

SREP Market View: feedback on key findings

In brief The Supervisory Review and Evaluation Process (SREP) guidelines for investment firms came into effect on 1 January 2023. During 2023 the AFM sent two SREP questionnaires to 240 investment firms, including portfolio managers as well as management companies of collective investment schemes with MiFID top-up authorisation to operate as proprietary traders and also trading platforms. In this SREP Market View, we provide market-wide feedback on the results as they relate to controlled and sound business operations.

Introduction

This feedback will help you determine whether further improvements in your business operations are possible. We highlight in particular several notable observations with regard to ICT management and control, the Product Approval & Review Process (PARP), governance, asset segregation and management.

Initial observations

ICT management and control

Effective management and control of ICT, alongside safeguarding the institution's business operations, is important for three main reasons:

1. It reduces the risk of abuses in the chain (in the case of outsourcing).
2. Cyber risks in the portfolio management market are increasing. This can cause service disruptions affecting end customers.
3. New laws and regulations for the sector (DORA) are imminent. Effective ICT management and control is the basis for DORA compliance.

In the first SREP information request, investment firms were asked to estimate their ICT risk management maturity level, using selected control measures from the DNB Good Practice. Information Security.

Surprisingly, many investment firms were evidently relatively unfamiliar with the DNB Good Practice Information Security and/or found themselves dealing with an information request in this manner (a self-assessment) for the first time.

The second information request consisted of more closed questions. The responses revealed that a third of investment firms still have scope for improvement in terms of establishing and/or managing and/or implementing their ICT risk management framework. This is striking, since effective ICT risk management and control begins with a well-defined and implemented ICT risk management framework. The institution sets out clearly in its ICT risk management framework how it addresses information security risks.

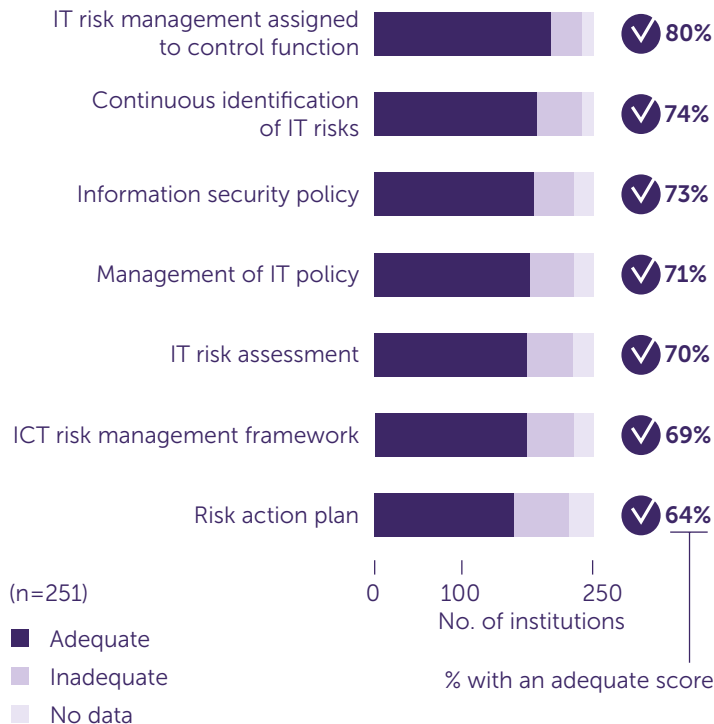
Furthermore, the results show that one in three investment firms do not perform risk assessments on a regular basis. As a result, investment firms risk being unaware of all the current and potential cyber threats and other types of threat they may face.

Finally, it was striking that a significant number of investment firms do not conduct a Business Impact Analysis (BIA) of any sort and/or have a risk action plan in place. It is important to recognise that a BIA and a risk action plan are two separate things: after performing a risk analysis, you formulate a plan to mitigate a risk, which is called the risk action plan; conducting a BIA serves as the starting point for your Business

Continuity Plan (BCP). A risk action plan sets out how firms address risks that are not sufficiently mitigated by existing security measures. Without a risk action plan, risks have the potential to inflict severe damage on the investment firm concerned and/or the financial system.

Figure 1. ICT riskmanagement

Estimate of ICT risk management maturity level for various aspects:



What does Figure 1 show?

What percentage of firms rate their ICT risk management as adequate? In this table, the score is broken down by several elements that are part of the ICT risk management framework.

Most investment firms, however, indicate that they have established an independent control function responsible for managing and monitoring ICT risks.

The SREP results also offer insights into the aspects of ICT management and control that investment firms seem to find problematic. These are, specifically, testing their digital operational resilience and testing the Business Continuity Plan. Regular testing gives firms insight into the actual resilience of their processes and systems.

Many investment firms judge their crisis communication plans as inadequate. The guiding rule here is that firms find an aspect challenging if fewer than 75% score satisfactorily in that regard.

Product Approval & Review Process

A well-defined and implemented Product Approval & Review Process (PARP) is important because:

1. It details the product and distribution strategy.
2. It provides insight into the balanced assessments of interests that must be undertaken when introducing new products and/or services to the market.
3. It serves as the foundation for elaborating the chain processes.

Significant work remains in relation to PARP, with too many investment firms (over 20%) wrongly believing that PARP does not apply to them.

Some investment firms think that PARP does not apply to them because they only offer portfolio management or provide investment services. Other investment firms believe that PARP does not concern them because they do not create their own products, work only with professional relations or select only external investment solutions. Even in the above circumstances, investment firms should nonetheless have a PARP in place.

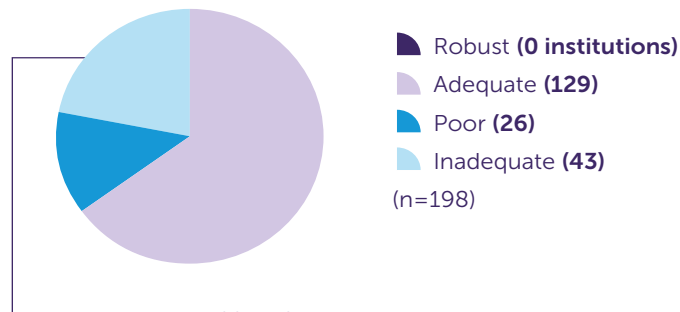
The quality of the Product Approval & Review Process is improved when:

- a. A matter is considered from multiple perspectives.
- b. For example: not only from the Legal and/or Compliance perspective, but also from the perspective of Risk Management, Operations and Product Management.
- c. Several aspects are included in the assessment, such as a defined target group, distribution strategy and manner of information provision. Clear separation of responsibilities, scenario testing as well as periodic evaluation of products and services are also part of the process.
- d. Target group identification is carried out in a structured manner, focusing on elements such as risk tolerance, sustainability, investment horizon, client location, knowledge and experience and cost.

Although the Product Approval & Review Process does not apply to all investment firms (for example proprietary traders, OTF and MTF trading platforms), the figure below shows that a third of the obligated investment firms do not have a PARP in place and/or that there deficiencies with regard to their process.

Figure 2. SREP scores PARP

What is the quality of the PARP that institutions have in place?



Roughly one-fifth of the institutions have an **inadequate PARP process** in place.

What does Figure 2 show?

Graphical representation of SREP scores on PARP. Based on analysis of the results from this first SREP-PARP, it can be concluded that two thirds of investment firms have an adequate PARP in place. A third of investment firms that might be expected to have a PARP in place receive unsatisfactory scores ('poor') or have no PARP in place as yet ('inadequate').

Governance: policy and internal control

The first SREP request involved compiling an inventory with regard to internal risk management and control. This addressed, among other things, policy documents, risk and other frameworks, codes of conduct and procedures. Good governance is important because it provides insight into how the firm:

1. Is structured with a view to ensuring the necessary separation of functions;
2. Ensures the effectiveness of control measures;
3. Ensures accurate and timely alignment between laws and regulations and the firm's procedures and processes.

A very large majority (>90%) states that they have policies in place related to 'internal control'. However, this does not necessarily mean that their policies in this regard are firmly documented and are also properly implemented. A significant proportion of investment firms (20%) have yet to formulate (and implement) policies with regard to other aspects, such as entering into loans and/or other transactions with directors, and implementing a whistleblower policy.

Asset segregation

Effective asset segregation is important since it helps facilitate:

1. Improved investor protection;
2. The financial stability of the sector;
3. Controlled business operations through clear administrative structuring and control.

The results indicate that investment firms apparently have limited insight into the services provided by their appointed custodian banks. Yet, clients of these investment firms derive clear benefits from this insight.

In the institutional segment in particular, investment firms indicate that they are not always aware of the agreements made between institutional investors and their custodian bank. This applies especially in relation to securities lending. Lack of awareness regarding institutional investors' custody processes and practices can affect an investment firm's business operations.

An investment firm must also be able to inform clients about what happens to their securities in the context of securities lending. Clients should be aware if the investment firm chooses to use multiple custodian banks, with one lending securities and the other not. It is additionally relevant whether the client also receives the full proceeds of the securities lending.

Management

The requests for information regarding the organisation of management focused on board composition and involvement, the separation of functions and the continuous suitability of directors. Measuring these aspects is important because sound composition, availability and involvement is an essential condition for:

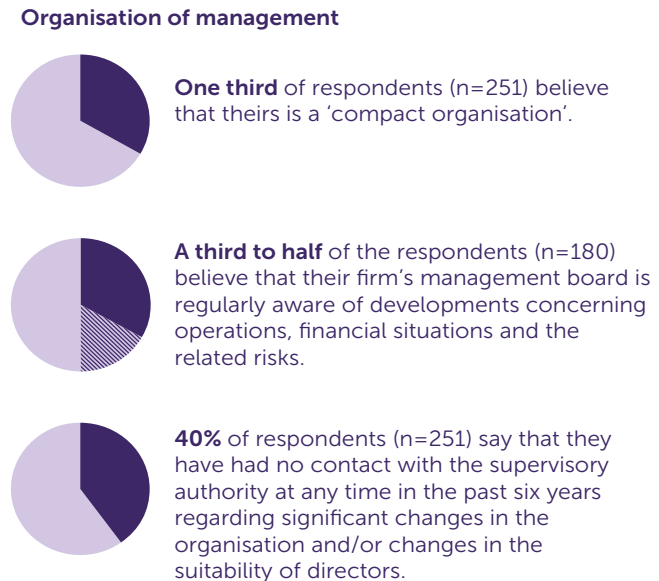
1. The continuity of the investment firm;
2. Ensuring the necessary separation of functions;
3. The continuous suitability assessment.

A third of the investment firms state that theirs is a 'compact organisation'; one in which the board prepares all the reports itself and/or is so deeply involved in the day-to-day operations that it remains constantly aware of the firm's current activities and state of affairs. 'Being aware' is not enough, however. Board involvement and the separation of functions should be formalised.

In answering a set of open questions, 180 respondents provided insight into the extent to which their firm's management board is aware of its operations, financial situations and the related risks. A third to half of these investment firms are at least regularly aware of the developments concerning their firm.

In a dynamic market, marked by, among other things, acquisitions, mergers, joint ventures and/or changes in the business model (including outsourcing), the AFM is struck by the fact that 40% of parties indicate that they have never or not recently (i.e. in the past six years) had contact with the supervisory authority regarding significant changes in the organisation and/or changes in the suitability of directors, despite the fact that it is mandatory to report such matters to the AFM.

Figure 3: Open responses to several management questions



What does Figure 3 show?

This figure is a graphical representation of the analysis of the open responses to a number of questions related to management as described earlier.

Method and scores

The AFM's focus in the SREP requests is primarily on the aspects related to controlled and sound business operations. This field is very broad, however. The AFM has therefore chosen to adopt a phased approach to requesting information on the various aspects, such as risk management, outsourcing, remuneration policy, leadership & culture. The results are converted into 'SREP scores'. SREP scores are registered on a scale of 1 to 4, with 1 indicating robust control and 4 inadequate control of the relevant risk. Within this system, a score of 2 corresponds to adequate, while 3 indicates poor.

Next request for information in September

Our next SREP request for information will follow in September 2024. Detailed information will be provided in due course. In addition to a number of standard data fields that allow a picture to be obtained of business operations, this year's questionnaire will also include sections on complaints and incidents, outsourcing and remuneration policy, among other things. A few weeks before the questionnaire becomes available for completion in the AFM Portal, you will receive the announcement letter and a PDF of the questionnaire to allow you to prepare.