Safe from harm

Do investment firms have the financial resources to protect their customers and themselves?

Risk and ICAAP benchmarking report 2019
Introduction

This year’s study is our biggest yet, based on input from over 40 participants, 33% up on last year.

It’s encouraging that firms are finding value in this exercise and want to participate in it for the real insights into the issues it covers, especially given the continuing regulatory interest in this area. Our findings come from a broad range of firms across all prudential categories, blending SREP feedback from the FCA with quantitative research.

The regulator’s focus this year has been around the CP19/20 guidance, which outlines its expectations around what an ICAAP should be in terms of practical action and financial resources. Whilst still in consultation, we welcome the clarity that this guidance brings to the process. Notably, it introduces a subtle change of language, focusing on ‘financial resources’ and thus bringing liquidity as well as prudential capital into the frame, validating the conclusions from our earlier reports. When this guidance becomes a Policy Statement and sets a benchmark for all firms, smaller firms may have some catching up to do.
It’s encouraging that firms are finding value in this exercise and want to participate in it for the real insights into the issues it covers.

It’s also noteworthy that the CP19/20 guidance includes direct references to ‘consumer harm’, which strengthens the connection between financial resources and the conduct agenda. It highlights that risk management is about risks to clients and markets, two of the risk factors under the incoming European regulation, as well as to the firm.

Finally, we’re all waiting to see how the new requirement under the European Investment Firm Regulation (IFR) will be implemented, which is widely expected to be implemented by summer 2021. The industry has already made known its view that current capital requirements are not fit for investment firms and we expect a sea-change in the approach. Regardless of Brexit, we expect that the new regime will be implemented for investment firms in the UK and firms ought to be thinking now about how the new regulations will impact their financial resource requirements.
Executive summary

Our analysis once again shows that there have been continued improvements in many aspects of the ways investment firms manage risk and assess capital. Perhaps these improvements have been the main driver behind the narrowing of the difference between firms’ own assessments of their capital requirements against those of the regulator, with the median difference now standing at 28% (2018: 39%).

Last year we reported that 21% of firms saw a doubling of their capital requirements following a SREP. This year that number has fallen to just 12% suggesting that more firms are getting it right. The majority of firms (75% of firms which had been subject to SREP) saw capital requirements increases of between 0% and 50%.

A notable change is the way the regulator has issued capital guidance; Individual Capital Guidance (ICG) not being the exclusive tool being used, some firms instead being issued fixed add-ons for operational risk. The number of RMPs have also reduced, with 45% of firms being issued with RMPs compared to 56% of firms last year. However, clearly not all firms are getting things right since 55% of firms are still seeing governance scalars being applied by the regulator.

Coming top of the table in terms of SREP feedback comments this year is liquidity risk, as foreseen in our 2018 survey. As a result, significantly more firms (79% of firms compared with 30% in 2018) are performing...
liquidity stress tests separate from capital stress testing; and more firms now have contingency funding plans in place. However, while most firms (79%) carry out liquidity stress tests using idiosyncratic scenarios, 18% of firms in our survey have not performed market-wide liquidity stress tests, despite this being required by the regulator. Our survey also suggests improvements in the approach to capital stress tests; the majority of firms now report to be loss-making under the stress test before management actions. This might suggest enhanced maturity in terms of approach and increased severity of the scenario inputs.

Taking a top-down view of capital requirements, while still increasing overall, fewer firms have reported an increase in their own assessments of capital: 59% of firms compared to 80% of firms last year. More than twice the number of firms (28% of firms in our survey, compared to 13% in 2018) actually reported a decrease in their own assessment. The median capital assessment as a proportion of AUM has also decreased slightly from 12.74 basis points to 12.10. Our survey suggests that the P1 and P2 firms are the winners here, with P3 firms seeing continued increases in the median capital requirement as a proportion of AUM.

In terms of Pillar 1 calculations, following our survey’s observation last year that only half the firms that have client settlement balances hold Pillar 1 credit risk capital against these, there has been much improvement with 84% of firms now doing this. Clearly, this will become an historic issue once the IFR comes into force, widely expected to be by summer 2021 at the time of writing. There has been only a small increase in the number of firms that have calculated the impact of the new regime on their capital requirement (31% of firms, 2018: 27%), with a roughly 50:50 split of firms expecting an increase/decrease in Pillar 1 requirements. Anecdotally, we observe the more proactive firms are considering how they can use the new capital assessment approach as an input to strategic product planning.

We’ve taken a deeper dive into the Pillar 2 calculations this year, examining some of the detail behind the operational risk scenarios. Our survey suggests that investment firms take a fairly consistent view of operational risks. Looking across all firms, the median number of operational risk scenarios for which capital is held is 10, with little differentiation across prudential categories. The top three most commonly identified operational risks for which capital is held are transaction error, severe regulatory breach and cyber-attack. Interestingly, the number of firms using quantitative capital modelling has remained static compared to last year, with smaller firms adopting simpler approaches to operational risk capital assessment that are easier to understand and challenge. Also remaining static has been the median level of diversification benefit (37%) and insurance mitigation (20%) compared to last year. However, it is interesting to note the reduction in the proportion of firms applying insurance mitigation since our survey began in 2015, a fall from 50% of firms to just 16% today.

Looking ahead to emerging risks, with Brexit planning largely complete, firms should turn their attention to the upcoming IFR and how the new regime will impact their assessment of capital requirements, as well as the level of capital headroom. The language used by the regulator in CP19/20 suggests a more explicit linkage between conduct and financial resources. Firms would do well to consider this in their ICAAP going forward.
About the research

Our risk and ICAAP benchmarking survey is now in its fifth year.

This year, we have the highest-ever number of participants (44), representing firms throughout the investment management industry: asset managers, wealth managers and investment platforms. They range in size from boutique asset managers to global vertically integrated investment firms. Across prudential categories we continue to see a good mix of participants, which allows for relevant peer comparisons based on size and complexity.

Firms per AUM (£)

<table>
<thead>
<tr>
<th>AUM Range</th>
<th>Firms</th>
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<tbody>
<tr>
<td>More than 200bn</td>
<td>10</td>
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<td>100bn - 200bn</td>
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<td>50bn - 100bn</td>
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<td>20bn - 50bn</td>
<td>16</td>
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<tr>
<td>Less than 20bn</td>
<td>7</td>
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</tbody>
</table>

Firms by prudential category

- P1: 8 firms
- P2: 15 firms
- P3: 21 firms

Firms by regulatory category

- IFPRU: 43%
- BIPRU: 57%
24 participants in this year’s survey have been subject to a SREP visit in the past four years. A further nine firms have been subject to a SREP or ARROW visit beyond this time period. As a result, a total of 75% of participants have been subject to a prudential visit by the regulator.

This year there are two notable themes around SREP outcomes. First, the regulator is still issuing an additional capital requirement to firms during the SREP, although some firms have received fixed add-ons for operational risk instead of ICG, which is expressed as a proportion of Pillar 1 capital. Out of those firms subject to a SREP in the past four years, 14% received a fixed add-on for operational risk while the remaining 86% received an ICG. ICGs and fixed add-ons are just two of the FCA’s capital tools. We see others being used on a regular basis during the SREP; approximately half of the firms subject to SREP are also subject to governance scalars or the issuing of risk mitigation programmes (RMPs) or both.

The second theme is an increasing number of firms whose own capital assessments are more aligned with regulatory expectations, continuing the trend we identified last year.
Over a third of firms subject to a SREP in the past four years assessed their capital requirement to be within 25% of the regulator’s assessment at the time of the regulator’s review. As a result, the median difference between firms’ own assessments and those of the regulator has narrowed from 39% last year to 28% this year. However, a significant minority of firms continue to get it wrong, with some experiencing differences of over 100%. For a firm subject to a SREP for the first time, this type of increase would result in a direct pound-for-pound doubling of regulatory capital requirements.

Although operational risk modelling remains one of the key sources of regulatory concern, this year the most common issue raised by the regulator was liquidity risk. The next most common issues were related to the risk management framework and governance, which are perennial areas of focus.

Proportion of respondents stating the following job holders were interviewed during the SREP

<table>
<thead>
<tr>
<th>Job Holder</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
<th>30%</th>
<th>40%</th>
<th>50%</th>
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Differences in firms’ own assessments versus that of the regulator at the time of the SREP

- 0-25%: 38%
- 25-50%: 38%
- 50-75%: 6%
- 75-100%: 6%
- 100%+: 12%

Outcomes of SREP reviews in the past four years

- ICG: 86%
- Governance scalar: 55%
- RMP: 45%
- Fixed add-on*: 27%

*This includes fixed add-ons issued for operational risk and pension obligation risk.
KPMG view:

It is encouraging to see a continuing trend towards closer alignment between firms’ own capital assessments and regulatory expectations. This demonstrates that many have conducted a more realistic assessment of their risk profile. During a SREP, the regulator also assesses the adequacy of risk management as a whole and will give capital add-ons where this is deemed to be inadequate. Therefore, where there is only a small difference between a firm’s own assessment of capital and the FCA’s, this shows the regulator has a higher degree of confidence in its ICAAP and in the embeddedness of the risk management framework.

The increased use of fixed add-ons for operational risk should be welcomed by many firms because it reduces the volatility in their regulatory capital requirements. Where Pillar 1 requirements are driven by fixed overheads, a fixed add-on also means that increased costs in the business will have a lower direct capital impact compared to an ICG.

The regulator’s continued focus on liquidity risk is a reflection of its emphasis on financial resources as a whole (i.e. both capital and liquid resources) as outlined in CP19/20. As a result of this continued focus, we have analysed how firms manage liquidity risk in more detail later in this report.

Governance and culture, and risk management frameworks continue to be an area of focus during the SREP. While regulatory capital is there to mitigate issues when they arise, firms need to have effective systems and controls in place to help manage these risks and prevent them from crystallising. Usually, firms that have a strong risk culture, including “tone from the top”, and effective capital assessments in place are those that are not subject to significant governance scalars or risk mitigation programmes.

Last year we highlighted that operational risk modelling was the most common SREP issue. We expect the number of findings in this area to reduce as firms increase their understanding of modelling over time, obtain external support through model validation reviews and, ultimately, act on regulatory feedback.
Since we started our survey we have seen a misalignment between the risk appetite statements and risk management frameworks of participant firms.

Over time, this has improved as firms have evolved their risk management frameworks (RMF) and approach to risk appetite (RAS). However, for some firms there continues to be a disconnect. This is particularly notable for group risk, reputational risk and interest rate risk, where a significant number of firms manage these risks but have not set risk appetite against them. More surprisingly, given its importance to the ICAAP, 29% of firms do not have a capital risk appetite in place.

In terms of quantitative risk appetite thresholds, for a third of firms, these thresholds are not binding and therefore do not lead to the risk being out of appetite if triggered. In addition, 18% of firms have not performed a review of Key Risk Indicators (KRIs) to ensure these are linked to key risks. A similar percentage does not include the Board in the review and approval of KRIs. The majority of firms (85%) provide at least quarterly reporting to the Board on risk appetite status, with a small minority (15%) reporting annually.
KPMG view:

While many firms have improved their alignment of risk appetite statements and underlying frameworks for key risks such as operational risk, there continues to be misalignment for other risks, such as group risk. Firms must be prepared to explain how the Board has set risk appetite against those risks to which it is exposed. Group risk is an area on which we have seen significant focus during recent SREP visits and we expect this to continue given that Senior Managers and Certification Regime (SM&CR) is driven by the regulatory requirements of individual legal entities.

Individual risk appetite statements may not be applicable for some risk types depending on how individual firms have implemented their risk management framework. However, we would expect all firms to have a capital risk appetite in place given the significance of this risk. Where firms do not have a capital risk appetite in place, it would be a challenge to demonstrate trigger points that would prompt management actions before capital breach. This impacts across the ICAAP through capital stress testing, reverse stress testing and wind-down planning. The lack of a capital risk appetite suggests that these ICAAP components have been performed in silos and are not used as tools to inform day-to-day risk management.

To pass the ‘use-test’, risks documented in the ICAAP need to be clearly linked back to the risk management framework, including to risk appetite monitoring. This enables firms to demonstrate that key risks are monitored effectively and reported on to senior management and the Board. One of the key mechanisms for this reporting is the use of quantitative risk appetite tolerances and supporting KRIs. Without these, the process for measuring and monitoring of the risk appetite can be overly subjective. Quarterly risk appetite reporting to the Board is expected, to align with the typical frequency of Board meetings. Reporting risk appetite status annually is not enough to demonstrate sufficient Board oversight. We would therefore expect this to be challenged by the regulator.
Overall capital requirements across all firms are largely consistent with those in 2018.

The median amount of capital held as a proportion of AUM across all firms is 12.10 basis points (2018: 12.74). Historically we have observed that larger firms hold proportionally more capital than smaller ones. However, this year larger participants (P1 and P2 firms) are holding proportionally less capital. In comparison, among smaller participants (P3 firms) we have seen another increase in overall capital requirements, up to a median of 11.77 basis points of AUM (2018: 10.54). 12% of firms subject to an ICG have self-assessed their requirement to be higher than their ICG in subsequent iterations of the ICAAP. These self-assessments are largely driven by Pillar 2 requirements. However 10% of firms have identified that the costs of wind-down are greater than their Pillar 2 assessment. Where this is the case, the expectation is that firms will hold capital to cover these wind-down costs.
Median overall capital requirement as a proportion of AUM (in basis points)

<table>
<thead>
<tr>
<th>Year</th>
<th>P1</th>
<th>P2</th>
<th>P3</th>
<th>All firms</th>
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<tbody>
<tr>
<td>2018</td>
<td>12.74</td>
<td>12.43</td>
<td>11.77</td>
<td>12.10</td>
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<tr>
<td>2019</td>
<td>11.05</td>
<td>10.54</td>
<td>9.40</td>
<td>9.75</td>
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KPMG view:
Consistency across the industry in the median amount of capital that firms hold as a proportion of AUM reflects the fact that capital assessments have evolved over the years and have now become mature processes, especially at larger firms. As we outline later in the report, there has not been a significant change in the amount of capital that larger firms are holding for operational risk this year. Therefore reductions in overall capital requirements we have observed for these firms are likely driven by either changes in other risk exposures they hold capital for, such as market or credit risk, or reductions in ICG.

Many P3 firms have had to play catch-up as they are not subject to as frequent reviews as for larger firms and therefore have not benefited from direct regulatory feedback on their assessments. We have therefore seen a delay in these firms increasing their requirements. However, even small firms can have a significant impact on customers or the wider market, so the regulator expects them to perform an assessment of their risk profile and to hold appropriate capital.
Pillar 1

For the vast majority of firms (88%), Pillar 1 capital requirements continue to be driven by the Fixed Overheads Requirement (FOR).

Pillar 1 credit risk calculations have been an area of inconsistent treatment in the past, as investment firms are forced to apply rules that were written for banks. Within this calculation, the treatment of settlement balances as a result of fund transactions was highlighted as an area of difference across the industry last year. This year, we have seen that many firms are now including these balances in their Pillar 1 credit risk calculations, with only 10% of firms not doing so compared with 28% in 2018. However, reflecting this inconsistency and other errors, Pillar 1 calculations have been identified as an issue for 25% of firms subject to SREP in the past four years.

Driver of Pillar 1 capital requirement

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

- Yes - we have a client settlement balance on our balance sheet and do not hold Pillar 1 credit risk capital against this balance
- Yes - we have a client settlement balance on our balance sheet and do hold Pillar 1 credit risk capital against this balance
- No - we do not have a client settlement balance on our balance sheet
KPMG view:

Pillar 1 requirements will be changing under the IFR. This will be welcome for many firms that currently have to adopt credit risk requirements that were designed for banks and do not reflect the inherent risks to which investment firms are exposed. However, while the current requirements remain in force, the FCA expects all firms to follow them.

The quality of prudential regulatory returns, including Pillar 1 calculations, continues to be an area where firms can expect regulatory scrutiny. In February 2018, the FCA issued a Dear CEO letter around the quality of prudential returns. Since this was issued many firms have performed reviews of their returns to ensure these are accurate. Where firms get this wrong, it tends to be due to: a failure to meet specific rule requirements; poor controls over reporting, leading to simple errors; or the impact of changes in the business over time. Changes can include developments in the contractual nature of transactions, types of capital held and accounting practices used. Where the regulatory capital impact of these changes is not assessed, errors usually follow. The FCA is responsible for the prudential regulation of over 2,750 investment firms that are required to perform an ICAAP and relies on the accuracy of prudential reporting to support their prudential supervision approach. Therefore, we expect that the regulator will perform more work in this area.
Pillar 2 operational risk

As typically the largest component of capital assessments for asset managers, operational risk continues to be an area of focus in our survey.

This year the median amount of capital held for operational risk as a proportion of AUM across all firms (7.23 bps) has remained broadly consistent with that per our previous report (7.14 bps). However, across prudential categories there has been an increase in the median amount of operational risk capital held by both P2 and P3 firms.

Last year we noted a significant increase in the number of firms using operational risk modelling. This year the proportion of firms doing so has remained constant (64% of participants have adopted this approach).

New for our survey this year, we asked for more information on the underlying operational risk scenarios for which capital is held. Responses show that the median number of operational risk scenarios for which capital is held across all firms is 10, with little differentiation across prudential categories. In terms of top operational risks, this year we also asked participants to identify the top three risks they held capital for. Across all firms the most common top-risks are shown overpage.
Top operational risks: percentage of firms with the following risks in their top three operational risk scenarios

- Transaction error: 58%
- Severe regulatory breach: 37%
- Cyber attack and/or data loss: 33%
- Mis-selling: 28%
- Mandate breach: 26%
- IT systems failure: 21%
- Fraud: 14%
- Change management issue: 9%
- Outsourcing issue: 9%
- Corporate action processing error: 9%
- CASS breach: 5%
- Market abuse: 2%

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### Median operational risk capital held as a proportion of AUM (in basis points)

<table>
<thead>
<tr>
<th>Year</th>
<th>P1</th>
<th>P2</th>
<th>P3</th>
<th>All firms</th>
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</thead>
<tbody>
<tr>
<td>2017</td>
<td>9.4</td>
<td>7.8</td>
<td>6.7</td>
<td>8.0</td>
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<tr>
<td>2018</td>
<td>8.0</td>
<td>5.7</td>
<td>4.2</td>
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<tr>
<td>2019</td>
<td>7.2</td>
<td>6.7</td>
<td>5.9</td>
<td>7.2</td>
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### Operational risk in basis points as a proportion of AUM: percentage of all firms in the following categories

<table>
<thead>
<tr>
<th>Category</th>
<th>P1</th>
<th>P2</th>
<th>P3</th>
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<tr>
<td>&lt;5 bps</td>
<td>29%</td>
<td>43%</td>
<td>33%</td>
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<tr>
<td>≤10 bps</td>
<td>57%</td>
<td>29%</td>
<td>33%</td>
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<tr>
<td>≤15 bps</td>
<td>14%</td>
<td>21%</td>
<td>22%</td>
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<tr>
<td>&gt;15 bps</td>
<td>12%</td>
<td>7%</td>
<td>12%</td>
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**KPMG view:**

Increases in the amount held for operational risk by P2 and P3 firms might be an indicator that firms are continuing to become more realistic in their assessment of operational risk. This is also likely to be a result of FCA SREP feedback, particularly for smaller firms being reviewed for the first time. In previous years we have observed that larger firms held disproportionately more capital; it is interesting to note a convergence of the proportion of the operational risk capital held across all firms. Not all firms adopt operational risk capital modelling since their use can make capital assessments unnecessarily more complex; hence our observation that the proportion of firms using them has remained largely unchanged from last year. We observe smaller firms adopting simpler approaches that can be more easily understood by first-line risk owners, senior management and the Board. Where models are used, it is critical that they are understood by the people providing inputs; this includes ICAAP subject-matter experts and, ultimately, senior management and the Board. We often see SREP findings that show firms are failing in these areas because models are either not being used as intended, or they are not fully understood by individuals responsible for governance of the ICAAP, or both.

The fact that P1 firms do not have a higher number of operational risk scenarios compared with smaller firms may be surprising. These firms are more likely to have a greater number of material risks due to the increased size and complexity of their businesses. Scenario selection is an inherently subjective process, so the number of scenarios for which capital is held should be supported by a robust scoring process and governance.

Investment firms are very similar in terms of the top operational risk scenarios for which they hold capital, with over half holding capital for transaction errors. The commonality reflects the fact that firms across the investment management industry face a similar range of inherent risks. Given how widespread these inherent risks are, we would expect all firms to have considered the impact of these in their own operational risk assessment.

With the FCAs focus on the link between conduct and prudential risk, we expect firms to start considering how conduct risk impacts across all operational risk scenarios. This should include assessing the client / market impact if each risk were to crystallise and the capital impact of any redress required in each of these scenarios.
Operational risk diversification and mitigation

The number of firms applying diversification to their operational risk assessment has fallen from 57% to 44%. However, this is largely attributable to movements in the population of firms in our survey. The number of firms applying insurance mitigation remains significantly lower than in the first year of our survey in 2015: this year only 16% are using insurance to reduce their operational risk capital requirements.

Alongside consistency in the number of firms applying diversification benefit and insurance mitigation, the median amount applied to both remains similar to previous years, at 37% and 20% respectively. However, for diversification benefit, there is a difference in the overall distribution of amounts taken around the median, with over 75% of all firms (2018: 53%) taking diversification benefit of more than 31%.
KPMG view:

The fall in the number of firms using diversification benefit can largely be explained by changes in the population of our survey. Additionally, there are also some firms that use quantitative models but do not apply any diversification benefit. As a result, they hold capital for a range of scenarios assuming that they all occur at the same time. Assuming that these individual scenarios are severe enough, this may result in an overly prudent assessment of capital required. Where firms do take higher amounts of diversification benefit, this will need to be supported by the underlying rationale and confidence in the assessments of correlations between risk scenarios.

Use of insurance mitigation continues to be an area where most firms are cautious, following strong regulatory feedback over the past few years.
Capital stress testing

Our findings this year show that capital stress testing over the business planning period continues to improve. In previous years, most firms performed idiosyncratic (firm-specific) and macroeconomic stress tests. But not all had carried out combined tests to understand the impact of external market events and internal firm-specific events crystallising at the same time. This year, 86% of firms are performing combined stress tests compared with 76% last year.

We still observe 25% of firms not performing all three types of stress test. The overall median number of stress tests performed (four) continues to be broadly in line with last year’s survey (five), with most firms carrying out a median of two idiosyncratic stress tests and performing individual stress tests for macroeconomic and combined scenarios.

This year, 85% of firms made a loss during stress testing before management actions, compared with 69% last year. This suggests that the inputs into stresses are becoming more severe. A similar number of firms (80%) continue to include management actions and their financial benefits in their stress testing analysis. This year we also looked at the impact of stress tests on regulatory capital; 65% of firms were in regulatory capital breach following stress testing, falling to only 5% following management actions.

In terms of governance around stress testing, 32% of firms continue not to involve the Board in the scenario selection process. In addition, 28% of firms have not linked the risks identified through stress testing to their risk registers.
The KPMG view

Stress testing has always been difficult for many investment firms, because of the cash-generative nature of their business models and the fact that lower revenues can typically lead to lower costs through management actions (such as bonuses). However, it is good to see that many firms continue to perform a number of different stress tests. All firms should perform combined stress tests as this is a regulatory expectation.

A consistent area of regulatory challenge is around the severity of stress tests. We emphasised last year that where firms continue to be profit-making in stress scenarios, they are open to challenge by the regulator around the severity of their scenarios. It is therefore noteworthy that a significant majority (85%) of firms in this year’s survey made a loss during their stress scenarios. The use of management actions continues to be important in this process, with many firms relying on them to reduce the impact of stresses on profitability and ultimately regulatory capital. As always, the management actions identified should be realistic in terms of their timing and financial impact.

Good stress testing should involve the Board in the scenario selection process so that scenarios reflect a ‘top-down’ view of business vulnerabilities and strategic risks. Where stress tests cannot be linked back to risk registers, this suggests that they have been developed in silos for the purposes of the ICAAP document only. For these to be an effective risk management tool, they should be linked to the risk management framework. This would demonstrate risks used in stress tests are those which are identified, assessed, mitigated and ultimately reported on an ongoing basis to senior management and the Board.
Liquidity risk management

Whilst there has been significant focus on fund liquidity over the past 12 months, regulated entities also have liquidity requirements. These are set out in BIPRU 12 and are the focus of our survey.

We have seen significant FCA focus on liquidity in recent years. In response, we have seen firms improve their liquidity risk management frameworks. A clearly defined liquidity risk appetite is the key output of a liquidity risk management framework and 79% of firms have a quantified liquidity risk appetite. Last year, 17% of firms had no liquidity risk management framework at all; this year, the figure has fallen to 10%.

Contingency Funding Plans are required under BIPRU 12. There continues to be a minority (14%) of respondents who do not have them documented. This year, we asked firms for the first time whether they had external funding facilities on which they could draw in the event of a liquidity crisis. The result was an even split, across prudential categories, between firms that have external facilities in place and those that do not.

KPMG view:

While the vast majority of firms have a defined liquidity risk appetite in place, our qualitative analysis suggests that many base it on business-as-usual operating conditions. This is not in line with regulatory expectations. Although liquidity risk appetites are generally conservatively set, they are often not linked. Where this is the case, there is a risk that liquidity risk appetite tolerances are too low.

Contingency funding has always been a problem area for many asset managers as most hold their regulatory capital in cash. On the other hand, wealth management and platform firms typically have contingency facilities in place, given the client money risks of their operating model. Our research shows that firms with these arrangements in place are not differentiated by size, their use remains reflective of individual liquidity risk exposures of each firm.
Liquidity stress testing should be carried out to identify sources of potential liquidity stress and to identify the liquid resources required to enable a firm to withstand them. Last year, only 30% of firms in our survey performed liquidity stress tests that were separate from capital stress testing. This year has seen a significant increase, with 79% of firms now doing so. However, a third of firms do not perform liquidity stress tests on an individual entity basis, which is a regulatory requirement.

Given the regulator’s focus on liquidity, this year we included a number of additional questions on liquidity stress testing. Across all firms, the average number of liquidity stress test scenarios is four. Our survey shows that idiosyncratic liquidity scenarios are the most common, carried out at 79% of firms. However, while it is a regulatory expectation, 43% of firms do not perform market-wide liquidity stress testing.
Concentration of liquid assets with one counterparty or in a limited number of products can lead to liquidity issues in a stressed scenario. Our survey shows that while most firms have diversified their cash across multiple banks, 14% are still holding cash with one bank.

Where firms have permission to hold client money, this can give rise to client money funding obligations where there are shortfalls in a client money bank account. These obligations typically last for a few days while trades are settling; however, they can be significant in size. This can especially be the case where firms ‘pre-fund’ client trading activity before cash is received from clients. This off-balance sheet funding obligation can have a significant impact on investment management firms. Whilst 64% of firms in our survey hold client money, only half of these firms consider the funding client money shortfalls in their liquidity stress testing.

KPMG view:

Liquidity stress testing is an area where firms continue to fall short of regulatory expectations, principally because they are not properly considering significant liquidity risks in the process. While the number of scenario types typically modelled (four) is encouraging and shows that different liquidity risks are being assessed, firms still fall short of expectations. Many firms have not carried out liquidity stress tests on a legal entity basis and 38% have not performed a combined liquidity stress test, both of which are regulatory requirements. Where firms hold client money but do not include an assessment of client money funding obligations, they are also likely to come under regulatory scrutiny as these amounts can be significant and could lead to consumer harm if not adequately funded.
Wind-down planning

Last year, we saw a decrease in the number of firms with wind-down timeframes of less than 12 months, as firms considered longer timeframes to be more realistic. This year, the average length of a wind-down period has remained at 18 months. This timeframe is consistent across all prudential categories, reflecting the fact that the majority of the inherent risks and uncertainties in a wind-down scenario and the operational tasks required during wind-down are consistent, irrespective of the size and complexity of individual firms.

The inclusion of business functions in the wind-down planning process continues to be limited for some firms. While more firms are using wind-down workshops which involve more people from across the business, almost a third do not involve Compliance, Legal or Human Resources functions in the planning process.

Under wind-down planning, the costs of winding down are assessed through analysis of revenues and expenses over the wind-down period. However, 24% of firms have not assessed their liquidity requirements during a wind-down scenario.
KPMG view:

An effective wind-down plan should be realistic in terms of timescales, assess the impacts on a range of stakeholders and be supported by strong governance. There should also be adequate inputs from across the business to ensure that the plan adequately reflects all of the operational tasks, including associated risks, and results in a realistic assessment. Given the typical wind down activities, we would expect the involvement of Compliance, Legal and Human Resources. The absence of the inputs of these critical functions can undermine the credibility of the wind down assessment.

Financial resources during wind-down should also include an assessment of the required liquid resources for the duration of the wind down. Revenues will be significantly lower and cash outflows typically higher and out of cycle; therefore an assessment of liquidity must be performed to ensure that firms can remain solvent while winding down.

We expect regulatory focus on wind-down to continue given the emphasis that was made on wind-down planning in CP19/20 and the fact that the quality of wind down planning remains a consistently raised issue during SREPs.

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

Unsurprisingly, Brexit has been a significant area of focus in the investment management industry as a whole. A third of firms in our survey stated that Brexit has had a material impact on their business model. Last year, we noted that 40% of firms were planning a partial relocation as a result of Brexit. However, three-quarters of firms have now undertaken activities to Brexit-proof their business. This includes setting up new entities in the EU, extending the permissions of regulated entities in the EU and adding substance to these entities.

Only 31% of firms have actually quantified their capital requirements under the incoming IFR rules. Where these calculations have been performed, there is an even split between firms that have higher Pillar 1 requirements under the new rules and those that do not. In terms of capital resources, only 20% of firms have calculated their capital resources under the new rules.
The KPMG view

Some firms in our survey have undertaken extensive entity restructuring programmes to prepare for Brexit. However, the impact on UK-focused firms is lower and these firms have not had to undertake these types of activities. Where new EU entities are being created, or firms are increasing their permissions in the EU, this can lead to additional regulatory capital requirements and the need to carry out an ICAAP on a solo basis. The legal entity structuring of these activities is therefore very important to ensure that optimal regulatory capital, tax and operational structures are in place. Additional legal entities and intercompany relationships also introduce other risks around trapped capital and group risk, which should be considered in the ICAAP by all firms undertaking these activities.

The IFR will be welcomed by some participants which have onerous Pillar 1 capital requirements based on a regime that has been designed for banks. However, some will be significantly impacted by the new regime and will see Pillar 1 capital requirements increase as a result of this. On the other hand capital resources under the IFR will decrease for many firms due to mandatory deductions of certain items from regulatory capital resources. All firms should therefore look to model the impact of IFR now, to ensure that there are no surprises by the time of implementation. The regulation will come into force 18 months from being published in the EU journal, which is expected by the end of the year. While there is time to implement it, capital impacts require business planning over a longer cycle so should be considered now.
## How can KPMG help?

### ICAAP health check

**Client type**
P3 investment management firm

**Client issues**
Our client was a P3 investment firm which had undergone significant growth in its business and had increased interaction with the regulator as a result. The client was seeking an external third party to review its ICAAP document to identify potential areas of challenge and improvement.

**Benefit of KPMG assistance**
We carried out a desk-top review of the ICAAP document and supporting documentation to review this against our understanding of industry practice for similar sized firms. The output of our work was a report summarising detailed findings and recommendations (graded by priority) and presented to senior management. As a result of this review, the firm was able to understand the extent to which its ICAAP document aligned to regulatory expectations and leading industry practice, and to remediate any areas of weakness.

### Risk appetite statements

**Client type**
Listed asset manager

**Client issues**
Following a SREP review, the firm was set an RMP to review its risk appetite statements and associated risk appetite tolerances to ensure these were fit for purpose and embedded across the business.

**Benefit of KPMG assistance**
We worked with the firm to change the way it had designed and implemented its risk appetite statements. We identified a number of gaps and weaknesses in its current approach and proposed changes to ensure risk appetite was set across all risk categories, clearly linked to quantitative limit thresholds and ultimately reflected the strategy of the business. This included benchmarking of quantitative limits used against industry peers to design a concise range of limits that reflected the key risks exposures of the firm. This resulted in a new set of risk appetite statements, owned by the Board, and enabled the client to evidence to the FCA that their RMP had been completed.

### SREP preparation

**Client type**
Listed investment firm

**Client issues**
The firm had experienced significant growth in the business and was due to undergo an FCA SREP visit for the first time. In preparation for this, the client required assistance from a third party to assist with interview preparation for its Board (Executive and Non-Executive Directors), members of the senior management team and subject matter experts.

**Benefit of KPMG assistance**
We performed a ‘red flag’ review of the client’s ICAAP and supporting information to identify areas of potential focus during the SREP. The results of this were presented to the Board, Senior Management and subject matter experts. Alongside this, we also presented on what to expect from the SREP visit. Following the presentation, we performed a number of mock interviews and challenge sessions. The interviews tested knowledge and understanding of the firm’s risk management processes. 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 subject matter experts were better prepared for their upcoming SREP visit.
**Pillar 1 calculation review**

**Client type**
UK Based Global Investment Manager

**Client issues**
Following developments in the firm’s business model, including acquisition of other regulated entities, 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.

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**Operational risk model validation**

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

**Client issues**
The firm had adopted an operational risk model for the first time. To help it prepare for a SREP visit from the FCA, the firm wanted an external model validation review to ensure that its use of the model was in line with industry practice.

**Benefit of KPMG assistance**
We reviewed the client’s operational risk modelling process, including underlying methodology applied, through a walkthrough of the model and supporting documents. We also provided benchmarking on the approach used by the firm to help it understand approaches among its peers. The outcome of this was a report outlining key findings, rated by importance to enable the client to address any issues identified in a targeted manner. As a result of the review, the client obtained a more robust, calibrated operational risk model. This also furthered understanding of operational risk modelling among key employees, which enabled them to clearly explain their methodology to the FCA during the SREP.

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