Taking a different perspective

Risk and ICAAP Benchmarking Survey 2021

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> **All investment firms must now perform an outward looking assessment of the harm they can cause. For some this will represent a significant change in their approach to risk management.**

Contents

Taking a Different Perspective

This year we have focussed our report on the impact of implementing the new prudential regime for investment firms.

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Foreword

As we present the seventh edition of our annual Risk and ICAAP Benchmarking Survey, the world is still a place of great uncertainty. Investment management firms continue to operate in a dynamic risk landscape and need to react to shifts in client expectations and wider macro trends. Maintaining operational and financial resilience continue to be a key area of focus. Risk functions have been preoccupied with ensuring risk frameworks are effective in managing near term and emerging risks as well as business as usual risks; and preparing for the implementation of the Investment Firms Prudential Regime ("IFPR").

Our latest benchmarking study focuses on the challenges of implementing the new regulation which comes into force on 1 January 2022. It is encouraging to see, three weeks before go-live, that most firms have quantified their financial resources requirements under the new regime. Those that have done so recognise the complexity and immediate challenge of implementing new quantitative components such as the K-factor requirements calculations, adapting to the revised rules for the Fixed Overheads Requirement and implementing the Internal Capital Adequacy and Risk Assessment ("ICARA") process which replaces the ICAAP. In addition, the IFPR is a wide-ranging regime that introduces new requirements around Governance and Remuneration which will have a significant impact for some.

It is perhaps surprising to see, given the effort required for the new quantitative components, that a significant majority of firms do not believe that the new regime will have any impact on their assessment of capital requirements. This suggests that either the level of capital for investment management firms has reached an inflexion point, or that firms are underestimating the changes that are anticipated by the regulator. For some, the new regime will simply mean taking a different perspective to reach the same outcome; for others, there will be a more fundamental change. However, all firms need to engage with the implementation to ensure they are compliant from day one.

About the research

For our 2021 benchmarking survey, we have received responses from a broad range of firms across the investment management industry. Our respondents include large global asset managers through to smaller UK-based firms providing a limited range of investment management services. All firms are subject to prudential regulatory supervision by the Financial Conduct Authority ("FCA").

Participant background

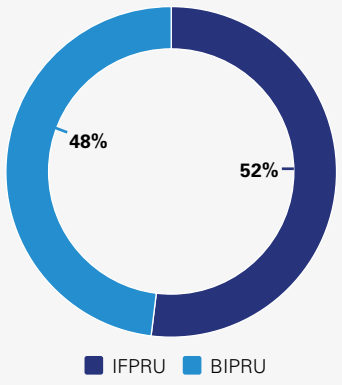
This year's survey is based on 40 participating firms of various scale as indicated by their assets under management ("AUM")[1]. Nine participants manage assets in excess of GBP 200 billion whilst eight have less than GBP 20 billion under management. From a regulatory perspective, half of our participants are classified as P1 and P2 firms (who would usually be subject to a 1-3 year review cycle) whilst the other half are P3 firms, some of whom have never been through a regulatory review.

Our survey approach – the new regime

Last year our survey was carried out under the backdrop of the COVID-19 pandemic; however, one year on, we are weeks away from the implementation of the Investment Firms Prudential Regime ("IFPR"). Therefore, the focus of our survey has shifted towards gaining an understanding of the industry's approach to and readiness for the new risk management and financial resource rules. These rules will affect investment managers from 1 January 2022, the date at which the IFPR comes into force.

Given the impact of the IFPR, our report is structured to focus on the key areas of the new regime. For each area we provide a summary of the new requirements, relevant benchmarking data from our survey and our views on both the impact of the IFPR and the results of the benchmarking.

Firms by regulatory category



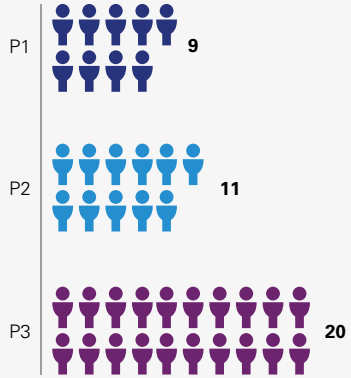
1 throughout the survey we use the term AUM to refer to the assets that each investment firm manages, administers or influences.

Supervisory Review and Evaluation Process

In contrast to our previous surveys, we have not included benchmarking data on the outcome of FCA Supervisory Review and Evaluation Process ("SREP"). The SREP is the process through which the FCA reviews and assesses risk frameworks and the financial resources of firms, including issuing additional capital and/or liquidity requirements. Since the onset of the COVID-19 pandemic, we have observed a significant reduction in the number of reviews performed by the FCA. Therefore, we have not included data on the outcomes and areas of focus from SREP reviews in our report for 2021.

Number of participating firms by AUM (£)

Split of firms by prudential category



Overview of the IFPR

Impact of the IFPR

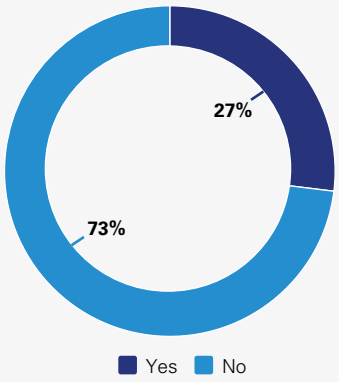
The IFPR is the new prudential regime which applies to MiFID investment firms and Collective Portfolio Management Investment Firms ("CPMIs") in the UK. This follows the Investment Firm Regulation ("IFR") and Investment Firm Directive ("IFD") in the EU which the FCA was involved in drafting prior to Brexit. The IFR/D came into force in the EU in June 2021; however the FCA announced a delay of six months to the implementation of the UK IFPR rules. Since making this announcement, the FCA has consulted on and published the majority of the IFPR rules throughout 2021.

The IFPR has been specifically developed for investment firms which had previously been subject to the capital rules set out in the Basel framework that was developed for the banking industry.

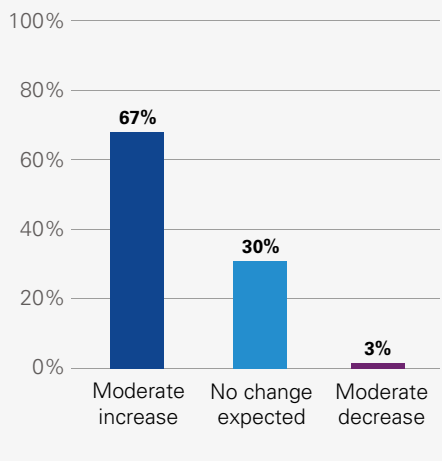
One of the key objectives of the IFPR was to more accurately reflect the risk profiles of investment firms. The key changes in the upcoming rules impact on capital and liquidity requirements, risk management frameworks and remuneration.

The IFPR introduces new FCA firm categorisations, resulting in smaller investment firms that conduct limited regulatory activity being referred to as 'small and non-interconnected ("SNI")' firms, whilst the larger investment firms with a broader range of regulatory permissions are referred to as 'non-SNI'. SNI firms are subject to a more limited range of the IFPR rules while non-SNI firms are required to meet the majority of the IFPR regime in full. We have based our analysis in this report on the requirements for non-SNI firms as these are the rules that will apply to all survey participants.

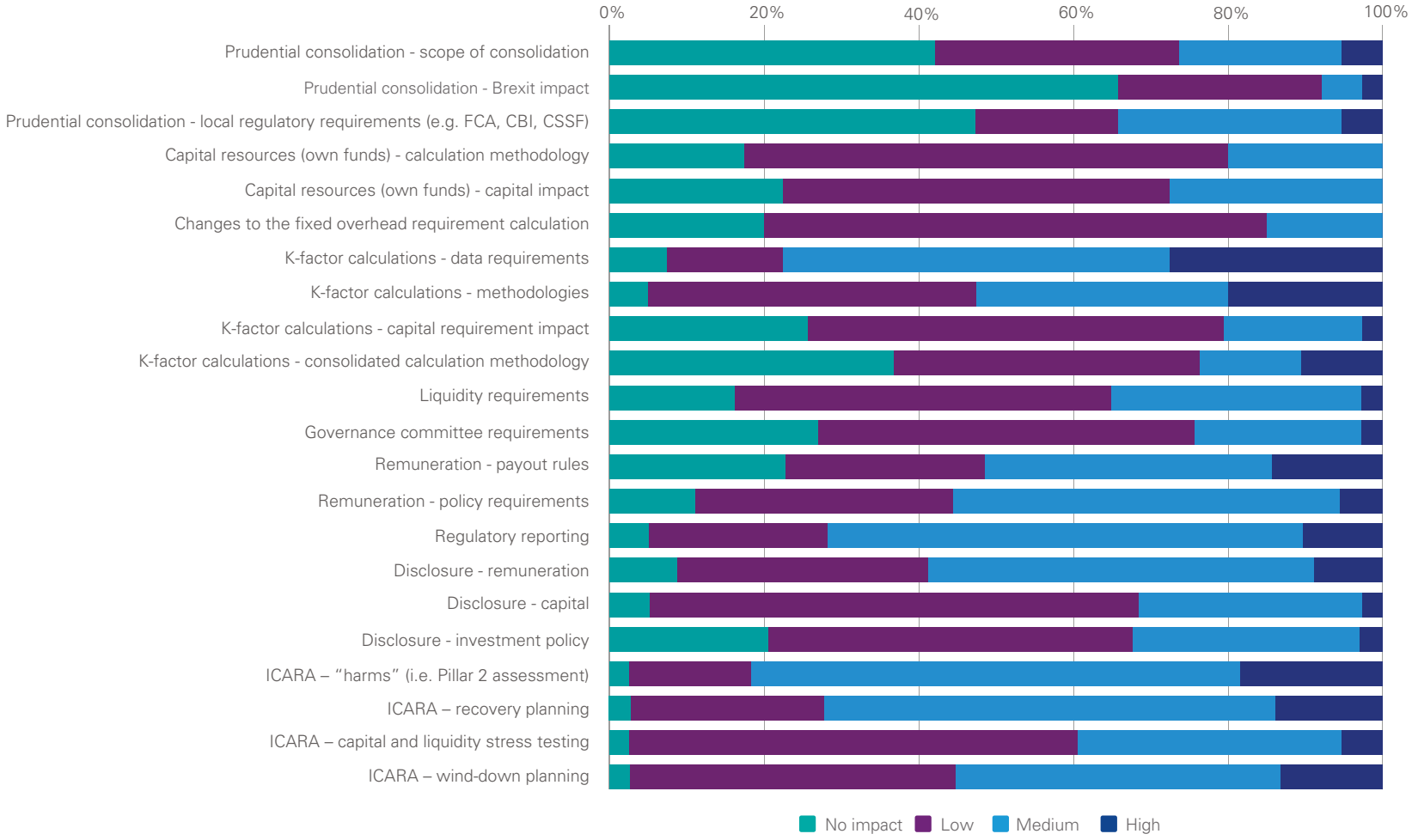
Do you expect the IFPR to lead to additional resource requirements in key functions responsible for this analysis (e.g. Risk, Finance, etc.)?



What is your assessment of the impact of IFPR reporting on internal operational resources compared to existing requirements?



Rating the impact of implementing the following IFPR components: firm views of the impacts of each component



Trends in the data

- Overall, the majority of firms do not anticipate the implementation of IFPR will significantly impact their business. However, survey participants have indicated that there are a number of specific components that will be more challenging to implement.
- For capital requirements, 78% of respondents see data requirements behind the new K-factors as having a medium or high impact.
- For risk assessments, 81% of respondents see the impact from the requirement to perform a "harms" assessment as being medium or high. The requirement to perform recovery and wind-down planning is also a notable area of challenge for some with just over 50% of firms seeing this as having a high or medium impact.
- For remuneration, only 14% of respondents felt the pay-out rules had a high impact. However, a majority of firms see both the pay-out rules and policy requirements as being medium or high impact.
- In terms of governance, two thirds of respondents considered the governance committee requirements as being either low or no impact at all.
- While the impact of specific elements of the new regime across the industry is mixed, over a quarter of firms expect the IFPR to lead to additional operational resourcing requirements in key functions. Of particular note, almost two thirds expect a moderate increase in the operational resourcing requirements for regulatory reporting.

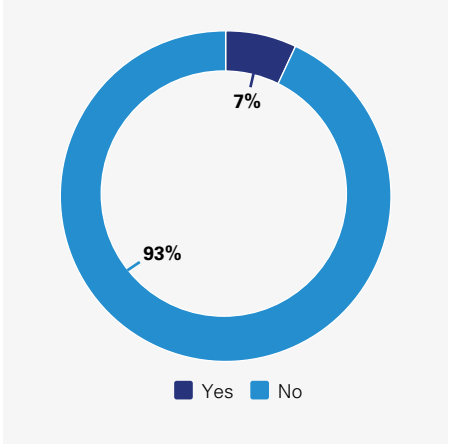
KPMG view

The IFPR represents a wholesale change in the way that investment firms need to assess and report on financial resources, implement their risk frameworks and remunerate key employees. The breadth of these requirements means that many firms are taking a phased approach to implementation, focussing on the key requirements that need to be in place from day one, such as K-factor calculations. In our view, the challenges firms have identified in the regime, such as the K-factors or remuneration, result from these being current areas of focus for implementation. Based on our experience of working with firms who are more advanced in their implementation programmes, other areas are also likely to have significant impact. For example, additional disclosure requirements around investment policies will likely have a high impact on the largest firms due to the type of data required to complete the disclosure.

Throughout the report we focus on these distinct themes in more detail. However, our survey shows that, overall, firms expect the new regime to have only a moderate impact across their organisation. This is reflected in only a quarter of firms expecting additional operational resources will be required to maintain compliance.

Prudential consolidation

Has the scope of prudential consolidation for your firm changed under the IFPR?



Impact of the IFPR

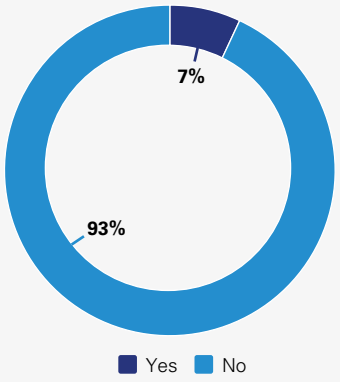
The IFPR will apply to investment firm groups on a consolidated basis. The new rules also introduce additional requirements on the type of relationships between entities that can lead to prudential consolidation. For some firms this may lead to consolidation requirements for the first time. The principle of this requirement is to include all relevant entities in a single group to capture risks to clients and markets from the activities of a group as a whole. Applying the consolidation rules may bring into scope activities performed by entities not individually subject to the new regime. For example, some firms will be required to calculate capital requirements based on activities carried out by entities outside the UK. This impacts across all key areas of the IFPR ranging from capital requirements through to remuneration.

There is, however, flexibility for some firms who are able to evidence that they pass the Group Capital Test ("GCT"). The GCT is an approach that allows firms to obtain an exemption from the FCA from prudential consolidation requirements. This alternative is in place for groups that are able to evidence a simple structure and satisfy the FCA that there are no significant risks arising from the activities of the group as a whole. Applying the GCT could potentially reduce capital and liquidity requirements, limit the scope of regulatory supervision and reduce remuneration requirements. However, for some firms this may have limited benefit if they already comply with existing regimes on a consolidated basis.

Trends in the data

- The scope of prudential consolidation has remained the same for 93% of respondents.
- Only 7% of respondents intend to apply to use the GCT.

Do you intend to apply to use the Group Capital Test (GCT)?



KPMG view

With only a small minority of firms identifying changes in their prudential consolidation group, this suggests the new consolidation rules will have little impact on the industry. However, for those firms who have identified changes, we have observed the impact of these to be significant. Therefore, all firms should assess the impact of consolidation rule changes to ensure that they are meeting the new requirements. Performing this assessment now will ensure that implementation of the IFPR is based on the appropriate interpretation of the rules from the outset.

Given the potential impact of applying the IFPR on a consolidated basis, (which may include bringing into scope entities outside of the UK), it is somewhat surprising to see that only a minority of firms intend to apply for the GCT. However, an exemption from consolidated requirements can result in both advantages and disadvantages, depending on a firm's structure and their existing regulatory requirements. The majority of firms opting not to apply for the GCT suggests that most firms do not believe there would be significant benefits in doing so.

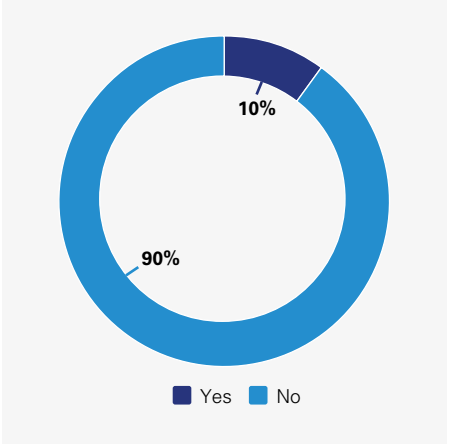
Governance

Impact of the IFPR

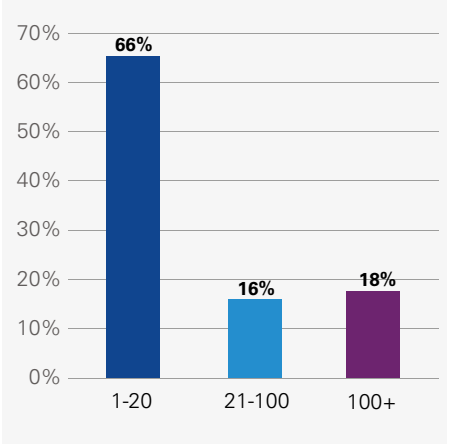
Having an effective governance framework in place has always been an important component of the risk management framework. Under IFPR, all firms will be required to demonstrate, at a legal entity level, that they have robust governance arrangements in place. This includes broad governance requirements for ensuring an effective risk management framework and adequate control environment are in place. Larger firms will be required to ensure governance arrangements at a legal entity level are appropriate given the scale and nature of the business model. This will come in the form of having Risk, Remuneration and Nomination Committees. For firms in scope, membership of each of these committees must be comprised of at least 50% of non-executives to ensure committees are sufficiently independent. Modifications are permitted under the IFPR so that group committees can be used if certain criteria are met.

There are new rules in relation to the composition of committees. These include all firms needing to have a policy to promote diversity, the disclosure of diversity targets, whether such targets have been met and any planned actions to remediate any shortfalls.

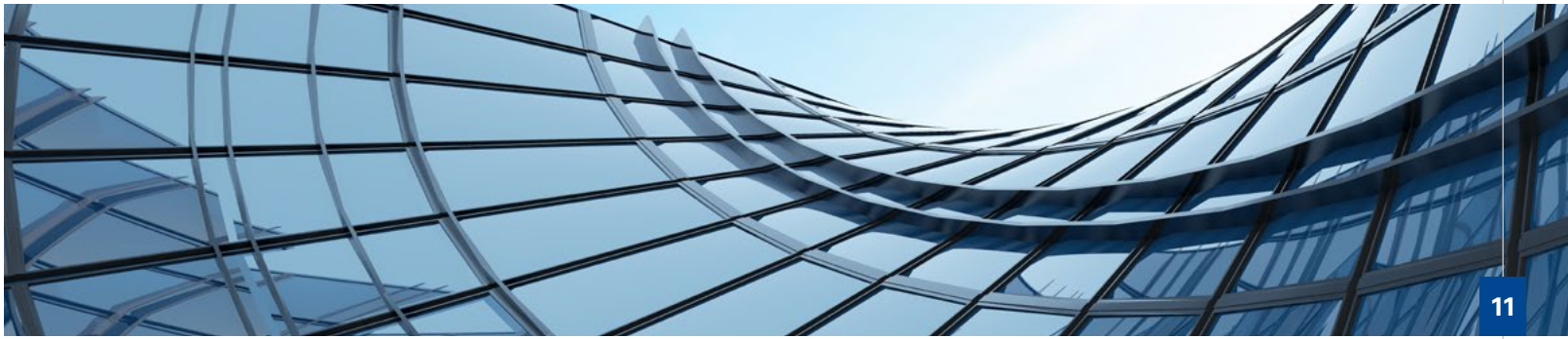
Do you intend to implement new governance committees due to the IFPR?



What is the average number of pages in the Board risk report?



5% of firms intend to make changes to the membership of governance committees



Trends in the data

- 90% of respondents do not intend to implement new governance committees due to the regime.
- Only one respondent intends to appoint new committee members due to the IFPR.
- 18% of firms intend to apply to use a group risk committee.

KPMG view

Governance has long been an area of focus for the FCA; historically our surveys have identified this as a key area of weakness identified during the SREP. As a result, we expect the largest firms in our survey (who are subject to the new IFPR governance committee requirements) to have already established the committees that are required under the IFPR. Therefore, it is not unexpected that so few firms are implementing new committees as many will already have these in place. This existing regulatory focus on governance is further reflected by so few firms intending to change the membership of committees. However, the FCA has stated that diversity and inclusion is a critical part of their work on governance and culture. Based on this regulatory scrutiny and the increased focus on diversity and inclusion within all firms, it is interesting to see that most do not plan to make changes to their committee membership. The IFPR will require that firms disclose their Board diversity policy and any actions that are being taken to ensure targets are being met. Therefore, we expect this will be an area of development following full implementation of the regime.

With the IFPR's increased focus on individual regulated entity governance, the key challenge for all firms will be to demonstrate that each Board takes ownership and is accountable for the risk management framework and financial resource assessments. Where firms currently rely on group committees, we expect increased scrutiny from the FCA on how risks are managed and overseen at the individual entity level. This challenge will already be a familiar one for the asset managers in our survey who have implemented changes to fund boards due to the FCA's focus on this.

Committee reporting is an ongoing area of challenge for many firms. While some may take comfort in providing substantial reports to the Risk Committee, reporting should also be succinct enough to enable committee members to focus on the most important risks and trends. Indeed we have observed an increased focus across the industry on more efficient and targeted reporting to facilitate more effective Board and Risk Committee discussions.

Pillar 1 capital requirements

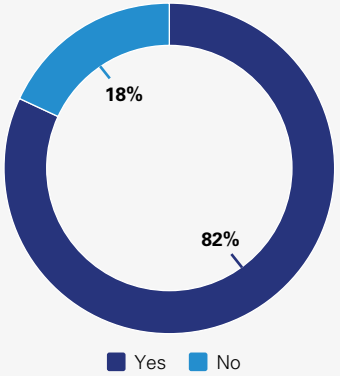
Impact of the IFPR

Pillar 1 capital requirements must be met from day 1 of the IFPR coming into force, therefore firms must be able to demonstrate compliance with these from 1 January 2022.

The IFPR introduces a new capital requirement, the K-factor requirement ("KFR"). The aim of this is to directly link capital requirements for investment firms to the risks and activities inherent in their business models, such as performing portfolio management services or holding client money.

While the KFR is new, the requirement to calculate the Fixed Overheads Requirement ("FOR") remains. Under the new regime, the Pillar 1 capital calculation is driven by the higher of KFR and the FOR. The FOR continues to be calculated based on the expenses of a firm; however, there are changes to the rules which may impact the calculation. For some firms the requirement will decrease as amortisation of intangible assets will be an eligible deduction from expenses. However, other firms may see increases as broadly defined deductions under the existing regime, such as for "variable expenditure", are removed from the new rules.

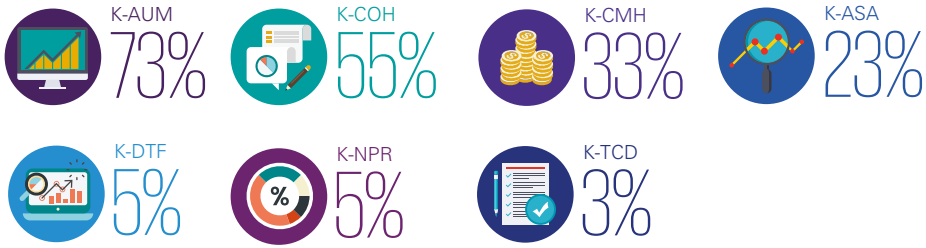
Has your firm quantified potential capital requirements under the IFPR?



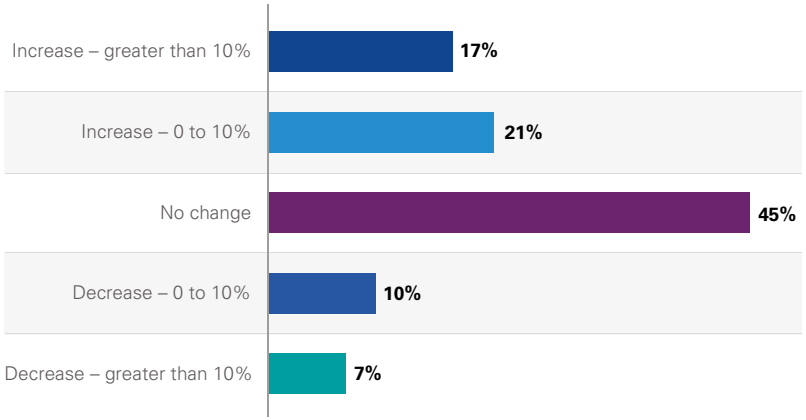
Trends in the data

- 82% of respondents have quantified potential capital requirements under the new rules. Of those yet to calculate the potential capital requirements under IFPR, the majority are smaller (P3) firms.
- The K-AUM, K-COH and K-CMH K-factors are those which are most likely to apply to investment management firms.
- 45% of respondents intend on calculating their K-factor requirements manually via spreadsheets, whilst 43% are opting to use a partially automated calculation.
- 28% of respondents are looking to internally develop their own automation tool to perform the KFR calculations.
- 38% of firms are expecting an increase in the FOR, while 17% are expecting this requirement to fall under the new. regime

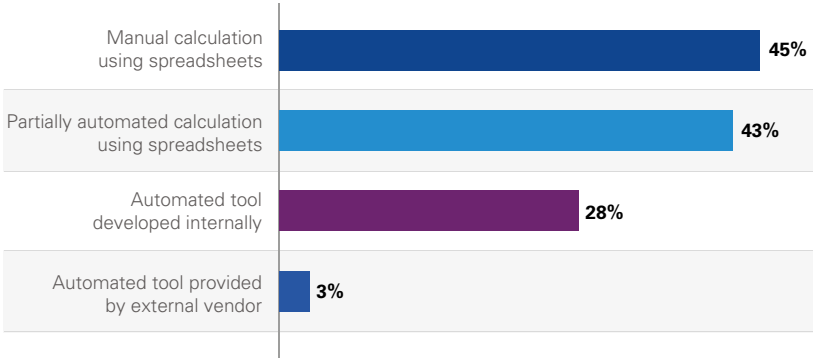
Percentage of firms in scope for each K-factor

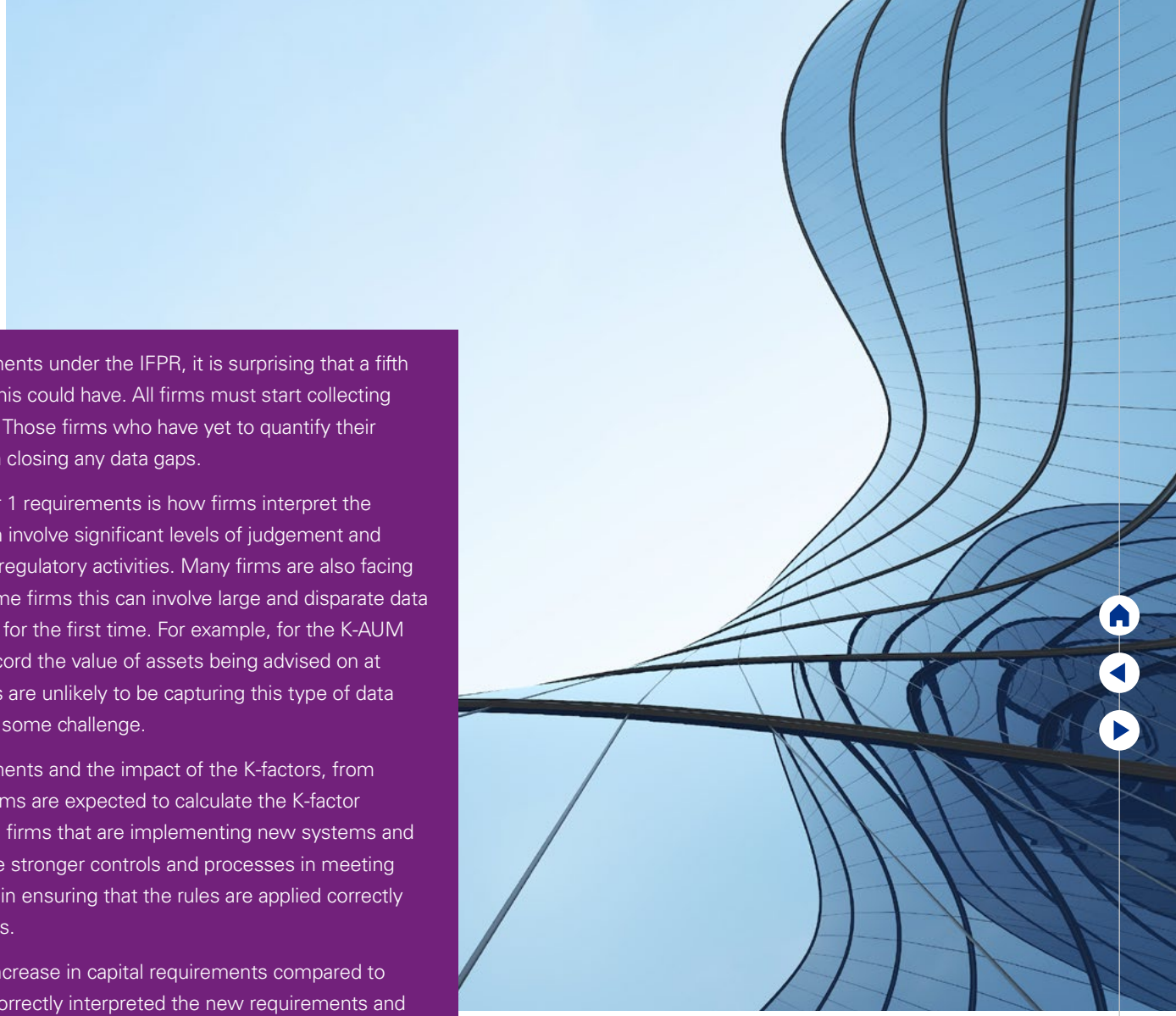


Expected change in Fixed Overheads Requirements (FOR) under IFPR



Approaches to calculation of the K-factor requirement under the IFPR: percentage of firms using the following approaches





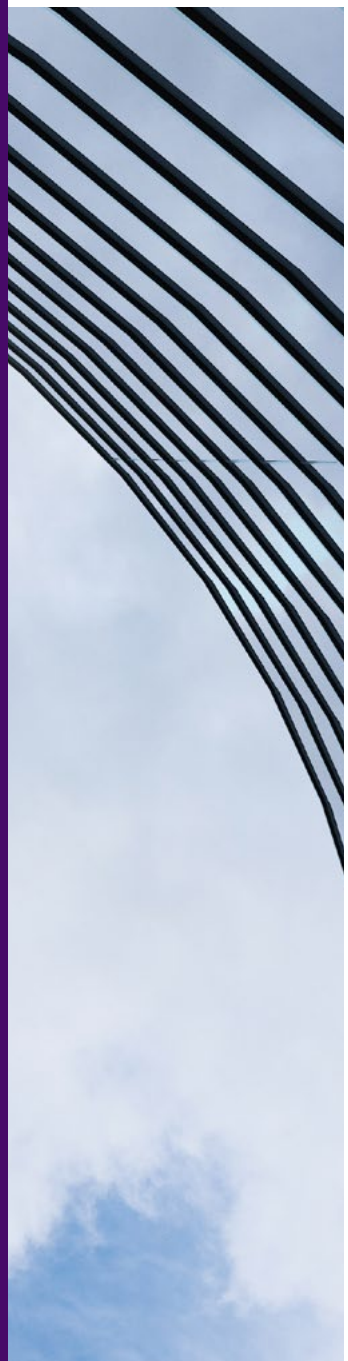
KPMG view

While the majority of firms have quantified their capital requirements under the IFPR, it is surprising that a fifth had not yet performed this exercise given the potential impact this could have. All firms must start collecting data to calculate the k-factor requirement from December 2021. Those firms who have yet to quantify their capital requirements under the new rules may find challenges in closing any data gaps.

The key challenge we observe in implementing changes to Pillar 1 requirements is how firms interpret the K-factor requirements for their specific business model. This can involve significant levels of judgement and complexity, especially where multiple entities perform different regulatory activities. Many firms are also facing difficulties in obtaining data to support their calculations. For some firms this can involve large and disparate data sets or implementing changes to systems to capture data fields for the first time. For example, for the K-AUM requirement, firms providing investment advice may need to record the value of assets being advised on at each point in time advice is provided. Some investment advisors are unlikely to be capturing this type of data currently; therefore, having to do so going forward may present some challenge.

Most firms expect the FOR to continue to drive Pillar 1 requirements and the impact of the K-factors, from a capital perspective, will be limited. Notwithstanding this, all firms are expected to calculate the K-factor requirement accurately, based on complete data sources. Those firms that are implementing new systems and automated solutions to support this may be able to demonstrate stronger controls and processes in meeting these requirements. However, the challenge for all firms will be in ensuring that the rules are applied correctly from the outset and whenever there are changes in the business.

For the FOR, a significant proportion of firms (38%) expect an increase in capital requirements compared to current rules; therefore, all firms should ensure that they have correctly interpreted the new requirements and appropriately applied these to their business model.



Risk management frameworks

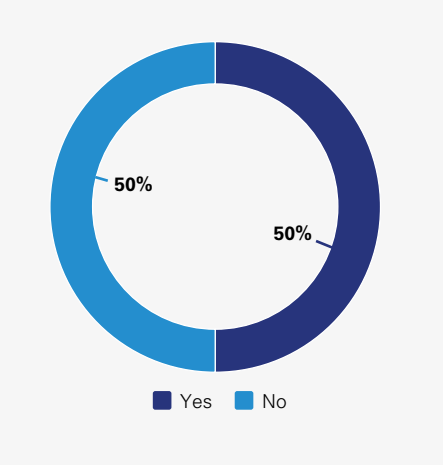
Impact of the IFPR

The IFPR introduces a requirement for firms to perform the Internal Capital Adequacy and Risk Assessment ("ICARA") process. Under the ICARA, firms are required to assess the harm they pose to clients and counterparties, the markets in which they operate and to the firm itself. This is a pivot in the way firms are expected to identify, mitigate, monitor and report on risks, focussing on an outward looking assessment of the harms they pose. All firms will need to continue to use the components of their overall risk management framework, such as their risk appetite statements, taxonomies and risk registers. However, the challenge for many will be in demonstrating this is an outward looking risk assessment and that this is embedded across the business. For some of these components, the ICARA rules introduce new requirements; notably there are specific 'triggers' for capital and liquidity levels which all firms must monitor. Breaches of these triggers require firms to notify the FCA.

14 Median number of risks the Board have set risk appetite statements for

37% of respondents with a GRC system are unable to leverage the full potential of the system across the 3 Lines of Defence in an integrated manner

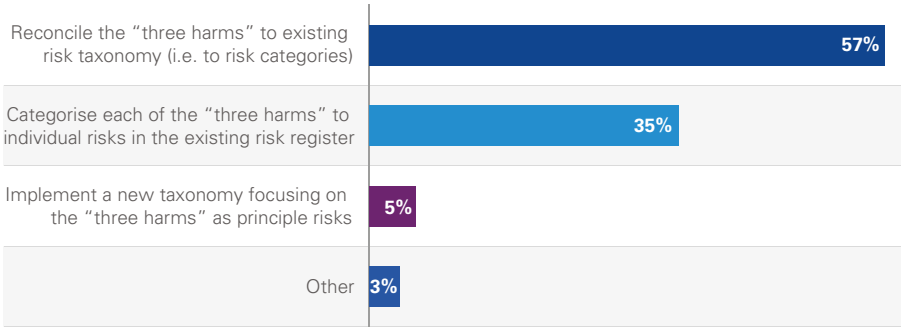
Do you intend to make changes to your risk management framework as a result of implementing the ICARA?



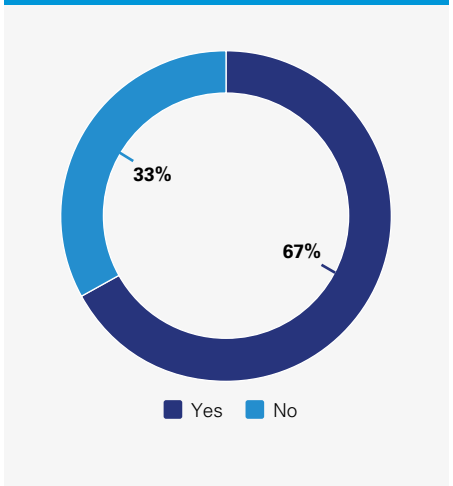
Trends in the data

- Half of our respondents intend to make changes to their current risk management framework as a result of implementing the ICARA.
- In terms of the actions firms are taking to reflect the new requirements, 57% are looking to reconcile the "three harms" to their existing risk categories and 35% are performing a more granular assessment of linking individual risks to harms.
- Just under half of firms (46%) intend to make changes to their risk appetite tolerances due to the introduction of the trigger requirements.
- In line with our survey from last year, over a third of firms are using Governance, Risk and Compliance ("GRC") systems as part of their risk management processes. Over 90% of firms think these systems are fit for purpose. However, just over a third do not leverage their GRC system across the 3 Lines of Defence (3LOD) in an integrated manner.

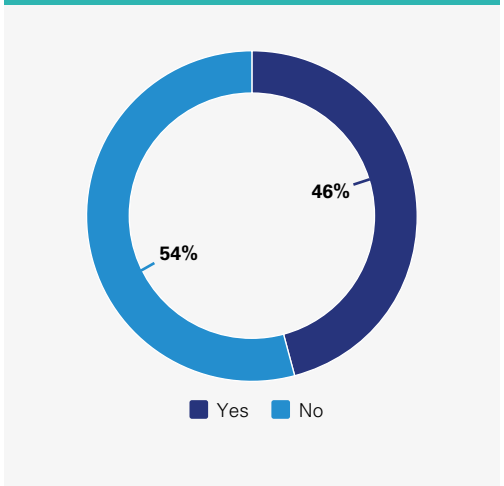
What actions will firms take to implement the ICARA process within their current risk assessment process?



Does your firm use a Governance, Risk and Compliance ("GRC") system as part of the risk management process?



Will you change your capital and/or liquidity risk appetite tolerances as a result of the FCA's 'trigger' notification requirements under the IFPR?



KPMG view

With the requirement to perform an outward looking risk assessment, including an explicit focus on risks to clients, it is surprising that half of firms do not expect to make changes to their risk framework to implement the ICARA process. For example, we would expect firms to implement changes to their risk appetite statements to reflect the FCA's "trigger" requirements. Where firms are not implementing changes, this suggests they are either comfortable that their current frameworks are appropriate for the new regime or that some are underestimating the impact of implementing the ICARA.

From our observations, many firms are focussing on the changes to the ICARA process document, with a more limited set of firms looking at wider expectations for the ICARA process. The ICARA process is an ongoing requirement and focusses on a firm's risk framework as a whole. In our view, this clearly aligns with the wider regulatory agenda, with a strong emphasis on how firms can impact on clients and markets. This is consistent with other key regulatory issues such as Operational Resilience and Consumer Duty. Therefore, firms should ensure that their risk framework sufficiently captures risks to clients and markets, and that it is consistently embedded across all functions (including for both financial and operational resilience).

Since our first report six years ago, we have observed greater and more effective use of technology, including GRC tools, by Risk functions. This looks set to continue under IFPR given the significant proportion of firms who assess their systems as being fit for purpose. We expect use of GRC systems to increase as firms look to manage risk in an efficient and consistent manner to implement the ICARA, including the harms assessment. It is not surprising that over a third of firms feel they are unable to currently leverage these systems across the 3 Lines of Defence ("3LOD"). Ability to do so if often constrained by both the types of systems used and key functions across the 3LOD adopting inconsistent approaches. In our experience where firms do use GRC tools across the 3LOD this can lead to a more effective risk framework, driving greater consistency and embeddedness of the approach to risk management. For Risk functions, new tooling presents an opportunity to take a more strategic approach to risk management. For example, new tools can simplify and automate risk management processes, such as risk event management or reporting, allowing Risk functions to spend a greater amount of time on strategic and emerging risk areas.

The ICARA document

Impact of the IFPR

Under the new regime, the ICAAP will be replaced by the ICARA. The new assessment requires investment firms assess harm to clients, markets and the firm itself, including quantifying capital and liquidity requirements to mitigate these harms. This represents a significant change for some firms whose existing own assessments of capital and liquidity can typically be inward looking and focussed on the impact of risk events on the firm.

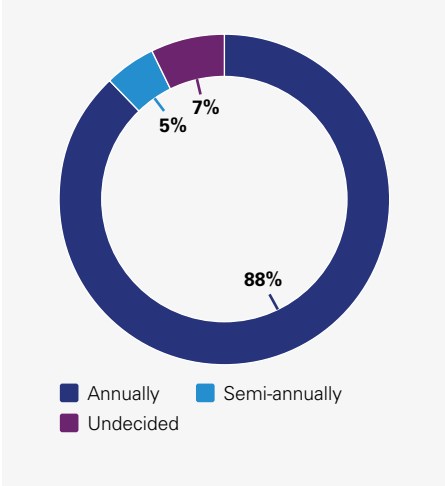
Firms can opt to perform the ICARA document on a group basis; however, the default requirement under the IFPR is for an entity level assessment. This is a significant departure from the current ICAAP rules where consolidated assessments are required. For firms with multiple entities in scope of the rules, an ICARA document for each entity could have a significant operational impact.

Alongside this shift in the assessment, the ICARA introduces new requirements for specific components of the document, such as recovery planning, and additional requirements for existing components. These will be new for all firms.

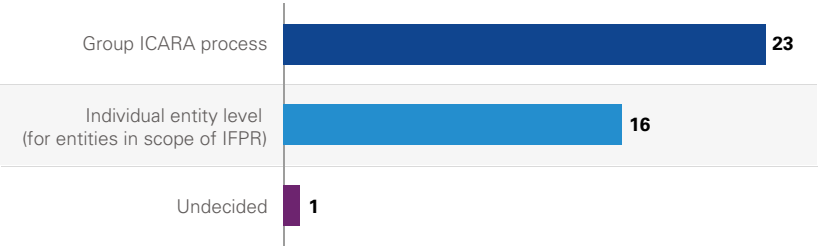
Trends in the data

- All firms, with the exception of one, have made a decision on whether to perform the ICARA process at Group or entity level. For P1 and P2 firms there is an even split in approaches. For P3 firms, 70% of firms are looking to perform the ICARA at Group level which is consistent with the current ICAAP approach.
- The frequency of the ICARA process appears to consistent with the ICAAP cycle, with the vast majority (88%) of firms continuing to carry out their assessments on an annual basis.
- 38% of firms expect to complete their first ICARA review for Board approval in Q2 2022.

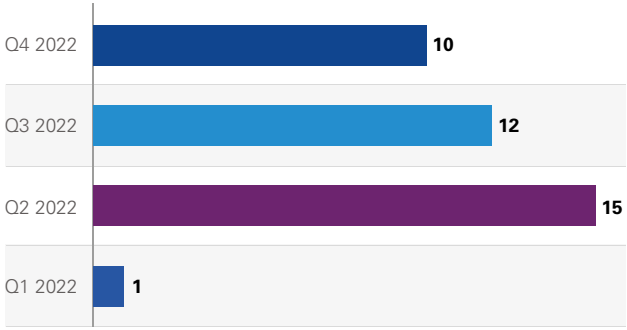
How frequently will firms carry out the ICARA process?



At what level will you perform the ICARA process under the IFPR?



When do firms expect the Board to approve the first ICARA review document?



KPMG view

Under the current regime, all firms are required to perform their own assessment of capital and liquidity requirements. Therefore, for firms with a mature ICAAP document, the ICARA represents an evolution in their process for assessing risk and adequacy of financial resources.

We have seen a marked improvement in the quality of ICAAP documents since we started the survey six years ago. With over half of firms 'opting-up' to performing a group ICARA assessment and almost all firms doing this on an annual basis, this likely reflects that most firms do not want to change their current approach unnecessarily

While a group ICARA approach is one that many firms are familiar with, performing the ICARA on an individual level may yield benefits for some firms through reduced capital and liquidity requirements due to the reduced scope and complexity of the assessment. Furthermore, the IFPR introduces additional requirements for individual entities which all firms must meet. Therefore, those firms electing to perform a group ICARA process will still need to make some assessments at a legal entity level.

In implementing the IFPR, we have observed some firms taking the opportunity to change the timing of their capital assessments and ICARA reference date. The FCA have been clear that firms can choose an ICARA assessment period that is suitable for their business. Therefore, this could present an opportunity for firms to perform their assessments at point in time where internal resources are under less pressure.

Regardless of the choice of approach to producing the ICARA document, all firms will need to ensure they meet the new requirements that are specific to the IFPR. In our view, this will require minor refinements to existing elements and more significant actions for new requirements.

Capital assessments

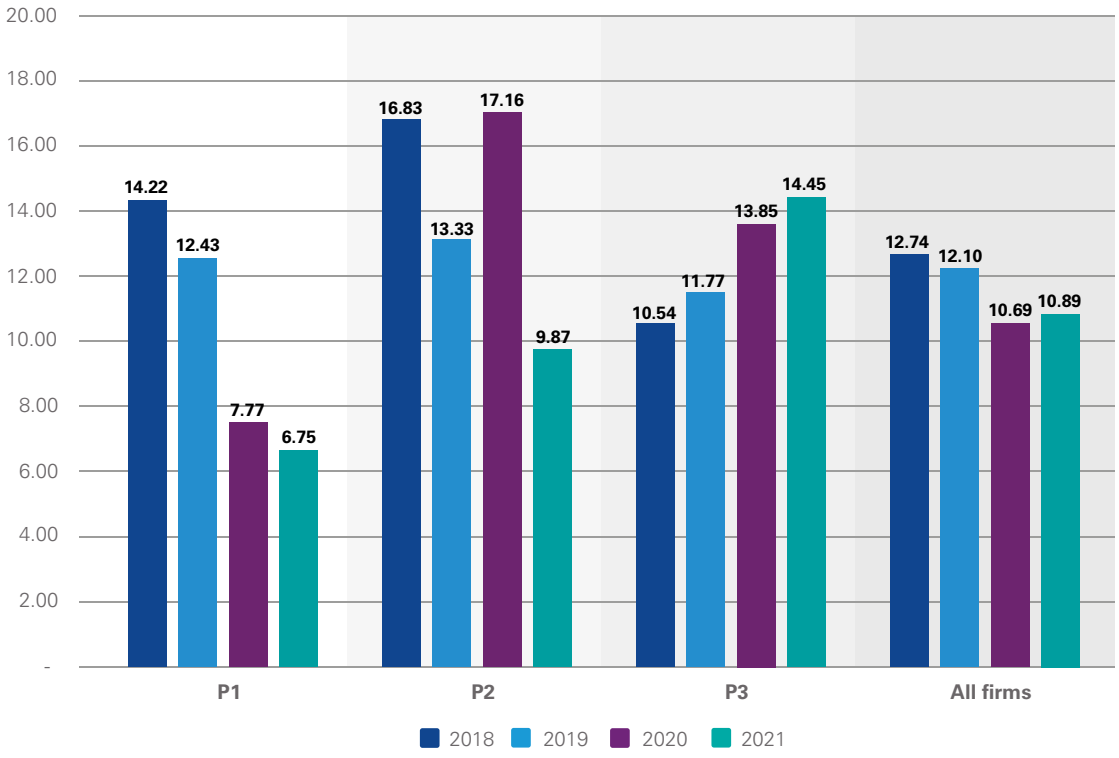
Impact of the IFPR

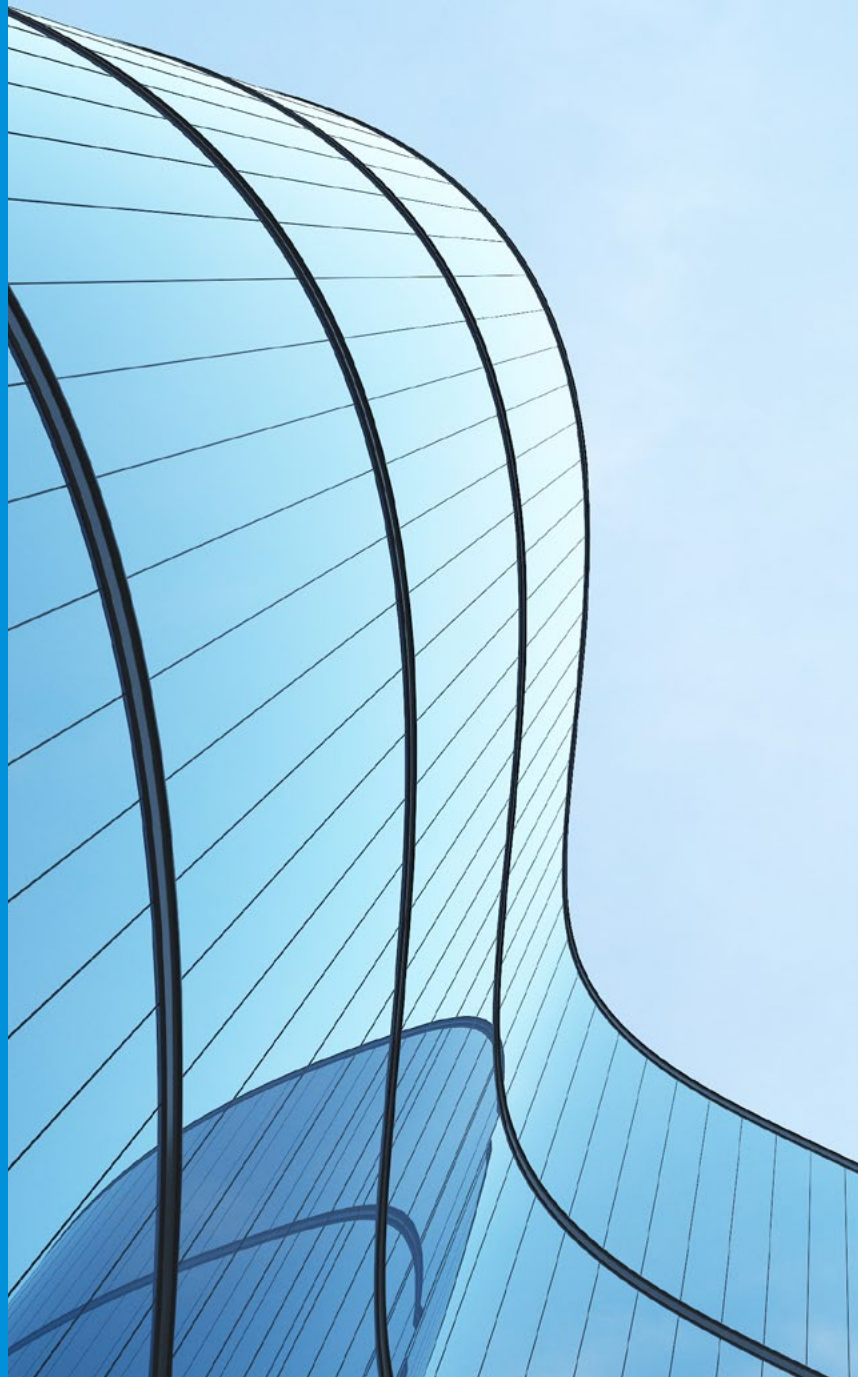
With a new regime in place, the approach and methodologies for assessment of a firm's capital requirements will inevitably change as investment firms transition to adopting the ICARA process.

The backdrop to this has already been set by the FCA in their Finalised Guidance 20/1 document on Assessing Adequate Financial Resources. This guidance focussed on the harms firms can pose and expectations for wind-down planning. Under the IFPR, the shift to identifying and assessing harms and additional capital required for wind-down is formally embedded as a key component of the new regime. The FCA will be able to set additional capital and liquidity requirements for all firms, including for wind-down.

This is a significant change from the current supervisory approach where the regulator has historically focussed on capital for ongoing requirements.

Assessments in the current ICAAP regime: median overall capital requirement as a proportion of AUM (in basis points)

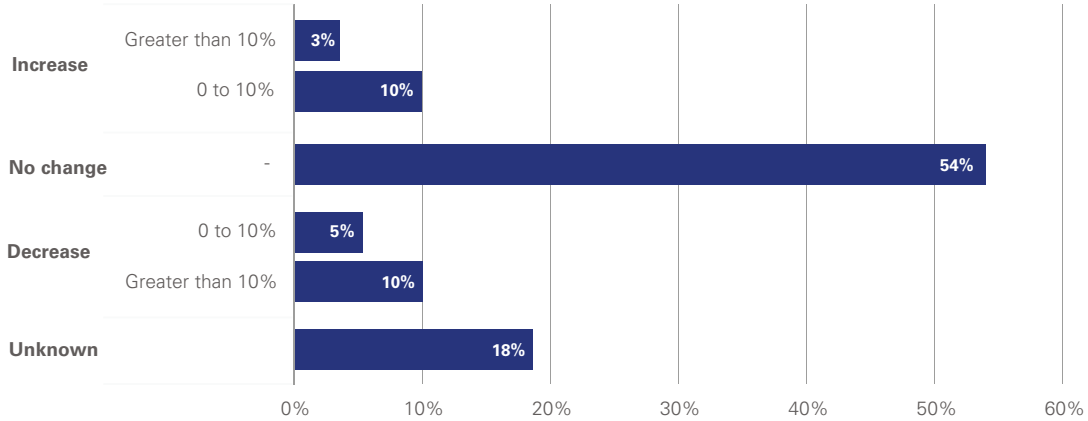




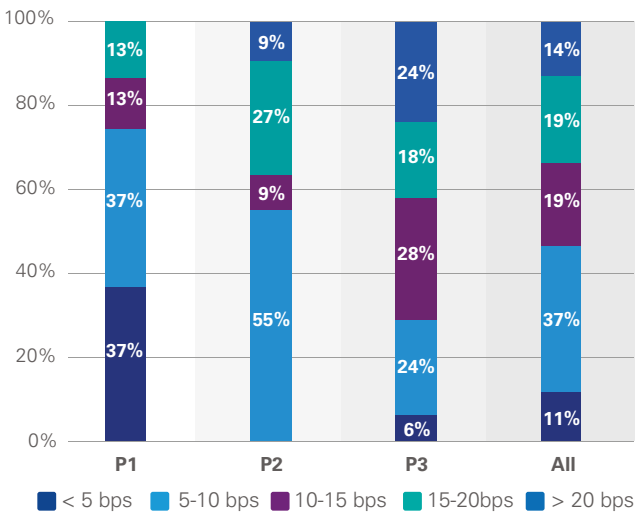
Trends in the data

- 70% of firms have seen an increase in their own assessment of capital requirements under the ICAAP, with 14% of firms seeing an increase of greater than 20%. The smaller, P3, firms in our survey drove the greatest increases.
- In terms of existing capital assessments, the median overall capital requirement as a proportion of AUM has remained stable at 10.89 bps (2020: 10.69 bps). Interestingly, there have been marked decreases for P1 firms (7.77 bps to 6.75 bps) and P2 firms (17.16 bps to 9.87 bps) which have been offset by an increase in median overall capital requirement for P3 firms to 14.45 bps (2020: 13.85).
- We continue to see significant variations in the amount of capital that all firms hold. While 48% of participants hold up to 10bps of AUM in capital, 33% hold over 15bps. While smaller firms are likely to hold proportionally more capital, this variation applies across all prudential categories.
- More specifically related to the ICARA implementation assessment, 54% do not anticipate any changes to capital requirements under the ICARA.

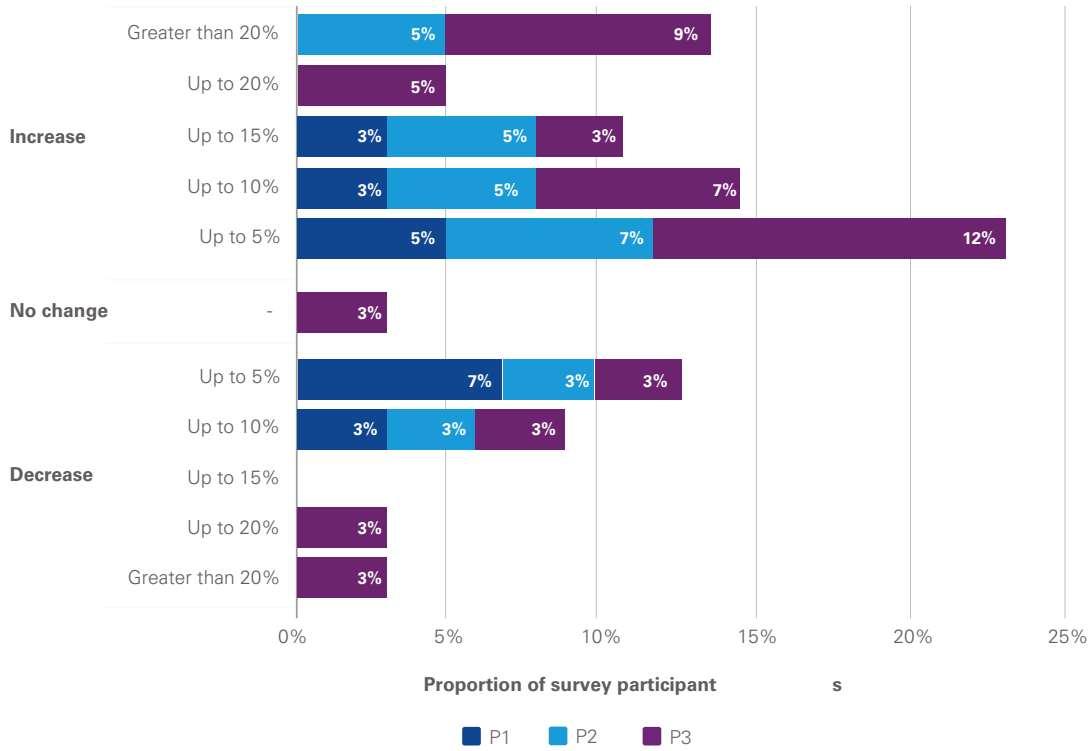
Change in own assessments of capital: how firms expect implementation of the ICARA to impact their capital assessment

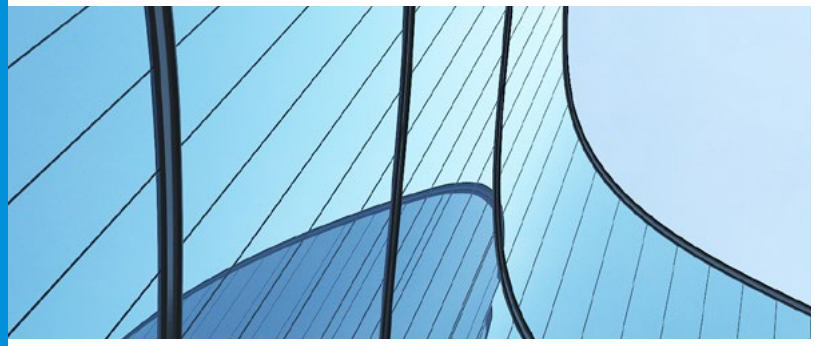


Overall capital requirement as a proportion of AUM (in basis points): percentage of firms in the following categories



Changes in own assessments of capital requirements: percentage change year-on-year by firm type





KPMG view

It is notable that once again, the majority of participants in the survey have increased their own assessments of capital requirements this year. Increases in firm's own assessments of capital are most likely driven by both firm specific and industry factors. Some participants have benefitted from the recovery we have witnessed in recent months resulting in significant growth in their businesses. With this growth, we would expect increases in capital requirements as the impact of risk events would naturally be greater. This could also be driven by changing risk profiles due to the emerging risks, such as those around 'greenwashing' for new products. While the pandemic has had a more limited impact on the investment management industry compared to other sectors, some risks have increased in materiality and could explain why some firms are holding additional capital.

Alongside firms increasing their own assessments of capital, we note a continuing trend in overall requirements; larger firms continue to have proportionally lower capital requirements than smaller ones. Our underlying data shows us that the absolute amount of capital held by larger firms has not fallen, suggesting that this change is driven by increases in AUM. As the IFPR directly links capital with assets managed, it will be interesting to observe whether this trend continues in future years.

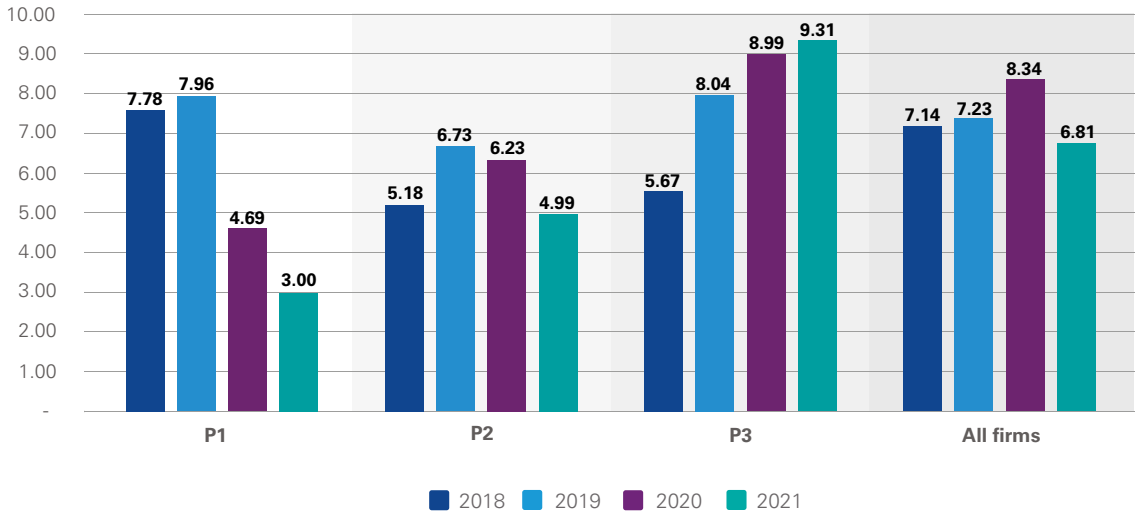
The wholesale change in Pillar 1 approaches under the IFPR is likely the driving factor behind both the expected changes in capital requirements as a result of implementing the ICARA. Firms expecting decreases are likely benefitting from removal of the credit and market risk rules that currently apply in the ICAAP. On the other hand, capital increases may be the result of a broader range of risks being considered in capital assessments (i.e. including risks to clients and markets) and more onerous requirements for wind-down planning. Many firms will take comfort in the fact that the majority do not expect these changes to be significant. However, given the ICARA rules are new for all firms, we are likely to see changes in the coming years as practices evolve and mature which impact on capital assessments in future.

Assessing harm - operational risk capital requirements

Impact of the IFPR

For the majority of investment firms, operational risk is the most significant component of their existing own assessments of capital requirements in the ICAAP. Under the IFPR there is a fundamental change in the nature of this assessment due to the introduction of the ICARA. Firms are expected to assess capital requirements for ongoing harms to clients, markets and the firm itself. Many firms are likely to base this new assessment on their current operational risk approach in the ICAAP. However, all firms will need to assess their existing methodology to ensure this adequately identifies harms and ensure that technical requirements for the ICARA assessment are met.

Assessments in the current ICAAP regime: median operational risk capital held as a proportion of AUM (in basis points)

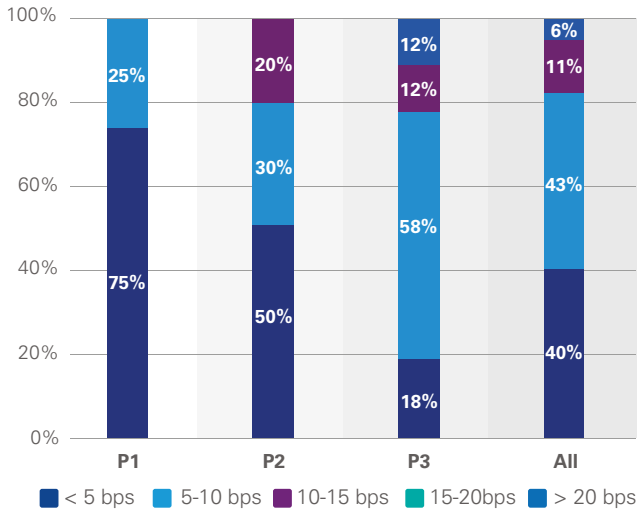


7 Median number of principal operational risk categories

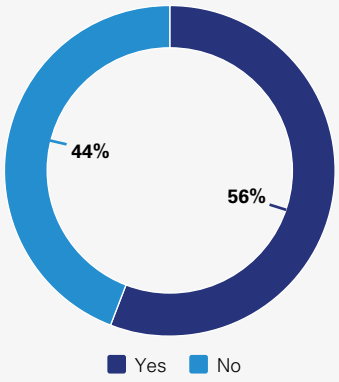
Trends in the data

- Across all firms, the median operational risk capital requirement (as a proportion of AUM) has fallen from 8.34bps in 2020 to 6.81bps.
- P3 firms had proportionally higher operational risk requirements, 24% holding more than 10bps in capital. This is a direct contrast to P1 firms with no respondents at this level.
- Firms continue to use operational risk models under the ICAAP with 55% of the firms in the survey adopting a model based approach as consistent with previous years.
- Under the ICARA process, 55% of respondents also intend on using an operational risk model for the "harms assessment". However, 8% of firms intend to change their approach under the ICARA (with some ceasing to use a model and others deciding to use one for the first time).

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



Do you intend to use an operational risk capital model for the "harms assessment" as part of the ICARA process?



Median number of operational risk scenarios developed across all firms by Basel category

KPMG view

Operational risk capital requirements continue to be an area where we observe significant variation across all firms in terms of the amounts of capital held. While the trend of proportionally higher requirements for smaller firms continues, we may see this peak this year as the IFPR provides an opportunity to recalibrate and rebase these assessments.

While we expect that firms will be able to develop their current operational risk assessments to align with the ICARA process, the key challenges will be in ensuring that 'material harms' have been thoroughly identified (including harm to clients), subject to a robust analysis and appropriately mitigated. While capital is one potential mitigant, the FCA's rules are clear that firms are expected to use the assessment to implement actions to manage and reduce the harm, where appropriate.

The FCA have explicitly stated that firms may continue to use statistical models for assessing risk under the ICARA process. It is notable that some firms are opting to use a model for the first time under the ICARA, while others have decided to stop using models and adopt a simpler approach. Where firms already use such models it can makes sense to continue to do so given this can produce a more robust approach to capital quantification. However, firms adopting a simpler approach could also see benefits in terms of reduced complexity and gain a better understanding of the capital assessment across the business as a result. However, all assessments will need to evolve to reflect the link between operational risk scenarios and the K-factors. For firms using a model this will likely require changes in the underlying methodology to demonstrate that capital is linked to K-factor activities.

Capital stress testing

Impact of the IFPR

The requirements and expectations for stress testing have been simplified in part under the new rules. All firms must perform capital stress testing and there is a regulatory expectation for more complex firms to perform reverse stress testing. Therefore, in practice, stress testing continues to be an important part of the ICARA process.

The IFPR also introduces a new requirement for all firms to document recovery actions. Recovery actions are actions firms would take to avoid breaches of requirements or to remediate any breaches in a timely manner; for example, reducing or cancelling dividend payments. Within the ICARA firms must also demonstrate robust governance and processes are in place to execute these actions, as well as considering the risks to the firm from implementation.

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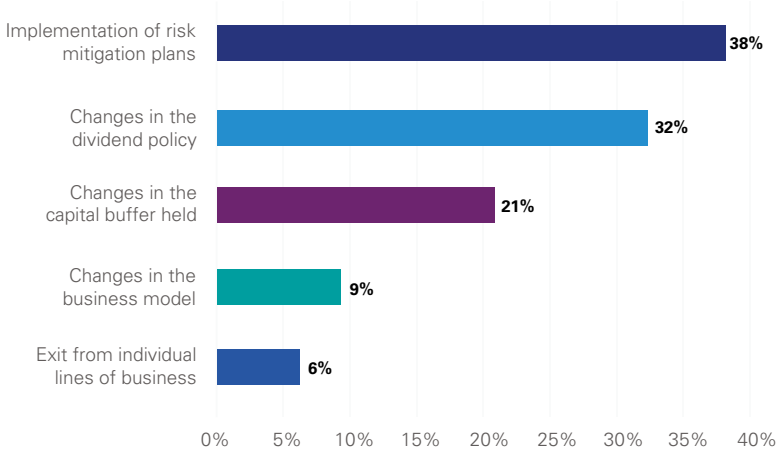
Actions firms have taken as a result of capital stress testing



Trends in the data

- The most common action taken as a result of stress testing is the implementation of a risk mitigation plan with 38% of firms opting for this. As a result of capital stress testing 32% made changes to the dividend policy whilst 21% made changes to the capital buffer held.

Median number of stress scenarios developed for the following categories

3

Idiosyncratic
(firm specific e.g. a single internal/loss event)

1

Macro-economic
(e.g. market downturn)

1

Combined stress test
(e.g. market downturn and an operational loss event)

KPMG view

Capital stress testing will continue to be an integral part of the ICARA process given the fundamental link between business planning and capital. Therefore, we would not expect to see significant changes in firms approaches to this under the ICARA. Fundamentally the business models of all firms continue to be exposed to the same strategic risks. Therefore, we expect the scenario types used for stress testing to continue to apply under the new regime.

With continued recovery from the COVID-19 pandemic, all firms should validate that their stress testing adequately reflects the new normal and risk landscape. We have observed many firms consider the risks around recovery from the pandemic as a key risk for stress testing analysis. Another emerging area, which many firms in our survey have identified, is Climate and ESG related risks. For most investment managers, the key Climate and ESG risks being considered relate to transition. Therefore, some firms in our survey have already started to stress their business model for climate and/or ESG related risks to understand potential medium-long term vulnerabilities in their business model.

The actions firms have taken as a result of stress testing can be used to develop recovery actions for the ICARA document. However, all firms will need to ensure that they have identified a full range of actions and can demonstrate these are credible and have been thoroughly assessed. For most firms we expect this will require a greater level of detail than in current ICAAPs.

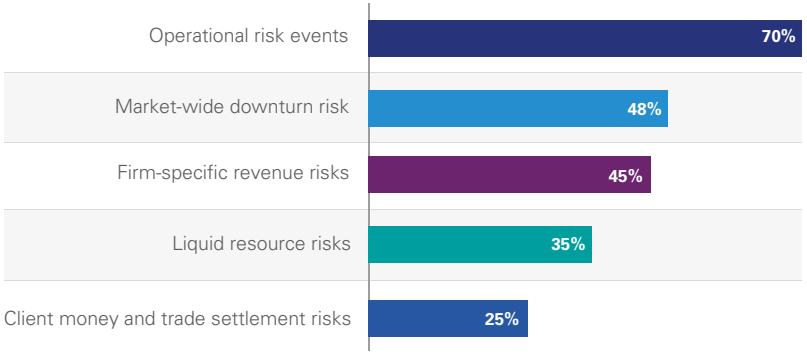
Corporate liquidity risk

Impact of the IFPR

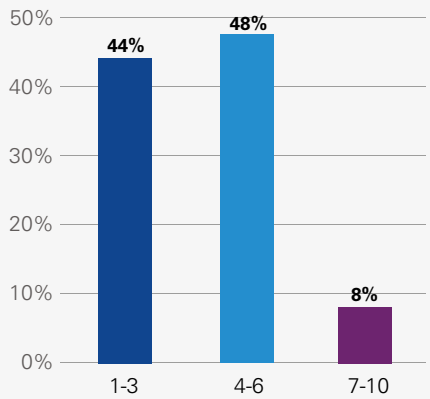
Under the IFPR all investment firms are required, for the first time, to hold a minimum amount of liquidity to cover demands as they fall due. This applies on both a legal entity and consolidated basis and is based on a prescriptive calculation under the rules. Firms can apply to the FCA to obtain a waiver from meeting this minimum requirement without the support of group entities.

However, all investment firms will also need to perform their own assessment of liquidity requirements as part of the ICARA process. This should cover ongoing requirements, including for stressed events, and requirements to wind-down the business in an orderly manner.

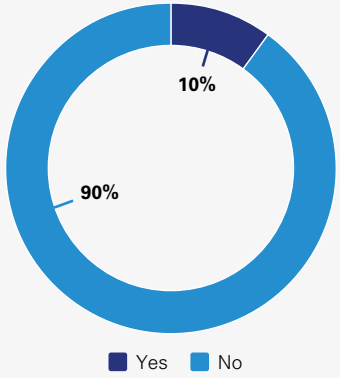
Percentage of firms considering the following risks in their liquidity stress testing



How many liquidity stress tests are firms performing?



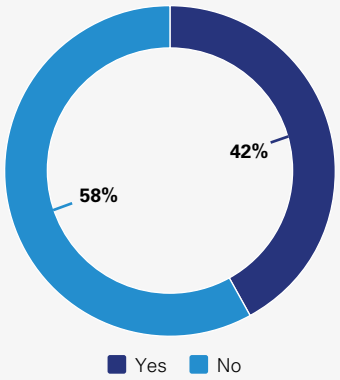
Do you intend to apply for a liquidity waiver under IFPR?



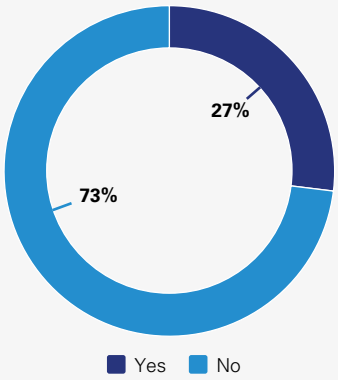
Trends in the data

- 48% of firms carry out between 4-6 stress tests.
- A broad range of liquidity stress scenario types continue to be performed with 70% of firms carrying out tests based on operational risk events (2020: 68%) and 48% utilising market downturn risk events (2020: 56%).
- In terms of the IFPR, 27% of firms will change the way they manage liquidity based on the requirements of the regime.
- Only 10% of firms intend to apply for a waiver from IFPR liquidity requirements.

Do you have committed external facilities or funding in place?



Will new IFPR requirements change the way liquidity is managed for in-scope entities?



KPMG view

The impact of the pandemic on markets and uncertainty posed by Brexit moved liquidity into an area of significant focus by the FCA. However, even pre-pandemic, liquidity was identified as one of the main areas of regulatory focus in our survey. We have observed some firms re-assessing their liquidity scenarios due to events since the start of the COVID-19 pandemic. This was a real liquidity test for some firms; so scenarios are likely to be based on the experience of firms during these events. This experience could explain the increases in the number and variety of liquidity stress tests.

The ICARA process brings together both capital and liquidity requirements under the overall financial adequacy rule. The formalisation of these requirements under one rule is not surprising given regulatory focus on liquidity. A quarter of firms changing their corporate liquidity management suggests that some firms will be significantly impacted by the new rules. However, as the majority of firms will not change their liquidity management approached under the IFPR, this does suggest that the FCA's focus on this area in previous years has led to the industry being well prepared for the new regime.

While the minimum liquidity requirement itself is a relatively simple calculation, in our experience the real focus will be on firms own assessments of liquidity risk and being able to demonstrate a complete and credible assessment has been performed. The regulatory guidance in this area has been available in Finalised Guidance 20/1 since last year. However, with additional requirements and guidance in the IFPR regime, all firms will need to consider this in developing their ICARA assessments for corporate liquidity risk. In our experience, firms often fall short in demonstrating that they have identified all liquidity risks relevant to their business model and typically rely on the same stress tests used for capital stress testing. While the two are linked, a full standalone assessment is the expectation under the IFPR. Firms will also need to ensure they have considered the additional technical requirements and guidance the IFPR introduces.

Wind-down planning

Impact of the IFPR

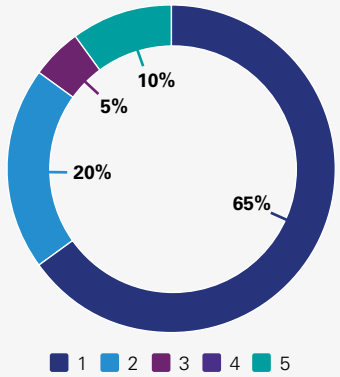
Prior to the development of the IFPR, wind-down planning was a component of the ICAAP based on regulatory expectations. Under the Overall Financial Adequacy Rule ("OFAR") investment firms will be required to hold the appropriate capital and liquidity to wind-down the business in an orderly manner. In addition to holding the appropriate resources, a credible wind-down plan must be set out at entity-level, including timelines of when and how plans are executed.

In addition to the requirements set out in the IFPR, the FCA have previously set out their expectations on wind-down planning in their Wind-Down Planning Guide. To demonstrate a credible wind-down plan is in place, the underlying assumptions must be aligned with the ICARA process, including assessing harm to clients during wind-down. This is particularly important when identifying wind-down triggers, which is a new concept for investment firms.

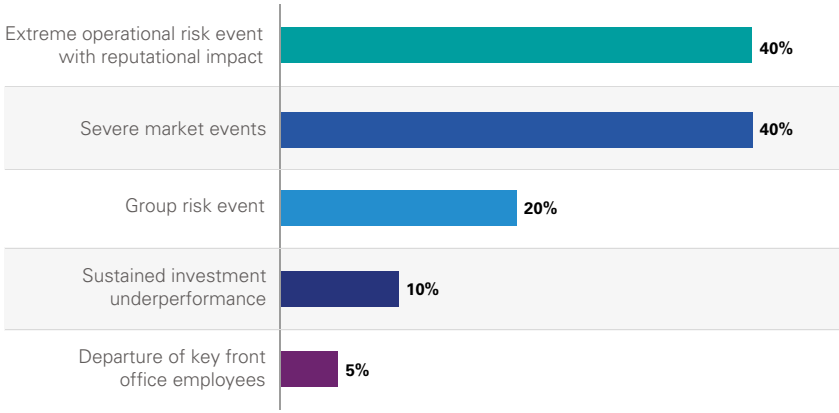
18 months

Median wind-down time period

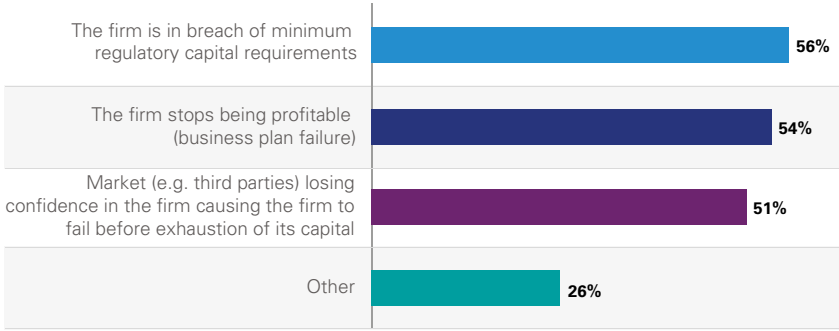
Number of wind-down scenarios: percentage of firms modelling the following number of scenarios



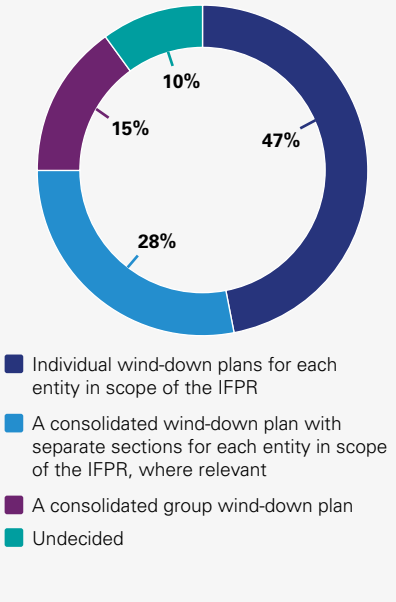
Proportion of firms including the following material risks in their main wind-down scenario



Percentage of firms including the following factors as points of failure used for reverse stress testing



Approaches to wind-down planning under IFPR: percentages of firms adopting the following approaches



Trends in the data

- 40% of respondents incorporate severe market events into their wind-down scenario. 40% also include an extreme operational event leading to a reputational impact.
- In terms of wind-down scenarios, 65% of firms base their modelling on just one scenario, with 10% using as many as five scenarios.
- In terms of the IFPR, 47% of respondents plan to set out individual wind-down plans for each entity in scope of the IFPR, whilst 28% are putting in place a consolidated wind-down plan with separate sections for each entity in scope. It is worth noting that 95% of P1 and P2 respondents are adopting these two approaches. Therefore, it is the smaller (P3) firms who intend to continue to perform consolidated wind-down plans.

KPMG view

Formalisation of the wind-down plan requirement in the IFPR will lead to greater consistency in the way firms identify capital and liquidity requirements for wind-down costs. As a result of the formal requirements, we expect to see more FCA scrutiny on these plans. In the current regime, we observe that firms have typically taken a variety of approaches to quantifying wind-down requirements for capital and liquidity. However, the focus in the IFPR rules on specific wind-down requirements, including assessing harm to clients and markets from wind-down, will put the onus on firms to demonstrate that their plans are realistic.

In our experience these plans can be highly subjective, which is reflected in the range of different scenarios firms use for developing the wind-down plan. With a formalised requirement and undoubtedly increased scrutiny from the FCA, all firms need to be able to demonstrate the assumptions and modelling in their plans are credible and focused on the risks of wind-down to clients and markets.

The requirement to perform wind-down planning for each authorised investment firm will have a significant impact for firms with multiple regulated entities. While some expect to be able to perform a single wind-down plan, the challenge will be in demonstrating that each regulated entity has been fully considered in these plans. Where this is not the case, firms will open themselves up to regulatory challenge.

Remuneration

Impact of the IFPR

The IFPR will introduce the MIFIDPRU Remuneration Code which will see new requirements on remuneration policies and practices.

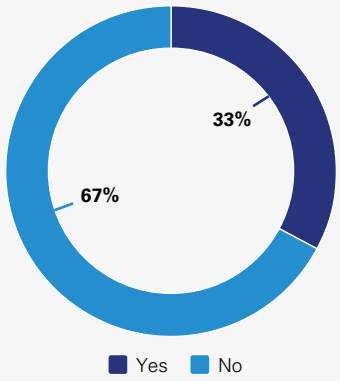
The nature of the remuneration requirements that need to be applied will be determined by the investment firm's regulatory category with larger firms (non-SNI firms meeting on-and off-balance sheet thresholds) being subject to the more prescriptive extended requirements. These requirements include the payment of 50% of variable remuneration in non-cash instruments and the deferral of at least 40% of variable remuneration over 3 years.

All non-SNI firms will be required to set out a ratio of fixed to variable remuneration. However, there is no maximum to this ratio, unlike the equivalent regime for banks. All variable remuneration must also be subject to risk adjustment provisions.

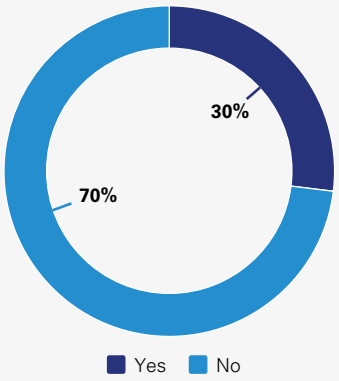
These provisions enable a firm to withhold deferred remuneration before it is paid out (referred to as malus) and to recoup remuneration after it is paid out (referred to as clawback) where risk events or adverse performance outcomes occur post award or payment. For some investment firms this will be a new requirement compared to existing regimes.

As well as the new Remuneration Code, the FCA also sets out quantitative disclosure requirements for all FCA investment firms, with the largest firms having to set out the number of Material Risk Takers ("MRTs") identified and the amount of variable and deferred remuneration they receive. Qualitative disclosure requirements also apply with all FCA investment firms being required to provide a summary of performance criteria across the firm.

Do you expect to be subject to 'extended' remuneration rules under IFPR?



Have you/do you intend to change reward structures and terms for employees due to the IFPR?

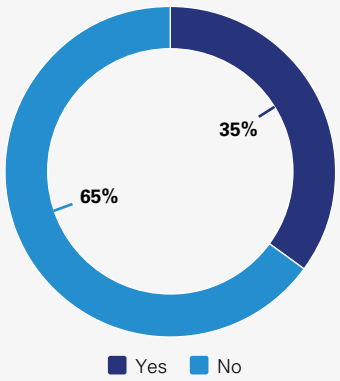


97% Percentage of firms undecided on the IFPR fixed to variable remuneration ratio

Trends in the data

- Our observations from this survey are that firms are still undecided on the "appropriate ratio" of fixed to variable remuneration.
- A third of firms are expected to be subject to the 'extended' remuneration rules.
- Although there is uncertainty on the specific aspect of setting the ratio, 30% of respondents intend to change their reward structures.
- 35% of firms expect the number of material risk takers to increase under the new rules.

Has the number of material risk takers in your firm increased due to the IFPR?



KPMG view

The impact of remuneration requirements varies depending on which (if any) of the FCA's Remuneration Codes currently applies. However, with over a third of firms identifying more MRTs, all non-SNI firms should ensure they have captured the right employees in this assessment given the new criteria set out in the MIFIDPRU Remuneration Code. The most significant changes are likely to be for those firms who are expected to be subject to the 'extended' remuneration requirements, although all non-SNI firms will now need to meet the rules on setting a ratio for fixed to variable remuneration and have malus and/or clawback policies in place.

As the new requirements will need to be applied for performance periods from 2022 onwards, the key actions we see firms taking now are assessing their status against the thresholds to determine which category of rules apply, identifying any new employees in scope, reviewing reward structures and implementing new policy requirements. Given this can take time, all firms should act now to ensure they meet the new Remuneration Code from the outset, although there is a little more time until the pay-out rules will need to be met for those with annual performance periods.

With only weeks to go to the regime coming into force, it is surprising that almost all firms continue to be undecided on their approach to identifying an appropriate ratio for fixed and variable remuneration. We observe that many firms intend to adopt a flexible approach to this requirement, primarily led by a review of their current reward structures and the level of variable remuneration within these.

How can KPMG help?

IFPR calculation support

The new IFPR rules will change current approaches to quantifying capital and liquidity requirements and will therefore represent a challenge to most firms. We have supported a number of firms in assessing the quantitative impact of these changes in order to provide greater certainty around capital and liquidity planning ahead of the implementation date of the IFPR.

Our role

We assist in assessing the quantitative impacts of the IFPR either through performing indicative calculations on behalf of clients, or by reviewing client prepared calculations and providing feedback. This includes an assessment of the following:

- Firm classification.
- K-factor requirements: scope, methodologies and calculations applied.
- Fixed overheads requirement: identifying changes to the requirement and quantifying impact.
- Capital resources: calculation of capital resources under the new regime, identification of any changes compared to current approaches and quantifying the impact.
- Liquidity requirements: quantifying liquidity requirements and liquid resources under the IFPR, based on current treasury management approaches.

The typical output is a KPMG report, or memorandum, on the results of this assessment, including a summary of key impacts.

Outcome

This enables firms to understand any capital and liquidity planning impacts of the new regime and prepare for these in time for implementation.

Board and functional training sessions

The governing body are ultimately accountable for meeting a range of IFPR requirements, with explicit regulatory expectations for the board. Therefore, all board members must be aware of the requirements applicable to them and regulatory expectations of the IFPR.

IFPR requirements cut across multiple functions of firms (Risk, Finance, Operations, Compliance, Human Resources), with many unaware of the specific impact on areas they are responsible for. Therefore, a training session on the core requirements of the IFPR helps to provide individuals and functions with the required knowledge needed to assess the impact.

Our role

We have provided IFPR implementation training sessions for both board members and key functions from across the business. The objective of the training is to provide attendees with an overview of the requirements of the IFPR and support boards and functions in their implementation process.

The technical training covers all key aspects of the IFPR, including capital, liquidity, the ICARA, governance, remuneration, reporting and disclosure. As an output of the training, we include a training pack which summarises each component and identifies the underlying applicable regulatory rules and guidance. The training can be customised to the firm's current approach in order to identify any key differences for each component under the new regime. Functional attendees for technical training typically include teams from Risk, Finance, Operations, Human Resources and Compliance.

Outcome

As a result of the training, individuals assigned responsibility for implementing each component of the IFPR have an awareness of the key requirements for each component and an understanding of the key changes relevant for their firm and function. This supports the implementation of the regime across the business.

IFPR impact assessments

We have worked with a number of firms to assist them in providing a view on the impact of the IFPR on their business model and to set them up for a focused implementation across all functions of the business.

Our role

Through a top-down assessment, we support firms in identifying the areas of the IFPR which will have the greatest impact on their existing operating model to enable them to prioritise their implementation efforts. The assessment report outlines the key IFPR changes by theme; considers these in the context of the firm's business and operating model; assesses impact using a red/amber/ green rating; and identifies key actions required to ensure compliance with the new regulations. The assessment covers key areas, such as consolidation, capital, liquidity, the ICARA, governance, remuneration, reporting and disclosure.

Outcome

Through the top-down assessment, firms can identify and plan for any key changes to their operating model required under the IFPR. This facilitates early identification of changes required and therefore allows for a considered and targeted approach to implementation.

Implementation programme support and oversight

A number of firms are seeking ongoing advice and support in planning for and implementing the changes required under the IFPR. We have been working with these firms on an ongoing basis to provide an external and independent viewpoint on the emerging regulatory rules and guidance.

Our role

Our implementation oversight work provides ongoing support to firms throughout their own IFPR implementation projects. This includes giving ongoing advice on key assumptions and decisions, where required, as well as attending periodic meetings to discuss areas of focus in the industry.

A final component of our programme support is an independent assessment of the way in which the firm has implemented key components of the IFPR, providing management assurance on the extent to which requirements are met.

Outcome

Through our programme support and assessment we provide confidence to the board on the firm's adopted approach; and enable the early identification of any remediation actions that are required, prior to the IFPR coming into force.

IFPR regulatory reporting

The IFPR introduces a new range of regulatory reporting requirements for all MIFIDPRU investment firms. This includes financial resource reporting on capital and liquidity through to the outputs of the ICARA review process and remuneration. The new reporting structure will require firms to implement new processes to ensure that accurate and complete regulatory reporting is provided to the FCA.

Our role

We are working with a number of clients to provide them with support in preparing for IFPR regulatory reporting for the first time. This includes:

- Assessment of the design of governance, process and control arrangements relating to a firm's IFPR regulatory reporting;
- Assessment of the accuracy of calculations used for regulatory reporting against IFPR regulatory requirements; and
- Assessment of the documentation of the key regulatory reporting interpretations, assumptions and judgements.

The output of this is a KPMG report outlining any observations on the key areas above as required. We are currently working with a number of clients to provide this based on 'dry-runs' to enable complete and accurate reporting from April 2022 onwards.

Outcome

Our support of regulatory reporting implementation under IFPR enables Management to improve the quality of regulatory reporting arrangements prior to submitted the first set of IFPR regulatory reporting and to demonstrate to both internal stakeholders and the FCA that these are fit for purpose.

ICARA process review support

The ICARA process document will replace the ICAAP in the existing regime. As a result, firms need to understand how their current approach to the ICAAP can be used for the ICARA, the key differences between the two assessments and the steps that need to be taken for a successful implementation in 2022.

Our role

We are currently working with a range of investment management firms to assist in the implementation of the ICARA process review for the first time. This includes providing both ongoing support throughout the ICARA process review and performing a formal assessment of the ICARA process review document prepared by firms.

Ongoing support

Our key ongoing support includes:

- Assessment of the current approach adopted in the ICAAP to identify areas which can be adopted for use in the ICARA process document;
- Identifying any key gaps in the current approach compared to the regulatory requirements for the ICARA process;
- Review of key judgements, interpretations and proposed approaches adopted by firms to validate these prior to implementation; and
- Providing ongoing advice on the practical steps firms can take to implement key parts of the ICARA process review (such as the harms assessment or documenting recovery actions).

ICARA process document assessment

Following our ongoing support, we will perform a formal assessment of the draft ICARA process review document against regulatory requirements of the IFPR and our observations of industry practice. The output of this review is a KPMG report setting out any observations, graded by priority and recommendations for areas of improvement.

Outcome

Through both our ongoing support and our formal assessment of the ICARA document, firms can obtain an external view on their approach to implementation. Providing ongoing support enables us to provide firms with advice on the approach taken and to validate key approaches prior to implementation. Our formal assessment of the ICARA document further enables Management to identify and remediate any potential areas of challenge prior to review by the Board and Senior Management. This also supports both the Board and Senior Management in demonstrating appropriate governance around the first review of the ICARA process review document.

Remuneration advice

The MIFIDPRU Remuneration Code applying to performance periods beginning on or after 1 January 2022 will see new requirements on identifying staff, payment of bonuses and principles for remuneration policies, along with associated qualitative and quantitative disclosure requirements for remuneration.

Our role

KPMG Law's Financial Services Regulatory team can support firms with:

- Determining the key implications of the new rules through impact assessments and gap analysis;
- Identification of Material Risk Takers;
- Advice on changes required to incentive schemes to meet the new rules;
- Reviewing and updating remuneration policies;
- Advice on staff communications;
- Provision of training to legal, compliance and HR; and
- Provision of expert updates on the developments / commentary

As a multi-disciplinary firm, we can work with our colleagues in other parts of the business, such as in Risk Consulting, Reward Consulting and KPMG Law's Employment team, to provide you with increased industry insight and peer benchmarking.

Outcome

By providing tailored and multi-disciplinary advice we can support firms with their full implementation project from identifying key issues to updating policies, procedures and incentive schemes.

Contacts

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