Sector Investment Managers Limited

Internal Capital Adequacy and Risk Assessment Process

Prepared by the ICARA working group:
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Approved by:	The Board of Sector Investment Managers Ltd
At a meeting held on:	*15 March 2022*
Signed:	
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1. Purpose of this document

This document is an explanation to the Financial Conduct Authority of the firm's internal capital adequacy and risk assessment process (ICARA). It is based on existing internal documentation of the business and is presented here as a summary of:

- key issues examined in assessing capital adequacy
- the risk assessment process used
- the risks identified, controls applied, and mitigating actions taken
- the firm's risk profile
- methods used for testing the impact of key risks
- results of stress testing and risk impact modelling
- capital adequacy calculations
- Pillar 1 capital requirements compared with ICARA calculations
- capital plans for the firm and forecasts of future capital requirements
- review of risk management systems, controls and improvements.

Annexes contain the firm's registration details and permissions, its financial position at the time the ICAAP was undertaken, a full risk assessment, risk quantification tables and a tabulation of capital resource required to meet the identified risks if they were to materialise.

2. Key issues in assessing capital adequacy

2.1 Background of SIM Limited

2.1.1 Description of business, transactions and customers	Sector Investment Managers Ltd (SIM) is an investment manager advising one FCA authorised OEIC.
2.1.2 Firm's structure (legal and operational)	SIM was founded in 2004 by Angelos Damaskos and Terence Bond who are the directors of the firm. Angelos is Chief Executive Officer and takes responsibility for all investment decisions. Terry takes responsibility for operational decisions
2.1.3 Current FCA regulated activities, firm's permissions and BIPRU classification	SIM is authorised by the Financial Services Authority (No. 400908) and holds the following permissions: • Advising on investments • Arranging deals in investments

- Dealing in investments as an agent
- Establishing, operating or winding up an unregulated collective investment scheme.
- Making arrangements with a view to transactions in investments
- Managing investments

Full details of the firm's permissions are given in the FCA Register, extracts of which are given in annex 1.
SIM currently calculates its capital requirement applying the FCA rules which apply to a BIPRU 50k limited licence firm.

2.2 Current lines of business and market condition

2.2.1 Current line of business and market conditions

SIM seeks to generate capital growth for its clients. Although benchmarks do not play a part in portfolio construction it is a useful tool that SIM considers that success in commodities markets investments usually results from identifying transformational value of companies at an early stage in their development. The directors of SIM see no reason why their current business success should not be continued.

2.2.2 Current business performance

SIM is trading profitably and has done so since its formation in 2004. Extracts from the latest accounts as of 31 May 2021 (see annex 2) are as follows:

Turnover	£355,441
Gross Profit	£319,911
Operating Profit	£106,691
Profit for the financial year after tax	£86,629

2.2.3 Trends in performance and planned business developments

The funds under management have shown longer-term growth since SIM's inception with the exception of 2008 when market volatility caused a material drop in asset values. However, since the peak of our target sectors in April-May 2011, funds have declined considerably, with income at SIM matching the decline in the funds. Costs have risen proportionally to the NAV throughout this period but have stayed higher since 2011 causing a drop in profitability.
Up to date performance figures of the funds can be accessed on the company's web site: http://www.sectorinvestments.com

2.2.4 Risks currently considered in calculating capital requirements

The firm currently calculates its capital requirement applying the FCA rules which apply to a BIPRU 50k limited licence firm, under which a firm's Base Capital Requirement is equal to the higher of:

€50k or
Credit Risk plus Market Risk or
Fixed Overhead Requirement

2.2.5 The balance sheet at the start of ICAAP assessment

The balance sheet at 31 May 2021 showed net assets of £258,473

2.2.6 Projected capital resource requirements based on current plans	Current plans for expansion are to pursue organic growth in the firm's market place. There is no anticipated increase in the capital resource requirement. The projected financial position of SIM, considering the planned sources of income, the extent of capital available and the capital resources required based on the plans for the company over the next three to five years, can be found in annex 4.
2.2.7 Pillar 1 Capital resource requirement calculation	When the ICARA commenced, the Pillar 1 Capital Resource Requirement for SIM was calculated as €50,000 and the fixed overheads requirement £30,000
2.2.8 Analysis of losses sustained by the firm in previous years	The firm has been profitable since its formation.

3. The identification of risks and their assessment under ICARA

3.1 The risk assessment process used

3.1.1 Outline of data gathering process and source of risk classification	The firm has completed its ICARA using a process of internal consultation, data gathering and analysis. A group of senior company managers have been designated as an ICARA working party (see page 1) . Information on the risks the firm faces and how it manages them was gathered from members of the working party by structured interviews and by scrutinising company records, including financial statements and control documents. The data was organised using the risk classification established by the Financial Conduct Authority *(Annex 1, The FCA's Risk Assessment Framework, August 2006)* and supplemented with additional risk classes identified by the Committee of European Banking Supervisors *(Ch.4, Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised, January 2007).*
3.1.2 Assessing inherent (or gross) risk scores	Each risk element has been considered in the light of current and past experience of members of the ICARA Working Party and its relevance to the business. Identified risks have been mapped on a matrix under appropriate headings together with brief descriptions. • Where specific risk elements were deemed not applicable to the firm's business, they have been logged as "Not applicable". • Where a risk element might apply to a firm of this type but is considered, in this firm's case, not to apply, or only to apply at a very low level of impact, it has been logged as "No significant risk to the firm identified".

- Where a risk element has been considered to be a composite of other already identified risks, cross references have been recorded on the matrix.

Each relevant risk has then been assessed by company managers, working with the consultancy, on two dimensions, probability (P) and impact (I), using a four point scale for each. The resulting inherent (or gross) risk [(P) * (I)] has been calculated for ranking purposes.

3.1.3 Mitigation of the identified risks and assessing net risk scores

Strategies, policies and procedures applied within the company to mitigate individual risks have been identified and brief descriptions logged on the matrix.

- Already existing mitigation is recorded in roman type (like this).
- Mitigation that would be applied in the event of a risk materialising is recorded *in italic type (like this) and is preceded by the term 'contingent mitigation'.*
- Mitigation that the company needs to put in place immediately to meet a deficiency in current company strategy, policy or procedures is recorded in **bold type (like this) and is preceded by the term 'action required'.**

The effect of mitigation on the inherent risk (P) and (I) scores has been assessed and a second set of scores (the net risk) assigned to each showing the degree to which mitigation has been considered to reduce either the probability or the impact of the risk materialising or its impact on the company, or a combination of both. These scores are those used in calculating the risk based Pillar 2 capital requirement.

3.1.4 Quantifying the net risk scores

The ICARA working party, in consultation with the consultancy, has quantified the net risk scores as follows:

Impact score expressed as Pillar 2 Capital requirement:

1. Financial cost not significant - can be met from current resources with no impact on profits; Pillar 2 capital requirement = £30,000
2. Financial cost significant - can be met from current resources but profits diminished; Pillar 2 capital requirement = £100,000
3. Financial cost very onerous – additional resources needed; Pillar 2 capital requirement = £250,000
4. Financial cost so great that the company can't survive Pillar 2 capital requirement = £500,000.

Probability score expressed as a multiplier

1. Likely to occur once in 5 years; factor = 0.25
2. Likely to occur once in 3 years; factor = 0.5
3. Likely to occur once in 2 years; factor = 0.75

4. Likely to occur within next 12 months; factor = 1.0

3.1.5 Calculating the total Pillar 2 capital requirement

As a consequence of the detailed risk classification adopted in this approach, careful attention has been given to avoiding double counting. Some confusion can arise between risks classed as business risks and risks classed as control risks. In some cases, individually identified risks are also contributory to other risks; for example reputational risk is treated in this analysis as a consequence of other risks, in particular Conflicts of Interest, Litigation Risk and People Risk.

By cross referencing such potential double counting on the matrix the net risk scores recorded provide what is considered to be a comprehensive but fair assessment of the risks facing the firm.

The net risk scores entered on the matrix automatically calculate and total the Pillar 2 capital requirement using the quantifications given in the tables above.

The full matrix and analysis is given in annex 3.

3.2 The risks identified, controls applied and mitigating actions taken

3.2.1 Gross risks identified

Five inherent or gross risks were identified as likely to have some impact on the firm if not mitigated effectively. They are listed below by risk name and the reference number they are assigned on the matrix.

<u>Business Risks</u>

Economic Environment, 1
Legislative/Political Environment, 2
IT Systems, 13
Other Business Process Risks,14
Market Risk, 17

<u>Control Risks</u>

Compliance, 45

3.2.2 Net risks identified

Mitigation reduced these risks to three lower, but still significant risks as detailed on the matrix analysis in annex 3. They are listed below:

<u>Business Risks</u>

Economic Environment, 1
Legislative/Political Environment, 2
Market Risk, 17

3.3 The firm's risk profile

As is demonstrated in the full analysis, the nature of the firm's business and the permissions under which it operates ensures that its exposure to major risks is limited to:

- risks arising from economic conditions affecting capital and investment
- risks arising from changes to the legislative and political environment
- risks arising from currency fluctuations

The business is managed by directors who are both attentive to developments in their market and to compliance issues in the conduct of the business. Accordingly, the ICARA working party assessed SIM as having a low risk profile.

3.4 Key Risks for stress and scenario testing

Stress and scenario testing is required for all the major sources of risks identified to SIM. These risks are identified in the risk matrix in annex 3 and specifically in 3.2.2 above and are documented in annex 5.

As all the net risks assessed would, if they materialised, impact the company by reducing its sales revenues, it was considered that the most straightforward stress test would be to project how long the business could survive if revenue was reduced to zero. Rather than model this as a cash flow exercise the ICAAP working group chose to consider this on the basis of scrutinising the current accounts and estimating the costs of closure. Without reducing staff or significantly reducing overheads, it was considered that the company could survive for at least a year without any income at all.

4. Stress testing the impact of key risks

4.1 Methods used for testing the impact of key risks

The Environmental, Market, Business Process and Prudential risks as outlined in the risk matrix are considered in the light of imagined and historical scenarios.

4.2 Key risks considered and stress test results

With regard to stress and scenario testing, the ICARA working group considered the impact to the company of a move in equity indexes of +/- 10%, a move in major currencies of +/- 6% and an interest rate move of +/- 2%.

The conclusion of the ICARA working group was that even if all three of the above events happened simultaneously, the impact to the company would not be significant

4.3 Scenarios considered and

Historical scenarios considered were:

stress test results

1992 EMS crisis
1994 Bond market crash
1994 Black Monday
1997 Asian currency crisis
1998 LTCM Russia crisis
2000 IT bubble bursting
2001 World Trade Centre

Prospective scenarios considered were:

U.S economic crash
Global economic crash
Accelerated inflation
Geopolitical unrest
Terrorist attack
Pegged currency breakdown
Oil price jump
Unrest in the Middle East
Emerging market crash
Euro area economic crash

The conclusion of the ICARA working party was that, even at the most severe combinations of the scenarios as outlined above, SIM is sufficiently well capitalised and flexible in the business environment to be able to survive, but may have to adapt in this potential environment of change.

4.4 Combined results and implications for capital resource requirements

By applying the impact scores as shown in 3.1.4 above to the net risk scores given outlined in 3.2.2 above and the risk matrix in annex 3, the Pillar 2 Capital Resource Requirement was calculated at £50,000. The ICARA working party, having considered the possible impact of scenario and stress testing concluded that this was an accurate risk reflection for SIM.

5. Capital requirements as calculated under ICARA

5.1 Capital adequacy calculations

Pillar 1 Capital Resource Requirement was calculated according to the set principles. Pillar 2 capital was calculated according to the ICAAP risk matrix taking due regard of stress and scenario testing.

5.2 Additional capital required for future development of the business

There is no anticipated increase in the regulatory resource requirement for SIM. The development of the business is organic and the overheads of the company in incorporating this expansion are not considered to be appreciably different to the current overheads.

5.3 Capital plans for the firm and forecasts of future capital requirements

SIM has no plans for exponential growth and future capital requirements for the company are envisaged to be similar to the current capital requirements under the new regulatory resource requirement.

5.4 Pillar 1 capital requirements compared with ICARA calculations	The firm's Pillar 1 Capital Resource Requirement calculated according to the principles described in 2.2.4 are currently €30,000 The Pillar 2 Capital Requirement is €50,000 Therefore, the capital requirement for SIM is £50,000

6.Review of risk management systems, controls and improvement

6.1 Current risk management and areas for attention over the coming twelve months	As a result of carrying out this ICARA, the working party are investigating actions to further mitigate any potential risks. These are listed on the risk matrix in annex 3 and are outlined as follows: • *IT Systems (13)* SIM will regularly test the effectiveness of Backup and Recovery systems, including intraday backups, and will update and test the Disaster Recovery Plan
6.2 Dates of next progress review and next full ICARA	This ICARA will be updated during March 2023. As part of that process a review of progress made in addressing the issue highlighted in 6.1 will be made.

Annexes

1. **FCA Register Extract**
2. **SIM Accounts as at 31 May 2021**
3. **Risk Assessment Matrix**
4. **Projected financial position and capital resource requirement over the next 3 – 5 years**
5. **Stress and scenario testing analyses**