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1. Draft amendments to Supervisory Statement 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP)'

In this appendix, new text is underlined and deleted text is struck through.

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2 Expectations of firms undertaking an ICAAP

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Risk of excessive leverage

2.43 The PRA expects firms to carry out an assessment of the risk of excessive leverage. This is defined as the risk resulting from a firm's vulnerability to leverage or contingent leverage that may require unintended corrective measures to its business plan, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets.

2.44 In carrying out their assessment, firms should consider any contingent leverage risk in transactions and trade structures that receive lower leverage ratio exposure measure values than other economically similar transactions. Examples include:

- agency models to transact in security financing transactions (SFTs) or derivatives, SFT netting packages, collateral swaps, and unsecured borrowing or lending of securities;
- internalised derivative positions (including written credit derivatives, equity swaps and total return swaps);
- any other trade structures that have a lower leverage ratio exposure value than economically similar trades.

2.45 The extent to which firms can use these more capital efficient forms of trades may be limited in certain conditions, for example, in the event of the default of counterparties, the movement of certain market parameters, or changes to broader market conditions. For example:

- Netting: a client may withdraw or default from one leg of a transaction that is netted, or one-directional markets in stress could lead to a lack of availability of netting opportunities. If the firm cannot find or replace that transaction, this may result in loss of netting and an increase in the total exposure measure for the purposes of the leverage ratio.

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- Internalisation: a client may withdraw or default from one leg of a transaction that is internally offset for hedging purposes. If the firm cannot replace the offsetting leg, the firm may use a cash hedge for the remaining leg of the transaction, increasing its total leverage exposure. In the case of written credit derivatives (in line with 'Article 429d' of the 'Leverage Ratio (CRR)' Part of the PRA Rulebook), the loss of an offsetting leg may result in the loss of conditions that allow the firm to internalise the effective notional amount of the credit derivative, and increase a firm's total exposure.

- Collateral swaps: some lower-quality forms of collateral may become less available in certain market conditions, and firms may have to replace the affected collateral swaps with other forms of financing.

2.46 Firms should consider the extent to which they would need, and be able, to continue to participate in these trades and the extent to which they would instead need to use economically similar transactions or structures that receive higher leverage ratio exposure measure values. Firms should consider the impact this might have on their leverage ratio and other regulatory measures (such as liquidity or risk-weighted metrics) as relevant.

2.47 Continued exposure to transactions or trade structures which receive lower leverage ratio exposure measure values may arise from a variety of reasons, including contractual obligations, franchise considerations, liquidity management, or other commercial reasons. To the extent that firms would not continue to participate in such trades in certain circumstances, firms should consider what implications this might have for their revenues. Examples of risks and assumptions that firms should pay particular consideration to include, but are not limited to:

- Contractual obligations: firms may be contractually obliged to maintain transactions with certain counterparties, even in circumstances where doing so might be detrimental to the firm's leverage ratio position.

- Franchise risk: firms, especially prime brokers, often offer their services to maintain a franchise value with their clients in addition to the revenues generated directly by the business activity. As such, a firm may roll over funding transactions at a client's request even in circumstances where doing so might be detrimental to the firm's leverage ratio position.

- Liquidity management: firms should consider the extent to which they may be able to maintain their funding without having to replace their transactions or trade structures with others that receive higher leverage ratio exposure measure values, such as secured borrowing.

2.48 As part of their ICAAP responses, firms should set out contingent leverage risks by each relevant trade structure that optimises leverage exposure.

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