Picking up the pace

Is risk management at investment firms keeping up with the regulator?
Risk and ICAAP benchmarking survey 2017

October 2017
Introduction

I am delighted to present KPMG’s latest report on risk management and ICAAP practices for investment management firms.

This is the third year that we have conducted our benchmarking study into an important area which remains at the forefront of the FCA’s agenda. In response to feedback from last year, we have focussed on providing insights into prevailing market practices on areas of topical interest, to both firms and regulators alike. Our objective is to encourage and support the development of robust risk management practices across a diverse industry, which ultimately seeks to protect the interests of customers and stakeholders.

Overall I am pleased to report that there continues to be improvement in a number of areas around risk management. However, while we observe and acknowledge the efforts being made by some firms in enhancing risk management arrangements, we still observe a diverse range of experience – from those who are leading on market practices to those who fall short of existing rules and, as such, leave themselves open to regulatory scrutiny. Clearly, there remains a number of further opportunities to improve in order to keep pace with both regulatory changes and the regulator’s expectations. This is the key message from our 2017 report: firms are picking up the pace; but the question remains, can they keep up with the regulator and the changes in the commercial and regulatory landscape?

David Yim
Partner, KPMG in the UK
Executive summary

Is the investment industry getting better at risk management? This year’s study again shows that firms are holding more capital, continuing an upward trend since our survey began in 2015. The question is, however, what’s behind this trend? Is there a growing sophistication in risk management, coupled with more maturity in market practices? Or are firms merely responding to pressure from the regulator?

Our analysis suggests that it’s a bit of both. This year, for example, we found that more firms are using increasingly sophisticated statistical models to quantify operational risk. On the other hand, we saw that firms subject to a FCA Supervisory Review and Evaluation Process (SREP) in the last four years were given a median increase of 82% in their capital requirements, compared with their own assessments. This can be seriously disruptive for firms’ plans. It suggests there is work to do if firms’ own assessments of capital requirements are to be aligned with those of the regulator.

Last year, we highlighted an apparent disconnect in the various components of the Risk Management Framework, with a differing set of risks captured in firms’ Risk Appetite Statements (RAS), Risk Management Frameworks (RMF) and Pillar 2 assessments. While this year has seen better connection between RAS and Pillar 2 assessments, the RAS/RMF disconnect remains.

We have also seen the use of insurance mitigation continue to fall. This time, only 25% of firms included it in their capital assessments, in contrast to almost 50% in 2015. Perhaps unsurprisingly, this has been coupled with a rise in the use of diversification benefit, which is supported by statistical models in most cases. The precise methodology being used for this has become an area of focus. Firms will need to demonstrate that they understand and can robustly challenge the workings of their model if they are to avoid reigniting a cycle of large add-ons if a mitigation technique is removed by the regulator.

The survey responses have shown a strong improvement in capital planning and stress testing this year. The results indicate increased use of multiple stress scenarios, with two thirds of firms now using all three types of stress scenarios (i.e. Idiosyncratic, Macro and Combined) in their ICAAPs. Most encouragingly, we have seen a sharp increase in the use of stress test outcomes in the decision making processes of firms.

Liquidity risk management still appears to be an area of concern, with practices generally falling short of the minimum regulatory requirements, particularly when it comes to the quality of liquidity stress testing and the presence of Contingency Funding Plans.

This year, we have seen many firms considering the potential impacts on capital requirements under their “Bre-location” plans. Interestingly we have found that, despite the underlying regulations being pan-European, there are large variances in local applications of Pillar 2 and SREP assessments. This can lead to significant differences in imposed capital requirements across different locations. Also on firms’ to-do lists is the need to consider the new EBA regime for Pillar 1 calculation, which few firms had yet tackled at the time of our survey.

Since we began this survey in 2015, we have seen a continual improvement in risk management across the industry, with the ICAAP (Internal Capital Adequacy Assessment Process) an increasingly integral component. But the question remains: are firms thinking strategically, or simply firefighting problems as they arise? This is a critical issue, especially in light of the complexities that Brexit and the new EBA regime will bring.

As the volume and pace of regulation continues to increase, can investment firms keep up?
KPMG’s benchmarking study of Risk and ICAAP practices at investment management firms is now in its third year.

This year’s study covered 32 firms to give a representative picture of the UK investment management industry. Respondents ranged from alternative focused boutiques to global investment managers. The mix of firms across prudential categories and CRDIII/IV (BIPRU/IFPRU) was broadly in line with the 2016 and 2015 studies.

### Entities per AUM (£)

<table>
<thead>
<tr>
<th>AUM Range</th>
<th>Number</th>
</tr>
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<tbody>
<tr>
<td>5bn - 10bn</td>
<td>3</td>
</tr>
<tr>
<td>10bn - 20bn</td>
<td>5</td>
</tr>
<tr>
<td>20bn - 50bn</td>
<td>12</td>
</tr>
<tr>
<td>50bn - 100bn</td>
<td>5</td>
</tr>
<tr>
<td>100bn - 200bn</td>
<td>4</td>
</tr>
<tr>
<td>More than 200bn</td>
<td>3</td>
</tr>
</tbody>
</table>

### Firms - prudential categories

- P1: 6 firms
- P2: 9 firms
- P3: 17 firms

### Firms - regulatory requirements

- 37% IFPRU
- 63% BIPRU
1. Capital requirements

Continuing the upward trend

For the overwhelming majority of investment firms, the capital requirements that they have voluntarily calculated have increased in 2017, continuing an upward trend since we first reported in 2015.

The average capital surplus is 164% but with significant variance across firms. It’s worth noting that those firms that had been subject to a regulatory visit in the last four years had a median increase of 82% in capital requirements imposed by the FCA. This suggests that firms that have not been visited are potentially underestimating their requirements.

In fact, firms who have been visited in the last four years have, on average, less than half the capital surplus of those firms that have not recently been visited, or that have not been visited at all.
Capital requirements: in basis-points vs AUM

Percentage of P1 firms in the following ranges

- < 10bps: 40%
- 10-15bps: 20%
- 15-20bps: 0%
- >20bps: 60%

Percentage of P2 firms in the following ranges

- < 10bps: 40%
- 10-15bps: 20%
- 15-20bps: 0%
- >20bps: 60%

Percentage of P3 firms in the following ranges

- < 10bps: 20%
- 10-15bps: 40%
- 15-20bps: 0%
- >20bps: 60%

Percentage of all firms in the following ranges

- < 10bps: 60%
- 10-15bps: 40%
- 15-20bps: 0%
- >20bps: 60%
As the regulator is now increasing its focus on smaller firms through desktop-only reviews, there’s a growing imperative for these organisations to ensure that their ICAAP document is of a high quality.

In the absence of face-to-face interviews and additional information requests, the ICAAP document may be the only means by which firms can demonstrate that robust risk management processes are in place. Where smaller firms have undergone reviews for the first time, there is a clear trend towards these firms facing higher capital requirements.

Since our survey began, we have seen consistent year-on-year increases in firms’ own assessments of the appropriate levels of capital to hold. Our results highlighted that for the most frequently reviewed firms (i.e. P1 firms), capital requirements were significantly higher as a percentage of assets under management than for P2 and P3 firms.

Have your capital requirements increased, decreased or remained consistent since your previous ICAAP?

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remained consistent</td>
<td>6%</td>
<td>6%</td>
<td>9%</td>
</tr>
<tr>
<td>Increased</td>
<td>72%</td>
<td>65%</td>
<td>84%</td>
</tr>
<tr>
<td>Decreased</td>
<td>22%</td>
<td>6%</td>
<td>6%</td>
</tr>
</tbody>
</table>

P3 Firms - capital requirements as a % of AUM

<table>
<thead>
<tr>
<th></th>
<th>All P3 firms</th>
<th>“SREP’d” P3 firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median</td>
<td>0.09%</td>
<td>0.09%</td>
</tr>
<tr>
<td>Median</td>
<td>0.12%</td>
<td>0.14%</td>
</tr>
<tr>
<td>Median</td>
<td>0.24%</td>
<td>0.01%</td>
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</tbody>
</table>

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ICG (% of Pillar 1) in 2015, 2016 and 2017 by prudential category

KPMG view: Improving industry practice or regulatory pressure?

It's clear that overall levels of capital requirements in the industry have increased significantly in recent years. However, it is not yet possible to discern whether this can be attributed to better practice or whether it simply reflects increasing regulatory expectations.
2. Firms’ own assessments of capital requirements

Struggling to keep pace

Despite firms’ own assessment of capital requirements, this continues to fall short of regulatory expectations.

In this year’s study, 26 out of 32 firms surveyed had been the subject of a SREP/ARROW visit since 2008. In all cases, these firms received guidance to hold more capital. Operational risk management frameworks and operational risk modelling now receive as much regulator challenge as governance and culture. This could be because more firms in our sample have been subject to SREP – but it underlines the fact that FCA is focused on Pillar 2.
Regulator’s issues raised by year

- Governance and culture
- Operational risk modelling
- Operational Risk Management Framework
- Risk Appetite Statement and related key risk indicators
- Insurance mitigation
- Pillar 2a credit risk
- Scenario analysis
- Stress testing
- Wind down
- Liquidity risk
- Diversification benefit
- Pillar 2a market risk
- Scoring and treatment
- Pillar 1
- Pension obligation risk
- Other

Has your firm had a SREP visit in the last four years?

- Yes: 34%
- No: 66%

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Individual capital requirement increases of firms that have had a SREP visit in the last four years

<table>
<thead>
<tr>
<th>P1 Firms</th>
<th>P2 Firms</th>
<th>P3 Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>122.6%</td>
<td>45.3%</td>
<td>91.0%</td>
</tr>
</tbody>
</table>

Average increase in capital requirements as a result of SREP visit in the last four years

P1: 122.6%  P2: 45.3%  P3: 91.0%

KPMG view:
Better capital assessments are essential for business

Some firms have had to cut or cancel dividends, or ask parent companies for a capital injection, following these increased capital requirements. In several high-profile cases, the increased capital requirement impacted on the share price.

Given the potential damage to business, firms need to bridge the gap between their own assessment and the FCA’s expectations. And in an increasingly tough regulatory and commercial environment – with the demands of compliance with MiFID II, the SMCR and GDPR – firms need money to spare for implementing regulations, as well as leaving capital free to invest in growth. Having a realistic, defendable capital assessment will enable firms to plan effectively for a fast-changing operating environment.
This year, there is a strong focus on the C-suite, with the Senior Managers and Certification Regime (SMCR) in consultation for investment managers and SREP feedback showing that governance and culture remains the top issue.

SMCR, MiFID II and the FCA market study all indicate further pressure on senior management and a greater degree of accountability. Senior management (including CEOs, CFOs and CROs) are consistently scrutinised as part of the SREP.

The impact of SMCR on investment firms will vary, with the FCA looking to take a proportionate approach to its implementation. The regime is therefore split into two main parts: Core and Enhanced. The proposed enhanced regime will introduce increased requirements for firms, bringing more senior management functions, including CROs, into scope and adding “Prescribed Responsibilities,” which need to be allocated within the firm. In addition, as consistent with the findings from the FCA’s investment management Market Study, a Prescribed Responsibility for “Value for Money” will apply for all authorised fund managers. Investment firms that meet the criteria below will be subject to the Enhanced regime:

- IFPRU firms
- CASS large firms
- Firms with an AUM of £50 billion or more
- Firms with total intermediary business of £35 million or more per year
Who was interviewed as part of SREP (responses by number of firms)?

- Chief Executive Officer: 13
- Chief Risk Officer: 13
- Chief Financial Officer/Head of Finance: 12
- Head of Operational Risk: 11
- Chief Compliance Officer: 10
- Non-Executive Director: 8
- Head of Internal Audit: 7
- Chief Operating Officer: 5
- Scenario Workshop Attendees: 5
- Head of Liquidity Risk: 4
- Financial Reporting Manager: 4
- Head of Market Risk: 2
- No interviews took place (desk-based review): 2
- Head of Credit Risk: 1

KPMG view:
SMCR will extend individual accountability to investment firms, including the risk function.

With the extension of SMCR to investment firms, their governance will face increased requirements, and more individuals will be held accountable. The current FCA proposals suggest that for all firms meeting the Enhanced criteria, CROs will be subject to the Senior Managers regime. This will mean more scrutiny of the risk function within firms.
4. How firms arrive at their capital adequacy assessments: A mixed picture

While survey results on SREP outcomes suggest that almost all firms need to increase capital requirements to meet the regulator’s guidance, the ways in which they are arriving at their assessments are moving in a positive direction.

In terms of the capital they need to hold for operational risk, firms are taking a more sophisticated approach and including scenarios in their assessments.

Percentage of firms using statistical models

- 2015: 41%
- 2016: 39%
- 2017: 56%
Percentage of firms using at least one of the following operational risk scenarios:

- Employment practices and workplace safety: 76%
- Damage to physical assets: 31%
- Business disruption and system failures: 86%
- External fraud: 79%
- Internal fraud: 83%
- Clients, products and business practices: 97%
- Execution, delivery and process management: 100%
That said, and despite an improvement compared to last year’s survey, there continues to be misalignment between risk appetite statements and risk management frameworks – something we also saw in 2016. For any risk framework to be effective, these two elements must be aligned. One of the most common SREP issues we see from the FCA is commentary over the embeddedness of the ICAAP and the associated governance process. It is misalignments such as these that can give rise to such commentary.

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

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>RMF</th>
<th>RAS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity risk</td>
<td>30</td>
<td>27</td>
</tr>
<tr>
<td>Market risk</td>
<td>30</td>
<td>27</td>
</tr>
<tr>
<td>Business/strategic risk</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Concentration risk</td>
<td>22</td>
<td>25</td>
</tr>
<tr>
<td>Pension obligation risk</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>Reputation risk</td>
<td>16</td>
<td>11</td>
</tr>
<tr>
<td>Residual risk</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>Group risk</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td>Securitisation risk</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Risk of excessive leverage</td>
<td>5</td>
<td>7</td>
</tr>
</tbody>
</table>

**KPMG view: Missed opportunity**

The approach to operational risk modelling is becoming more sophisticated, yet there remains a mismatch between firms’ stated appetites for risk and the way in which they are intending to manage it. This suggests that components of risk management frameworks continue to be considered in silos: it is easy for the regulator to pick up on this and form conclusions about the degree to which risk management frameworks are properly embedded.

For senior managers and non-executive directors at investment firms, alignment is good practice and a source of opportunity. When day-to-day risk management information is aligned with risk appetite and strategy, risk monitoring becomes more effective.
In our previous reports, we highlighted the regulatory trend of reducing, and in many cases removing, the use of insurance mitigation in operational risk capital assessments.

We have seen a continuation of that trend this year, with only 25% of firms applying it compared to 39% in 2016. Increasingly, FCA feedback on the use of insurance mitigation is accompanied by strong feedback from the regulator on a firm’s overall operational risk management framework. This suggests that whether or not insurance mitigation is allowed depends on the quality of the supporting risk framework as much as on the actual nature of the insurance contracts themselves.

While the use of insurance mitigation to reduce capital requirements is steadily falling, there’s been an uptick in firms using diversification benefit, with 50% applying it, up from 35% in 2016. This year, the increase in the use of diversification benefits means that 27% of survey participants are using both mitigation methods.
KPMG view: Sharper focus on models

The decline in the use of insurance mitigation comes as no surprise, as we have seen the regulator remove it as part of their assessment of firms capital requirements. This year, we have seen evidence that firms are making more use of diversification benefit, often adopting more sophisticated modelling approaches to support it. For diversification, everything depends on the models firms are using – and whether senior management understand them well enough to provide robust challenge. As SREP feedback shows, modelling approaches continue to be an area of focus for the regulator. This is particularly pertinent given the increase in firms adopting it. Three key elements need to be in place: an appropriate methodology, governance over the model, and the involvement of subject-matter experts. In the case of insurance mitigation, firms should also consider whether they are actually looking to solve the wrong problem: in many cases, the main issue is not the insurance itself, but flaws in the underlying operational risk management framework.
6. Wind-down planning: Time to gear up on wind-down

Although 2017 shows firms are applying more realistic wind-down periods, some 44% still don’t have early warning indicators in place and 83% don’t have separate plans for stressed and unstressed markets.

Do you have early warning indicators in place?

- Yes: 48% in 2016, 44% in 2017
- No: 52% in 2016, 56% in 2017

Do you have a separate wind-down plan for stressed and unstressed markets?

- Yes: 17% (2016), 17% (2017)
- No: 83% (2016), 83% (2017)
Who takes part in the development of the wind down plan?

- **Insolvency experts**
  - 2016: 6%
  - 2017: 6%

- **HR function**
  - 2016: 32%
  - 2017: 53%

- **Legal function**
  - 2016: 45%
  - 2017: 66%

- **Marketing function**
  - 2016: 13%
  - 2017: 34%

- **Finance function**
  - 2016: 90%
  - 2017: 94%

- **Compliance function**
  - 2016: 61%
  - 2017: 59%

- **Risk function**
  - 2016: 84%
  - 2017: 84%

- **Subject matter experts from across the business**
  - 2016: 74%
  - 2017: 84%

- **Any relevant historic events**
  - 2016: 48%
  - 2017: 47%

- **Wind down plan workshops**
  - 2016: 42%
  - 2017: 53%
KPMG view:
Some way to go

It is clear that progress has been made in this area, with wind-down planning spreading beyond risk and finance to involve more business functions. The FCAs guidance, first issued in May 2016, was then included in the FCA handbook from December 2016. Highlights from the guidance include:

- Consider scenarios that are severe, relevant to the firm and that may result in the regulated business not being viable
- Early warning indicators - well-structured management information allows a firm to identify if there are any emerging risks that may make the firm unviable
- Identify processes for proactively identifying and mitigating any material risks that may arise in the course of wind down

Our experience is that the industry still has some way to go in fully embedding this guidance into their wind-down plans.
Liquidity risk is an area of FCA focus. Although some firms have improved their practices around this, most do not appear to have the minimum components in place as required under the regulatory Liquidity Regime (BIPRU 12).

Understandably, investment managers have focused primarily on liquidity at the funds level, with less scrutiny at the firm level. In particular, we have seen consistent regulatory feedback on the standard of liquidity stress testing. In our survey, 41% of firms are applying the same time horizon for stress tests that are carried out for capital planning rather than a specific analysis of liquidity risk over a shorter time period. Another area of concern is that 31% of firms did not have a Contingency Funding Plan in place, which is a requirement of BIPRU 12.

The requirements of BIPRU 12 apply at the individual entity level and do not follow the same consolidation basis as the ICAAP. Our findings suggest that this is a commonly misunderstood area, with only 27% of firms carrying out stress testing at the individual entity level.
Does your firm have a LRMF?  
- Yes (28)  
- No (4)

Does the firm’s Liquidity Risk Management Framework capture the following?

- Liquidity stress testing analysis
  - Yes (38\%)
  - No (62\%)
- Stressed inflows and outflows
  - Yes (63\%)
  - No (37\%)
- Liquidity risk governance
  - Yes (59\%)
  - No (41\%)
- Liquidity risk monitoring and reporting process
  - Yes (72\%)
  - No (28\%)
- Liquidity risk identification process
  - Yes (28\%)
  - No (72\%)
- Liquidity risk metrics/early warning indicators
  - Yes (63\%)
  - No (37\%)
- Liquidity risk appetite
  - Yes (69\%)
  - No (31\%)
- Breakdown of the firm’s liquidity resources
  - Yes (53\%)
  - No (47\%)
- Analysis of the inflows and outflows of the firm
  - Yes (63\%)
  - No (37\%)
- Internal definitions of liquidity (sub-)risks and liquidity thresholds
  - Yes (53\%)
  - No (47\%)

KPMG view: A focus area that must be addressed

Liquidity risk is in the spotlight as never before. Although the requirements set out in BIPRU 12 are clear, our observations suggest that while most firms have signed off that they are fully compliant in their FSA055 GABRIEL returns, few have taken all the necessary steps in this area and are therefore open to regulatory challenge. Liquidity risk is a focus area that needs to be urgently addressed.
8. Stress testing and Brexit: More sophistication, more complexity

Firms’ approaches to stress testing indicates a gradual increase in sophistication. This year, 78% included stress test outcomes in their decision-making process, against 65% in 2016.

Stress test outcomes increasingly inform both operational and strategic decision making, and a greater percentage of tests now include management actions. However, 34% of firms surveyed are not carrying out all three types of stress test scenarios, suggesting that progress is still needed.
Types of test performed

- Combined stress test (e.g. market downturn and an operational loss event) 72%
  - 2017: 61%
  - 2016: 69%
- Idiosyncratic (firm specific, e.g. a single internal/loss event) 84%
  - 2017: 81%
- Macro-economic (e.g. market downturn) 88%
  - 2017: 75%
- All three types of scenarios 66%
  - 2017: 48%

Stress test outcomes

- Stress test outcomes do not inform decision-making process 52%
  - 2017: 7%
  - 2016: 11
- Inform the operational decision making process 48%
  - 2017: 15
  - 2016: 14
  - 2015: 14
- Inform the strategy decision making process 48%
  - 2017: 19
  - 2016: 18

KPMG view:
More firms are taking combined stress testing approaches with the outcomes informing decision making. This is a positive development as it enables firms to demonstrate that their risk profile is embedded in the business.
As for Brexit – it’s still unclear how the UK’s decision to leave the EU will impact investment managers. However, the FCA wants firms to be fully prepared, ready for a range of possible outcomes. Most firms are expecting a degree of equivalence and for delegation to continue, as it does for other third countries. In 2017, more firms have included a consideration of Brexit in their ICAAP document and more have performed stress tests, as the UK’s exit from the EU steadily becomes a reality.

**KPMG view:**

Brexit uncertainty will compel firms to compare regulatory regimes in different EU locations. All firms want continued access to the EU market. However, with a lack of clarity around what will happen to delegation rules, many are considering setting up an operational base in an EU country so they can carry on providing their current range of services. “Bre-location” encompasses many areas: tax, employment laws and the availability of skilled human capital, as well as prudential capital requirements in different locations. All of these issues need to be thoroughly considered as part of detailed contingency planning. In this context, it is also interesting to note how different EU regulators have interpreted the same EU rules. For example, we have seen a vast disparity in the application of additional (i.e. Pillar 2) capital requirements outside of the UK. With its strict interpretation, could the UK find itself at a competitive disadvantage in a post-Brexit environment?

**Performed stress test capturing Brexit impact?**

- 2016: 29%, 32%, 39%
- 2017: 44%, 34%

**Description of Brexit impact in ICAAP?**

- 2016: 39%, 29%
- 2017: 32%, 25%, 6%, 69%
9. New EBA regime: Next on the to-do list

The European Banking Authority (EBA)’s new regime will change the way Pillar 1 calculations are determined. The EBA released further detail on this regime in May of this year. At the time of our study, not many firms had digested this and quantified the potential impact.

As the sophistication of financially regulated firms’ prudential requirements has grown substantially in recent times, there has been a growing acceptance that the bank-centric rules have not been a good fit for investment firms.

This was formally acknowledged as part of CRD IV, where several articles (i.e. CRR Articles 493(2), 498(2) and 508) specifically provided for a review of the prudential regime that applies to investment firms.
Overview of the EBA’s new classification approach for capital requirements

The process was formally kicked off with an initial EBA report in December 2015, followed by a discussion paper and consultation process in 2016 and 2017.

In September 2017, the EBA published their opinion on the design and calibration of a new prudential framework for investment firms.

This now includes enough detail for firms to begin to assess the potential impact in capital terms.

This section summarises the main points of note for UK firms that do not operate a trading book.

For firms that do operate a trading book, there are additional components of the K-factor approach that will apply to trading book positions which we have not covered here.

New categorisations

The new EBA classification approach will now mostly focus on firms’ actual activities and size, as opposed to the old categorisation systems of Limited Licence, Limited Activity and Full Scope, which were primarily anchored on permissions. There is, however, a caveat that some activities (e.g. holding client money or trading on own account) will have a threshold of zero, so if it is being carried out at all, these firms will be categorised as a Class 2 firm at the minimum.

The FCA classification of P1 to P3 firms is likely to stay in some form independently of the three classes. This local classification will then continue to be used to dictate the frequency of UK SREP visits.

Class 1

Types of firms: This will capture a very small number of systemic investment firms or investment firms which are exposed to the same types of risks as credit institutions. The EBA will develop a Regulatory Technical Standard (RTS) outlining the criteria for identifying these firms.

Capital requirement: Will continue to be subject to CRD IV. A permanent minimum capital amount of €5m will also apply.

Class 2

Types of firms: This will capture a large proportion of the investment firm population, as the thresholds for Class 3 firms (outlined below) are quite low.

Capital requirement: Higher of:
- Permanent Minimum Capital requirement
- Fixed Overhead Requirement
- K-Factor Requirement

Class 3

Types of firms: Small and non-interconnected investment firms, that do not meet any of the thresholds outlined above for Class 2 firms. The K-factor requirement will not apply to these firms.

Capital requirement: Higher of:
- Permanent Minimum Capital requirement
- Fixed Overhead Requirement
Threshold for Class 2/3 firms

Any firm that fulfils any one of the conditions below will be excluded from Class 3 and will therefore be a minimum of Class 2 (amounts in EUR):

- Assets Under Management (including both discretionary and non-discretionary (advisory) arrangements) - higher than €1.2bn
- Client Orders Handled (cash trades) - higher than €100m a day
- Client Orders Handled (derivative trades) - higher than €1bn a day
- Balance sheet total (net assets) - higher than €100m
- Total gross (revenue - higher than) €30m.

Three activities have a zero threshold, which means a firm will be Class 2 even if it is below the size thresholds laid out above, if it carries out any of the following (regardless of size):

- Assets Safeguarded and Administered
- Client Money Held
- Net Position Risk, Client Member Guaranteed, Trading Counterpart Default and Daily Trading Flow – these all relate firms that have a trading book (Seeding and management box are not included)

Permanent Minimum Capital Requirement

This refers to the existing €50k, €125k and €730k minimum amounts. The way in which they apply is largely unchanged, although the amounts will increase to €75k, €150k and €750k respectively.

Fixed Overhead Requirement

The CRR method will apply to all firms in the regime. Effectively, this means no change for IFPRU limited-licence firms and a move to a slightly stricter approach for existing BIPRU firms.

K-Factor Requirement

This will apply to Class 2 firms only. However, this will be a large part of the investment firm population and will even capture a significant portion of current P3 firms. For the purpose of this summary, we have excluded the K-factor element that will apply to firms with trading books. The K-factor for current limited-licence firms is summarised below:

The sum of:

- 2 basis points of AUM (including both discretionary and non-discretionary (advisory) arrangements)
Appendix
# Case studies

## 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.

## Pillar 1 calculation review

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

**Client issues**
As part of its annual ICAAP submission process, the firm required assistance with its approach to calculating Pillar 1 as it had concerns relating to both its methodology and approach as well as the completeness and accuracy of its regulatory returns.

**Benefit of KPMG assistance**
KPMG assisted this firm to ensure that its approach and methodology for Pillar 1 calculations was in line with regulatory requirements. KPMG also performed a full review of the Pillar 1 calculations and regulatory returns (COREP and GABRIEL), which culminated in a report outlining the appropriateness of the calculation approach and areas of inconsistency in relation to regulatory expectations. As a result, the firm was able to strengthen its Pillar 1 approach, enhance the skills and knowledge of its Finance function and gain comfort over the completeness and accuracy of its regulatory returns.
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.

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 FCAs 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.

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.
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