

Chapter 7

Governance and risk management



7.4 Internal capital adequacy and risk assessment (ICARA) process: overview and baseline obligations

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

Purpose

7.4.2 G ■ MIFIDPRU 7.4 to ■ MIFIDPRU 7.9 contain *rules* and *guidance* which supplement the overarching requirements for *MIFIDPRU investment firms* under:

- (1) the appropriate resources *threshold condition* in Schedule 6 to the Act (as explained in ■ COND 2.4) under which a *firm* must have appropriate resources in relation to the *regulated activities* that it carries on; and
- (2) *Principle 4* (Financial prudence) under which a *firm* must maintain adequate financial resources.

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- (1) The overall purpose of the rules in ■ MIFIDPRU 7.4 to ■ MIFIDPRU 7.9, together with the other requirements in *MIFIDPRU*, is to ensure that a *MIFIDPRU investment firm*:
 - (a) has appropriate systems and controls in place to identify, monitor and, where proportionate, reduce all potential material harms that may result from the ongoing operation of its business or winding down its business; and
 - (b) holds financial resources that are adequate for the business it undertakes.
- (2) The requirement for adequate financial resources is designed to achieve 2 key outcomes for *MIFIDPRU investment firms*:
 - (a) to enable a *firm* to remain financially viable throughout the economic cycle, with the ability to address any potential material harms that may result from its ongoing activities (including both *regulated activities* and *unregulated activities*); and
 - (b) to enable the *firm* to conduct an orderly wind-down while minimising harm to *consumers* or to other market participants, and without threatening the integrity of the wider *UK* financial system.
- (3) The *rules* and *guidance* in ■ MIFIDPRU 7.4 to ■ MIFIDPRU 7.9 build on the *FCA*’s general approach to assessing the adequacy of financial

resources explained in Finalised Guidance FG20/1. *Firms* should also refer to that *guidance* when considering their obligations under those sections of *MIFIDPRU*.

7.4.4 **G** The *FCA* recognises that:

- (1) there is a vast range of potential harms and it will not be possible for the *FCA* or *firms* to eliminate all potential risks and sources of harm;
- (2) the *FCA* and *firms* should focus on material harms, adopting a proportionate and risk-based approach to each *firm's* business and operating model; and
- (3) some *firms* may still fail, but the *FCA* and *firms* should aim to ensure that any wind-down of those *firms* occurs in an orderly manner, minimising the impact on *consumers* and the wider market.

Proportionality and application to different business models

7.4.5 **G** Although all *MIFIDPRU investment firms* are subject to the appropriate resources *threshold condition* and *Principle 4*, the practical steps that a *firm* must take to meet these requirements will vary according to the *firm's* business model and operating model. Therefore, a *firm* with a more complex business or operating model should generally take a more detailed approach to the monitoring and management of a wider range of potential harms than a smaller *firm* carrying on simpler activities.

7.4.6 **G** ■ *MIFIDPRU 7.4* to ■ *MIFIDPRU 7.8* contain a set of core requirements that every *MIFIDPRU investment firm* should incorporate into its *ICARA process*. This does not mean that the manner in which each *firm* implements these core requirements will be identical. When considering the appropriate way to satisfy these core requirements, a *firm* should focus on the potential material harms that may arise:

- (1) from the ongoing operation of its business; and
- (2) during a wind-down of its business.

Overall financial adequacy rule

7.4.7 **R** (1) A *firm* must, at all times, hold *own funds* and *liquid assets* which are adequate, both as to their amount and their quality, to ensure that:

- (a) the *firm* is able to remain financially viable throughout the economic cycle, with the ability to address any material potential harm that may result from its ongoing activities; and
- (b) the *firm's* business can be wound down in an orderly manner, minimising harm to *consumers* or to other market participants.

(2) The requirement in (1) is known as the *overall financial adequacy rule*.

7.4.8 **G** (1) The *overall financial adequacy rule* establishes the standard that the *FCA* applies to determine whether a *MIFIDPRU investment firm* has

adequate financial resources. The amount and quality of *own funds* and *liquid assets* that each *firm* must hold will vary according to its business model and operating model, the environment in which it operates and the nature of its internal systems and controls.

- (2) The remainder of this section explains the basic requirements of the *ICARA process*. The *ICARA process* is the collective term for the internal systems and controls that a *firm* must operate to identify and manage potential material harms that may arise from the operation of its business, and to ensure that its operations can be wound down in an orderly manner.
- (3) A *firm* should use the *ICARA process* to identify whether it complies with the *overall financial adequacy rule*. The focus of the *ICARA process* is on identifying and managing risks that may result in material harms. Depending on the nature of the potential harms identified, the only realistic option to manage them and to comply with the *overall financial adequacy rule* may be to hold additional *own funds* or additional *liquid assets* above the *firm's own funds requirement* or *basic liquid assets requirement*. However, in other cases, there may be more appropriate or effective ways to manage the potential harms. ■ MIFIDPRU 7.4.16G contains further *guidance* on reducing the risk of material potential harms.
- (4) ■ MIFIDPRU 7.6 contains *rules* and *guidance* about how a *firm* should use the *ICARA process* to assess the *own funds* that the *firm* requires to comply with the *overall financial adequacy rule*.
- (5) ■ MIFIDPRU 7.7 contains *rules* and *guidance* about how a *firm* should use the *ICARA process* to assess the *liquid assets* that the *firm* requires to comply with the *overall financial adequacy rule*.
- (6) ■ MIFIDPRU 7.10 contains *guidance* on how the *FCA* will normally conduct a *SREP* on a *firm's ICARA process* or may conduct a thematic review of a sector in which multiple *firms* are active. Where the *FCA* considers that the *firm's ICARA process* has not adequately identified and managed the risks of material harm, the *FCA* may require the *firm* to take corrective action. In appropriate cases, this may include requiring the *firm* to hold additional *own funds* or *liquid assets* to ensure that the *firm* is complying with the *overall financial adequacy rule*. The *FCA* may also take supervisory action in connection with the prudential requirements of a *MIFIDPRU investment firm* outside the context of a *SREP*. Where the *FCA* has conducted a sectoral review, it may impose additional requirements on some or all *firms* that are active in the relevant sector.

ICARA process: baseline obligations

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- (1) A *firm* must have in place appropriate systems and controls to identify, monitor and, if proportionate, reduce all material potential harms:
 - (a) that the ongoing operation of the *firm's* business may cause to:
 - (i) the *firm's clients* and counterparties;
 - (ii) the markets in which the *firm* operates; and
 - (iii) the *firm* itself; and

- (b) that may result from winding down the *firm's* business, to ensure that the *firm* can be wound down in an orderly manner.
 - (2) If any material potential harms remain after a *firm* has implemented the systems and controls in (1), the *firm* must assess whether to:
 - (a) hold additional *own funds* to address the harms in accordance with ■ MIFIDPRU 7.6.2R; and
 - (b) hold additional *liquid assets* to address the harms in accordance with ■ MIFIDPRU 7.7.2R.
 - (3) The requirements in this *rule* apply to a *firm's* entire business, including:
 - (a) all *regulated activities*, irrespective of whether they are *MiFID business*; and
 - (b) any *unregulated activities*.
 - (4) The systems, controls and procedures operated by a *firm* to comply with the requirements in this *rule* are known as the *ICARA process*.
- 7.4.10** R A *firm's* *ICARA process* must be proportionate to the nature, scale and complexity of the business carried on by the *firm*.
- 7.4.11** R A *firm* must ensure that its *ICARA process* complies with the requirements in ■ MIFIDPRU 7.4 to ■ MIFIDPRU 7.8 in a consistent and coherent manner.
- 7.4.12** G
- (1) ■ MIFIDPRU 7.4.11R requires a *firm* to ensure that the inputs to, analyses applied by, and conclusions arising from, its *ICARA process* are properly linked and reflect a consistent and coherent analysis of the *firm's* business and operating model.
 - (2) The following are examples of the consistency and coherence required by the *ICARA process*:
 - (a) the potential material harms that the *firm* identifies under ■ MIFIDPRU 7.4.13R are consistent with the *firm's* articulation of its business model and strategy under ■ MIFIDPRU 7.5.2R(1) and with the *firm's* stated risk appetite under ■ MIFIDPRU 7.5.2R(2);
 - (b) the *firm's* analysis under ■ MIFIDPRU 7.5.2R(4) of the *own funds* and *liquid assets* that are necessary to comply with the *overall financial adequacy rule* is consistent with:
 - (i) the potential impact of the potential material harms that the *firm* identifies under ■ MIFIDPRU 7.4.13R;
 - (ii) the *firm's* projections of its future requirements under ■ MIFIDPRU 7.5.2R(4); and
 - (iii) the impact of the stressed scenarios that the *firm* has identified under ■ MIFIDPRU 7.5.2R(5);
 - (c) the potential recovery actions specified by the *firm* under ■ MIFIDPRU 7.5.5R(2) are consistent with the *firm's* projections of its future requirements under ■ MIFIDPRU 7.5.2R(4) and the potential stressed scenarios that the *firm* has identified under ■ MIFIDPRU 7.5.2R(5);

- (d) the *firm's* wind-down planning under ■ MIFIDPRU 7.5.7R is consistent with the levels of *own funds* and *liquid assets* that the *firm* has assessed would be necessary to wind-down the *firm* for the purposes of the *overall financial adequacy rule* and with the *firm's* assessment of the potential harms that might result from winding down its business under ■ MIFIDPRU 7.4.13R; and
- (e) the *firm's* wind-down planning is consistent with the potential recovery actions specified by the *firm* under ■ MIFIDPRU 7.5.5R(2) and the circumstances in which the *firm* has concluded that no further recovery actions would be feasible or desirable.

ICARA process: identifying harms

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As part of its *ICARA process*, a *firm* must assess its business model and identify all material harms that could result from:
 - the ongoing operation of the *firm's* business; and
 - the winding-down of the *firm's* business.
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When assessing potential material harms for the purpose of ■ MIFIDPRU 7.4.13R, the FCA considers that the following non-exhaustive list of considerations will be relevant:
 - the level of detail required in the assessment is likely to vary depending on the complexity of the business and operating model. More complex business and operating models are likely to involve a wider range of potential material harms and so will generally require a more detailed assessment;
 - the obligation under ■ MIFIDPRU 7.4.13R is to identify all material harms that could result from the *firm's* business, even if those harms can be appropriately mitigated. It is important that a *firm* starts by identifying all potential material harms that could arise from its business and operating model. The issue of how the identified harms can be mitigated should be considered separately, including assessing under ■ MIFIDPRU 7.6 and ■ 7.7 whether the firm should hold additional *own funds* and *liquid assets*;
 - the potential for harm may evolve throughout the course of an economic cycle. Therefore, the assessment should consider how the risk of harm may develop in the future, rather than simply performing a static assessment based on current economic circumstances;
 - risks to the *firm* itself may result in an increased risk of harm to the *firm's clients* or counterparties and therefore should form part of the assessment. For example, if the *firm* is affected by a significant disruption or suffers a significant loss, this may prevent the firm from providing important services to *clients* or from being able to meet its liabilities to counterparties. Significant and unexpected financial losses sustained by a *firm* may also decrease the financial resources available to the *firm* to address other potential harms and may increase the risk of disorderly wind-down and sudden disruption of services to the *firm's clients*; and

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firms should refer to the guidance in Finalised Guidance FG20/1 on “Identifying and assessing the risk of harm” when assessing the impact of potential harms.

- (1) ■ MIFIDPRU 7 Annex 1 contains additional *guidance* on identifying potential material harms that are relevant to the business models of most *firms*.
- (2) ■ MIFIDPRU 7 Annex 2 contains additional *guidance* on identifying potential material harms that are likely to be relevant to *firms* that *deal on own account* or hold significant investments on their balance sheets. This *guidance* is intended to apply in addition to the general *guidance* in ■ MIFIDPRU 7 Annex 1.
- (3) The FCA may issue further *guidance* or publish additional information to reflect its observations of how *firms* are implementing the ICARA process or to take into account developments in relation to particular products or sectors. *Firms* should consider any additional *guidance* or information that the FCA has published when applying the requirements in this section.

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ICARA process: risk mitigation

- (1) The ICARA process is an internal risk management process that a MIFIDPRU investment firm must operate on an ongoing basis. As part of that process, a firm should consider whether the risk of material potential harms can be reduced through proportionate measures (other than holding additional financial resources) and, if so, whether it is appropriate to implement the measures. The nature of any potential measures will vary depending on the firm’s business and operating model. Examples may include implementing additional internal systems and controls, strengthening governance and oversight processes or changing the manner in which the firm conducts certain business. A firm will need to form a judgement about what is appropriate and proportionate for its particular circumstances. That judgement will be informed by the firm’s risk appetite.
- (2) A firm must assess whether it should hold additional *own funds* or additional *liquid assets* to mitigate any material potential harms that it has identified. This may be the case where the firm cannot identify other appropriate, proportionate measures to mitigate harms, or where it has applied these measures, but a residual risk of material harm remains. Any assessment must be realistic and based on severe but plausible assumptions.