the *guidance* on assessing harm in MIFIDPRU 7;

(b) the *FCA's* expectation that relevant *individuals* within the *firm* who are responsible for the *firm's* risk management function or for the oversight of that function should fully understand how the model operates, including any relevant assumptions or limitations and should be able to explain how this contributes to compliance with the *overall financial adequacy rule*;

(c) the accuracy of the model depends on ensuring that the inputs into the model are appropriate and properly reflect the *firm's* business;

(d) the importance of periodically checking that the outputs of the model remain appropriate. This includes model validation; and

(e) the fact that excessive reliance on the model may result in the *firm* failing to operate wider risk management systems and controls.

(5) In some cases, it may be reasonable for a *firm* to take into account the impact of insurance when assessing potential harms and considering how the *firm* manages risks. However, *firms* should note that in many cases, insurance may not be an adequate substitute for financial resources that are required to address harm immediately. *Firms* should also consider the terms of any insurance, including any limitations or exclusions, when assessing the extent to which insurance may be an appropriate and effective risk mitigant.

Examples of situations that may result in material harm to clients

1.3 G The following are non-exhaustive examples of risks to *clients* or to the market that may arise from a *firm's* business:

(1) breach of an investment mandate, resulting in *clients* being exposed to risks outside of their specified tolerance or to investments which are otherwise unsuitable for their objectives;

(2) trading or dealing errors that result in losses to *clients*;

(3) outages in, or other problems with, the *firm's* systems that cause disruption to the continuity of the *firm's* services (for example, by preventing the *firm's clients* from being able to see the value of their investments or from being able to issue trading instructions), leading to financial losses for *clients*;

(4) corporate finance advice which results in a legal claim against the *firm*;

(5) losses to *clients* caused by the activities of the *firm's tied agents* or *appointed representatives* (including in respect of any business which is not *MiFID business* for which the *firm* may be liable as principal) for which the *firm* is responsible;

(6) provision of unsuitable *investment advice*, for example in relation to pension transfers or investments, resulting in *clients* suffering losses;

(7) failure to comply with any applicable provisions of *CASS*, resulting in potential losses to *clients*; and

(8) the inability to return money received by the *firm* by way of *title transfer collateral arrangement* promptly to a *client* when required.

Examples of situations that may result in harm to the firm

1.4 G (1) Events that result in material harm to a *firm* may affect the viability of the *firm's* business. In turn, that may affect the *firm's* ability to meet its obligations to *clients* or to its other counterparties and may increase the risk of a disorderly wind-down.

(2) The following are non-exhaustive examples of situations that may result in material harm to a *firm*:

(a) claims on *tied agents* or *appointed representatives* that result in the *firm* being liable as principal;

(b) the failure of significant *clients* or counterparties upon which the *firm* relies to generate a significant proportion of its revenue;

(c) significant operational events, such as the failure of key systems or internal fraud; and

(d) obligations of the *firm* relating to liabilities under a defined benefit pension scheme.

Assessing the harm that may result from insufficient liquidity

1.5 G When assessing potential harms that may occur in connection with its business, a *firm* should consider any potential impact on its *liquid assets*. Where a *firm* has insufficient *liquid assets* to cover the relevant harm, it may find itself unable to pay its debts as they fall due. In turn, this could trigger an unexpected insolvent wind-down, which has the potential to cause harm to *clients*, counterparties and the wider markets.

1.6 G (1) The systems that the *firm* uses to identify and monitor liquidity risk should be tailored to its business lines, the currencies in which it operates and its structure (taking into account, for example, whether it operates *branches* or supports *subsidiaries* or other *group* entities). In addition, those systems should consider liquidity costs, benefits and risks, including intra-day *liquidity risk*.

(2) The systems that a *firm* uses to identify and monitor *liquidity risk* should be proportionate to the complexity, size, structure and risk profile of the *firm* and the scope of its operations.

1.7 G When a *firm* is assessing the quality and amount of *liquid assets* that it has available, the following is a non-exhaustive list of factors that may be relevant:

(1) the extent to which assets held by the *firm* can be converted into cash within a reasonable time period;

(2) any legal or operational restrictions that may apply to the *firm* or to particular assets, which may affect the *firm's* ability to realise assets or to access cash in a timely manner;

(3) the extent to which *liquid assets* may be held, or the proceeds of the *firm's* assets may be received, in currencies other than the expected currency of the *firm's* liabilities and the ease with which those currencies can be converted (including in stressed market conditions); and

(4) any legal or practical restrictions on the transferability of funds between the *firm* and other members of its *group*, including in stressed market conditions.

1.8 G When a *firm* is assessing the amount of *liquid assets* it may need to address potential harms, the following is a non-exhaustive list of factors that may be relevant:

(1) any concentration of the *firm's* funding arrangements, including in relation to:

(a) counterparties (or groups of connected counterparties) providing funding;

(b) products or facilities used to provide funding; and

(c) currencies;

(2) the extent to which the *firm* may be exposed to mismatches between the maturity of its assets and its liabilities;

(3) whether stressed market conditions could lead to accelerated cash outflows from the *firm* or longer-term reductions in the availability of *liquid assets*;

(4) whether intra-day obligations could affect the *firm's* ability to meet its payment and settlement obligations in a timely manner (including potential margin calls in relation to the *firm's* own positions, or positions of the *firm's clients* in respect of which the *firm* has an obligation to meet the relevant margin call);

(5) any requirements on the *firm* (whether or not they are legally binding) arising from any off-balance sheet arrangements, including:

(a) commitments under any credit or liquidity facilities (including those which may be cancelled at any time) or guarantees;

(b) obligations under any liquidity facilities supporting securitisation programmes; or

(c) obligations in relation to *client money*;

		(6)	payments that the *firm* may make to maintain its franchise, reputation or brand or to ensure the continued viability of its business, even though the *firm* may be under no legal obligation to make the payments; and
		(7)	the possibility of other unexpected payment obligations, such as: (a) direct or indirect costs arising from litigation; (b) redress payments; or (c) fines or penalties.
1.9	G	(1)	When considering *liquidity risk* and potential harms, a *firm* should consider whether it has sufficient diversification in funding sources.
		(2)	A *firm* should consider whether there may be a correlation between different market conditions and the *firm's* ability to access funding from different sources.
		(3)	When analysing what level of funding diversification is appropriate for its business, a *firm* should consider the following: (a) the maturity date of any funding arrangements; (b) the nature of the counterparty providing the funding; (c) whether the funding arrangement is secured or unsecured; (d) if the funding arrangement is in the form of a *financial instrument*, the relevant type of instrument; (e) the currency of the funding arrangement; and (f) the geographical market of the funding arrangement.
		(4)	A *firm* should regularly assess whether its ability to raise short, medium and long-term liquidity is sufficient for its ongoing requirements.
1.10	G	(1)	A *firm* should consider whether it has appropriately addressed potential harms arising from *liquidity risk* in relation to the following aspects of the *firm's* significant business activities: (a) product pricing; (b) performance measurement and incentives; and (c) the approval process for new products.
		(2)	A *firm* should take into account the *liquidity risk* arising from any significant business activities and product lines, whether or not they are accounted for on the *firm's* balance sheet.
		(3)	A *firm* should clearly identify the liquidity costs and benefits attributable to particular significant business and product lines and relevant *individuals* within business line management for those areas should have an appropriate understanding of such costs and benefits.
		(4)	A *firm* should address all significant business activities, including those that involve the creation of contingent exposures which may not have an immediate balance sheet impact.
		(5)	Incorporating liquidity pricing into a *firm's* processes may assist in aligning the risk-taking incentives of individual business lines within a *firm* with the *liquidity risk* and potential harms that may result from the activities of those business lines.
1.11	G	(1)	*Firms* should consider intra-day liquidity positions when considering the *liquidity risk* and potential harms that may result from their operations.
		(2)	As part of their *ICARA process*, a *firm* should identify: (a) any significant time-critical payment or settlement obligations and any arrangements that are in place to prioritise the payments;

(b) any significant payment or settlement obligations that the *firm* may have as a result of acting as a custodian or a settlement agent;

(c) any potential net funding shortfalls that the *firm* may have at different points during the *day*;

(d) potential significant disruptions to its intra-day liquidity flows and any arrangements in place to deal with these; and

(e) any arrangements necessary to ensure the proper management of collateral.

1.12 G When identifying *liquidity risk* and potential material harms that may result in relation to a *firm's* use and management of collateral, the following considerations are relevant:

(1) the *firm's* ability to distinguish clearly at any time between encumbered assets and assets that are unencumbered and available to meet the *firm's* liquidity needs, particularly in an emergency situation;

(2) the jurisdiction in which the assets are based or registered and any legal or regulatory restrictions that may apply to the availability or use of the assets as a result;

(3) any operational restrictions that may apply in relation to the assets;

(4) the extent to which collateral deposited by the *firm* with a counterparty or third party may have been rehypothecated;

(5) the extent to which the assets available to the *firm* to use as collateral are likely to be acceptable to the *firm's* major counterparties and liquidity providers;

(6) the impact of any existing financing or security arrangements entered into by the *firm* (which may contain financial covenants, warranties, events of default or negative pledge clauses) on the *firm's* ability to provide collateral; and

(7) the potential impact of severe but plausible stressed scenarios on the *firm's* ability to provide collateral where necessary and on any collateral received by the *firm*.

1.13 G A *firm* that has significant positions in foreign currencies should consider the *liquidity risk* and potential harms that may arise as a result of the positions.

1.14 G As part of its assessment under MIFIDPRU 7.9.2R, a *firm* that forms part of a *group* should consider the extent to which membership of that *group* may have an impact on the *firm's* own liquidity position.

In-depth stress testing and reverse stress testing

1.15 G The *guidance* in MIFIDPRU 7 Annex 1.16G to MIFIDPRU 7 Annex 1.20G is relevant to *firms* with more complex businesses or operating models.

1.16 G Stress testing carried out by a *firm* should involve the following:

(1) identifying severe but plausible adverse scenarios which are relevant to the *firm* and the market in which it operates;

(2) stating clear assumptions, when compared to the *firm's* business-as-usual projections, which are consistent with the scenarios identified in (1);

(3) considering the impact of the scenarios identified in (1) against the *firm's* own risk appetite, by reference to:

(a) individual business lines or portfolios; and

(b) the overall position of the *firm* as a whole;

(4) assessing the impact of the scenarios in (1) on the *firm's*:

(a) available *own funds* and *liquid assets*; and

(b) *own funds requirement* and *basic liquid assets requirement*;

(5) estimating the effects of scenarios identified in (1) on each of the following as they relate to the *firm*, both before and after taking into account any realistic management actions:

(a) profits and losses;

(b) cash flows;

(c) the liquidity position; and

(d) the overall financial position; and

(6) the *firm's governing body* regularly reviewing the scenarios identified in (1) to ensure that their nature and severity remain appropriate and relevant to the *firm*.

1.17 G When considering the impact of the scenarios in MIFIDPRU 7 Annex 1.16G(1) on a *firm's* available *liquid assets*, the *FCA* considers that the following factors are relevant:

(1) correlations between funding markets;

(2) the effectiveness of diversification across the *firm's* chosen sources of funding;

(3) any potential additional margin calls or collateral requirements;

(4) contingent claims, including potential draws on committed lines extended to third parties or other entities within the *firm's group*;

(5) *liquid assets* absorbed by off-balance sheet vehicles and activities (including conduit financing);

(6) the transferability of *liquid assets*;

(7) access to central bank market operations and liquidity facilities;

(8) estimates of future balance sheet growth;

(9) the continued availability of market liquidity in a number of currently highly liquid markets;

(10) the ability to access secured and unsecured funding;

(11) currency convertibility; and

(12) access to payment or settlement systems on which the *firm* relies.

1.18 G Reverse stress testing carried out by a *firm* should involve the following:

(1) identifying a range of adverse circumstances which would cause the *firm's* business model to become unviable;

(2) assessing the likelihood that the adverse circumstances in (1) will occur;

(3) determining whether the risk of the *firm's* business model becoming unviable is unacceptably high when compared with the *firm's* risk appetite or tolerance; and

(4) where the *firm* determines under (3) that the risk is unacceptably high, adopting effective arrangements, processes, systems or other measures to prevent or mitigate that risk. This may include making appropriate changes to the *firm's* business model or operating model.

1.19 G For the purposes of reverse stress testing, the following are non-exhaustive examples of when a *firm's* business model may become unviable:

(1) all or a substantial portion of the *firm's* counterparties are unwilling to continue transacting with the *firm* or seeking to terminate their contracts with it. In some circumstances, the failure of a single major counterparty or *client* may cause a *firm's* business to become unviable, particularly if this could result in wider market disruption;

(2) another member of the *firm's group* is unable or unwilling to provide the support which is necessary for the *firm* to continue its business (for example, by withdrawing access to shared services or funding arrangements);

		(3)	the *firm's* existing shareholders or owners are unwilling to provide new capital when required; or
		(4)	a sustained and continued reliance on income or revenue generated from a peripheral activity (for example, interest income derived from *client money*).
1.20	G	The following table is a simple example of how a *firm* might analyse and record the outcome of stress testing using the *guidance* in MIFIDPRU 7 Annex 1.18G.	

Example scenario	Likelihood	Mitigants
Failure of a significant counterparty leads to a liquidity shortfall that causes the *firm* to default on its own obligations	Medium – above *firm's* risk appetite	Contingency funding plan
30% drop in revenue over a 6-*month* period leads to sustained losses and management actions have little impact	Low – in line with *firm's* risk appetite	
Management actions after a stress event fail to rebuild capital and the *firm's group* and shareholders are unwilling to inject further capital	Low – in line with *firm's* risk appetite	
Large numbers of staff and outsourced providers are absent due to illness during a pandemic and the *firm* is not able to operate revenue-generating activities for a *month*	High – above *firm's* risk appetite	Identify back up outsourcing providers and enable staff to work from home
Cyber-attack results in the *firm* being unable to access systems and provide services for 3 weeks. This results in loss of revenue, a liquidity shortfall and fines from regulators	Medium – above *firm's* risk appetite	Improvements to cyber resilience

1.21	G	A *firm's* business model may become unviable long before the *firm's* financial resources have been exhausted. The *FCA* recognises that not every business failure is the result of a lack of financial resources and individual *firms* may vary in their assessment of when they would be unwilling or unable to continue carrying on their activities. Examples of where a *firm's* business model may become unviable before its financial resources are exhausted include:	
		(1)	the *firm* has a sustained and continued reliance on income or revenue generated from a peripheral or ancillary activity, such as interest income derived from *client money*; or
		(2)	the *firm* is reliant on *title transfer collateral arrangements* to meet its *basic liquid assets requirement* on a sustained basis.

7