
This year has been one of much change in regulatory and financial reporting requirements. We have continued with industry benchmarking, analysis of annual reports and Internal Capital Adequacy Assessment Process (ICAAP) benchmarking. But for the first time we have also analysed hot topics included in the annual reports, together with benchmarking information on the Financial Conduct Authority’s (FCA) client money and asset protection rules. As well as looking back at the past financial year, we look ahead too; exploring aspects of new regulation, key trends and emerging themes. Our intention is to illuminate the evolution of the investment management industry.

No one can doubt that the investment management landscape is changing. We are committed to identifying and communicating key trends. Earlier this year, we published “Investing in the future,” an in-depth analysis on the megatrends that are reshaping the investment management industry. We suggested that predicting the future is impossible. This report continues the theme of navigating an uncertain, constantly evolving future, focusing on the issues that are important now.

There are significant opportunities for companies that can adapt their operating models, but the challenges are immense. Product offerings must meet changing demographics. Global connectivity and the emergence of developing markets will require new distribution channels. Pension regulation changes mean businesses need to plan for the next generation of investors. The list is lengthy and complex.

Such developments will impact the investment management industry significantly. Those companies that acknowledge and plan for change will be better positioned for the future. Extensive transformations involving significant modification to strategic plans and product offerings may be required.

However, transformational change is rarely easy, especially in complex, global operations. It can be a frightening journey for many. If shareholders are not adequately informed, shareholder confidence can suffer serious, long-term ramifications. It is therefore critical that companies articulate the vision to shareholders who in turn understand the value of the changes. Financial reporting is a key communication tool, re-emphasising core issues, challenges and the importance of clear and concise financial statements.

To help navigate the pathways of change we have structured this report as follows:

**Communicating performance:** How companies communicate performance to stakeholders and how the various changes to narrative front-end reporting have been implemented over the most recent reporting cycle.

**Executive reward:** We analyse how executives are compensated, with specific emphasis on the relationship between deferred and variable pay. We also analyse information included in the directors’ remuneration reports which are included in annual reports for the first time this year.

**Corporate governance:** Compliance with the corporate governance code and how various changes have been implemented.

**Regulation:** An analysis of a KPMG survey with industry participants, exploring the challenges facing the sector in relation to ICAAP, including capital requirements and aspects such as ownership of the process, nature of governance processes and frequency of regulatory review. We also assess the impact of changes to the FCA’s client money and asset protection rules and benchmark the findings of our annual Client Assets Sourcebook (CASS) audit activity.

**Industry benchmarking:** We compare and analyse the key financial metrics across 16 of the largest investment management companies.

**Accounting changes:** We provide a summary of new International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Principles (GAAP) accounting standards and the timeline for adoption.

I am excited to share our research and insights with you and welcome your feedback.

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**Jon Mills**
Partner, UK Head of Financial Services Audit
Narrative reporting provides the story behind the numbers. As financial statements continue to become more lengthy and complex, and as users turn to other sources of financial information in order to assess performance, management needs to ensure that the performance story is appropriately delivered and that it corresponds to what the numbers are actually saying.

Investors tend to look for three key things when assessing a company:

- Fundamental analysis of qualitative and quantitative factors affecting performance so they can understand the business and its prospects
- Clear, consistent, disciplined approach to strategy and financials, delivering steady predictable performance, and meeting investor expectations
- Management that is focused on creating long-term sustainable value for shareholders.

The annual report explains how management seeks to deliver these objectives and to reveal actual performance in a comparable fashion. This is on top of the legal and regulatory guidelines that underpin much of its content. The company’s communications strategy must ensure that the annual report, and indeed other sources of financial information that investors rely on, are clear, concise and meaningful.

Getting the balance right is vital. Whether it is between disclosure overload and insufficient detail, or between discussion of good and bad news, companies need to consider whether they are explaining their underlying narrative clearly, accurately and in a balanced way. They must tell their story whilst complying with legal and regulatory obligations.

In this section, we analyse how the investment management sector has communicated performance in the 2013/14 reporting cycle and how many of the changes that impacted narrative reporting were implemented.
The overhaul of narrative reporting

The requirement to prepare a strategic report was implemented for financial periods ending on or after 30 September 2013. Non-mandatory guidance was issued by the Financial Reporting Council (FRC) in August 2013 to help companies improve the quality of narrative reporting.

Whilst the actual changes to existing requirements were modest, the intention was that they would be a catalyst for more concise and relevant narrative reports and to “provide information about the business and its development, performance or position that is not reported in the financial statements”.

As a result, we have seen companies providing a more detailed explanation of their business models and strategies. Many have provided financial and non-financial key performance indicators (KPIs) linked to their strategy and have a “forward-looking orientation”. Linked to the requirement for annual reports to be fair, balanced and understandable (see Corporate Governance on page 11) the expectation was that “the strategic report should address the positive and negative aspects”.

In June 2014, the FRC recognised that few companies were wholly compliant with their expectations for the strategic report and issued further guidance. The key areas highlighted were:

- More rigorous descriptions of the business model and strategy
- Renewed focus on the strategic report complementing the financial statements
- Greater use of non-financial performance measures
- Better linkage between elements of the report.

Future developments

We expect that from 2016 onwards, auditors will be required to give a positive opinion on the strategic report and the directors’ report in accordance with the Companies Act, illustrating its increasing importance. Companies should embrace the additional guidance so that they can clearly meet the expectations of the users of the annual report.

We have looked at the KPIs that have been disclosed within the strategic report. Companies most commonly identify flows of AUM/FUM. AUM/FUM values, along with operating margins and dividend growth, are the key KPIs.

It is important that the KPIs are relevant by being linked to long term strategy and by being able to be directly influenced by the actions of management.
Longer reports

Annual reports are increasing in size, length and complexity. This is largely because of the changes set out earlier, along with a number of new corporate governance reporting and accounting requirements. The annual reports we analysed have increased from an average of 107 pages in the 2012/13 cycle to 120 pages in 2013/14. Whilst many companies have implemented the recommendations contained in the FRC’s 2011 report ‘Cutting the Clutter’, new and additional reporting requirements have outweighed any reductions achieved.

Change to stakeholders’ reliance on other sources of information

Given the length, complexity and timing of publication of the annual report, it is not surprising that preliminary announcements and analyst presentations are the primary tool for many stakeholders to assess financial performance. This not only calls into question whether financial statements are fulfilling their fundamental purpose (enhanced articulation of strategy and the real drivers behind performance will help in this regard), but may also lead to additional reporting risks for companies. This is because the rigour applied to the production of such additional financial information is not always as robust as it is for the annual report.

We reviewed analyst presentations where available, generally finding consistency in their structure and in the areas they focused on. Many of these areas are non-GAAP measures containing a high degree of judgement or subjectivity or other aspects where no assurance about their completeness or accuracy is obtained whilst also making comparability difficult.

Whilst analysts and other stakeholders can assess company performance from these measures, a number of high profile and important metrics can only be found in the annual report, such as executive remuneration, employee numbers and certain valuation metrics.
**Non-GAAP measures are a key metric**

Most investment managers report adjusted or underlying profit before tax (PBT) in the annual report and in other announcements, but the methodology varies across the industry.

Commonly the adjusted or underlying PBT figure was stated before amortisation of intangibles, restructuring costs and exceptional items. This is understandable given investors’ desire to understand the picture for current earnings as a base for forecasting future results. The adjusted earnings figure is the metric most commonly discussed and analysed in results presentations and as part of manage-ments’ commentary on the financial results. Given the level of focus on these non-GAAP measures and the judgements inherent in determining which items are to be included in adjusted earnings, governance processes need to be strong. Advisor input, sector convention and feedback from the investment community provide some assistance and control. However, non-executive directors could play an additional role in challenging whether the adjustments that have been made are the right ones and how the adjusted earnings figure relates to their overall view of company performance.

Annual reports remain the centrepiece of each company’s financial reporting cycle. But as they become ever lengthier and more complex, only the financial elite can interpret them. General users therefore obtain much of the financial information they require from other sources and place their main focus on the narrative information and other non-GAAP measures from the ‘front end’ of the annual report. To ensure integrity of reporting, it is important that boards apply the same level of internal and external rigour and scrutiny to the publication of additional financial information that stakeholders rely on.

The FRC sees the clarity of annual reports as a high profile issue and continues to develop its ‘Clear & Concise’ initiative.

The FRC’s 2014 Annual Report on Corporate Reporting also identifies non-GAAP measures and narrative reporting as a continuing issue, calling into question how effectively non-GAAP measures can provide a balanced view of performance.
Executive reward


The wreckage caused by the financial crisis is clearing, but its legacy casts a nervous shadow on the financial services industry. Although regulators are doing what they can to avoid another meltdown, their actions have resulted in additional regulation in relation to remuneration.

One aim of the regulations is to align executive remuneration with company performance. Linking executive reward with company performance is intended to benefit customers by promulgating investment management strategies which favour long-term capital appreciation and discourage riskier activity which targets short-term returns. The desired outcome is to have remuneration linked to company performance over the longer term, payouts that are only made when shareholders are receiving a return on their investment and lastly to ensure that payouts are linked to effective risk management. By creating a remuneration strategy that satisfies these objectives, it should encourage appropriate employee behaviours and therefore reduce the likelihood of another financial crisis.

The remuneration elements of Capital Requirements Directives III and IV (CRD-III and CRD-IV) are intended to drive the focus on long-term performance and risk-adjusted remuneration. For those affected, these introduce rules around deferral, clawback and the ratio between fixed and variable remuneration - although the cap doesn’t apply to all investment managers as they often qualify for an exemption.

However, the benefits ascribed to the new regulation are not without consequence. Sceptics argue that UK companies will lose the ability to attract top-talent as the best and brightest individuals leave the country for less prescriptive remuneration elsewhere.

In addition to increased regulation in the financial services sector, there is enhanced regulation in relation to remuneration disclosure for Main Market listed companies in the UK. The reporting requirements dictate how and what executive remuneration data has to be disclosed in annual reports, and stipulates new rules around shareholder voting. The aim of these new regulations is to increase transparency in remuneration reports and to increase shareholder power by allowing them a binding vote on a company’s remuneration policy.

Our recent analysis suggests that CEO pay is generally in line with company performance, which is the aim of both the financial services remuneration regulation and the disclosure regulations applicable to Main Market listed companies. However, the relationship between linking pay to performance and driving appropriate behaviours is difficult to assess. Famously, Jeffrey Skilling, CEO of Enron, and Richard Fuld, Chairman and CEO of Lehman - staunch supporters of performance-linked awards – led their organisations to collapse. The relationship between performance and pay needs to be monitored over time in order to assess correlation and draw appropriate conclusion.

Whether changing the way executives are remunerated changes behaviour is moot. But it is self-evident that if the new regulation adds barriers such that companies cannot operate effectively or compete effectively, it will be the investors, and possibly the UK financial services industry as a whole, that will suffer.

**KEY POINTS**

- External pressures have led companies to revamp remuneration so they align risk and reward
- Encouraged by regulators and industry, financial services companies are increasingly moving towards deferred remuneration
- Various comparables are being used in benchmarking total shareholder return when assessing remuneration
- New voting rights have increased shareholders’ influence over remuneration policies

“Remuneration is very much on regulators’ radar. Regulatory approaches to remuneration are a combination of seeking greater transparency, imposing restrictions and encouraging alignment of interests”

Evolving Investment Management Regulation, KPMG Report, June 2014
CEO pay

Despite the popular notion that CEO pay is disproportionate to company performance, data suggests that CEO pay is not out of line with underlying KPIs.

Comparing the increase in salary for CEOs and employees, employees were slightly better-off. In our sample, CEO salary remained flat whilst employee pay increased broadly in line with inflation.

CEO bonuses rose significantly from prior-year but employees received a proportionately better increase in bonus pay.

In fact, CEO pay is reasonably in line with key financial metrics.

How executives are paid

Fixed vs variable

Using our sample as a proxy for the wider investment management industry, the split between fixed and variable remuneration for executives is around 1:3 across the sector. This is slightly more weighted towards variable pay than the FTSE 350 as a whole, and less so in comparison to the broader financial services sector where more companies are affected by the cap on variable pay stemming from CRD-IV as many companies in the investment management sector qualify for an exemption.

Deferred vs upfront variable pay

The graph shows variable remuneration for executives split by amounts paid immediately and paid out in future years (deferred bonus and vested Long-Term Incentive Plans (LTIPs)).

More than 70% of companies surveyed include deferral in their bonus plan, with a split of variable pay upfront versus deferred of approximately 1:1. Deferral is typically for around three years. About three-quarters of the companies include malus provisions in relation to unvested variable pay awards. Malus provides companies with the ability to recoup awards in the event of certain negligent or fraudulent acts, such as misstatement of performance, failure of risk management or serious misconduct. A small number of companies said they would apply clawback to vested awards in the event of major misconduct.

Regulatory development

Although they are likely to affect only a few investment management firms, the final rules from the Prudential Regulation Authority (PRA) on the application of clawback have recently been published. These will affect Level One and Level Two firms subject to the remuneration code. Under these rules, variable remuneration will be subject to malus and clawback for seven years from the date of an award (this changed from the previous proposed six years from vesting). This allows flexibility, in that the award can be subject to malus – and thus clawback for longer.
Benchmarking performance

Affecting 14 of the 17 companies surveyed, the Companies Act 2006 requires main listed companies to include a graph of total shareholder return in respect of their quoted equity shares compared to that of a broad equity market index. Although all companies operate in the same sector, seven different benchmarks were used, with some companies adopting multiple benchmarks. This may excite some sceptics when combined with the notion that all companies outperformed their referenced benchmark.

Analyst insight

Despite regarding the annual report being too long and poorly timed, many industry analysts still use it as a key document for information on employee remuneration.

Media may be unfairly scrutinising executive pay as analysis shows compensation is consistent with company performance.
New requirement – shareholder voting

The new directors’ remuneration reporting regulations have changed the way shareholders vote on directors’ remuneration. The directors’ remuneration report is now split into a remuneration policy section, a forward-looking document outlining remuneration policy for the next three years, and an annual report on remuneration, a retrospective document disclosing how policies have been implemented and awards made during the year. Shareholders continue to have an advisory vote on the annual report on remuneration, but now also have a binding vote on the remuneration policy. The aim is to give shareholders greater power over directors’ pay.

Of the companies in the comparator group who are required to put their directors’ remuneration report to a shareholder vote, and which held its AGM by the end of September 2014, none received a majority vote against either the annual report on remuneration or the remuneration policy.

The future focus of director remuneration is expected to follow remuneration regulatory changes of the last several years with an emphasis on the relationship between risk and reward.

“If the advisory vote on the annual report is lost, the directors’ remuneration policy must be brought to a binding vote at the next AGM. This may result in a vote on remuneration policy outside the three year period.”

Guide to Directors’ Remuneration Reporting - Quoted Companies, KPMG December 2013
The last reporting season has seen boards and audit committees get to grips with the new reporting requirements introduced by the 2012 UK Corporate Governance Code in response to greater investor focus on audit-related issues and governance processes.

Whilst we are clearly at a very early stage in the development of this enhanced reporting, we have been pleasantly surprised by the usefulness of some of the disclosures in providing an important medium to help assess the stewardship of a business and the quality of its reporting and auditing in a world that is rarely black or white. They also help underpin the credibility and trust that needs to be inherent in the relationship between the leadership of a company and its shareholders.

The example shown by those companies that have embraced the new disclosure requirements is to be applauded. However, the new disclosures are not universally strong and there are still cases where reporting is more reflective of a boilerplate approach, leaving investors asking questions. We expect that reporting will evolve as examples of good practice emerge.

**Fair, balanced and understandable**

Directors are now required to state that, taken as a whole, they consider their annual report and accounts to be fair, balanced, understandable and provide the information necessary for shareholders to assess the company’s performance, business model and strategy. This was also reported on by exception by auditors.

Whilst none of the auditors of the annual reports we analysed said the document was not ‘fair, balanced and understandable’, we saw a high degree of variation around the description of the business model and strategy – and how results for the year were discussed and linked to wider strategy and goals.

Boards will need to engage with stakeholders to ensure that the content of the annual report meets their needs and that it is written in an accessible way.
We spoke to a range of users of financial reports, including investors and analysts. Whilst most were unaware of the specific changes in relation to ‘fair, balanced and understandable’, all felt that there was not currently fair weighting between good and bad news. Some felt that performance was often not described in context of the wider market and that they gained better strategic insight when they met with management.

In their annual report on corporate reporting for the year ended 31 March 2014, the FRC has challenged companies on whether:
- Narrative reporting is consistent with reporting within the financial statements
- Too much focus is being placed on good news
- Appropriate balance is placed on discussions of GAAP and non-GAAP measures
- KPIs are adequately explained
- Sufficient strategic reports have been prepared for smaller listed and Alternative Investment Market (AIM) companies.

Audit committee reporting
For periods that began on or after 1 October 2012, audit committees have had to prepare a report describing how they had discharged their responsibilities, specifically discussing their views about what they consider to be the ‘significant issues’ in relation to the annual report and how these were addressed.

For the participants covered by these requirements, audit committees considered between two and seven significant issues. There is a high degree of consistency across the industry in the issues that audit committees consider to be significant to the annual report.

As shown below, accounting for goodwill and other intangibles is the most significant issue across the industry. This is unsurprising given the judgements and estimates that are inherent in the accounting for these assets. Other areas that audit committees commonly find challenging are accounting for acquisitions and disposals, recognition of revenue and performance fees and also provisions for contingent liabilities and claims. This shows that audit committees generally focus their attention on the right areas. Their biggest challenge is on transactions that are non-standard involving significant estimates and judgements.

Going forward, more consideration should be given to whether appropriate disclosure has been made within the related accounting policies and notes to the financial statements that link back to these risk disclosures. The FRC has identified this as a key focus area.
Compliance with the Corporate Governance Code

Investment managers often place high corporate governance expectations on the boards of companies in which they invest. It is important that these managers also display the same level of governance themselves. As an industry, the provisions of the Corporate Governance Code are well applied. However, some companies still do not comply with certain provisions. For example, a number of participants failed to comply with provisions B.1.2 and D.1.1.

B.1.2
At least half the board, including the chairman, should comprise non-executive directors determined by the board to be independent. Smaller companies should have at least two independent non-executive directors.

D.1.1
Performance related remuneration schemes should be designed in line with the provisions of the code.

Board effectiveness reviews

All participants had conducted either an internal or external board effectiveness review during the period and discussed this in the annual report. Such reviews illustrate that the role played by the board and the expectations on the directors is evolving. Common themes identified include:

- **Strategy**: Reviews found that greater focus was needed by boards on the overall strategy and oversight of management implementation. Some reviews suggested that better analysis of competitors and the marketplace was also required.

- **Board Papers**: Improvements were suggested to the quality of information presented to boards and an overall reduction in the length of papers that need reviewing.

- **Process and Skills**: Focus to be placed on ensuring that director training is kept up-to-date and that boards contain the right level and mix of skills.
Board diversity

The revised Corporate Governance Code released in June 2010 first introduced a principle recognising the importance that gender diversity brings to board performance. In November 2012 the European Commission adopted a proposal for a directive to introduce a minimum representation of women on the boards of listed companies of 40% by 2020.

As demonstrated below, the UK investment management industry has some way to go to meet such aspirational targets.

There are many measures of diversity, with gender diversity being but one. Our analysis focuses on this measure as it is specifically reported in annual reports.

The companies we analysed had between zero and 29% of female directors. The average was 15%, with just 4% at executive director level. The majority of companies did not have any female executive directors as reported in the 2013/14 annual report and accounts.
Many investment managers will no doubt feel they have already passed through the eye of a storm in dealing with the volume of regulatory change in the last twelve months.

Capital Requirements Directive IV implementation, CoREP reporting or just dealing with more intensive and intrusive supervision; it’s all added pressure. However, it is clear that the fundamental shifts in the regulatory environment are just the start of the beginning. Regulators at UK, EU and global levels are at work to try to enhance the underpinning frameworks to make them (and firms within their remit) more robust and resilient, both in times of financial stress and through the economic cycle.

In the UK, the FCA has focused on capital adequacy and investor protection. For capital adequacy, we have observed an increasing trend of alignment between investment management and the wider financial services sector. For investor protection, attention has been fixed firmly on the fiduciary duties of agents when acting for clients and acting in clients’ best interests through initiatives such as changes to the use of dealing commission, and thematic reviews, such as best execution, product governance and fairness and transparency of fund charges. Many of these initiatives have resulted in wide-ranging remediation to areas such as governance structures, policies and procedures, documentation, quantity and quality of capital held and, in a number of cases, clients and end investors.

Looking to the future, there appears to be no let up to the sheer volume and weight of regulatory change. There are a number of challenges as well as opportunities ahead, with the regulatory spotlight increasingly being turned onto the investment management sector as a distinct category rather than a subset of banks or credit institutions and insurers. In Europe particularly, the sector is caught between the ‘shadow banking’ debate on the one hand and initiatives to stimulate long-term financing on the other. Regulatory reform is ongoing, with both significant implementation projects such as MiFID 2 and new legislative proposals such as money market funds and long-term investment funds.

The FCA’s rule-making powers continue to be constrained by the move from EU directives to regulations. Regulations are laws that have direct effect, unlike directives that allow some wriggle room in local transposition. Unless the directives and regulations provide explicit areas of ‘national discretion’, regulators cannot add to or adapt the rules. Only in areas not covered by EU rules can national regulators still write their own, but such areas are few and decreasing. Also, the powers of the European supervisory authorities, specifically European Securities and Markets Authority (ESMA), are growing.
Meanwhile, with the backing and impetus of the Financial Stability Board, IOSCO is increasing its output and reach. In addition to a steady stream of publications on regulatory principles, it is working on a number of detailed issues. For example, it is consulting on the regulation of custody of collective investment scheme assets at the same time as ESMA is consulting on the Level 2 measures to underpin the depositary provisions in UCITS V.

All this could imply that we are in a period of convergence of regulation in Europe and more widely. Whilst this is true of European rules and their interpretation, we are seeing an increasing number of national regulators adopting their own stances: for example, to product ‘complexity’ and product governance. This requires firms to adopt more national distribution practices and hence leads to further fragmentation of the single market. This calls into question the purpose of the passports that many directives aimed to provide. It would seem the debate of ‘more or less Europe’ is not just restricted to politics, but has found its way into regulation and financial services.

While it is clear the past twelve months have been the start of the beginning, the question on many investment managers’ minds is where will it all end and what do I need to focus on next? Just how long is this regulatory tunnel and what colour is the light at the end of it? From experience, the key to answering these questions successfully does not lie in taking a piecemeal approach to each change in regulation, but rather in taking a strategic step back from the regulatory turbulence, taking stock and assessing the opportunities.
ICAAP and regulatory capital – background

This year we have performed a capital management survey and internal ICAAP benchmarking review. We asked a number of firms, including traditional investment managers, hedge fund managers and wealth management companies, to complete a questionnaire about capital management practices and ICAAP emerging practices. Sixteen firms participated.

The FCA’s focus on capital management is not solely to determine whether firms hold sufficient capital to cover their risks. Increasingly there is an emphasis on the effectiveness of the end-to-end capital assessment process, specifically on governance and senior management oversight and challenge.

Here we have compared participating firms’ processes and practices, with detailed analysis on:

- Capital management practices
- Key components of ICAAP, specifically Pillar 1 / Pillar 2 analysis
- The operational risk capital assessment component of ICAAP

Capital management survey

The capital management questionnaire contained 44 questions on three key areas:

- Scope of application of the capital requirements
- Key aspects of ICAAP
- Industry practice and emerging trends in relation to ICAAP

Of the 16 firms that participated, 11 classified themselves as ‘traditional investment managers’. The remaining five firms’ classifications included ‘wealth manager’ and ‘hedge fund manager’. Assets under management ranged from £5 billion to over £200 billion, with a median of £64 billion.

Scope of application of the capital requirements

All participants were asked about the composition and corporate structure of their group. The majority of firms are part of groups consisting of both regulated and non-regulated businesses. The majority were also regulated on a consolidated basis, rather than on a solo basis.

Under current regulatory requirements, firms may apply for waivers from the FCA, allowing them to comply with capital requirements on a solo basis. Of the 16 firms surveyed, two had obtained an investment firm consolidation waiver in order to address the capital deficits caused by deductions for intangible assets and/or goodwill.

Scope of CRD IV

Our 2013 survey explored the implications of CRD IV on firms’ capital requirements. The overwhelming majority of participants expected limited changes, and only a fifth had completed an impact analysis at that point. Following implementation of the regulations on 1 January 2014, we asked respondents whether they were in or out of scope for CRD IV.

Of the 16 surveyed, half said that they were in scope. For the majority of those within scope, this was primarily due to holding the permission of safeguarding and administration of assets (without arranging). Of those within scope, a quarter also held the outward MiFID passport of placing financial instruments on a firm commitment basis.
Ownership of ICAAP

The results confirm that the risk function typically owns ICAAP process, with the proportion increasing from last year (see chart below). Our experience is that the finance function maintains significant involvement in ICAAP because of the nature of the process. In particular, it is involved in stress testing and wind down analysis activity. For smaller, less complex firms, ICAAP is facilitated by the compliance function, with the support of finance and risk.

In large complex firms, we have observed an increase in the time the board commits to overseeing and challenging the process.

Review and approval of ICAAP

Our recent experience of ICAAP reviews indicates increasing regulatory attention and scrutiny of governance processes, particularly the level of senior management engagement, oversight and challenge. We asked participants to confirm the nature of the challenge and review process used for ICAAP. Most firms say the board is the primary source of challenge and review. Risk and finance functions are typically involved in the production process, reducing the ability to challenge the output independently.

This next chart illustrates the range of practices:

Capital requirements

The key drivers behind capital requirements depend on whether the capital is driven by Pillar 1 (prior to application of Individual Capital Guidance (ICG)), Pillar 2 or wind-down costs. Survey results confirm that for the majority of firms, the Pillar 2 assessment is the most severe, as outlined below:

<table>
<thead>
<tr>
<th>Drivers of capital requirements</th>
<th>Percentage of firms</th>
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<tbody>
<tr>
<td>Pillar 1</td>
<td>25%</td>
</tr>
<tr>
<td>Pillar 2</td>
<td>69%</td>
</tr>
<tr>
<td>Wind down</td>
<td>6%</td>
</tr>
</tbody>
</table>
Typically, the Pillar 1 assessment drives the on-going capital requirements due to the application of ICG by the regulator as part of the Supervisory Review Evaluation Process (SREP). This is consistent with the application of ICG to link to Pillar 1, as it is a flexible measure based on either ‘market + credit risk’ or the Fixed Overhead Requirement (FOR) and reflects changes in the nature and size of the company over time.

For those firms that have recently been subject to a SREP review, we have observed a change in treatment of market and credit risk in the Pillar 2 calculation. This resulted in a higher capital requirement as firms are required to reflect the higher of Pillar 1 or Pillar 2 market and credit risk when assessing the overall Pillar 2 requirement. We note this marks a convergence of practice between the investment management and banking sectors, where this approach has historically been applied.

Our review of ICAAP documents revealed that the Pillar 2 requirement as a percentage of the Pillar 1 requirement ranged from 25% to >400%, with a median of 200%.

**Supervisory Review Evaluation Process**

We asked participants to indicate when their ICAAP was last formally reviewed by the FCA. The responses are summarised below:

The frequency of SREP reviews is primarily determined by the prudential supervision categorisation assigned by the FCA. SREP reviews are typically scheduled for every 24 or 48 months depending on the category of the firm and the significance of issues identified in previous reviews. The chart below illustrates the split of firms by prudential supervision category:

For firms where a SREP review has been completed, four have no ICG applied to Pillar 1, 10 received ICG and two firms did not wish to disclose this information. For those firms that received ICG, the range was from 30% to 300%, with a median of 170%.

Depending on the severity of issues identified during the SREP, a number of firms have been issued with scalars. Of the firms that had been subject to a SREP review, four received scalars reflecting FCA concerns such as lack of senior management oversight and governance, and weaknesses in operational risk capital assessment methodologies.
Key components of the ICAAP and movement in capital requirements

This section analyses key components of the capital requirements and whether they have increased or decreased since the last assessment. The survey also seeks to determine the reasons for the movement of the requirements over the period and identify trends across the sector.

Movement in capital requirements

We asked participants to describe the change to capital requirements since the last iteration of their ICAAP. Of the 16 firms surveyed, 75% have experienced an increase in capital requirements, with the rest decreasing since the previous assessment.

The movement in capital against the prior period is illustrated below:

We analysed the factors that have resulted in the increase or decrease in overall capital requirements:

- Seven firms highlighted the operational risk capital assessment
- Seven firms identified the impact of an adjustment to the ICG
- Three firms highlighted changes to methodology.

It should be noted that capital requirements may increase in line with the growth of fixed expenses as part of the fixed overhead requirement calculation. However, the majority of increases are greater than 10%, which would be beyond a gradual increase in expenses and will relate to factors such as those listed above.

Pillar 2 capital requirements

The Pillar 2 capital assessment requires firms to consider all present and future risks that face the business and allocate an appropriate amount of capital to support those risks. Our review of ICAAPs submitted by the participants highlighted the following risks for which capital is being held:

We also analysed the proportion of Pillar 2 capital requirement attributable to the material risk categories. The information below shows the range of each category as a proportion of total Pillar 2 capital requirements:

- Market risk ranged from 1% to 50%
- Credit risk ranged from 9% to 24%
- Operational risk ranged from 34% to 82%
- Business risk ranged from 2% to 12%
- Pension obligation risk ranged from 2% to 36%.
At the median level, the proportion of the Pillar 2 requirement attributable to key risks is illustrated in the following table:

<table>
<thead>
<tr>
<th>Proportion of Pillar 2 capital by risk type</th>
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<tbody>
<tr>
<td>Operational</td>
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</table>

Further analysis revealed the following insight:

- **Market risk** is driven by exposure to foreign exchange risk, with 10 firms identifying this as a key risk. Seven firms also consider seed capital when assessing market risk.
- **Business risk** is an area in which we have observed varying practices. 33% of participants hold capital under Pillar 2, with the remainder considering the impacts of business risk as part of the stress and scenario testing activity.

**Stress testing**

Firms are required to reflect the uncertainty of future outcomes and the impact adverse business conditions can have on the medium to long-term performance. This is achieved by stress testing the business model. Of the firms surveyed, 44% use a three-year timeframe for financial projections; 50% use five years and 6% use a four-year timeframe.

The regulatory expectation is that firms should seek to ensure that stress tests are proportionate and relevant to the business model and where possible consider correlated events, which is borne out in the responses below:

- 81% of firms use combined scenarios e.g. market fall with an operational event
- 50% use single stress parameters e.g. market fall only
- 31% of firms use the published Bank of England anchor scenario.

**Wind down analysis**

In addition to on-going risks, firms must assess the amount of capital necessary to ensure an orderly wind down of the business. In summary, firms are required to perform a detailed assessment of the expected net cash flows and must document the assumptions used and the supporting rationale.

One of the key assumptions is the period of time it would take to complete the wind down. The range of responses are outlined below:

<table>
<thead>
<tr>
<th>Wind down period</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 to 18 months</td>
</tr>
<tr>
<td>6 to 12 months</td>
</tr>
<tr>
<td>3 to 6 months</td>
</tr>
</tbody>
</table>

From our experience, firms are extending their wind down period to reflect the increasing complexity of business operations and the timeframe necessary to obtain regulatory permissions. Generally, firms are more optimistic about management fees due during the wind down period, reflecting the reality that funds will not transition to new managers immediately.

**Capital requirements for operational risk**

Our analysis revealed that the Pillar 2 operational risk assessment continues to be the dominant component of capital requirements. As highlighted earlier, operational risk is a key factor in respect of increases to capital requirements. Accordingly, this section provides in-depth analysis of the areas of practice.

**Calculation methodology of the capital requirement**

We reviewed the approach to the calculation of the capital requirement for operational risk in the ICAAPs received.

We observed a variety of approaches, including:

- Monte Carlo approach
- Scenario approach
- Simple estimation method.
Seven of the 16 firms adopt a Monte Carlo approach to operational risk, with the remaining firms adopting a simplified or scenario approach, as outlined below:

Firms with a statistical approach to assessing operational risk capital requirements are generally larger and more complex. Smaller firms typically adopt a more simplistic approach, with a greater reliance on subject matter experts to assess required capital.

**Operational risk scenarios**

Scenario analysis is an established technique for operational risk capital assessment as a standalone activity or as an input to modelling. The number of scenarios developed varies between participants, and generally reflects the underlying risk management framework and taxonomy.

From our experience, the choice of the number of scenarios is a key decision: too few may result in an inability to demonstrate appropriate coverage of the risk profile. Conversely, too many scenarios create the need for diversification and could lead to a drop in quality because of the volume of data.

**Use of loss data**

The use of loss data is likely to be an area of scrutiny for the regulator when determining the appropriateness of the operational risk capital assessment, as the exercise is inherently subjective. Therefore the use of internal and external loss data is an area we asked participants about:

- 81% use both internal and external loss data as part of the capital assessment
- 12% focus solely on internal data
- The main sources of external data are consortium data e.g. ORX and publicly available information such as FCA enforcement notices.

Half of firms use loss data to validate the capital assessment and 37% use loss information as a data point to help build the scenario i.e. to define severity points for stochastic modelling.

**Use of diversification**

Diversification allows firms to reduce the operational risk capital requirement on the basis that not all risks will occur within the same 12-month period. Of the firms surveyed, 44% use diversification to reduce capital requirements, with the percentage discount ranging from 10% to >40%.

The use of diversification requires robust documentation and justification. It is likely to be an area of scrutiny during a SREP review. As described previously, operational risk typically drives overall capital; therefore the lack of loss data exacerbates the challenges firms face when applying diversification within ICAAP.

**Insurance mitigation**

Insurance mitigation is another opportunity for firms to reduce capital requirements. Insurance cover may protect firms against extreme events, but in our experience, the FCA expects that firms will reflect the uncertainties of cover with an appropriate haircut to the deduction. Factors that should be considered include the credit quality of the insurance provider, timeliness of payment and whether the specific event is covered within the insurance terms.

Of the 16 firms reviewed, half included insurance cover in their ICAAP analysis. The discount applied for insurance mitigation ranges from 10% to >40%.
The failures of Lehman Brothers, MF Global and other financial services firms were a major catalyst for change that increased focus on client asset protection. During each insolvency process, issues around identifying and returning customer assets and funds illuminated firms’ inability to comply with the rules. It’s clear that the rules themselves were somewhat lacking and often unable to achieve their purpose. The FCA responded by increasing regulatory scrutiny – evident in the level of fines and penalties issued – and by instigating major changes to their rules in June this year.

Firms have had to make significant investments in their control environment over the past few years to keep up with this shift in expectations. This is set to continue over the next 12 to 24 months as the rule changes contained within CASS Policy Statement 14/9 (PS 14/9) bed down. We conducted a survey amongst CF10as from a sample of firms within the Investment Management industry asking them about the preparedness for rule changes and also around the CASS control environment and other CASS governance structures. We have seen varying degrees of readiness for the rule changes, with some firms progressing well whilst others are still only assessing impacts.

Away from the Policy Statement, we have seen the largest level of regulator activity around governance structures. Again, our survey has shown various stages of CASS governance maturity across firms. There is no doubt that this will continue to be a topic on the FCA’s radar for some time to come.

**CASS PS 14/9**

In June 2014 the FCA released its Policy Statement 14/9. This resulted from extensive consultation and is the biggest shake up of the client money and asset rules since their introduction.

Whilst many of the changes set out in the Policy Statement codify existing best practice, a number of fundamental rule changes and new rules are already having a significant impact on the investment management industry.

These rule changes come into effect over three waves: the first set of changes were implemented on 1 July 2014, additional rules come into force on 1 December 2014 and final full compliance is required by 1 June 2015. Given the timeline needed for design and testing of updated business processes, we encourage all firms to take a proactive approach to ensure full compliance can be achieved by the deadline.

**KEY POINTS**

- Increase in documentation, governance and oversight activities
- Potential re-papering of client agreements for interest, DVP and other matters
- Changes to the operation and eligibility for the DVP window
- Requirement for cleared funds prior to trading and immediate segregation
- Mandatory standard trust status letter templates
- Restrictions on the use of term deposits for client money
- Removal of the use of ‘method 2’ when undertaking internal client money reconciliations for some firms

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We asked a number of CF10as across the industry where they perceived the impacts of the Policy Statements would be most significant. The results showed that the Policy Statement is expected to have the highest impact on updating business processes and controls challenges would lie in working with administrators or other third party service providers.

These results are generally in line with our view on the impact on the industry; however, potential funding implications may have a higher impact than currently envisaged. It is important that fund houses discuss the impact of changes to the DVP window with their administrators and transfer agents, and that others in the industry fully consider the immediate segregation and cleared funds requirements.

**CASS governance**

All respondents to our survey stated that CASS governance issues were raised when internal or external reviews were undertaken during 2013 and 2014. Governance has also been a key area of focus in reviews that the FCA undertook in 2013 and 2014.

We asked participants a number of questions about governance structures, functions and levels of responsibility. Almost all of them have a dedicated CASS risk committee or similar. These committees generally meet quarterly, although some firms hold them monthly. For these committees to function effectively firms must ensure that management information is appropriate and reports on the CASS risks they face.

These committees are headed by the CF10a, a position commonly at director or board level.

However, some respondents indicated it was held by a senior manager. To allow for the CF10a role to be undertaken effectively, it is important that they have the appropriate level of seniority.

**Benchmarking**

We have analysed the results of the CASS work that we perform of all of our investment management clients who held client money or custody assets with year-ends between 30 September 2013 and 31 March 2014.

**CASS findings**

A large majority of the CASS work that we perform at firms identifies breaches of the CASS rules. These results are broadly consistent with wider industry results that we are aware of. A key part of the control environment are the structures that identify when breaches take place, capture and report them appropriately and take action to ensure that these do not re-occur. In most instances the breaches identified were identified by internal processes at firms.

**Types of breach**

The majority of breaches we see relate to client money rules. Common breaches related to trust status letters, the use of the DVP window for collective investment schemes, internal reconciliation processes and funding or transfer of surpluses or shortfalls identified. This is indicative of both the fact that firms generally find these rules more difficult and complicated to comply with and also that a number of firms in the sample only held client money during the relevant period.

Many firms within the industry place a high degree of reliance on third party administrators and as a result their performance has a significant impact upon compliance. Whilst a task may be outsourced, ultimate responsibility to comply still rests with the firm. Effective monitoring, regular communication and a thorough understanding of processes and controls at third party administrators is fundamental to this.
Key highlights include an average growth of 13% in AUM with all but three managers reporting AUM levels above pre-crisis (2007 / 2008) levels. Firms whose AUM grew by more than 10% attributed this to net inflows, improved equity market performance and favourable exchange rate movements.

Ravi Lamba, Director, FS

Over the years this report has followed the investment management industry through the financial crisis, benchmarking key financial metrics included in the annual reports from the biggest companies in the industry. In doing so, we have illuminated the financial crisis’s pervasive and crippling impact on the industry and plotted the slow and steady road to recovery ever since. Today, we’re pleased to share the results of better times. This year’s analysis suggests that companies are broadly returning to their pre-crisis levels with significant increases to revenue and assets under management across most companies.

This year our industry analysis covers 17 investment managers in the UK:

- Aberdeen Asset Management PLC
- Ashmore Group plc
- Brewin Dolphin Holdings PLC
- Charles Stanley Group PLC
- F&C Asset Management plc
- Hargreaves Lansdown plc
- Henderson Group plc
- IFG Group plc
- Impax Asset Management Group plc
- Intermediate Capital Group plc
- IP Group plc
- Jupiter Fund Management plc
- Man Group plc
- Melon Group plc
- Rathbone Brothers Plc
- Record plc
- Schroders plc
Adjusted profit before tax

The majority of companies report an adjusted or underlying profit before tax (PBT) figure, with adjustments mostly for amortisation, the FSCS levy, restructuring costs and exceptional costs. This year, all companies recorded growth in adjusted PBT despite the moderate UK economic recovery. Changes in pension schemes regulation appear to be key factors impacting performance, and the continued roll-out of the Retail Distribution Review (RDR).

The most noticeable drivers for performance have been an increase in investment causing an increase to assets under management, gains on investments held and companies reducing costs. The graph below illustrates the percentage change in adjusted profit before tax in the current year against the prior year.

### Observations

- Average percent change in PBT is 23% year on year
- All companies reported an increase in adjusted profit before tax over the prior year in their annual report.
Profit before tax

Profit before tax fluctuates considerably after adjustments for amortisation and exceptional costs. All investment managers surveyed recorded a profit before tax in their latest financial results, three of which reported losses in the previous year. By contrast, last year over half of the investment managers experienced falling PBT, compared to only two in this year’s analysis.

Many of the investment managers commented on the continued contribution to the FSCS affecting their results for the year.

The graph below illustrates the percentage change in profit before tax in the current year against the prior year.

**OBSERVATIONS**

- All investment managers reported a profit before tax in their latest annual report.
- 11 investment managers reported an increase in profit before tax in their annual report over prior year.
- Three investment managers reported profits in the current year from losses in the previous year.
- Slightly fewer than half of the investment managers in the sample are now reporting profits above 2007/2008 levels.
Cost management

Investment managers continue to look to cost savings to improve margins. Two investment managers saw a decrease in their assets under management yet still managed to record an increase in profits due to cost efficiencies.

The graph illustrates the percentage change in the ratio of operating expenses to net revenue; it also demonstrates the change in operating costs from the current to the prior period.

The ratio has improved for some investment managers significantly, but has decreased for others, albeit by small percentages. The largest decrease in operating costs were attributable to decreases distribution costs, impairments and other firm specific costs.

**OBSERVATIONS**

- The percentage ratio of operating cost to net revenue has improved for some investment managers significantly, but has decreased for others, albeit by small percentages. The largest decrease in operating costs were attributable to lower distribution costs, impairments and other firm specific costs.
- Over half of investment managers saw a decrease in operating costs as a percentage of net revenue.
**AUM**

The average increase in AUM across all the investment managers was 13%, the same as last year.

The graph below illustrates the cumulative AUM change in the assets under management from 2007/2008 to 2013/2014.

**Cumulative percentage change in assets under management**

Only three investment managers have AUM levels below their 2007/2008 levels.

The investment managers whose AUM grew by more than 10% attributed this to net inflows, improved equity market performance and favourable exchange rate movements.
**Total shareholder return**

Companies Act 2006 requires the Directors’ Remuneration Report of main listed companies to include a graph of total shareholder return in respect of their quoted equity shares.

This chart shows the value of £100 invested in each investment manager from 2008/2009 to 2013/2014.

IFG Group plc, Miton Group plc and Impax Asset Management Group plc are excluded from the analysis as either data was not reported or is considered an outlier.
IFRS 10 & 12: Consolidation Suite

- Effective 1 January 2014 EU-IFRS; currently effective for IFRS.

IFRS 10: Consolidated financial statements

- New single model for control based on power, exposure between variability in returns and link between two.
- Introduces non-consolidation for investment entities.

IFRS 11: Joint arrangements

- New accounting for subsidiaries and joint ventures (now joint arrangements), and making limited amendments in relation to associates.

IFRS 12: Disclosure of interest in other entities

- Disclosure requirements for entities that have interests in subsidiaries, joint arrangements, associates and/or unconsolidated structured entities.

New UK GAAP

- Whilst listed UK companies are required to prepare financial statements under EU-IFRS, often companies, within listed groups, and many unlisted companies continue to apply UK GAAP. FRS 100 introduces significant changes to UK GAAP and sets out the choices available.
- Effective 1 January 2015; early adoption permitted.

KEY OBSERVATIONS

We observe implementation of IFRS 12 to be a challenge for companies across the industry, specifically around the determination of whether an entity qualifies as a "structured entity". Determination whether an investee is a structured entity is a key factor in determining the extent of disclosure required under IFRS 15 and companies will need to evaluate each of their investees to make an appropriate determination.

The new requirement will affect companies in different ways and some more than others. The standard suggests that variable consideration – performance fees – is a potential area where some entities could end up recognising revenue earlier as a result. However, as the revenue recognition criteria includes the constraint that the revenue must be "highly probable" that significant reversal may not occur, it is unlikely many entities will include recognise performance fees earlier than under the existing requirements. We also observe that the new standard could impact the way companies account for deferred acquisition costs and upfront fees.

As IFRS 9 substantially retains the scope and recognition/derecognition of IAS 39, we do not anticipate the introduction to have a significant impact on the investment management industry. Notably, companies holding investments at fair value will continue to do so upon adoption of the standard.
IFRS 9: Financial Instruments
- Effective 1 January 2018; not yet endorsed by EU.
- New standard largely retains the requirements of IAS 39 relating to the scope and derecognition of financial instruments.
- Structured in three phases:
  1. Phase 1: Classification and measurement of financial assets/liabilities.
  2. Phase 2: Impairment.

IFRS 15: Revenue from contracts with customers
- Effective 1 January 2017; not yet endorsed by EU.
- The standard introduces a new revenue recognition model for contracts with customers that recognises revenue either at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognised.
- New qualitative and quantitative disclosure requirements.
- Amended guidance on capitalisation of incremental costs.

FRS 101:
- Reduced disclosure framework that may be applied in the individual financial statements of ‘qualifying entities’ that otherwise apply the requirements of EU-IFRS.
- For subsidiaries of entities preparing EU-IFRS consolidated financial statements, FRS 101 will allow the use of accounting policies that are more consistent with those of the group, without the perceived burden of applying the full disclosure requirements of EU-IFRS.

FRS 102:
- Replaces the previous body of UK GAAP standards with standards based on IFRS for small and medium entities (SME).
- List of disclosure exemptions for ‘qualifying entities’.
- Based on IFRS for SMEs, FRS 102 is designed to be easier to apply than IFRS.
- Available to qualifying small entities.

Exposure Draft: Leases
- New accounting standard for leases which may result in most operating leases (except for some short term and other leases) being recognised on the balance sheet as a “right to use asset” with a lease liability measured at the present value of future lease payments.
- Originally planned as a converged standard between IFRS and US GAAP. However some key divergences emerged as the project unfolded and deliberations continue as of the date of this publication.

Available online – KPMG publications for additional guidance
1. “IFRS Practice Issues: Adopting the consolidation suite of standards”
2. “Guide to annual financial statements – IFRS 12 supplement”
4. “First Impressions: Revenue from contracts with customers”
5. “New on the Horizon: Leases”
6. “Cutting through UK GAAP”
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