



# Counting the cost

**How investment firms are taking  
a more precise measure of risk**

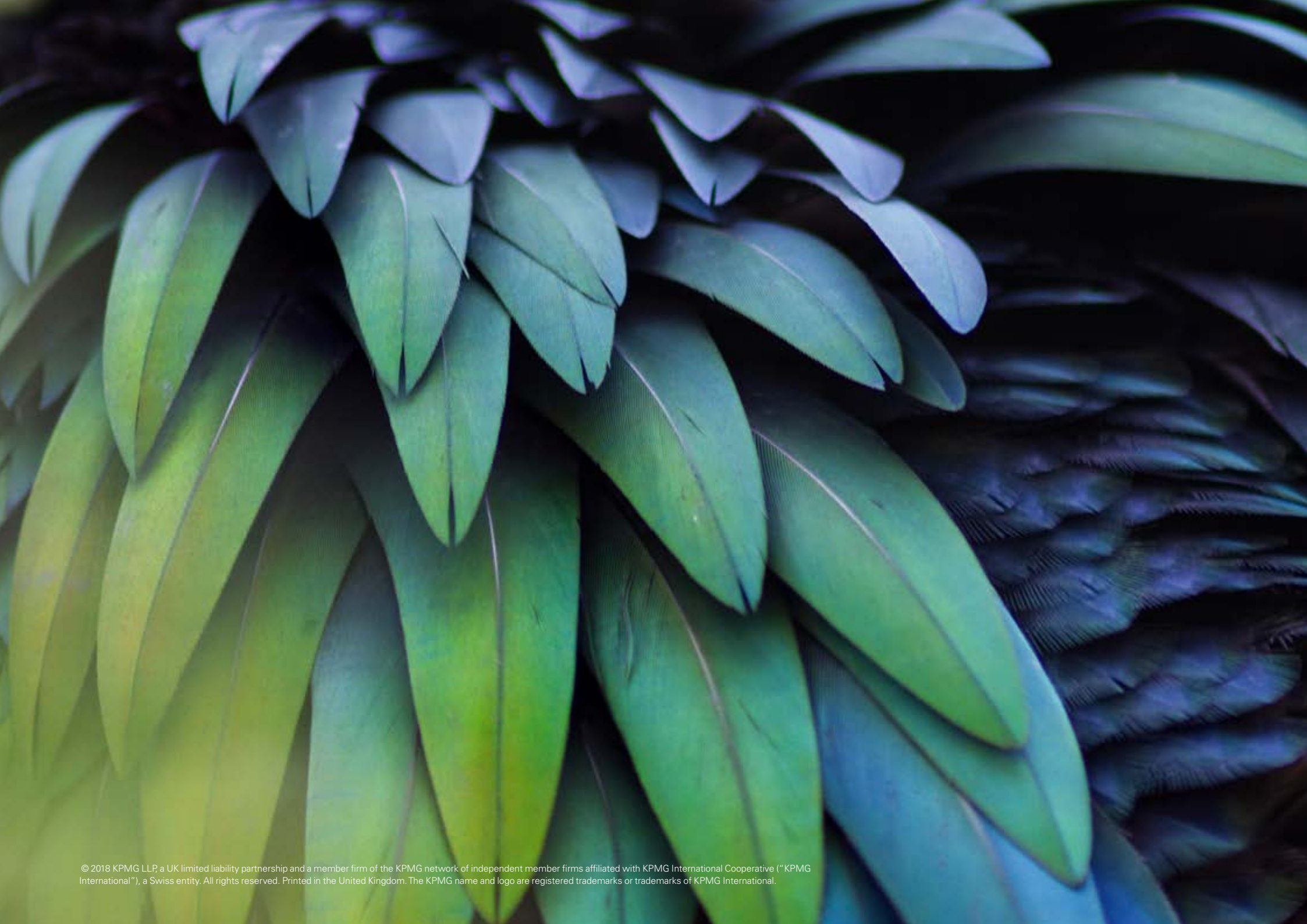
Risk and ICAAP benchmarking  
survey 2018

November 2018

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# Introduction



With our annual benchmarking report now in its fourth year, I am pleased to report that investment firms continue to take risk management and ICAAP much more seriously.

It is clear from our findings that firms are devoting both time and resources to this continued area of focus for the regulator. We see improvements in the key areas of operational risk modelling, stress testing and wind-down planning. This is encouraging. However, our survey continues to highlight areas where firms fall short.

Undoubtedly, 2019 will be a year of challenge for the industry, with the impact of Brexit and the expected publication of the final rules on the new prudential regime for investment firms. It is perhaps surprising to see that many firms have yet to quantify the potential impact of the new regime based on the draft proposals. At the most fundamental level, risk is defined as uncertainty; and in an environment of enhanced uncertainty the regulator is likely to scrutinise how firms respond to evolving risks. Firms need to be focused on both the macro level challenges as well as counting the cost of risk at a granular level.

**David Yim**  
Partner, KPMG in the UK

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# Executive summary

Our latest survey suggests that, in several areas, investment firms are taking a more sophisticated approach to how they assess and manage risk. Could 2018 (the year of our fourth annual Risk and ICAAP benchmarking survey) mark a step-up in the precision and maturity of approaches?

The story starts with capital requirements increasing for 80% of firms, since their last Internal Capital Adequacy Assessment Process (ICAAP).

Although it is encouraging that some firms are self-assessing their capital requirements to be higher, for all firms in our survey that were subject to a Supervisory Review and Evaluation Process (SREP), the regulator assessed the requirement to be even higher still. Of those that underwent a SREP, a little under half of firms received governance scalars, suggesting the regulator still lacks confidence in how some of them are dealing with ICAAP and risk management. However, governance is no longer top of the SREP findings list, suggesting the FCA is becoming more detailed in its feedback. This time, its place has been taken by operational risk modelling, now subject to more scrutiny.

Some inconsistencies are also revealed in this year's study. Half of firms do not hold Pillar 1 capital against client settlement balances, an area of focus for the regulator – and one which presents capital management issues for some firms, including the potential for larger swings in the capital requirements, in particular for those firms with a high Individual Capital Guidance (ICG).

Survey responses this year indicated a growing sophistication in the approach to Pillar 2. More respondents are using operational risk models compared to 2017, and this year also saw firms covering more of the Basel operational risk categories in their selected scenarios. The use of insurance mitigation has again decreased, reflecting consistent challenge from the regulator. However, the number of firms applying diversification benefit has gone up, which is consistent with the increased use of operational risk modelling.

Stress testing is also improving, with most firms now linking stress scenarios back to the risk register. There has also been an overall increase in the number of firms using all three types of stress scenarios. However, the severity of stress scenarios selected, and their use by governing bodies, still appears to be an area of weakness.

Wind-down plans are also showing increased rigour. More firms are using early-warning indicators, additional business functions (especially HR) are becoming involved, and wind-down timelines are continuing to lengthen, with more firms having wind-down timelines of 12 to 24 months. That said, with wind-down guidance now published nearly two years ago – and with operational resilience a growing area of regulatory focus – wind-down plans are likely to see increasing scrutiny.

More firms have quantified their capital requirements in anticipation of the new EBA prudential regime, for which few had prepared last year. However, just over a quarter of firms in our survey have quantified the likely impact on their capital position. Given its potential impact on the capital assessment process, it is important that firms carry out a comparative analysis of the current and upcoming regimes sooner rather than later.

Something else to watch out for in 2019 is the regulatory capital impact of the IFRS 16 accounting standard, where it applies. The standard on the treatment of operating leases will bring changes to the balance sheet which is, of course, the starting point for both regulatory capital and Pillar 1 calculations. For wealth and asset management firms subject to EU capital requirements, this will have a direct impact on their regulatory capital position.

Brexit planning is also high on the change agenda for investment firms. In this year's survey 40% of firms are planning partial relocation, which raises the question of how they will manage capital requirements across multiple regulatory jurisdictions.

In 2017, we asked whether firms could keep up with the volume and pace of regulation. This year's survey suggests that while there are still areas of concern, firms are no longer on the back foot, as they take a more rigorous and comprehensive approach to risk management.

# About the research

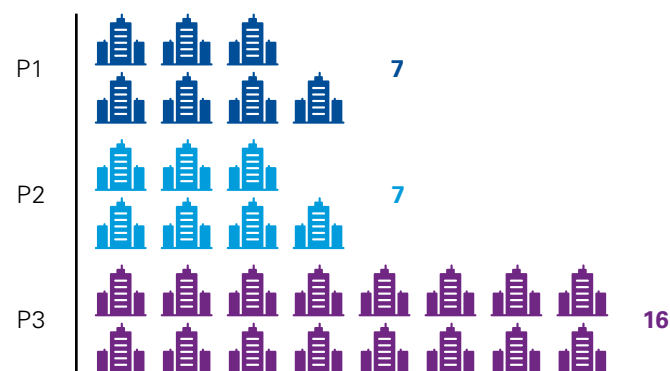
KPMG's benchmarking study of risk management and ICAAP practices at investment firms is now in its fourth year.

This year's study encompassed 30 firms of varying sizes to give a representative picture of the UK asset management industry. Respondents ranged from platform operators to alternative focused boutiques and global asset managers. The mix of prudential categories and the BIPRU/IFPRU split was broadly in line with the previous studies.

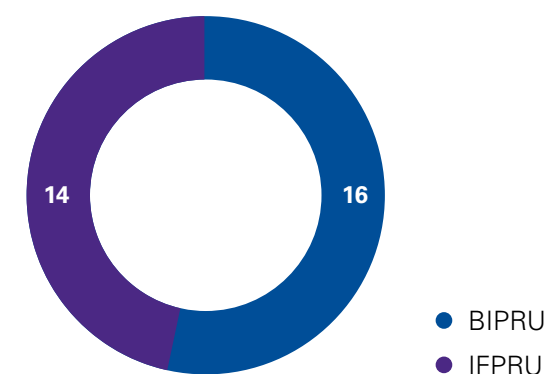
**Firms by AUM (£)**



**Firms by prudential category**



**Firms by regulatory category**



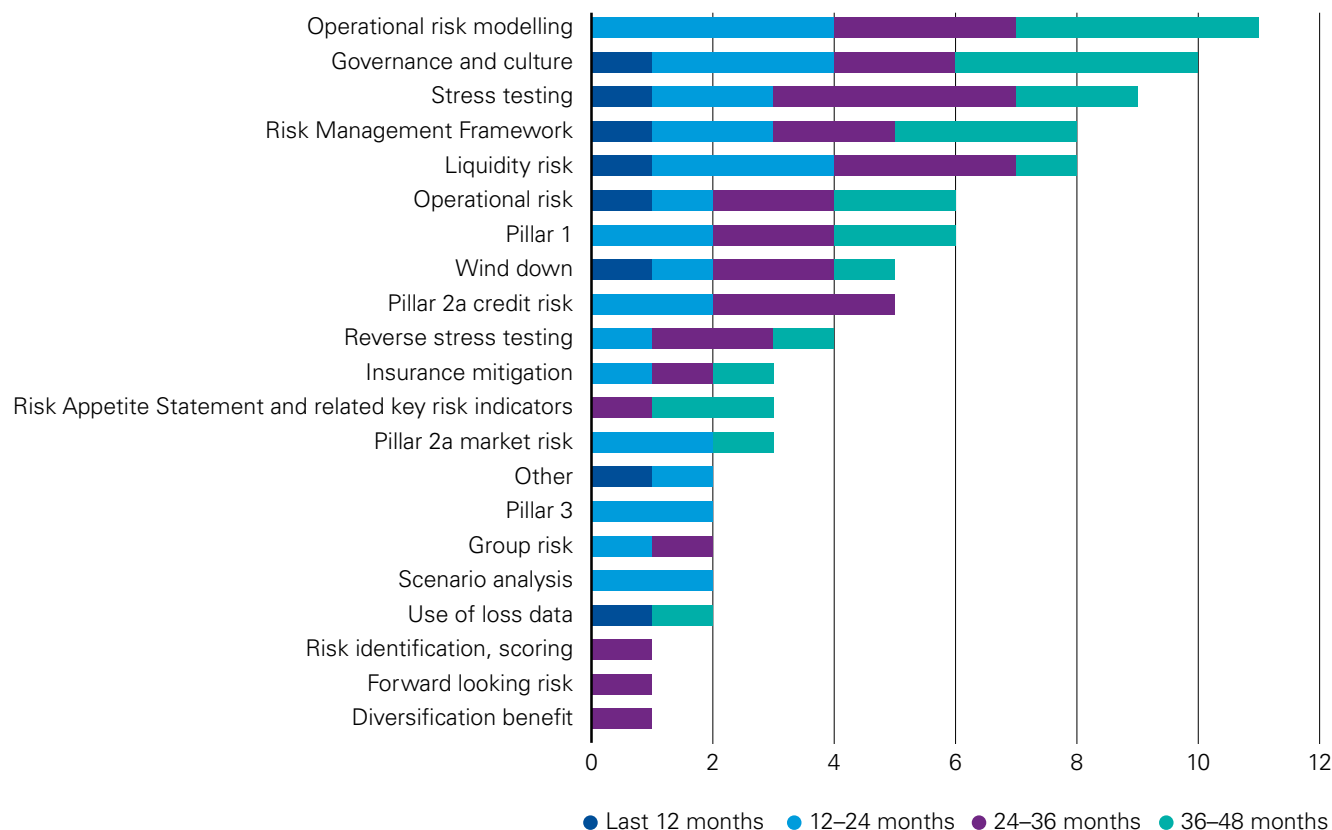


# SREP findings

## Getting into the detail

The regulator still expects firms to hold more capital. In this year's study, 24 out of 30 firms surveyed have been subject to a regulatory visit (SREP and ARROW). Of the firms that underwent a SREP over the last four years (from 2015 to 2018), all received guidance to hold more capital, with a median increase of 39% above the firms' own assessment. However, compared with the 82% median increase reported in our 2017 survey, it suggests that many firms are making improvements in how they calculate their own capital requirements and that the regulator has more confidence in their risk management frameworks. We have also observed that the mean increase as a result of SREP against firms' own assessments is 65%, compared to the median of 39%. This appears to suggest a significant gap is emerging between the large add-ons experienced by firms perceived to have serious weaknesses in their assessments and risk management frameworks, and the 'tweaks' that are experienced on a more routine basis.

## Issues raised by the regulator in the past four years

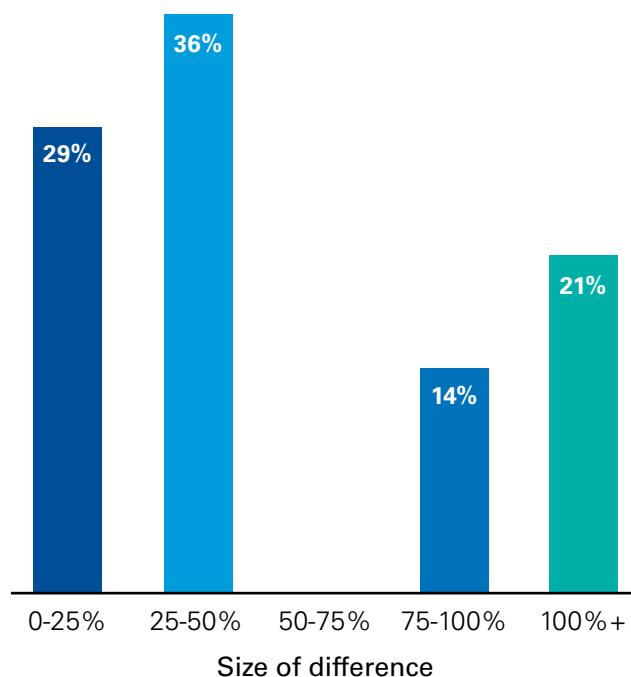


In addition to receiving Individual Capital Guidance (ICG), just over half (56%) of firms had a Risk Mitigation Programme (RMP) imposed, just under half (44%) were given a governance scalar and approximately a third (28%) received a fixed add-on. This reinforces the point that, despite improvements in the risk and capital assessment process, the regulator continues to identify a number of issues with risk management that need addressing at investment firms.

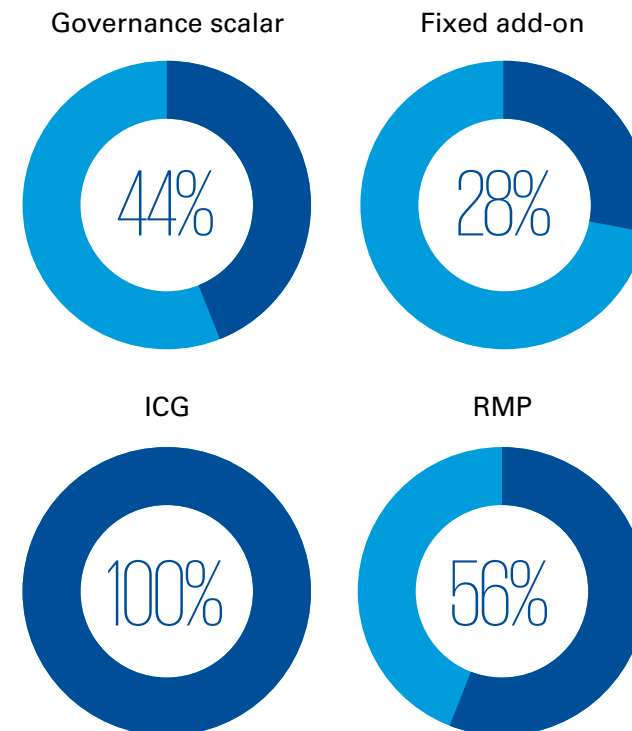
Governance and culture continues to be an issue raised by the regulator, with governance concerns identified at one third of firms subject to SREP. However, this year, SREP feedback letters have highlighted operational risk modelling more frequently than any other topic over the past four years. It has always been an area of focus, but the increased use of modelling in recent years has made it subject to a greater degree of scrutiny.

#### Differences in firms' own assessments versus that of the regulator in the past four years

Percentage of firms in the following ranges



#### Outcomes of SREP reviews





# The KPMG View

While there is clearly a continuing trend around capital add-ons arising from regulatory reviews, their size is reducing. This may be a reflection of firms' own assessments becoming more realistic and that many are better able to demonstrate the "embeddedness" of risk management. Those firms that are getting this right are seeing lower increases in capital requirements, while those that fall short are seeing ever sharper increases. The difference this year is that the cost of imprecision is increasing, with 21% of firms subject to SREP over the last four years experiencing add-ons of over 100%.

Operational risk modelling continues to be a key issue raised. This reflects the increased use of modelling, discussed later in the report, and also the challenges firms often face around the use of models. If they are applied incorrectly or seen as a "black box" solution, then capital add-ons and governance scalars are very likely to follow.

Last year we highlighted the fact that governance and culture was repeatedly identified as a weakness by the regulator. To get this right, firms need to be able to demonstrate a business-wide risk culture,

starting at the board and executive level. For many firms, this can be a challenge and we believe that senior managers will continue to be under the spotlight as SMCR is finally introduced in December 2019. We have also seen the regulator using governance scalars to ensure that these issues are addressed.

Stress testing and liquidity risk are also areas of significant regulatory focus. This is no surprise, given that many firms continue to fall short in these areas.

The regulator is now scrutinising all firms with greater intensity. Where firms are subject to an onsite SREP visit, we have noted that the number of people being interviewed and the depth of questioning in these interviews is on the rise. Firms which are subject to a desktop-only review tend to be smaller in scale. For them, the challenge lies in ensuring that their ICAAP document is of a high quality and clearly articulates their risk management practices, as there is little or no opportunity elsewhere to demonstrate the effectiveness of their risk management arrangements.



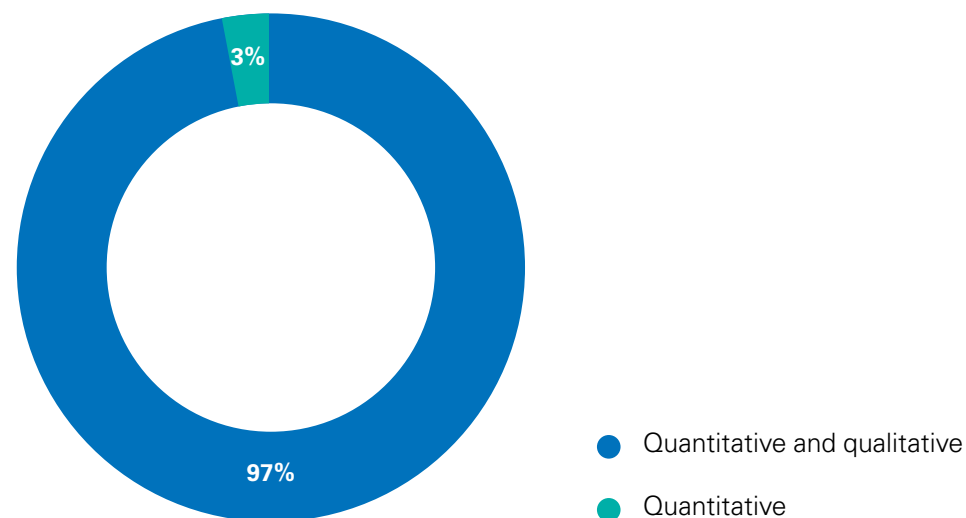
# Risk appetite

## Not yet in sync

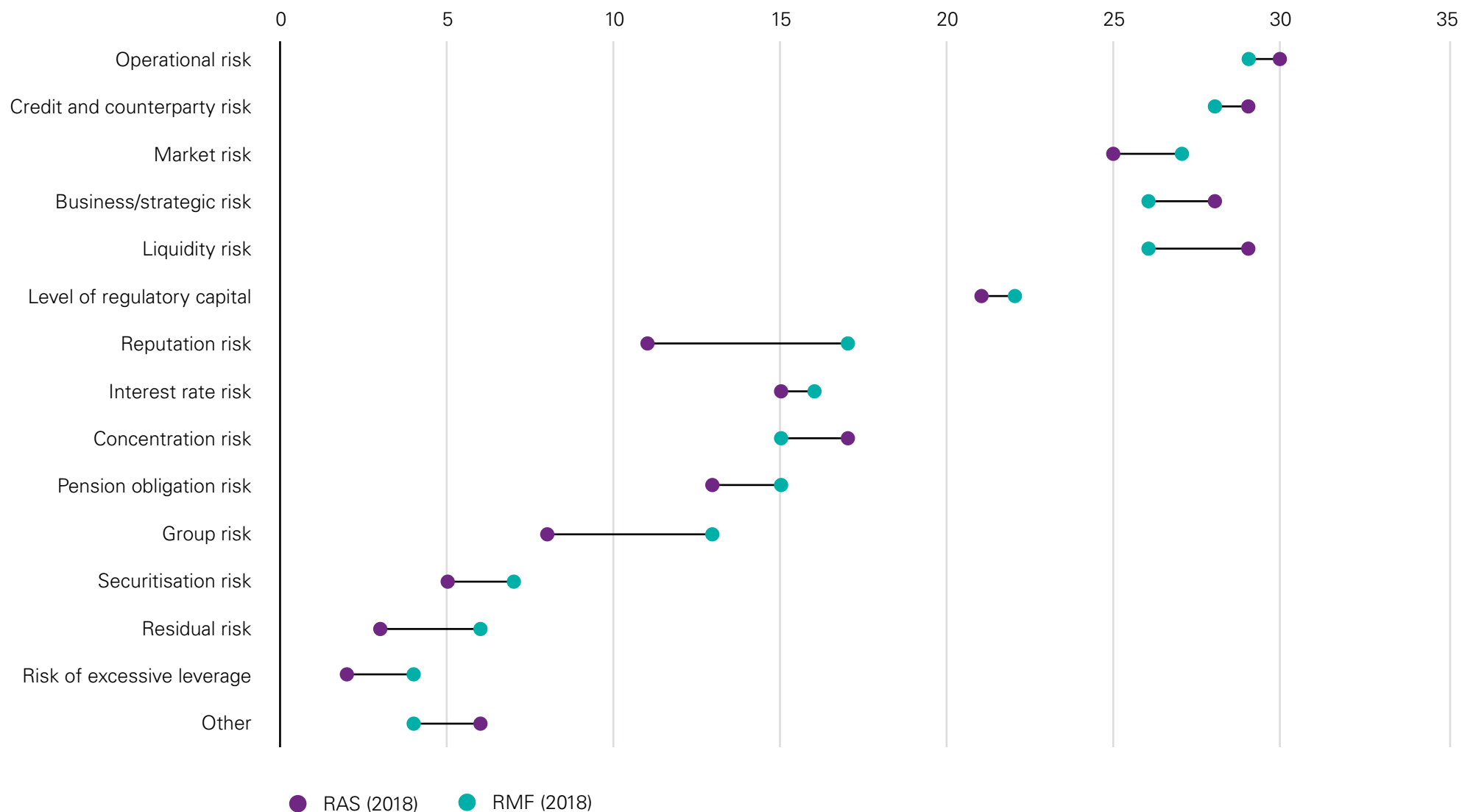
Continuing the trend from last year, there appears to be an overall improvement in firms' approaches to risk appetite, with the majority having a risk appetite policy in place. For the first time since our survey began, all firms have quantitative risk appetite thresholds, enabling more effective risk monitoring by senior management.

However, examining the detail more closely, there continues to be a misalignment between risk appetite statements (RAS) and risk management frameworks (RMF). This is a trend we also observed in 2016 and 2017. Ideally, these two components should be in sync. The biggest disconnects between the RMF and RAS are liquidity risk, residual risk, group risk and reputation risk. The change in the level of misalignment compared to last year's survey is minimal, suggesting that components of the risk management framework continue to be considered in silos.

## Risk appetite thresholds

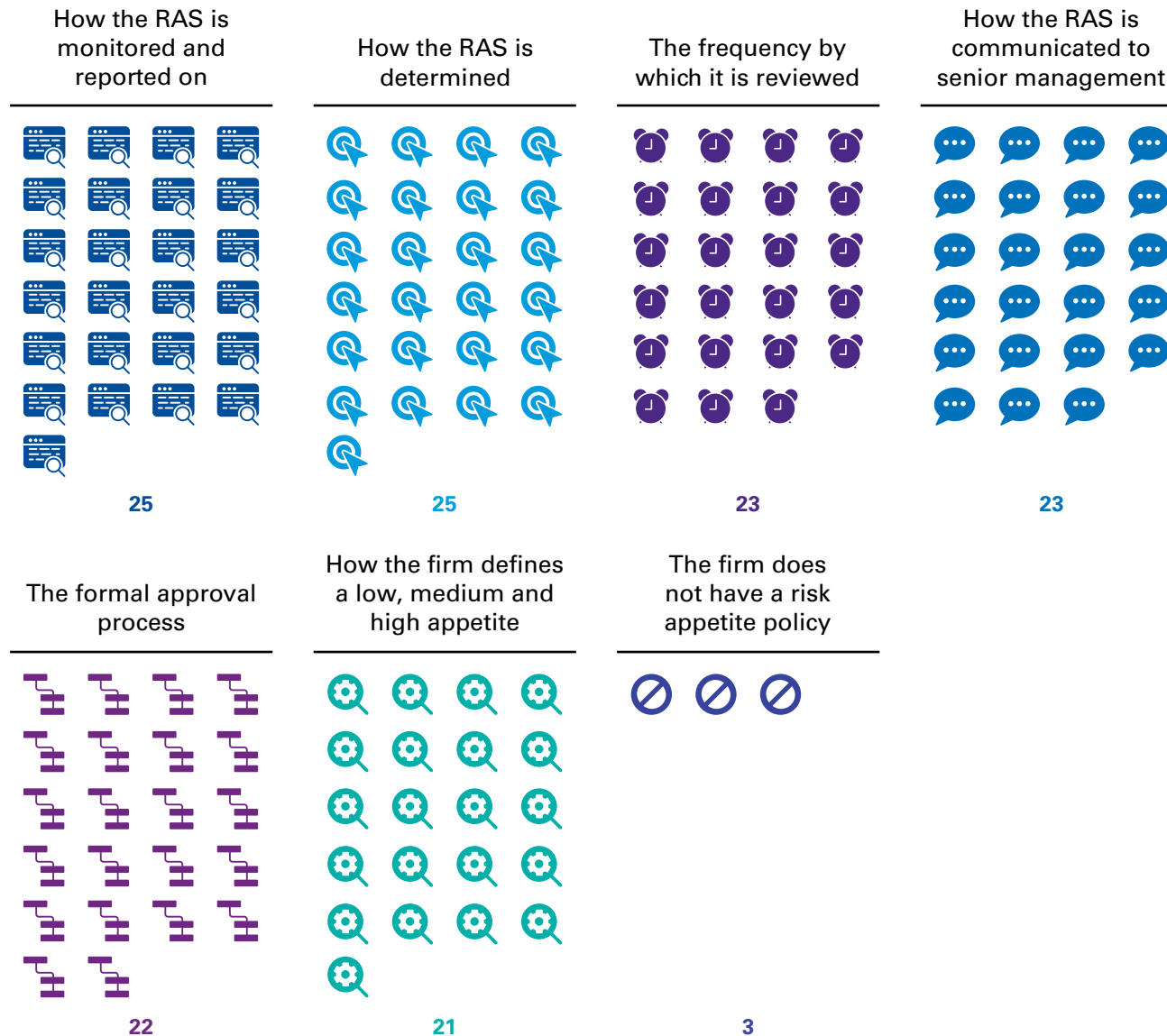


### Misalignment between RMF and RAS: number of firms including the following risks





### Number of firms including the following in their Risk Appetite policy



## The KPMG View

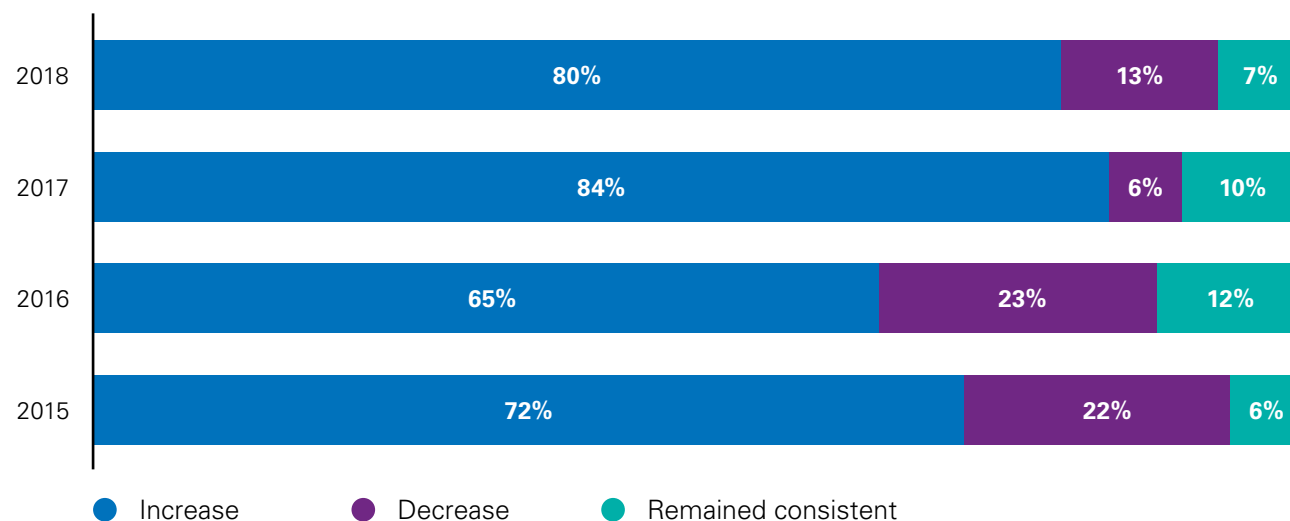
Risk appetite is the foundation of a robust risk management framework: it represents the amount of risk a firm is willing to take in order to achieve its objectives. A disconnect between the RAS and RMF can be seen to suggest that the risk profile of a firm is not subject to board-level review and challenge. In other words, they should be able to join the dots. It also implies that the board cannot effectively monitor the risk profile of the business. As we have identified, governance continues to be a key issue from FCA SREP visits: this is linked to the disconnect between risk appetite and the degree to which the risk management framework is embedded in the business.

# Capital requirements

## Still rising

Overall capital requirements have increased for the majority (80%) of firms, with the median percentage increase from 2017 to 2018 for all firms in our survey across all prudential categories now standing at 9%. We have seen consistent year-on-year increases in capital requirements since we published our first report in 2015 and this represents a continuation of this trend. The increase has been driven by firms in higher prudential categories having increased capital requirements of 20% (P1 firms) and 23% (P2 firms) on average.

### Overall change in capital requirement for each year

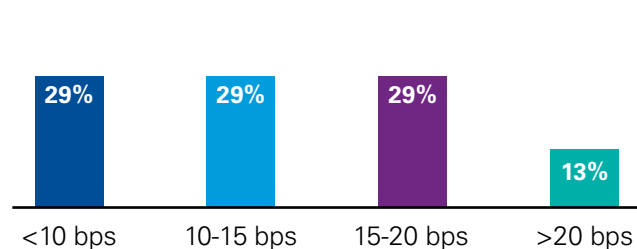


Operational risk is a key area for asset management firms, due to the agency nature of the business. Our survey shows that firms are raising their levels of capital for operational risk, with the median amount of capital held for this risk category increasing by 22%, compared to the prior year. The median level of capital held for operational risk across all firms is now 7.14 basis points as a proportion of AUM.

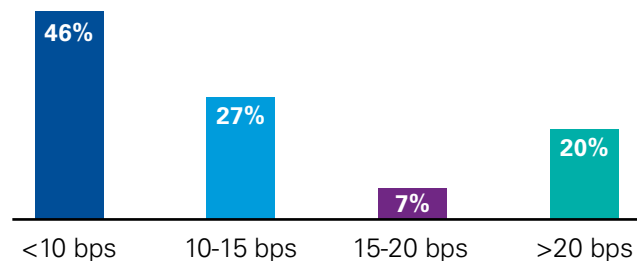
Given the SREP findings we have previously outlined, and the increases in firm's self-assessments, it is not surprising that overall capital requirements as a proportion of AUM have risen. The median capital requirement as a proportion of AUM is 12.74 bps compared to 9.40 bps across all firms in last year's survey. While capital requirements can be driven by the regulator through ICG, a third of firms subject to ICG have self-assessed their capital requirements to be even higher than the regulator's guidance issued during their previous review. This is the result of firms' business models and risk profiles evolving since their last review by the regulator.

### Capital requirements: in basis-points vs AUM

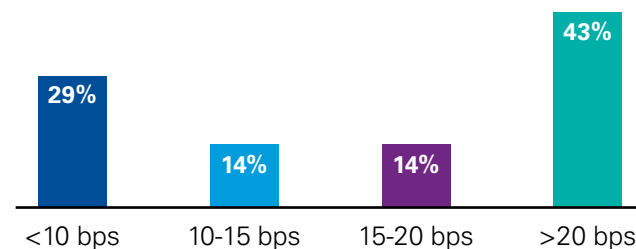
Percentage of P1 firms in the following ranges



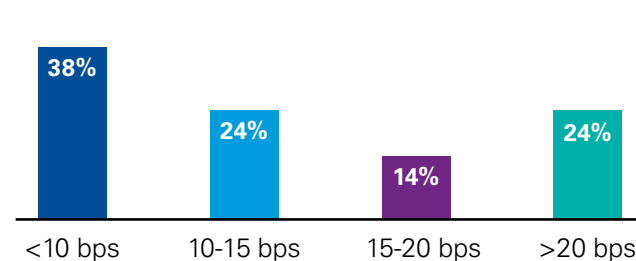
Percentage of P3 firms in the following ranges



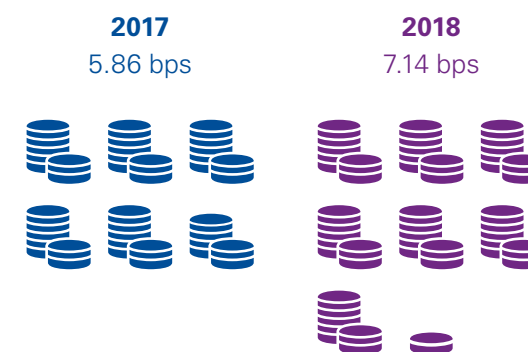
Percentage of P2 firms in the following ranges



Percentage of all firms in the following ranges



### Median amount of capital held for operational risk as a proportion of firms AUM





# The KPMG View

Results suggest that the way in which firms are arriving at their capital requirement is continuing to evolve in a positive direction, as the ICAAP continues to mature and the assessment process becomes more comprehensive. Large firms continue to hold higher requirements than smaller firms, which reflects the different business models and the more complex operations within these firms. This may also be influenced by the higher frequency of FCA visits to large firms, due to their impact on consumers and their relative importance in the financial system. While overall capital requirements have also increased, it is encouraging to see that some firms are self-assessing their requirement to be higher than the ICG issued in their last SREP. This implies that more robust assessments are taking place and firms are not waiting for regulatory visits to reflect changes to their risk profile in their capital assessment.

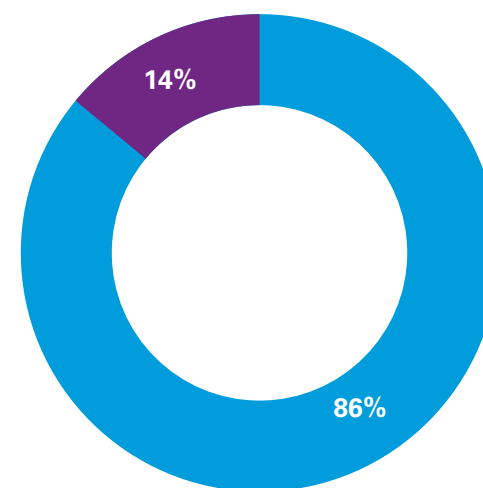


# Pillar I

## Under scrutiny

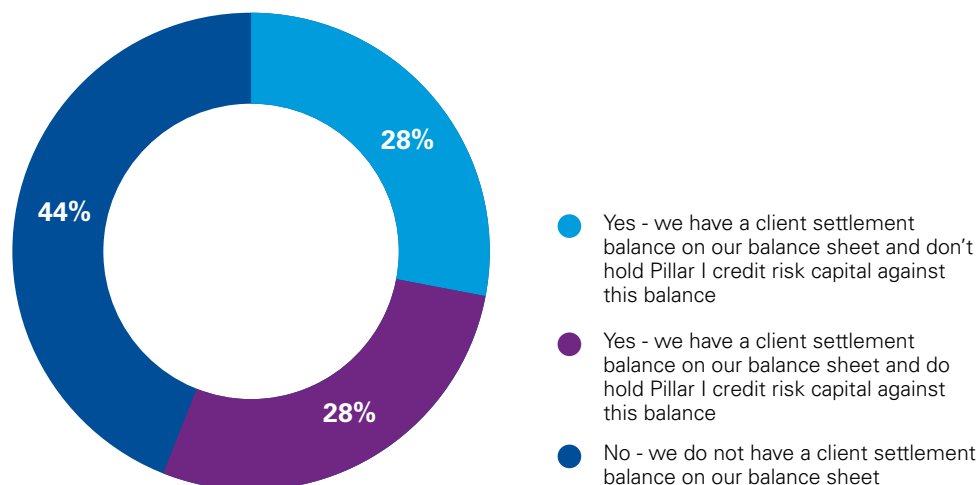
As we observed in previous years, for most firms (86%), Pillar 1 is driven by the Fixed Overhead Requirement (FOR). For this year's analysis, and in response to discussions with a number of firms, we have examined more closely the factors that drive Pillar 1. The treatment of on-balance sheet trade receivables related to fund transactions is, in particular, an area of topical interest. Just over half the firms in our survey (56%) have these items on their balance sheet. Of these firms, only half hold Pillar 1 credit risk capital against it.

### Driver of Pillar I capital requirement

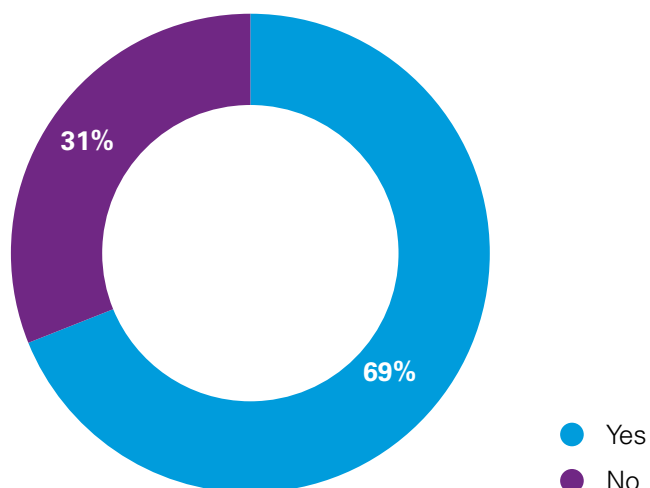


- Fixed overhead requirement
- Credit and market risk

### Do you have a client settlement balance (resulting from the purchase and redemption of fund units) on your balance sheet?



### Have you performed a review of prudential regulatory returns?



## The KPMG View

Pillar 1 has become an area of regulatory focus this year. In February 2018, the FCA issued a “Dear CEO” letter concerning the quality of prudential regulatory returns and we have also seen increased scrutiny of Pillar 1 as part of SREP visits. Despite this, our survey shows that 31% of firms have not performed a review of their prudential returns. Given the prescriptive nature of Pillar 1, the regulator expects firms to carry this out properly. And, bearing in mind the regulators’ intention to start reviewing a sample of regulatory returns in late 2018, it’s an area firms must address urgently.

The treatment of client settlement balances poses a challenge to the industry, which has adopted inconsistent approaches. Inclusion of these balances in the credit risk calculation is required by the regulations, but creates the potential for large, albeit very short-term, volatility in capital requirements. These balances are driven by investor flows that are highly unpredictable. When coupled with an ICG, the impact on capital requirements is amplified. This could lead to potential capital breaches that should be reported to the regulator. We note that this could be a temporary issue, given that the new EBA Investment Firm capital regime is on the horizon.

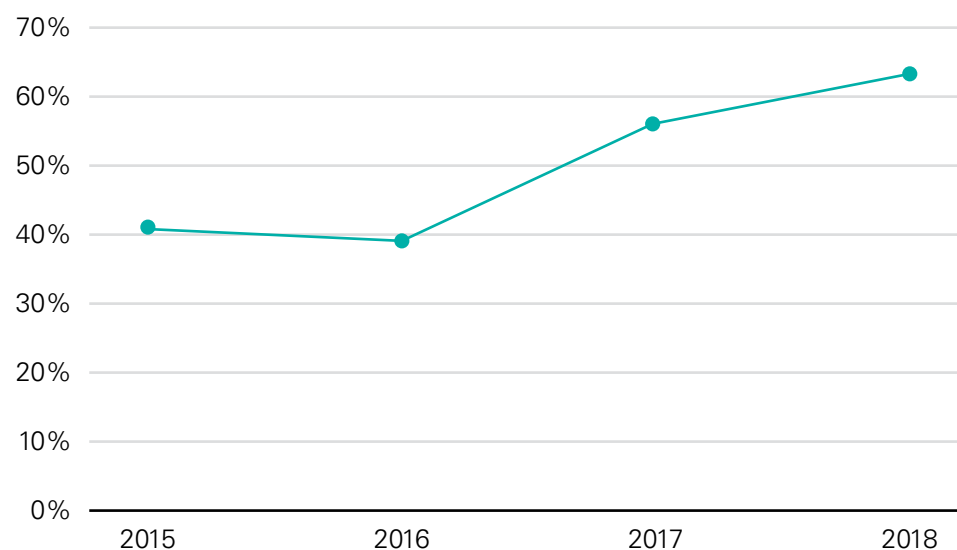


# Pillar II approach

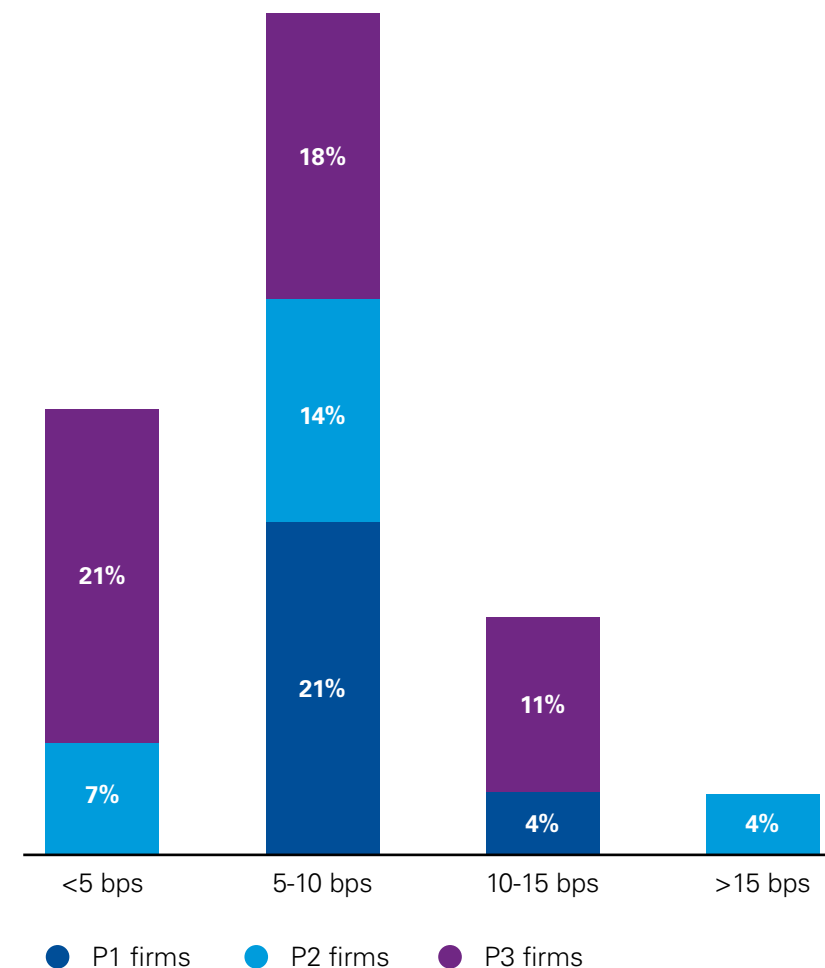
## Greater precision

As expected, operational risk continues to be the largest component of the Pillar 2 calculation. This is an area where we have seen further improvement this year. Firms are including a broader range of scenarios, and more firms are using operational risk models, which leads to a more quantitative approach to calculating operational risk capital. During the four years that this study has been carried out, the percentage of investment firms using a statistical model for operational risk has increased from 41% in 2015 to 63% today. Use of these models varies across prudential categories: 86% of P1 and P2 firms use statistical models, compared to just 44% of P3 firms. Firms that use a statistical model in the calculation of their operational risk capital tend to see higher levels of Pillar 2a operational risk capital as a proportion of AUM.

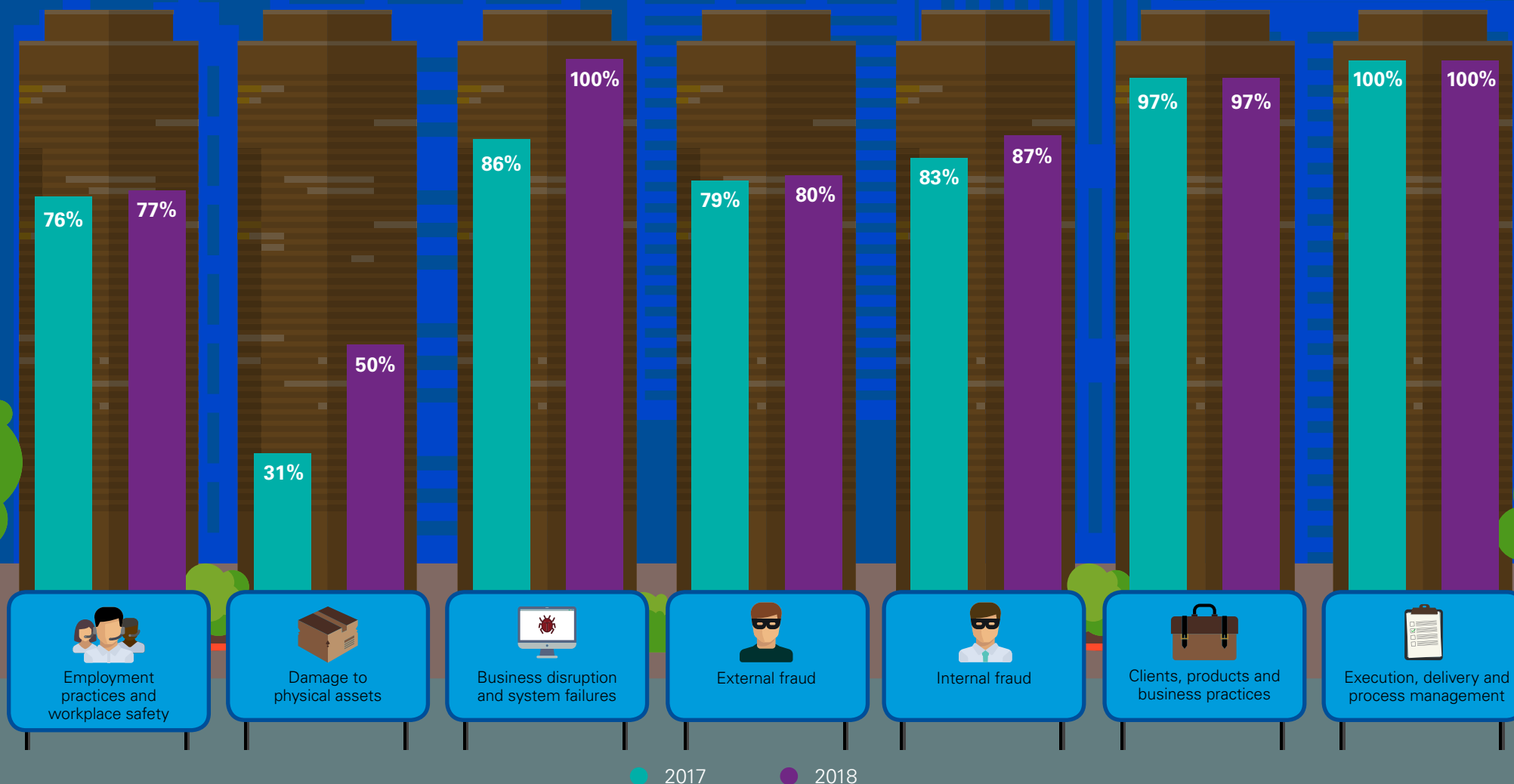
### Proportion of firms using statistical models



### Operational risk as a proportion of AUM: percentage of all firms in the following categories

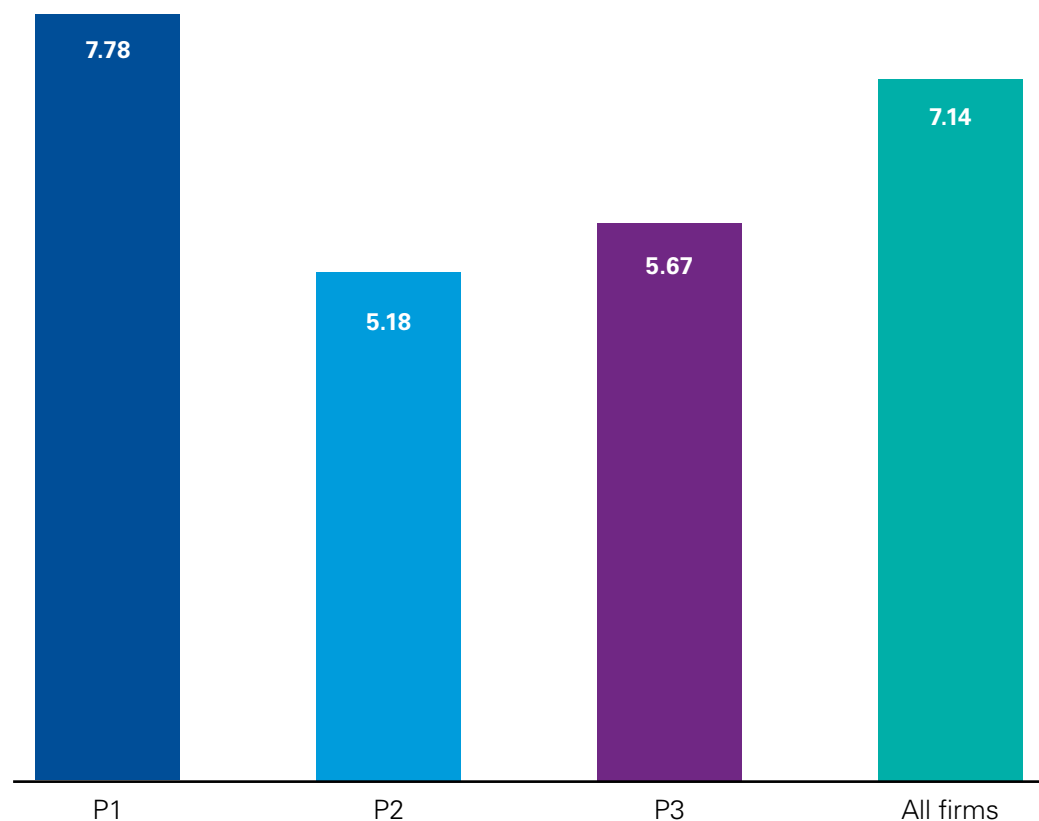


Percentages of firms using at least one of the following operational risk scenarios





### Median operational risk capital requirement as a proportion of AUM in basis points



## The KPMG View

Using a statistical model does not necessarily mean operational risk capital will be reduced. This might seem counterintuitive, as firms using statistical models can benefit from diversification. The higher levels of capital requirement could be explained by the fact that firms using models tend to be larger and more complex, with a higher risk profile. In addition, the use of a model can lead to more realistic scenario inputs, resulting in more robust calculations. Where firms take a simplistic approach, this could lead to optimistic inputs into scenarios and therefore lower capital requirements that do not stand up to regulatory scrutiny.

Regardless of approach, the regulatory expectation is that the correct risks are identified and comprehensively assessed. Firms must therefore be aware of the associated strengths and weaknesses of their chosen methodology for assessing operational risk capital requirements. This assessment can be enhanced through a modelling approach. Where modelling is used, it is extremely important to ensure the appropriate governance over the approach is in place, to apply a robust methodology and to gain input from subject matter experts from across the business. This will help firms meet the heightened regulatory scrutiny around modelling previously identified in this report.

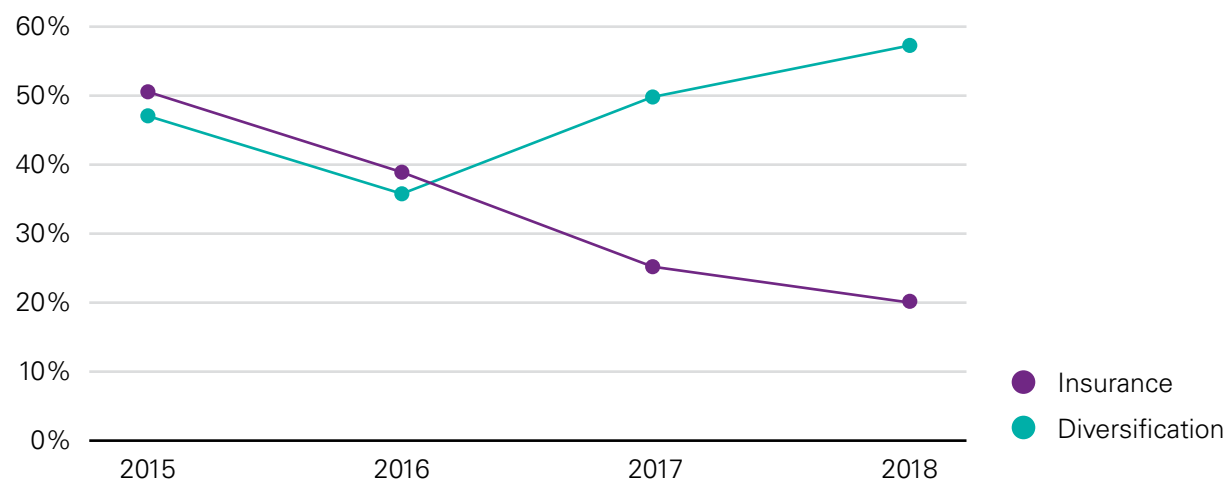
# Insurance and diversification

## Down and up

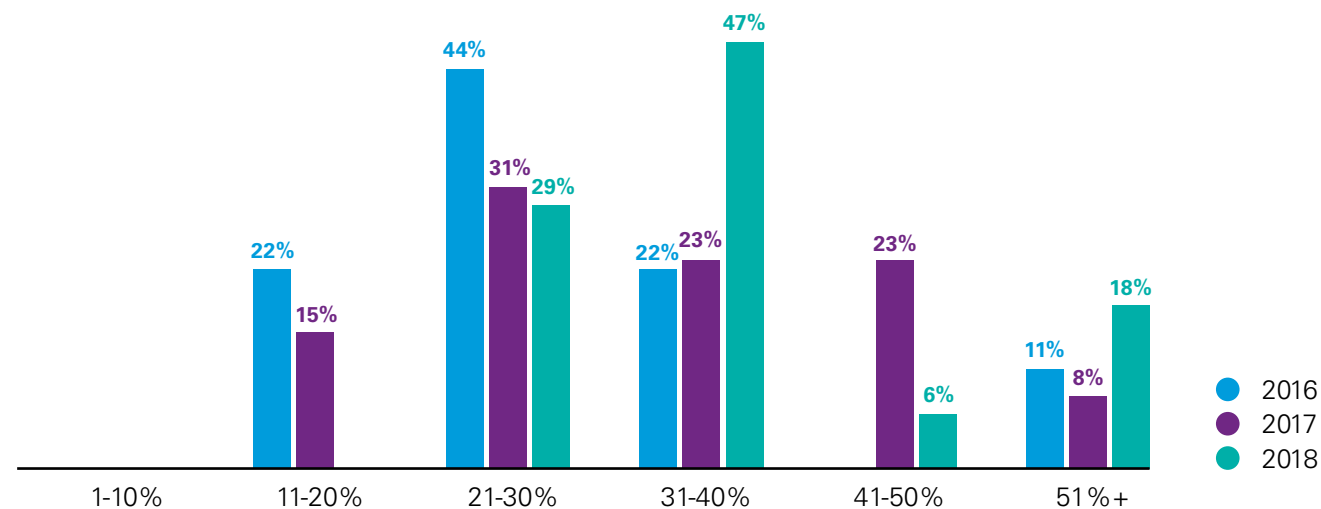
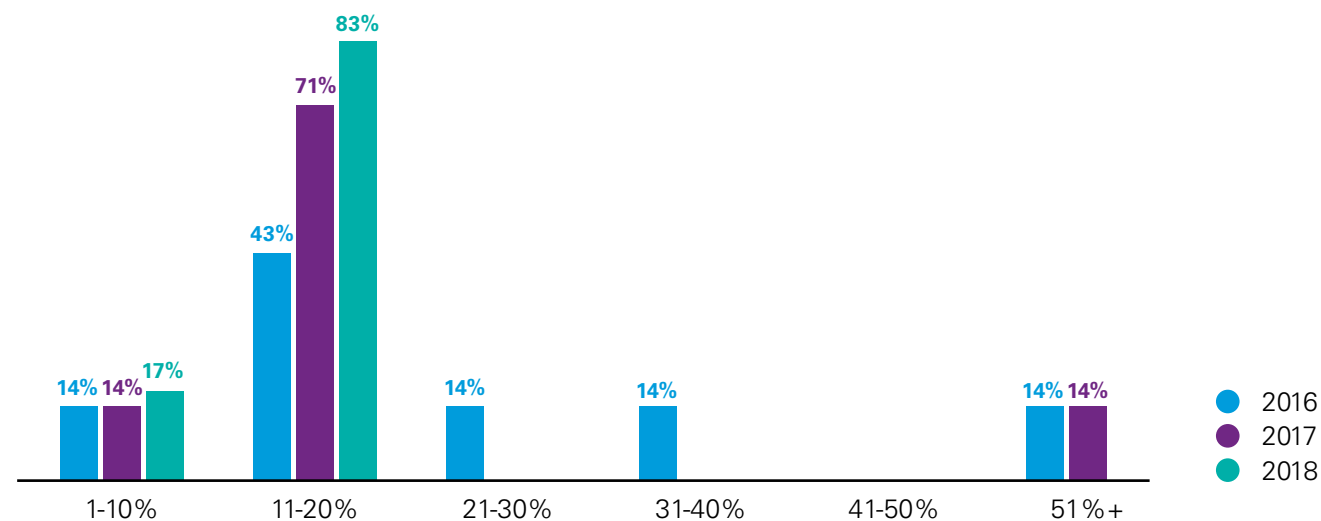
The number of firms applying insurance mitigation has remained broadly the same, compared to 2017. However, the mean insurance mitigation level has decreased, reflecting a continuation of a trend we have seen for the last number of years. The maximum amount of insurance mitigation used in this year's survey is 20%, a downward trend from last year where the maximum was greater than 50%.

A further theme identified last year was an increase in the use of diversification benefit. It has risen again, with 57% of firms now using it, compared to 50% last year. We have also seen a rise in the levels of diversification benefit applied. In 2017, the range of diversification benefit was 21% and 30%; this has now increased to between 31% and 40% in 2018.

### Percentage of firms using insurance mitigation and diversification benefit

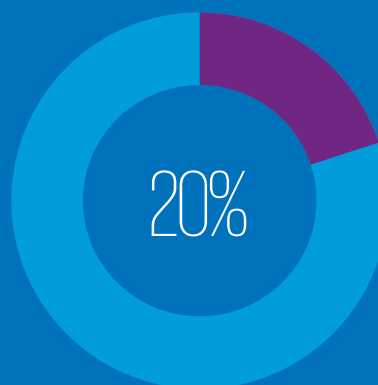




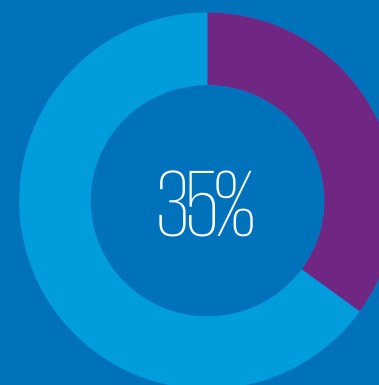
**Amount of diversification benefit applied: percentage of firms in the following categories****Amount of insurance mitigation applied: percentage of firms in the following categories**



## Median insurance mitigation and diversification benefit applied by firms in 2018



Insurance mitigation



Diversification benefit

### The KPMG View

The rise in both the number of firms applying diversification benefit, and the size of diversification taken, is to be expected, given the increased use of statistical models. However, the application of diversification benefit must also be supported by a detailed rationale to validate the assumptions made.

Where firms apply insurance mitigation, they do so to a smaller degree. This is likely to be the result of strong feedback from the regulator on firms' overall operational risk frameworks and their justifications for using insurance mitigation. As we reflected in our report last year, where firms successfully apply insurance mitigation, it is based on being able to demonstrate to the regulator that a robust risk management framework is in place.

# Stress testing

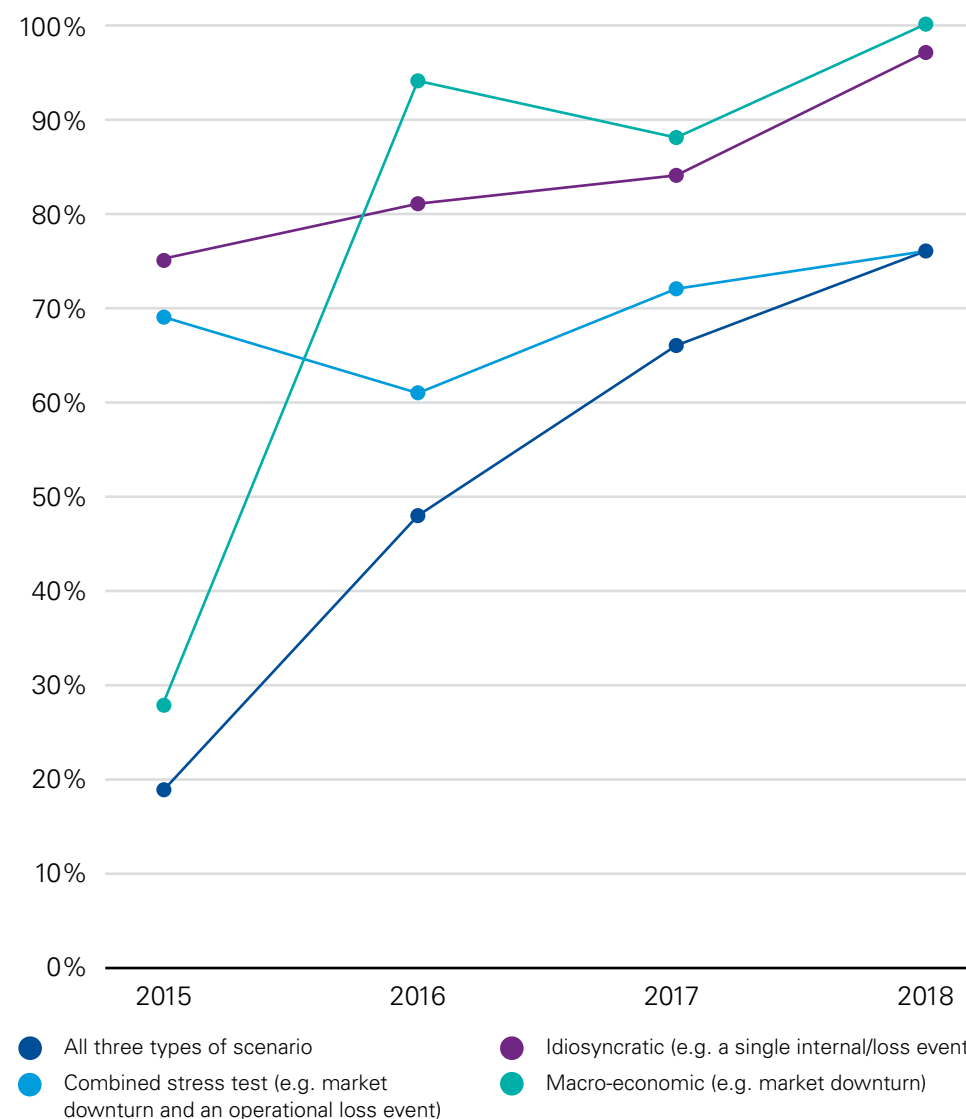
## Focus and rigour

Our findings this year show an increase in focus and rigour around stress testing. There is a further year-on-year increase in the percentage of firms carrying out all three types of stress tests, from 66% in 2017 to 76% in 2018. For the first time since our survey began, all firms carry out macroeconomic stress testing and the vast majority also perform idiosyncratic stress tests (97%). The median number of idiosyncratic stress tests performed across all firm types is three, indicating that many firms focus on risks specific to their business when identifying stress scenario types. Some 77% of firms also link stress scenarios back to the risk register, which is a further indication of improved thinking around the specific risks to which firms are exposed.

While the breadth of stress test scenarios used by firms has improved, there also appears to be more detail within each scenario. We have observed changes in the use of management actions in stress testing, with 83% of firms now including the financial impact of these in their stress test results. The majority of firms (76%) use stress testing analysis to inform capital surplus levels. This demonstrates a greater awareness of the implications of stress events on capital surpluses, and therefore suggests they are better prepared for multiple eventualities.

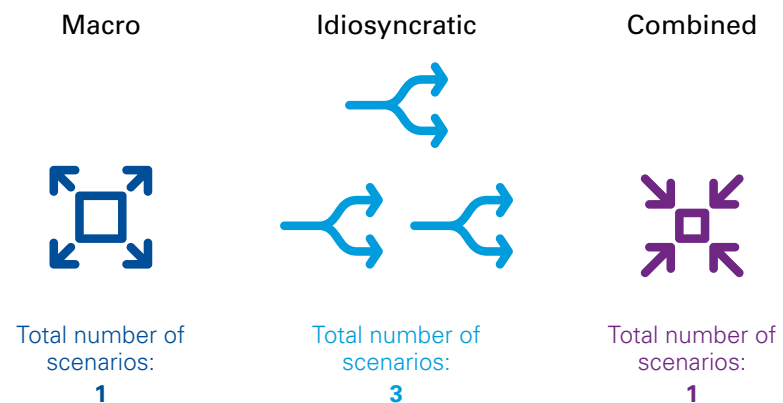
However, despite these improvements, 31% of firms still continue to be profit-making under all of their stress scenarios and almost half (47%) do not involve the board in the stress test selection process.

Percentage of firms performing the following stress scenario types

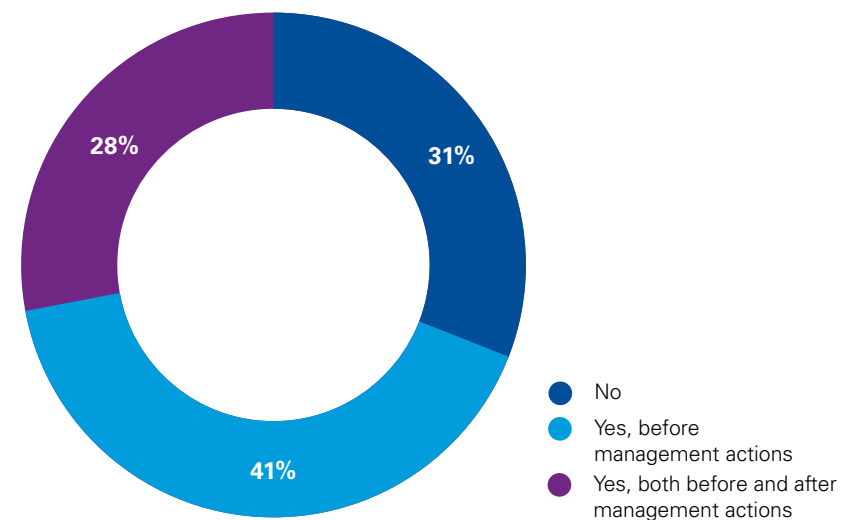




### Median number of stress test scenario types performed

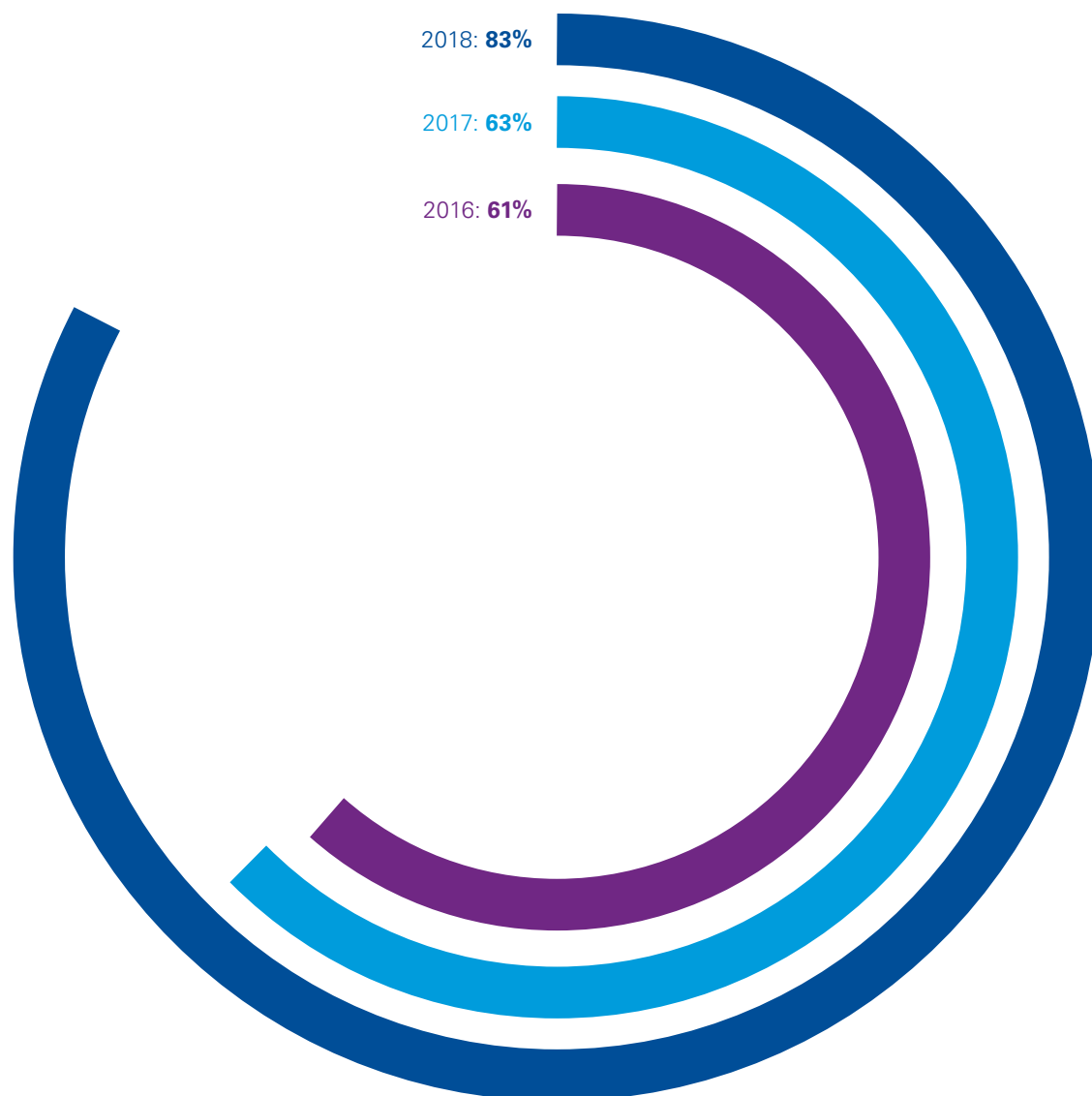


### Do any stress tests performed lead to the firm making a loss?





## Percentage of firms including the financial benefit of management actions in stress testing



## The KPMG View

Since this survey began, we have seen continual improvements in stress testing. More firms are using a wider range of events, including multiple macroeconomic, idiosyncratic and combined scenarios, to reflect a broader range of risks. This approach should result in stress tests that are more relevant for individual firms and of greater use to senior management. Increased use of quantified management actions in stress tests is a positive development. However, firms must ensure that actions identified are realistic and stand up to scrutiny. Where firms continue to be profit-making across all stress tests, they are open to challenge from the regulator around the severity of their scenario types and inputs. All firms should also seek to include the board in the scenario selection process to ensure their views are reflected in stress testing. Ultimately, the regulator expects firms to demonstrate that stress testing is embedded in the business, not just a regulatory exercise.

# Liquidity

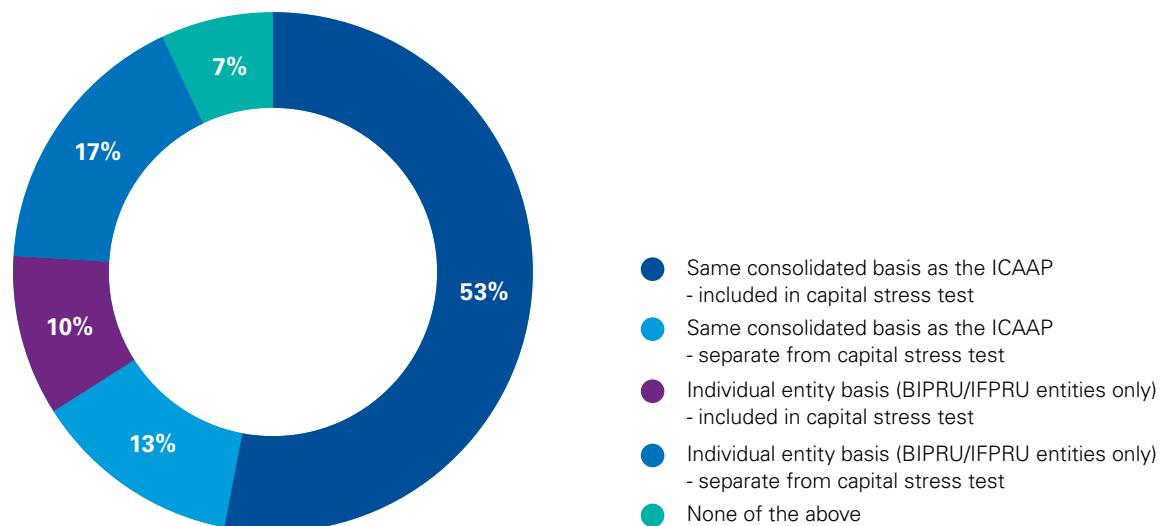
## Falling short

While the FCA continues to increase its focus on liquidity risk, many firms are still not compliant with BIPRU 12, the regulatory regime for liquidity. Many firms' liquidity risk management frameworks are lacking key components: for example, only 60% of firms in our survey capture stressed inflows and outflows, only 53% capture the liquidity risk identification process in the liquidity risk management framework, and 17% of firms have no liquidity risk management framework at all.

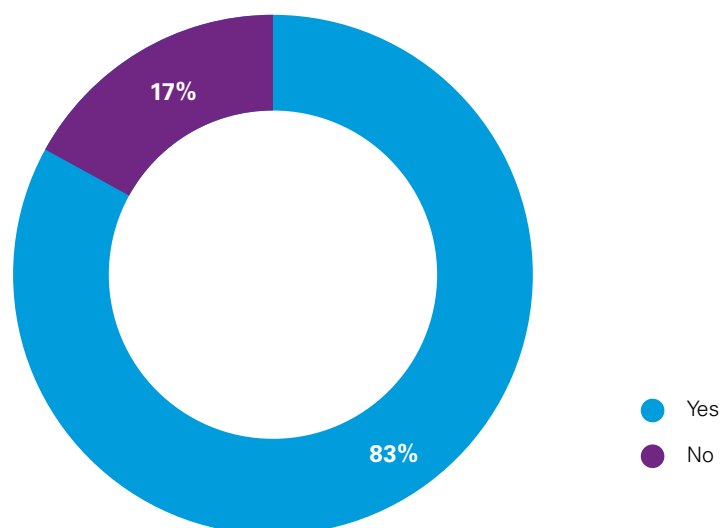
More than half of firms run liquidity stress scenarios on the same consolidated basis as the ICAAP and as part of the capital stress test. Firms are falling short in this area because the regulatory expectation is for capital and liquidity stress tests to be run independently of one another. In addition, liquidity stress testing should be done at the regulated entity level, with a need to demonstrate self-sufficiency.

This year's results suggest that more firms have a Contingency Funding Plan (CFP) in place: 83% compared to 69% last year. Those firms still without a CFP are falling short of the regulatory requirement under BIPRU 12.

### On what basis are liquidity stress scenarios run?



### Does your firm have a Contingency Funding Plan in place?



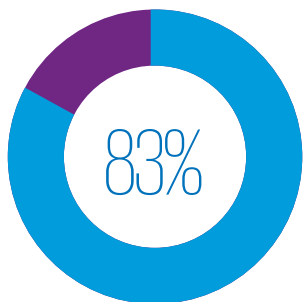
## The KPMG View

We have consistently seen liquidity risk management identified as a significant issue in the regulator's SREP feedback. It is not surprising, therefore, that our survey shows some firms suffer from significant weaknesses in liquidity risk management. Where firms fall short in this area, they often show a 'tick-box' approach to liquidity. For example, many have contingency funding plans in place, but do not support them with the necessary underlying detail, such as a comprehensive liquidity risk management framework. Some firms demonstrate a lack of understanding of their regulatory requirements and do not perform individual liquidity stress testing for each entity subject to BIPRU 12. Overall, firms can expect continued regulatory focus on liquidity. They will need to be able to demonstrate that their approach to liquidity risk management is supported by an underlying framework.

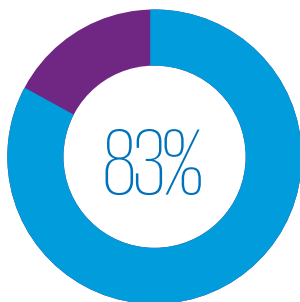


### Does the firm's Liquidity Risk Management Framework capture the following?

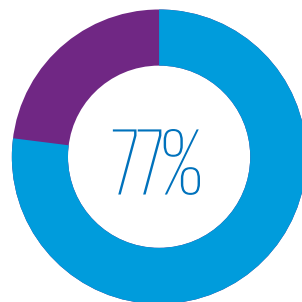
Liquidity risk monitoring and reporting process



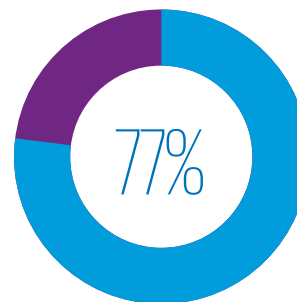
Breakdown of the firm's liquidity resources



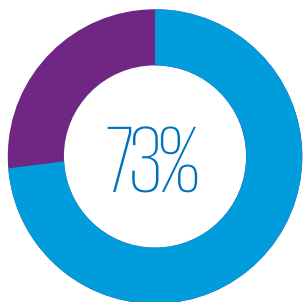
Liquidity risk governance



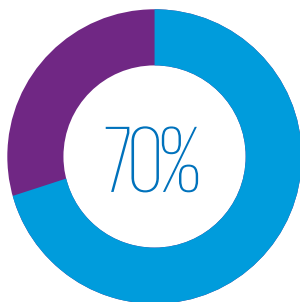
Liquidity Risk Appetite



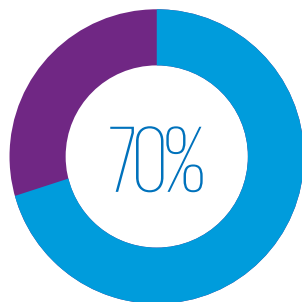
Liquidity stress testing analysis



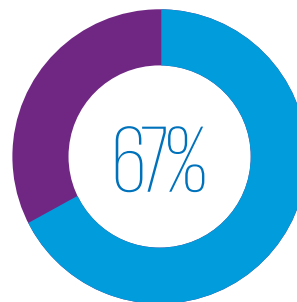
Analysis of the inflows and outflows of the firm



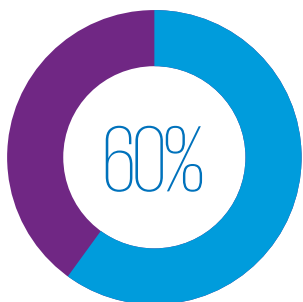
Internal definitions of liquidity (sub) risks and liquidity thresholds



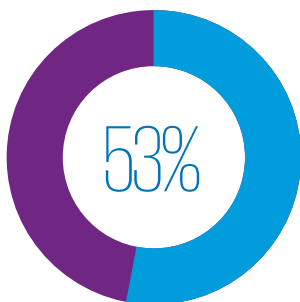
Liquidity risk metrics/early warning indicators



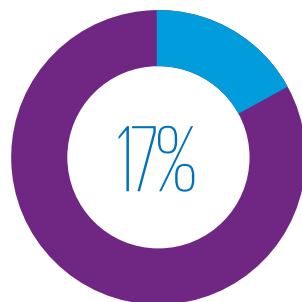
Stressed inflows and outflows



Liquidity risk identification process



The firm does not have a Liquidity Risk Management Framework



● Yes  
● No



# Wind-down

## Stronger and more thorough

Wind-down planning also shows many improvements in 2018. Firms are looking at longer and more realistic timeframes: there has been a dramatic year-on-year drop in firms using 6-12 month timeframes, coupled with an increase in the percentage of firms planning for 12-18 and 18-24 month wind-downs.

More firms are using early warning indicators in their wind-down plan, compared to the last two years, with 77% now using early warning indicators, as against 52% in 2016. More business functions have an active role in the development of the wind-down plans, with key functions such as Compliance, Legal and HR functions now more involved in the plan development process. However, almost half (47%) of firms do not assess the risks to an orderly wind-down.

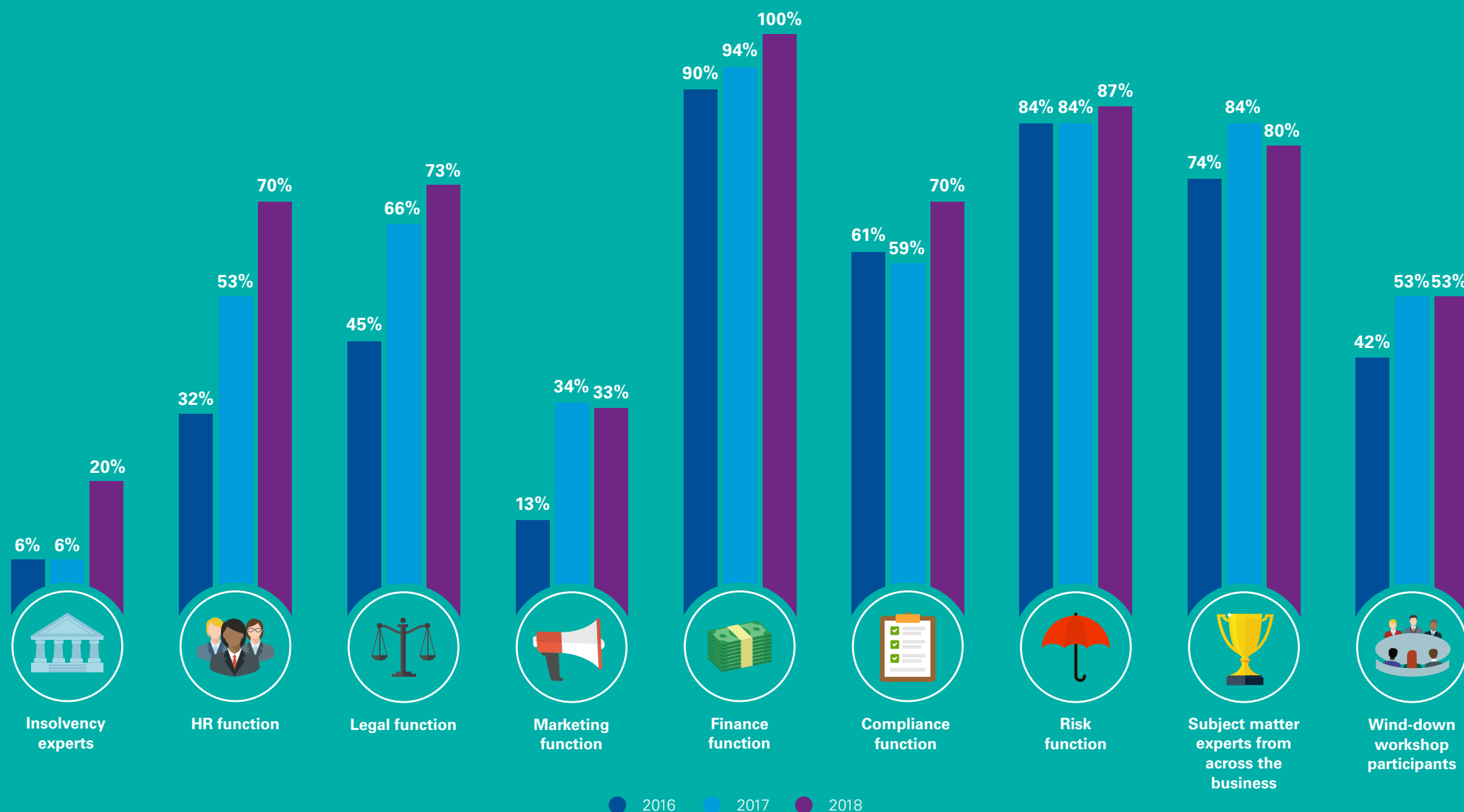
Overall, this year's study suggests that firms are taking a more thorough, strategic and realistic approach to wind-down planning, and taking into account the early warnings that would help them better prepare for a wind-down.

## Median wind-down timeframe



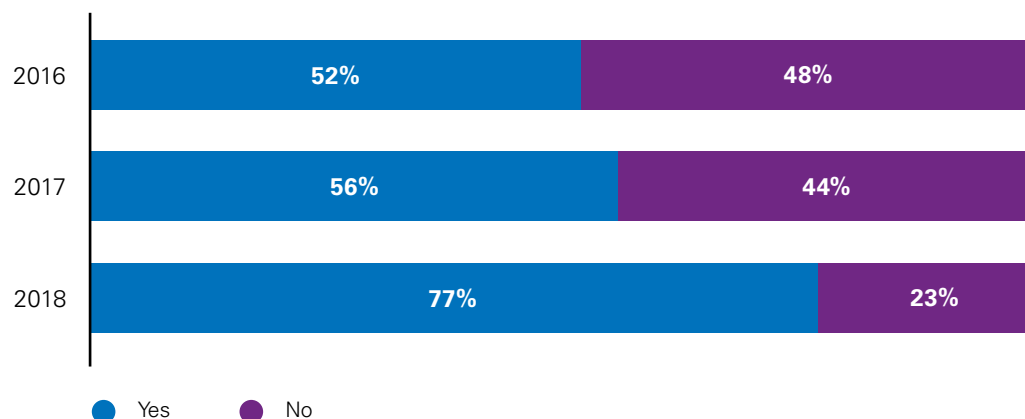
18  
months

## Who takes part in the development of the wind-down plan?



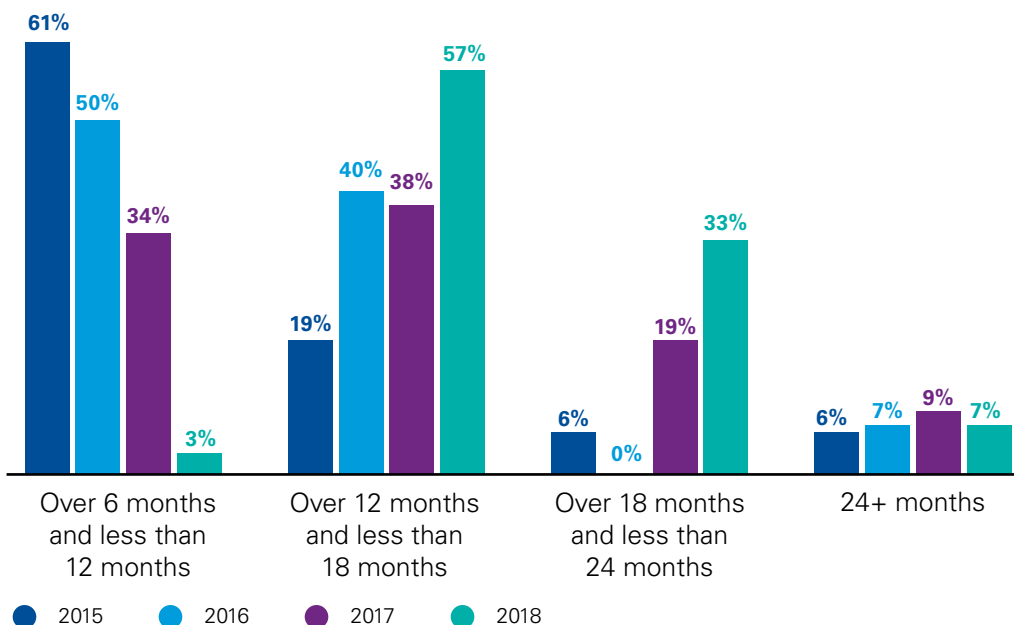


### Percentage of firms with early warning indicators in place



### Wind-down period time frames

Percentage of all firms in the following ranges



## The KPMG View

The continued improvement in wind-down planning is a reflection of firms taking a more realistic approach to the exercise, applying guidance from the FCA and engaging a wider number of stakeholders from across the business. For some firms, wind-down planning can be viewed as an academic exercise. But, in our experience, where firms undertake a thorough and comprehensive assessment, it can identify vulnerabilities in their business model.

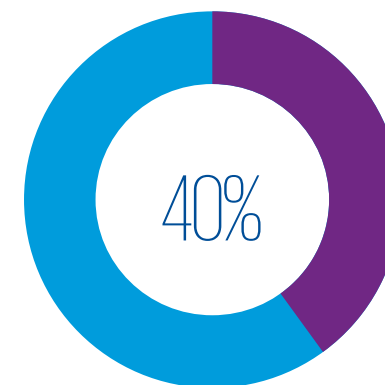
Where firms have weaknesses in their wind-down plans, we expect them to be the subject of scrutiny from the regulator, for two reasons. Firstly, wind-down planning guidance has been in the FCA handbook for almost two years, so it is assumed that all firms will have properly applied it to their wind-down plans. Secondly, the current focus on operational resilience from both the PRA and FCA is likely to lead to further scrutiny of wind-down planning. Wind-down scenarios must address the continuity of business services and potential consumer harm, both of which are key aspects of operational resilience. Therefore, a strong wind-down assessment should identify those issues to consider as part of operational resilience, as well as the overall risk management framework.

# Upcoming changes

## Brexit

Many investment firms want access to the EU market. To maintain those ties, they have already started 'Brexit proofing' their business by setting up EU27 hubs to continue servicing clients regardless of what the final trade agreement looks like. Of the firms in our study, 40% are planning partial relocation, with none considering a full relocation. Many EU member states have made concentrated efforts to attract these firms and increase their share of the asset management industry. Meanwhile, the European Commission has noted that supervisory approaches to delegation vary across the EU and that this can lead to regulatory arbitrage. As a result, there is a new focus on 'letterbox' entities and therefore firms planning to partially relocate must have some substance behind their strategy. The FCA is also actively monitoring industry responses to Brexit by requesting details of contingency plans and holding quarterly updates on these with large asset managers.

Percentage of firms planning a partial relocation as a result of Brexit



## The KPMG View

The impact of Brexit on investment firms is mixed; those with a UK-focused client base are less directly affected, compared to Global Asset Managers. From a Risk Management and ICAAP perspective, Brexit presents a number of challenges. Firms are expected to address the shorter term macro-economic impact of potential shocks from a "no-deal" agreement in their stress testing scenarios. However, risk management functions should also be able to demonstrate an understanding of the impact of Brexit on their business model and, where this is significant, that there are appropriate contingency plans in place for this.



## New prudential regime for investment firms

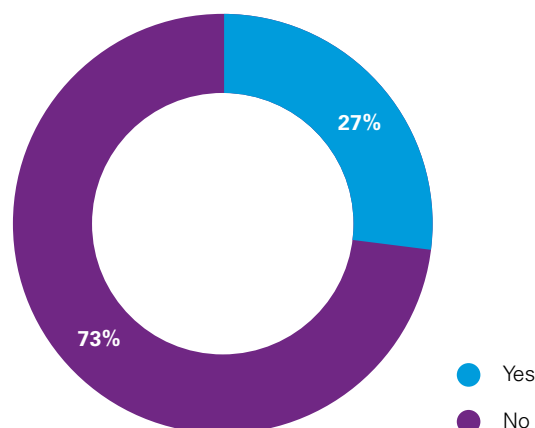
In December 2017, the European Commission published proposals for a new prudential regime for investment firms. The new proposals aim to align prudential requirements with investment firms' business models and move away from previous regimes primarily designed for banks. One anticipated benefit is a reduced administrative burden through a simplified capital requirements calculation.

At the time of our study, just over a quarter of firms had digested this and quantified the new regime's potential impact. As implementation looms, firms should ensure they are comfortable with the new method of calculation and iron out any issues early on.

Of the firms that have quantified the k-factors to date, just under 90% expect that their Pillar 1 capital requirement will continue to be driven by the Fixed Overhead Requirement.

	K-factors are higher	K-factors are lower
<b>Fixed Overhead Requirement</b>	<b>13%</b>	<b>87%</b>
<b>Sum of credit and market risk</b>	<b>38%</b>	<b>62%</b>
<b>Total Pillar I</b>	<b>13%</b>	<b>87%</b>

### Have you quantified potential capital requirements under the new regime?



## The KPMG View

A new regime that is better tailored to investment firms has long been awaited, and will mostly be welcomed by the industry.

Given that the regime is predicted to come into force in early 2020, firms should ensure that they are sufficiently prepared for its impact on their capital assessment process and subsequent capital requirements. For nearly all of the firms that calculated a k-factor requirement, it was lower than their current Pillar 1 assessment.

It's important to remember that, while Pillar 1 calculations should now be more tailored to the business models of asset management firms, there will still be a strong onus on firms to conduct their own thorough assessments of the risks they face.

As most firms have not yet carried out a comparative analysis of the current and upcoming regimes, there is a risk that they may not be adequately prepared when the new prudential regime comes into force.

## IFRS 16

IFRS 16 applies to all accounting periods starting from 1 January 2019. This will create new on-balance assets for the majority of firms. For investment firms subject to either CRD III (BIPRU) or CRD IV (IFPRU), this will have a direct impact on their regulatory capital position, as follows:

### IFPRU firms

1. An increase in Pillar 1 credit risk requirements through the application of a risk weighting to the newly on-balance sheet assets.
2. A decrease in available capital where the value of the newly on-balance sheet liabilities exceeds the related assets.

### BIPRU firms

The impact will depend on whether the firm has adopted the illiquid assets or the material holdings approach under GENPRU 2.2.19.

For material holdings firms, the treatment will be similar to that of IFPRU. However, for illiquid assets firms, a full deduction of the assets is likely to be required.

## The KPMG View

Given that IFRS 16 is effective for all accounting periods from 1 January 2019 onwards, the first firms impacted by this will be those with accounting periods ending in December 2018. These firms are required to reflect changes under IFRS 16 in their regulatory reporting and ICAAP from 1 January 2019. The impact of this therefore needs to be understood immediately, to identify any potential changes to both capital resources and capital requirements and to enable firms to plan accordingly.

# Summary

This year's report suggests that, when it comes to risk and capital adequacy assessments, firms are indeed "counting the cost" – applying more rigour to the process and assessing more carefully the cost of getting it wrong. The consequence of this maturity is that risk assessments are becoming more robust, with a more precise view of the risks to which their business is exposed.

Risk management is also becoming embedded into the business to a greater degree. More functions are getting involved in the development of stress tests and wind-down plans, and there is greater board and senior management engagement in the risk and ICAAP space.

Yet there's still plenty more work to be done. While the increased use of models is adding precision, it's important that they aren't "black boxes"; if management decisions are to be well informed. The regulator is still calling out governance, an area that is clearly not yet resolved in relation to ICAAPs. And there are also issues to be considered around IFRS 16 and liquidity stress testing.



# How can KPMG help?

## ICAAP health check

Client type  
**Listed investment manager**

### Client issues

The firm was due to submit their ICAAP document to the FCA after undergoing a merger with another large investment manager. The client was seeking an external third party to review the consolidated ICAAP document submission to the FCA in order to identify potential areas of challenge and improvement.

### Benefit of KPMG assistance

KPMG carried out a desk-top review of the consolidated ICAAP document and performed interviews with key stakeholders to understand the risk management framework and specific areas of client concern. KPMG provided a report summarising its findings and recommendations (graded by priority) and presented it to senior management. As a result of this review, the firm's ICAAP document clearly reflected the practices within the combined business and aligned to regulatory expectations and leading industry practice.

## Board training

Client type  
**Global investment manager**

### Client issues

After several changes to the composition of the board, the firm was seeking to refresh the board's understanding of ICAAP requirements and expectations of board members.

### Benefit of KPMG assistance

KPMG provided a two hour training session to the Board to outline the FCA's prudential capital regime (three pillars framework, prudential capital calculations, general prudential requirements), role of the enterprise risk management framework and the FCA's expectations around the ICAAP process (including the SREP process). As a result of this, Board members enhanced their understanding of prudential capital requirements, what "good" looks like and key areas of FCA focus. This enabled the Board to more effectively challenge the ICAAP process and engage with the regulator in a constructive manner.

## Operational risk modelling

Client type  
**UK branch of a global investment manager**

### Client issues

The firm was seeking assistance in enhancing its understanding of its operational risk model as it was outsourced to an external provider and they were being challenged by the regulator.

### Benefit of KPMG assistance

KPMG provided benchmarking on the operational risk methodology to help the firm understand approaches among its peers. KPMG also provided technical training to walk through step by step guidance on how to build an operational risk model. This enabled the client to develop and build an in-house model with the support of KPMG throughout the build and validation process. As a result of the review, the client obtained a more robust, calibrated operational risk model. It also furthered its understanding of operational risk modelling, which enabled the firm to clearly explain their methodology to the FCA.

## Liquidity risk management framework

Client type  
**UK branch of a global investment manager**

### Client issues

Following a SREP visit by the FCA, the firm's liquidity risk management framework and compliance with BIPRU 12 was identified as an area requiring improvement. The firm was seeking assistance in rectifying these issues and embedding a more robust liquidity risk framework.

### Benefit of KPMG assistance

KPMG worked with the firm to develop a comprehensive liquidity risk management framework, including a Contingency Funding Plan. KPMG provided comments around the firm's liquidity risk governance. As a result of KPMG's review and advice, the client was able to demonstrate it had effectively addressed the regulator's comments, aligning it to BIPRU 12 requirements and industry leading practice. The client was also able to clearly articulate the governance and controls around its liquidity risk management processes and enhance understanding within the firm.

## SREP preparation

Client type

**UK branch of a global investment manager**

### Client issues

The firm had significantly expanded its UK operations and offering since its latest SREP visit. In preparation for an upcoming regulatory visit, the firm required assistance from a third party to assist with interview preparation for its Board (Executive and Non-Executive Directors) and selected members of the senior management team.

### Benefit of KPMG assistance

KPMG performed a number of mock interviews and challenge sessions with members of management and the Board. The interviews tested their knowledge and understanding of the firm's risk management processes and documents. The interview process also highlighted inconsistencies and areas of improvement in the firm's overall risk management processes, including the ICAAP. As a result of the preparation, executive, non-executive and certain senior management individuals were better prepared for their upcoming SREP visit.

## Pillar 1 calculation review

Client type

**UK Based Global Investment Manager**

### Client issues

As part of its response to the FCA's Dear CEO Letter on the quality of regulatory reporting, we were commissioned by the firm to undertake a review of its Pillar 1 calculations, prudential regulatory returns and associated regulatory reporting processes and controls.

### Benefit of KPMG assistance

KPMG supported the firm by undertaking a substantive review of its pillar 1 calculations and FSA/COREP regulatory returns to assess whether these were in line with the applicable regulatory rules and guidance. Our approach also included a review of the design of the processes and controls established by the firm over regulatory reporting to assess whether these were in line with our experience of common market practice. The output of our work was an exceptions based report outlining our findings and recommendations for remediation / enhancement to enable management to improve the quality of the firm's regulatory reporting arrangements and to demonstrate to the regulator that these were fit for purpose.

## Technical training session and skills assessment

Client type

**Listed investment firm**

### Client issues

During a SREP visit, the FCA identified that the firm had gaps in technical knowledge around ICAAP. As a result, an RMP was issued which included the need for the firm to ensure that Risk and Finance team members increased their understanding of the regulatory requirements for ICAAP.

### Benefit of KPMG assistance

KPMG provided an initial day long interactive training session with the firm to provide an in-depth understanding of regulatory requirements. This included complex areas of the rules where firms are often identified as falling short following SREP visits. Following on from this KPMG provided the client with an assessment questionnaire which was completed by all Risk and Finance team members. The questionnaire included a range of questions, ranging from basic to advanced, on the key areas of the prudential rules. From this a skills assessment was produced which highlighted areas of strength and weakness for each participant. As a result, the client was able to increase the technical knowledge of their team on a targeted basis and also able to clearly demonstrate objectively measured results to the FCA.



# Contacts

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