Chapter 7

Governance and risk management

Additional guidance on assessing potential harms that is relevant for firms dealing on own account or firms with significant investments on their balance sheet

Purpose

2.1 G (1) This annex contains *guidance* on how a *MIFIDPRU investment firm* should assess the potential harms arising from its business as part of its *ICARA process*. This *guidance* is primarily intended to be relevant to *firms* that *deal on own account* or hold significant investments on their balance sheets. It should be interpreted in light of the *firm's* individual business model.

(2) *Firms* are reminded that their *ICARA process* must be proportionate to the nature, scale and complexity of their activities. This *guidance* should be interpreted by reference to what is proportionate for a particular *firm*.

2.2 G A *firm* that *deals on own account* or holds significant investments on its balance sheets may be at increased risk of events that result in significant losses or other harm to the *firm*. In turn, this may increase the risk of a *firm* defaulting on its obligations to counterparties or becoming insolvent and entering a disorderly wind-down.

Examples of situations that may result in material harm to the firm

2.3 G The following are examples of situations that may result in harm to the *firm*:

(1) material adverse changes in the book value of the *firm's* assets;

(2) the failure of the *firm's clients* or counterparties; and

(3) losses incurred or payments due in connection with positions taken by the *firm* in *financial instruments*, foreign currencies and commodities (irrespective of whether those positions form part of the *firm's trading book* or not).

2.4 G When a *firm* is assessing potential harms connected with material changes in the book value of the *firm's* assets, the following non-exhaustive list of factors may be relevant:

(1) changes in the creditworthiness or the default of a *client* or counterparty, where that change or default may result in the *firm* realising assets below their book value or recording impairments, revaluations or write-downs;

(2) changes in market conditions which may affect relevant prices, indices or rates, including changes in equity, debt or foreign exchange markets or interest rates;

(3) operational events or natural disasters that may affect the value of the *firm's* assets;

(4) any concentration of the *firm's* assets in relation to a specific:

(a) *client* or counterparty (or group of connected *clients* or counterparties);

(b) economic sector or sub-sector; or

(c) geographical market.

This concentration assessment should not be limited to the particular

risks covered by the requirements in MIFIDPRU 5, but should involve a broader assessment of the risks that may arise in relation to the concentration;

(5) whether any of the *firm's* assets are, or have a value which depends on, complex products, such as interests in securitisations or structured products which are complex or opaque;

(6) the extent to which the *firm* has used leverage (including contingent leverage); and

(7) whether the *firm* has any exposures under off-balance sheet items, such as commitments or guarantees.

2.5 G When a *firm* is assessing potential harms arising from the failure of its *clients* or counterparties, the following non-exhaustive list of factors may be relevant:

(1) changes in the creditworthiness or the default of a *client* or counterparty, which may result in direct losses for the *firm* or the need to revalue or replace transactions;

(2) changes in market conditions which may result in the *firm* incurring greater costs to replace a transaction that the *client* or counterparty has failed to settle;

(3) the risk that collateral received from the *client* or counterparty may not be as effective as expected at covering the losses arising from that *client* or counterparty's failure or default; and

(4) any concentration of the *firm's* exposures in relation to the *client* or counterparty or the economic sector or geographical market in which that *client* or counterparty is active.

2.6 G Where a *firm* is subject to the *K-TCD requirement* or the *K-CON requirement*, the *FCA* would generally expect the *firm* to consider whether those requirements are sufficient to cover the harms that may result from the failure of its *clients* or counterparties to fulfil their obligations. In some cases, those requirements may not apply in relation to the *client*, counterparty or position in question, or may not adequately address the relevant risks. Where this is the case, the *firm* should consider other measures to address the potential harm.

2.7 G Where a *firm* is assessing potential harms arising from the *firm's* positions in *financial instruments*, foreign currencies and commodities, the following non-exhaustive list of factors may be relevant:

(1) the extent to which the relevant position may involve risks that are not adequately captured by the *firm's K-NPR requirement*, *K-CMG requirement* or *K-CON requirement*, such as:

(a) basis risk between certain products;

(b) risks arising from approximate valuations applied to non-linear products;

(c) the risk that large movements in pegged currencies may be underestimated; or

(d) risks arising from inadequate proxy market data;

(2) whether a position is illiquid or distressed, or whether it may become so under severe but plausible market conditions, and how this may affect the expected holding period for that position;

(3) the extent to which it is possible to hedge a position under both normal, and severe but plausible, market conditions;

(4) whether a position is difficult to value because of a lack of recent observable market data;

(5) whether the intra-day exposure associated with a position differs significantly from the end-of-day exposure;

(6) any known weaknesses in any model used by the *firm* to assess the risks arising from the position; and

(7) the concentration of the portfolio in which the position is held, including by reference to:

(a) issuers or counterparties;

(b) economic sectors or sub-sectors; and

(c) geographical markets.