



## Right from the start

Why investment firms need better  
capital adequacy assessments

Risk and ICAAP benchmarking survey 2015

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# from the start



## Why investment firms need better capital adequacy assessments

Could investment firms' actions today be storing up problems for tomorrow? Our 2015 risk and Internal Capital Adequacy Assessment Process (ICAAP) benchmarking survey reveals how omissions or errors in the fine detail of Financial Conduct Authority (FCA) submissions could have substantial knock-on effects.

In some cases, firms could be compelled to hold up to double the capital that they had calculated. This could restrict their ability to

operate successfully and respond to industry changes like new pension rules, which compel firms to invest in innovative investment solutions and distribution channels. Restricted available capital will limit the ability of firms to invest and grow.

It's not all bad news. Some of the 2015 findings indicate that aspects of risk and ICAAPs are improving, especially in terms of more widespread board ownership of the processes, and more robust capital calculations. But the overriding feature remains that in fundamental areas – like Risk Appetite Statements (RAS), insurance mitigation, and diversification – current practice is exposing firms to

a real risk of being required to seek substantially more capital at short notice.

For most firms, the ICAAP submission is their only opportunity to show the regulator they have robust risk management processes in place. As the ICAAP is a firm's articulation of its overall approach to risk management, a robust framework and best-practice submission will not only help firms meet the regulator's expectations – it will also protect them from unforeseen and damaging consequences.

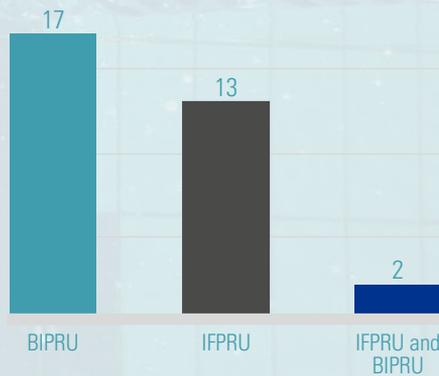
## About the research

This report, which was conducted in Q3 2015, is based on a study of 32 investment firms, excluding banks. Their businesses include a mixture of traditional asset management, platform, wealth management and hedge fund activities. Of the firms that participated, 21 provided us with a copy of their ICAAP document. As most ICAAPs are developed for a group of companies, some participants noted that their primary business included more than one of the types of businesses noted above.

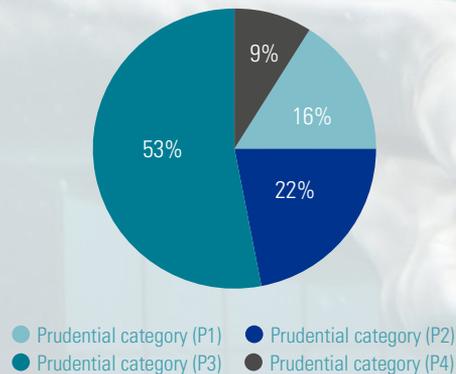
Participants manage client assets ranging from £4bn to £300bn, comprising institutional, retail, high net worth individuals, platform and other similar types of asset.

Firms were split more or less evenly between prudential sourcebook for banks, building societies and investment firms (BIPRU) (56 percent) and prudential sourcebook for investment firms (IFPRU) (44 percent), which includes two participants who are part of the same group (one BIPRU the other IFPRU).

### Firms within the scope of BIPRU or IFPRU



### Prudential categories of participating firms



by David Yim

# Introduction

Welcome to this new research from KPMG. In previous years we have covered risk management and the ICAAP as part of our broader Financial Reporting by Investment Managers survey. This year, however, in response to growing demand from our clients and greater complexity in some areas of risk management and the ICAAP, we have commissioned a separate report on the subject that drills down into more detail.

It's clear from our findings that firms are taking risk management and ICAAP much more seriously and devoting more time and resource to these imperatives. This is encouraging. But in the absence of formal guidance from the regulator, it's important that firms stay on top of the issues and have the clearest possible insight into best practice.

By shedding light on the latest practices and offering a view on the most important areas of focus, this benchmarking report is intended to help firms understand not only how to meet

the regulator's expectations, but how to improve overall risk management processes.

## Summary of results

Of the survey participants, 69 percent noted that their firm was subject to a Supervisory Review and Evaluation Process (SREP). Of these participants, 86 percent received an Individual Capital Guidance (ICG) and in more than half (58 percent) another form of capital add-on.

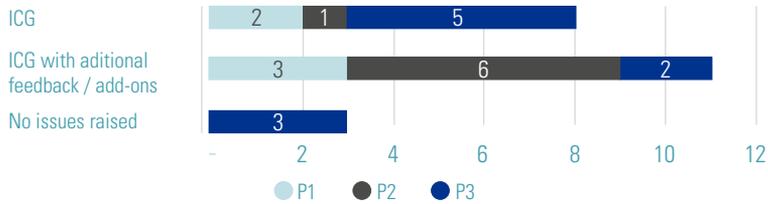
SREP reviews identified operational risk modelling as an area of focus at 32 percent of firms reviewed, while RAS and related key risk indicators (KRIs), and governance and culture were picked up at just over a quarter of firms.

In addition to the above, prudential category 2 firms were subject to particular attention for their scenario analysis, treatment of diversification benefits and wind-down plans.

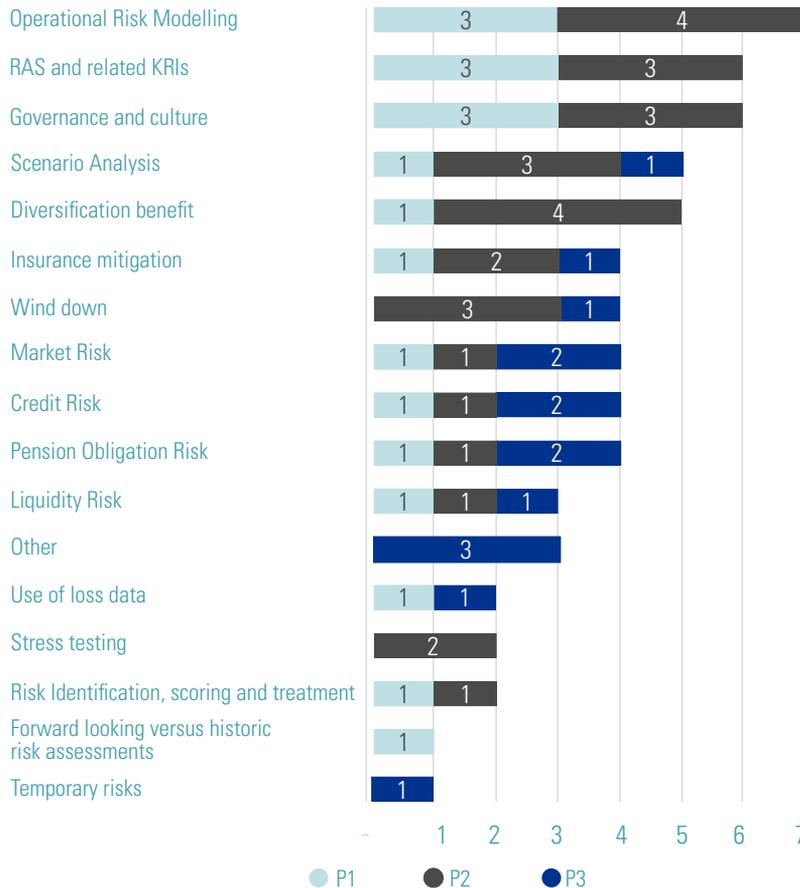
On an overall basis the total capital add-on given to companies by the regulator (ICG, scalars and fixed add-ons) has increased from prior year to current year for prudential category 1 and 2 firms. The capital add-ons across all participants ranged from 110-440 percent (2014: 130-300 percent).

Prudential category 3 firms in the survey noted no scalars or fixed add-ons, but the question is whether these firms can really take comfort in these results? 37 percent of the responses from firms who received an ICG were prudential category 3 firms. Of these ICGs it is not clear whether it was provided by the FCA or Financial Services Authority (FSA).

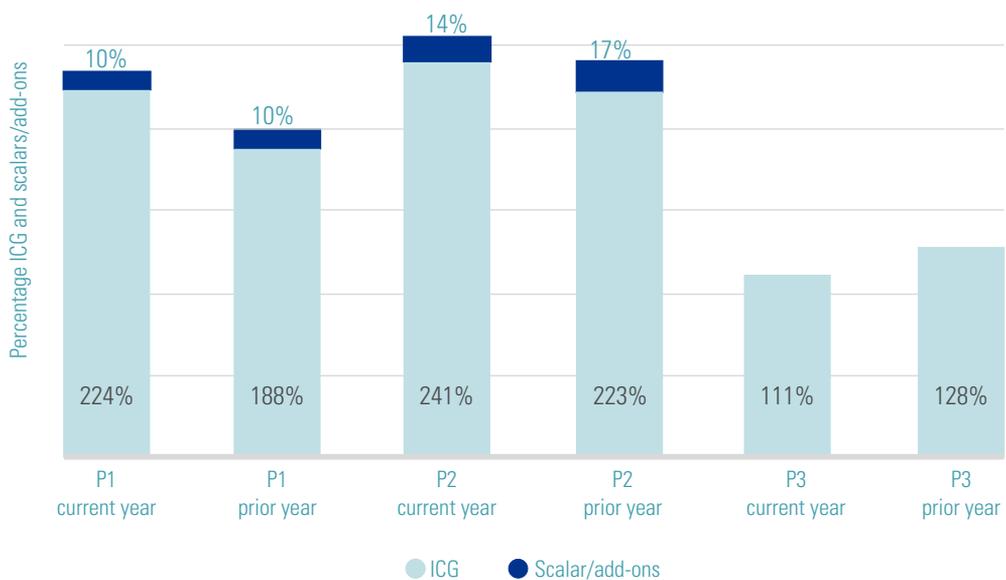
### What was the outcome of the last SREP review for firms per prudential category

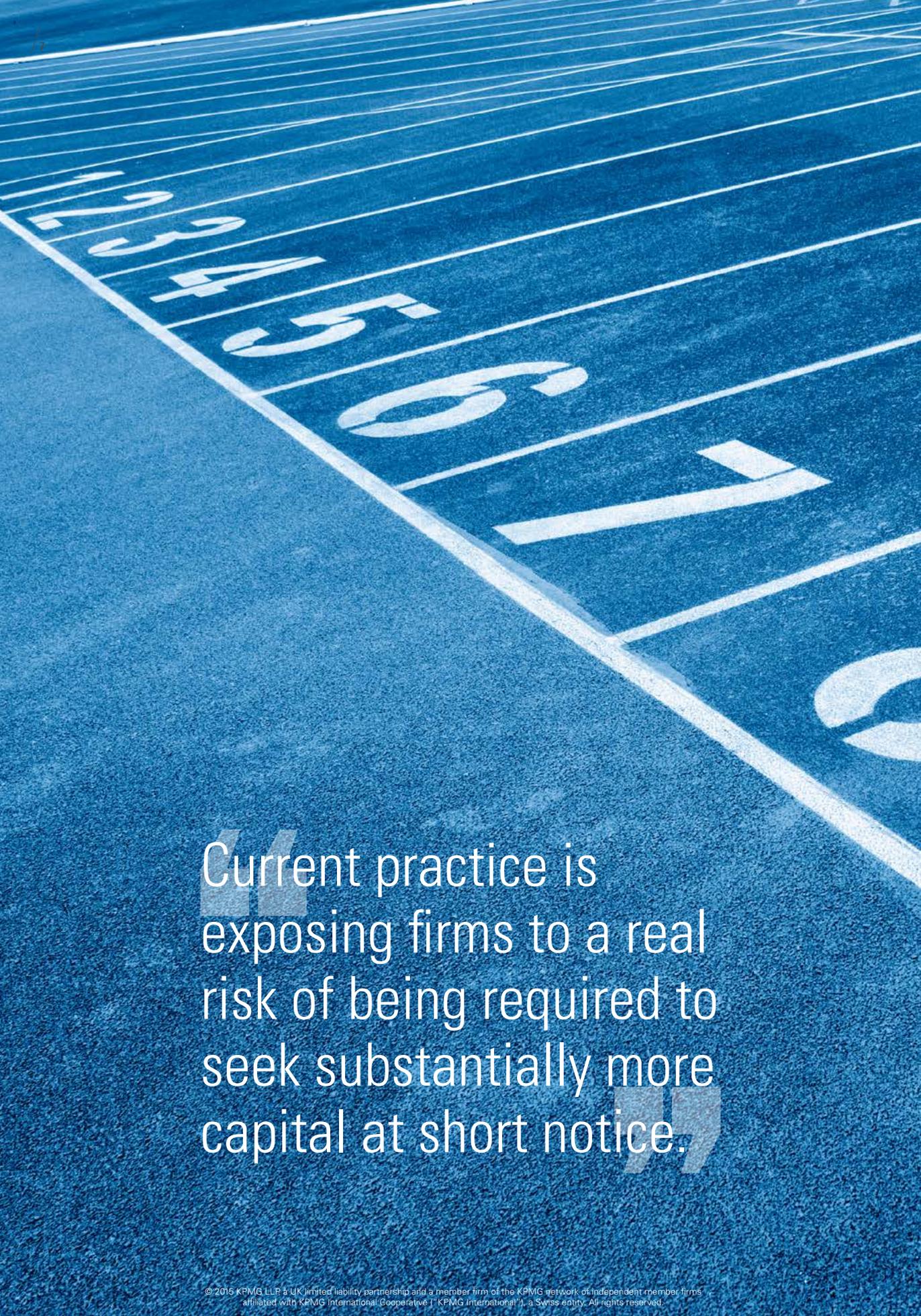


### Issues identified for firms during SREP reviews per prudential category



Average ICG and scalar per prudential category for 2014 and 2015





“Current practice is exposing firms to a real risk of being required to seek substantially more capital at short notice.”



# Uncertain appetites

**The RAS is a fundamental building block of the risk management framework. It should clearly define and embed the firm's attitude to risk. Yet we found that in over 50 percent of cases, these statements fell short of the quality and detail needed to define the risk appetite on which the firm's risk management framework is based.**

## Risk appetite lacks clarity

Based on the ICAAPs reviewed, 52 percent did not articulate risk appetites for individual risk categories. Just under half of ICAAPs (43 percent) included neither quantitative nor qualitative methods.

## Disconnected from the business

Of the ICAAPs received only 33 percent of firms had alignment between the business strategy, RAS, KRIs, key risks, risk categories and treatment of those risk categories in the capital adequacy assessment process.

However scrutiny of the survey results also reveals a positive message, with 88 percent of participants reporting that they have KRIs. Failure to include these in the ICAAP is a missed opportunity for firms that have limited communication with the regulator.

## Board ownership and regular review

While there are clear opportunities to improve the RAS themselves, our study revealed that in most cases, the board now has ownership of the RAS, with specific risk functions or committees owning the RAS in fewer than 28 percent of cases. Another positive finding was the frequency of which respondents now review their RAS. While all

firms review their RAS annually, 16 percent update it on a more frequent basis.

## Feedback from the regulator

Of the ICAAPs that were subject to a SREP review, 27 percent received commentary on their RAS from the FCA.

“Without appropriate risk appetites, firms are unable to accurately determine their capital requirements – and are therefore exposed to the risk of holding insufficient capital to cover losses.”

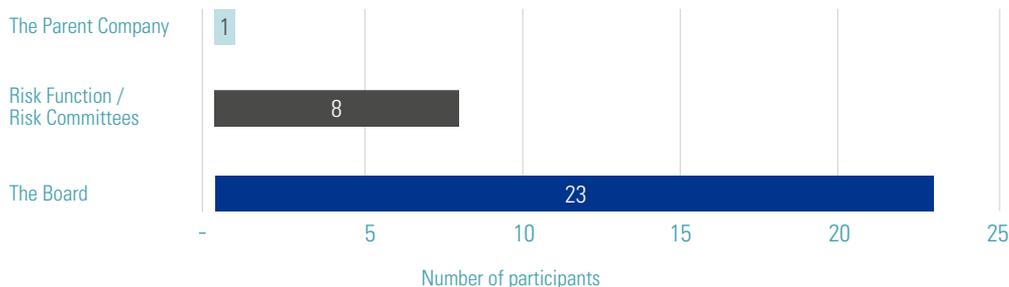
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of cases, risk appetite is not aligned with business strategy, key risks and KRIs

52%

of ICAAPs reviewed did not articulate a risk appetite for individual risk categories

#### Who owns the RAS



#### An urgent area of focus

It is encouraging to see the degree to which boards have taken ownership of the RAS and the way in which firms are recognising the need for the RAS to be regularly reviewed.

However of the risk appetites we studied, over half were deemed inadequate. When firms do not appropriately develop, define and monitor the risk appetite for each

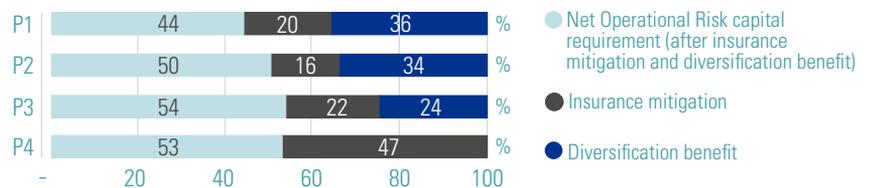
key risk and risk category, there are important consequences. Boards and senior management may not get sufficient early warning of the risks the business takes on, which makes it more likely that the risk appetites will be exceeded. Without appropriate risk appetites, firms are unable to accurately determine their capital requirements – and are therefore exposed to the risk of holding insufficient capital to cover losses.

RAS are fundamental. If firms get them wrong, then it is likely that other important elements of the risk framework, like key risk identification, are incorrect too. There is an urgent need for firms to look more carefully at these statements.

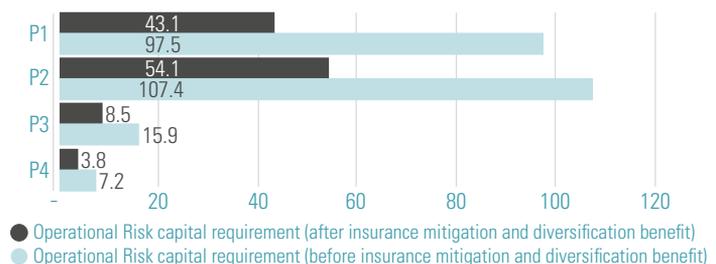
# Mitigating circumstances

**While insurance mitigation and diversification benefits can take a sizeable chunk out of capital requirements, the devil is in the detail. The most striking finding of our report was that inadequacies in applying insurance mitigation, coupled with confusion over the technical requirements of how diversification should be applied, could expose firms to very damaging demands for additional capital.**

Breakdown of average total operational risk capital requirement, insurance mitigation and diversification benefit taken per prudential category



Operational risk capital requirement per prudential categories (£m)



“If the FCA disallows both a firm’s insurance mitigation and diversification benefit, its capital requirement could double in value. This may restrict its ability to invest in growth strategies.”

### Raising the bar

The use of insurance mitigation has decreased in 2015, with 44 percent of participants now making use of it compared to 50 percent in the prior year. The average mitigation has decreased from 29 percent to 24 percent across the full population of those surveyed. However when removing a single outlier, the average insurance mitigation across all prudential categories is 18 percent.

When determining and deriving insurance mitigation, the majority of firms consider insurance policy

terms and caps on the amount of insurance. Yet only half of those firms that take insurance mitigation consider factors such as length of time for payment and review, challenge and approval by the risk function. Only 36 percent consider historical events that required insurance pay outs.

We understand that going forward the FCA will apply a more sophisticated approach when assessing the level of insurance mitigation. Our results indicate that firms generally need to enhance their approach in order to justify the insurance mitigation they can take.

### Average value of insurance mitigation (£m) taken by firms

The chart illustrates the average monetary impact for firms by prudential category if the FCA had to remove all of the insurance mitigation applied by companies.



### Diversification demystified

While 41 percent (2014: 44 percent) of participants reported using diversification benefit to reduce capital requirements, only 15 percent of these firms indicated that their considerations were based on correlation – the probability of scenarios occurring at the same time independently of one another. This is in spite of the clear guidance to firms set out in the Basel framework to base analysis of diversification on correlation.

The majority of participants who take diversification benefit did not consider all of the guidance in accordance with Basel framework, such as developing a specific diversification methodology for their firm, using individual experts or functions to develop each diversification percentage, or having the diversification benefit challenged by the risk function.

### Average value in diversification benefit (£m) taken by firms

The chart illustrates the average monetary impact for firms by prudential category if the FCA had to remove all of the diversification benefit applied by companies.



### Deep impact

Lack of attention to the small print can have profound consequences. In the worst-case scenario, if the FCA disallows both a firm's insurance mitigation and diversification benefit, its capital requirement could double in value. This may restrict its ability to invest in growth strategies.

With the regulator examining insurance mitigation with greater

rigour, firms need to review policies more closely. Many have already received feedback from the FCA in this area.

The FCA is raising the bar on how firms apply insurance mitigation and is looking for more detailed assessments around areas such as the adequacy of policies and how long it takes them to pay out.

Diversification is another clear area of concern, given the degree

to which firms are applying it incorrectly. Not only does it need to be clearly based on correlation according to the Basel framework, it must be backed up by a strongly supported rationale and based on evidence.

# Better risk identification

**Firms are gradually getting better at risk identification, involving more stakeholders from across the business and factoring in loss experience. However, there is more work to be done to ensure that the risk management frameworks are effective and fully embedded in the business.**

## Enhanced stakeholder engagement

Our survey reveals that the business is now more closely involved in identifying risks. Participants responded positively to the involvement of the board, risk function and subject matter experts from across the business in the risk identification (85 percent of participants) and scenario development (65 percent of participants) processes.

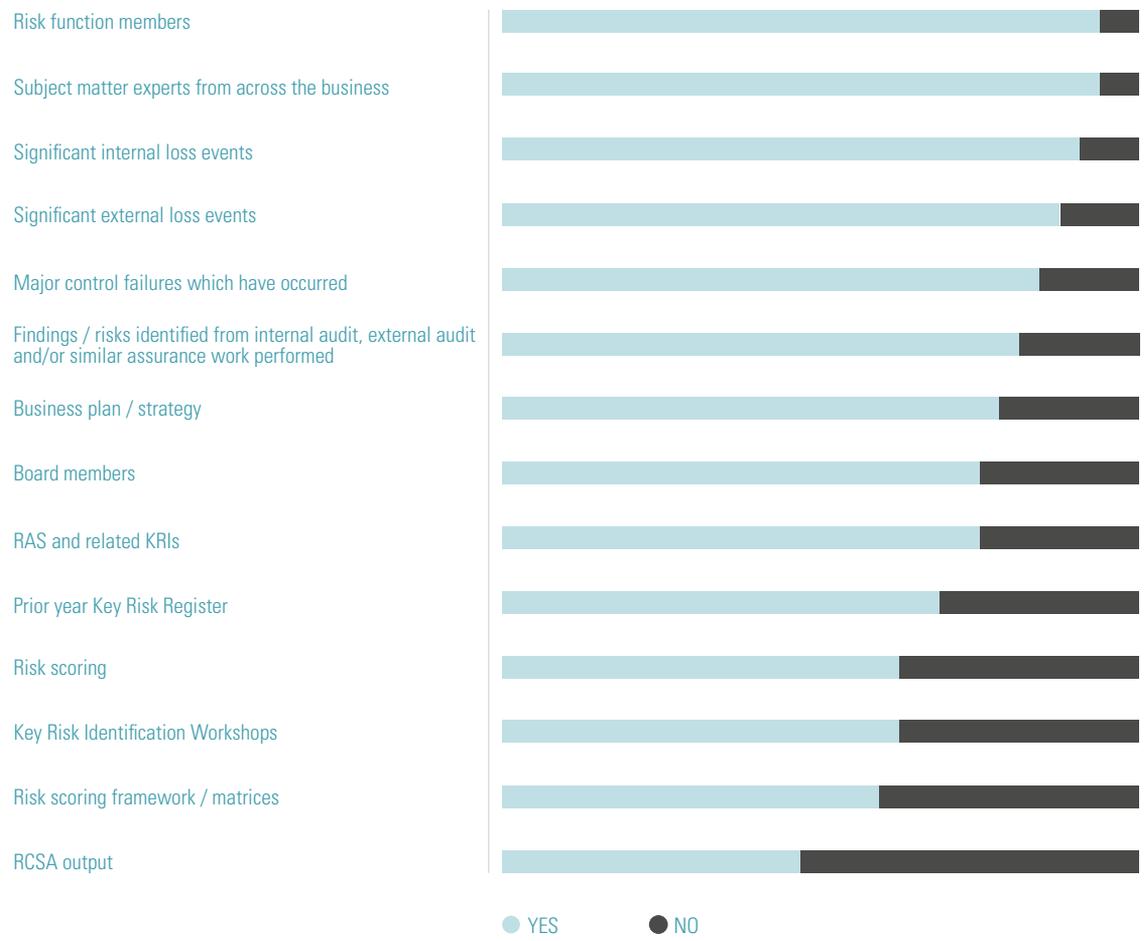
Furthermore, firms considered a range of risk factors in the risk identification (over 70 percent of participants) and scenario development (55 percent of participants) processes, such as Risk Control Self-Assessment (RCSA), internal and external loss events, significant control failures and the results from internal and external audits.

## Areas for improvement

While there is better cohesion in risk identification, only 14 percent of firms clearly articulated key risk and scenario owners in their ICAAPs. In addition, as we identified earlier, 67 percent of firms had misalignment between their business strategy, RAS, key risks and KRIs, and 22 percent of firms do not make use of a risk scoring mechanism. This suggests that there is more work to be done to embed risk processes across the business and ensure effective monitoring.

“Assigning clear ownership for key risks and scenarios will make for more effective risk monitoring.”

Does the key risk identification process include any of the following?



**Creating strong foundations**

Only by identifying the right risks in the first place can firms calculate appropriate capital requirements. While our findings show that businesses are taking a more cohesive approach to identifying and scoring risk, there are many opportunities for improvement.

The use of risk scoring will help firms ensure they correctly

identify key risks and validate scenarios used for capital modelling, while assigning clear ownership for key risks and scenarios will make for more effective risk monitoring.

By adopting these practices, firms will put in place appropriate risk frameworks and processes that will embed risk management in the business effectively.



“ A robust risk management process, clearly articulated in the ICAAP, will not only help firms meet the regulator’s expectations - it will also protect them from unforeseen consequences. ”



# Orderly conclusion

**Rather than simply showing a financial analysis, the FCA requires that wind-down plans within the ICAAP must clearly demonstrate the processes and actions needed to achieve an orderly wind-down. While our findings suggest a growing recognition of the need for more robust planning, there is much more that firms need to do to ensure that wind-down plans meet the regulator's expectations.**

## Longer wind-down periods

In our survey, 56 percent of participants indicated a wind-down period of 6-12 months (2014: 63 percent), while 9 percent of firms reported a period of less than three months. This year, 31 percent of participants told us their wind-down period was longer than 12 months, more than double the 13 percent in 2014. This indicates that the industry is becoming more aware of the intricacies involved in the wind-down process.

## To stress or not to stress

Only 19 percent of participants have plans that consider a wind-down in both stressed and unstressed market conditions. For most firms, therefore, there is the possibility that wind-down capital requirements could be understated because they do not sufficiently consider the range of scenarios in which the firm could wind-down.

Similarly, of the ICAAP documents we analysed, only 14 percent included an operational loss event in the wind-down plan. Again, this implies that capital requirements could be understated because of scenarios that have not been considered – this is another area of focus for the regulator.

## More challenge needed

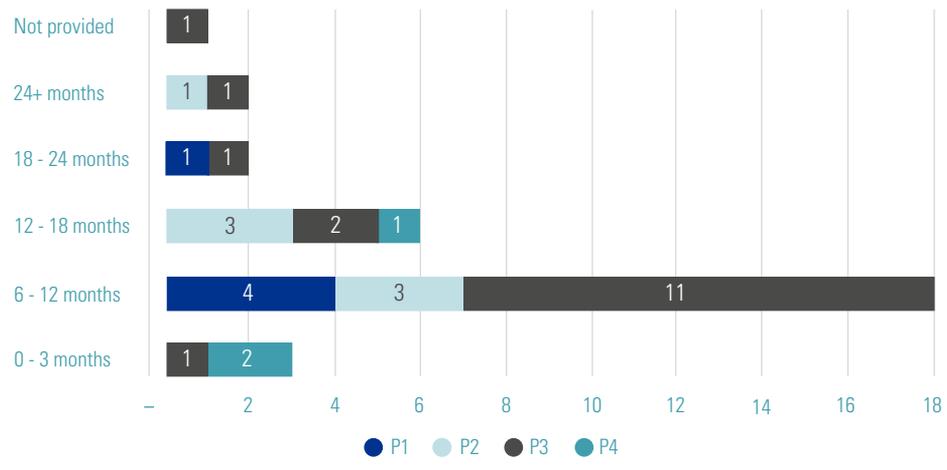
Although finance is clearly still the driving force in drafting wind-down plans, 60 percent of participants now include the broader business – the board, the risk function and subject matter experts – in the development, review and approval of the plans. Compliance departments, however, are involved in the identification and development of the wind-down plan at only 34 percent of firms. Given the legal and regulatory advice required to ensure an orderly and compliant wind-down, this is an area of concern, especially considering the extra capital that additional regulatory steps could require.

“The regulator expects a step-by-step plan based on robust assumptions and with clear actions and responsibilities identified.”

**56%** of participants indicated a wind-down period of 6-12 months

**19%** only of participants have plans that consider a wind-down in both stressed and unstressed market conditions

Wind down timeframe by prudential category



**Firmer plans**

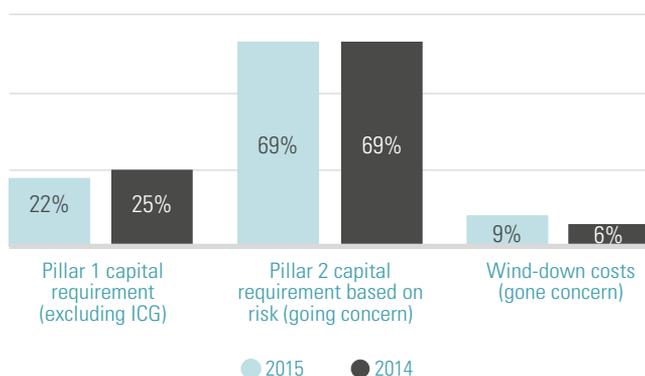
The FCA has indicated that wind-down plans need to include more than just analysis and numbers. The regulator expects a step-by-step plan based on robust assumptions and with clear actions and responsibilities identified. To ensure an orderly wind-down, the plan should take into account additional factors such as fraud or attrition that

can come into play during this potentially turbulent period. Firms should decide whether the wind-down plan stands alone or is the end point of their stress testing process, as this will have a bearing on the time that should be allowed. Our results show that the average time for a standalone wind-down plan is 6-12 months; 12-18 months or more for those that include stress and reverse stress scenarios.

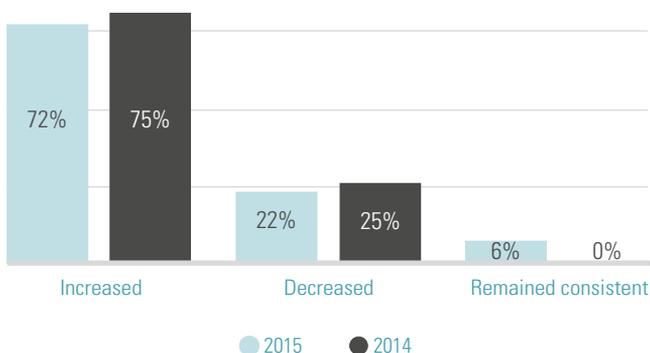
# Refining capital calculations

In an encouraging development, the governance and methodologies used to calculate risk capital requirements are gradually becoming more robust. While the composition for Pillar 2 calculations has remained largely the same from 2014-2015, there are signs of a relaxation in the treatment of pension obligation risk.

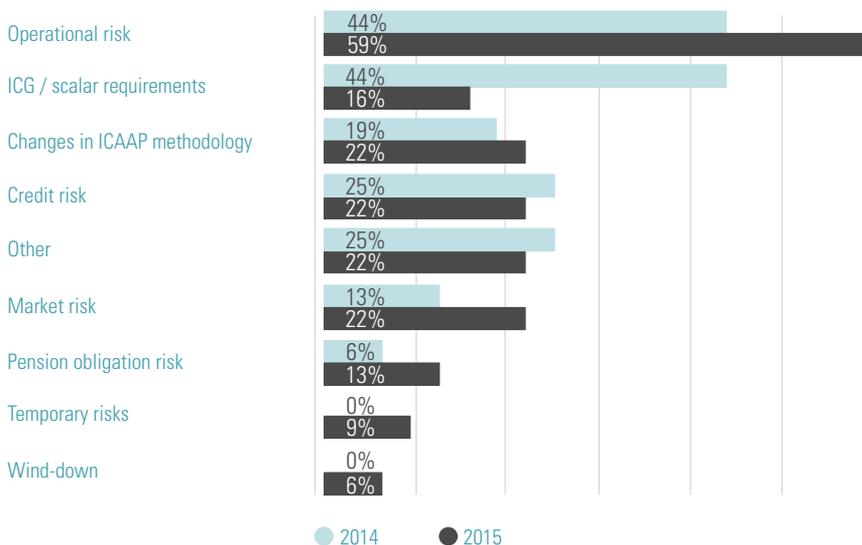
What is the main driver of your capital requirement?



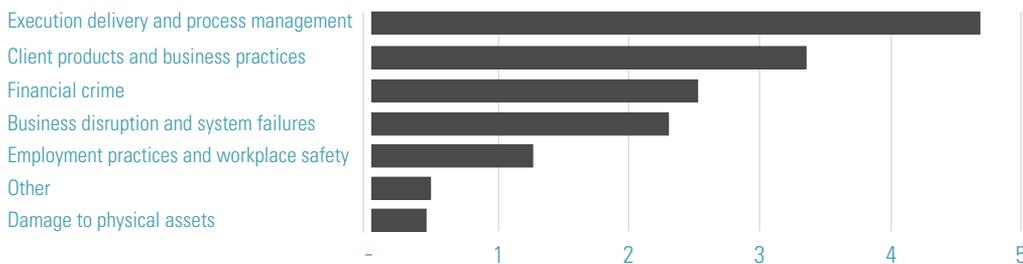
Have capital requirements increased, decreased or remained consistent?



### Key drivers in the changes to capital requirements



### Average number of scenarios developed per Basel category for operational risk capital requirements



### Overall movements in Pillar 2 capital requirement calculations

The results indicate that the primary driver of the capital requirements have remained consistent as 69 percent (2014: 69 percent) of firms indicated it is the Pillar 2 capital requirement (going concern).

The results indicating an increase or a decrease in capital requirements have similarly remained fairly consistent as

72 percent (2014: 75 percent) indicated an increase in capital requirements.

### Combining approaches to operational risk capital

Survey findings show a move towards firms using a combination of techniques to arrive at a value for the operational risk capital requirement. From 2014 we have seen a 6 percent increase in firms using both statistical approaches and simple aggregation.

This steadily increasing rigour is good news for capital requirement calculations. However it is important to note that in 67 percent of the ICAAP documents reviewed, key risk information was not aligned. Since key risk information is used to define the inputs into capital models this can present an issue for firms. To be an effective capital management tool, any model requires robust inputs.

## The three operational risk categories that have the biggest monetary impact on operational risk capital requirements are:

01

Execution, delivery and process management

02

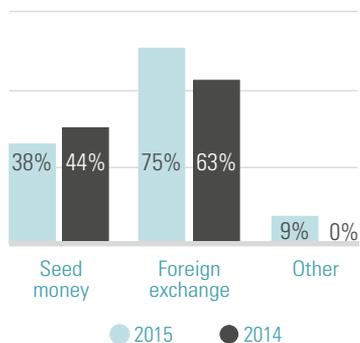
Clients, products and business practices

03

Financial crime

### Market and credit risk

What elements are considered when calculating Pillar 2 market risk



Three-quarters of participants indicated foreign exchange as the biggest element of the market risk calculation, followed by seed money.

For credit risk, cash and money market balances, and debtor's receivables were the most significant contributors to requirements.

The change in the treatment – to select the higher of market and

credit risk capital requirements calculated for Pillar 1 and Pillar 2 – has seen only a marginal increase in the overall market and credit risk capital requirements.

### More relaxed on pension risk

Anecdotally, the subject of how best to treat the pension obligation risk capital requirement within the ICAAP has been of topical interest. This survey confirms a trend we have picked up in discussions with the industry towards taking a less severe and more practical approach that reflects real-world decisions. Most notable is the idea of reaching agreement with trustees to pay off the deficit value over a longer period of time rather than a mere 12-month period.

Of the 12 firms in our survey that hold capital for pension obligation risk, three apply a one-year period, while five allow 1-5 years and four allocate between five and 10 years to repay a pension deficit.

The average capital held for pension risk overall is £8.7m. None of the prudential category 4 participants held capital for pension obligation risk.

While there is no specific FCA guidance on this issue, firms will be expected to clearly record their decisions and assumptions in the ICAAP, and cross-reference them with underlying documentation.

Average capital held for Pension Obligation Risk per prudential category (£m)





### **Finer calculation**

It is encouraging to see a 2014-2015 increase in the percentage of firms that combine both simple aggregation and statistical modelling approaches to arrive at the operational risk capital requirement. Also positive is the more pragmatic approach in the field of pension obligation risk, where we're seeing a treatment that more accurately reflects real

world conditions and places a less severe burden on the firms in question.

Both of these trends show firms developing more robust processes to calculate capital requirements that are appropriate for their businesses.

# Engaging the board

**The good news is that boards, senior managers and the business are getting more closely involved in ICAAPs and bringing their knowledge to the table. While firms are adopting a more coherent approach to developing capital requirements, there's still a need to align the ICAAP's different components.**

## More management time

The business is spending more time on the ICAAPs. That's a clear positive message from this year's survey, which shows a strong upward trend in the hours boards and senior managers spend considering them. Over half of participants indicated that these groups spend more than 10 hours on the ICAAP.

## Shift in ownership

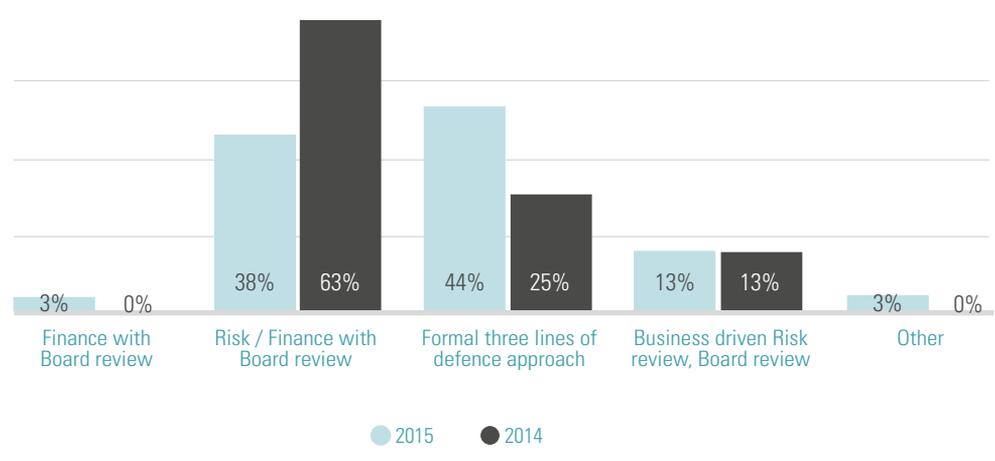
Last year, more than 60 percent of firms only used the board for review and approval of the ICAAP. This year, we have seen a move away from this approach and towards a more integrated "three lines of defence" or business-driven model, where both the risk function and board review the document together. This more cohesive approach also suggests that subject matter experts are becoming more closely involved in risk management and capital adequacy assessments.

## Shared production

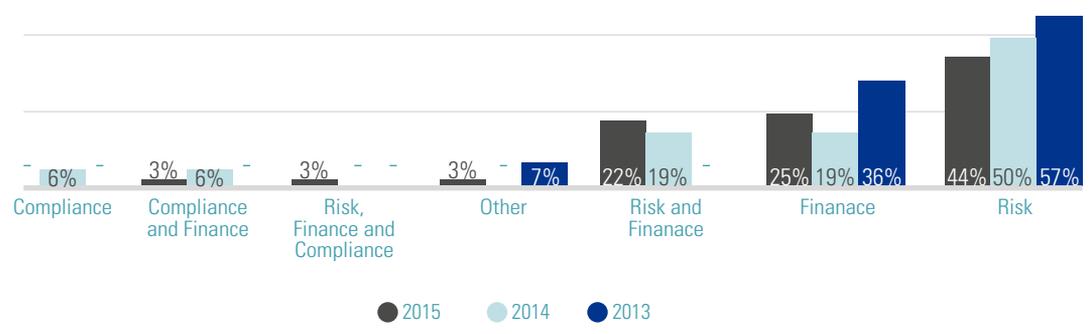
Over the past three years we have seen a movement in who produces the ICAAP. Whilst risk remains predominantly responsible for this (44 percent) we have seen a trend towards shared responsibility between risk and finance, with 22 percent of firms adopting this approach in 2015.

“Failure to demonstrate ownership, understanding and challenge in the risk management processes leaves firms exposed to regulatory attention”

### Review and approval of the ICAAP



### Responsibility for production of the ICAAP



#### Spreading responsibility

It's clear that ICAAP is gaining a higher profile within firms. But until its components are aligned, there will always be a risk that the capital it identifies may be insufficient to manage the risk facing the business.

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# Conclusion

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## **The key to survival?**

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Receiving an ICG or capital add-on puts investment firms at a significant disadvantage. For a start, it renders them less able to deal with upcoming regulatory change. Many are still in the process of responding to the demands of CRD IV, preparing for MiFID II and the upcoming Basel IV; these are likely to impose further demands on capital.

Starting out with a robust ICAAP is therefore, in effect, a form of insurance against regulatory change. However it can also be seen as an investment in future growth, because firms subjected to an ICG or capital add-on may also be deprived of the funds they need to grow: money for expansion plans, new products and the marketing and communications needed to promote them.

Getting this right is now more important than ever. The relaxation of UK pension rules has opened up a major opportunity for investment firms. A sub-standard ICAAP could mean that traditional firms miss out to competitors.

Getting this important submission right from the start could be more than just good practice: it could be the key to survival in the long term.



### **Acknowledgements**

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