LSE:CIN

2 June 2014

City of London Group plc ("COLG" or "the Company" or "the Group")

Pillar 3 Disclosures

Executive Summary

City of London Financial Services ("COLFS") is an FCA registered investment management company whose principal business is the provision of operator's services to a number of unregulated collective investments. COLFS does not undertake execution only business.

The investment management services are provided direct to the manager. Discretionary clients represent 100% of clients by number and 100% of funds under management.

As a result of the limited scope of its activities and distribution, COLFS believes that the risks inherent in its business are also very limited. It is noted that the FCA have ranked the company as C4/P3 being the lowest risk categories. They fall into three categories:

Pillar 1 – Operational risks
Pillar 2 – Business risks
Strategic risks

COLFS does not invest on its own account or hold market positions. Nor does it directly provide credit facilities of any nature. We therefore conclude that these Pillar 1 risks do not apply to the business.

In attempting to quantify the potential impact of the Pillar 1 (operational) risks it has been concluded that the impact of risk failure in this area would expose COLFS to one or more claims from client/s or from other parties. The potential impact of these claims has been estimated in order to provide an indication of the likely impact of such a claim on COLFS.

It has been assumed that the impact of the Pillar 2 (business or strategic) risks run by COLFS will be to impair COLFS' ability to generate profits as a result of incurring trading losses. In order to estimate the total capital reserves required by COLFS it has been assumed that there may be a large claim following an operational risk failure combined with loss of business as a result of damage to COLFS' reputation. It is believed that this combination of events would have the most potentially damaging impact on COLFS's capital position.

The consequence of identified risks should, however, be seen in the context of COLFS, which is a limited company. There are directors. Capital would only be affected in the event of a major operational risk failure.

In the event of a potential claim under a Pillar 1 risk along with the negative impact of a serious downturn or business risk COLFS Directors would take further steps to cut costs.

Summary of Conclusion

The budget projections of COLFS have been stress tested in scenarios that are considered to be extreme over the next five years. The only Pillar 1 risks run by the company are operational risks. There is currently no insurance to cover claims. It is considered extremely unlikely that COLFS would suffer from claims resulting from multiple errors (rather than multiple claims from a single error) and that the current capital requirement is more than sufficient to meet all foreseeable circumstances. Nevertheless as part of COLFS' capital planning process, further capital can be provided from COLG if required.

This ICAAP assessment has been challenged and reviewed by COLG and now forms part ofthe firm's strategic and operational planning processes.

Overview

Background

City of London Financial Services ("COLFS") is an FCA registered firm. Its activities primarily relate to the provision of operator agreements for Limited Liability Partnerships.

COLFS was formed as a private limited company in 2006 and does not hold client assets or cash, or the like – in essence as simply structured as is possible.

The operations of City of London Financial Services ("COLFS")

COLFS has no staff but has the use of an administrator as required. It operates from its principal office at Cannon Street, London. The main activity is an operator for LLPs which are unregulated collective investment schemes and as operator for LPs which are leasing and lending businesses. These activities generate approximately £50,000 by way of revenue per annum. COLFS currently has four LLPs as clients and two LPs. The average assets managed per LLP is around £3m and this may increase and the total assets managed by the LPs is £10m. The LLPs are managed through Therium Capital Management Ltd ("Therium") a subsidiary of COLFS' parent, the City of London Group plc ("COLG"). As a secondary activity COLFS undertakes the review, for compliance purposes, of marketing material prepared by other COLG subsidiaries for which it receives an annual fee of £5,000 from COLG.

Sources of new business

The current activities both as operator and compliance reviewer are derived principally through the COLG group.

Investment Administration

The LLPs are managed by Therium using its own investment management back-office system. The LPs are managed by Credit Asset Management Ltd ('CAML'). COLFS monitors theseon a regular basis.

Organisation structure and monitoring/review processes

Appendix 4 sets out the monitoring and overview process within COLFS.

Compliance overview

The Compliance Officer holds the controlled function for compliance and is assisted by the other staff as appropriate. An annual high level review of our in-house Compliance work is carried out by external compliance consultants and the report from this audit is reviewed by COLFS' Directors.

Outsource suppliers

COLFS does not have material outsourcing arrangements due, in part, to the separate appointment of Therium and CAML as managers.

Background – the ICAAP process

There have been five elements to the ICAAP process within COLFS:

1. The identification of all of the risks to which the business is exposed and the estimate of the impact of these risks.
2. The assessment of the current capital and the degree to which that is sufficient to cover the risks.
3. An assessment of COLFS operational failures which have occurred in the past.
4. Projected future capital requirements based on the company's known strategies and projected forward for three years form the basis of the company's annual budget for the year to March 2015.
5. The projections have then been "stress tested" by the overlay of three scenarios on the budgeted current year results. On the basis of estimated increases in both costs and revenues over the next five years, similar conclusions can be drawn. In conjunction with this has been an assessment of the ability of the business to access additional capital should it be required at that time.

Having undertaken its ICAAP process, the company has elected for a Pillar 1 plus approach to calculating its capital requirements.

Section 1 – Identification of Risks

<u>Pillar 1 risks: credit, market and operational risks</u>

<u>Credit Risk</u>

In the conduct of its business of operating LLPs, the company does not (and does not expect to) undertake any activities that result in exposure to credit risk. No lending is carried out or extension of credit terms to any client, agent or other party. NOT APPLICABLE.

<u>Market Risk</u>

The company does not trade on its own account nor does its fee income vary with market/fund movements. The company's cash reserves are held on deposit with the subsidiary of a major clearing Bank and, therefore, it is believed that the company's capital is not directly exposed to market risk. For the purposes of Pillar 1, market risk has been assessed as NOT APPLICABLE.

<u>Operational Risk</u>

The firm does not, due to its size, have significant or material operational risks. COLFS does not undertake business outside its current core activities.

It is believed that COLFS' operational risk is lower than that of many similar businesses due to the limited range of its activities. It is believed that the standard level of Pillar 1 capital requirements should therefore apply. The details are provided in Appendix 2.

<u>Pillar 2 risks: business and strategic risks</u>

Under the Pillar 2 risks we have identified those risks that will not result in a specific claim against the business but relate to the ability of the business to sustain and generate profits and maintain its future capital reserves. Under Pillar 2 we have examined:

<u>Business risks</u>:

- Reduction in client numbers/funds under management as a result of damage to reputation, failures in service or standards.
- Reduction in profitability as a result of declining margins due to increased costs.

<u>Strategic risks</u>:

- Failure to identify or adopt strategies to enable the business to retain its customers, resulting in reduction in profitability over time.
- Reduced demand from LLPs for operator services over time
- Disposal of Therium

Unlike the Pillar 1 operational risks that are more likely to result in single "hits" to the firm, the impact of Pillar 2 risks will likely be spread over a period of time. When assessing the impact of Pillar 2 risks we have also considered the ability and the extent to which the

Directors could take actions such as reducing costs or introducing capital to mitigate or remove entirely the impact of the risk to the firm's capital adequacy.

Risk Mitigation and Monitoring

Appendix 4 provides an overview of the processes that the business undertakes to monitor its risks.

Statement of Risk Appetite

Appendix 5 sets out the firm's risk policy and its appetite for risk. This has been reviewed and approved by Directors and forms an input and context to the development of our future plans and will be reviewed on an annual basis at the time further plans are developed.

Business Strategy

The firm's strategy is to extend its core business areas opportunistically through ensuring that its client service remains of the highest standard.

The firm may seek to significantly broaden the scope of its activities or the products offered to clients. Operator agreements for clients based on agreed investment mandates is expected to remain the main core of the firm's business. However the firm will also consider undertaking operator services for regulated schemes and undertaking investment management activities directly.

The financial impacts estimated to arise from the firm's strategy and the related mix of business has been included within the projections against which the ICAAP scenarios have been tested.

Other products and services

COLFS is not contemplating offering other products and services.

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Material Risks

Pillar 1 – Operational Risks

The Operational Risks of the business relate primarily to claims on the business as a result of failure to adhere to regulatory requirements or to provide agreed service levels for clients, or dealing errors. The key Operational Risks and the steps taken to identify, mitigate and manage them are provided in Appendix 1.

The impact of a major risk failure by the business is likely to have one of the following impacts: A claim from a client or clients for reimbursement due to a failure to comply with client's investment instructions.

- A claim from a member of staff, client or other party including a regulatory body as a result of failure to comply with legislation or regulation.

- Reputational damage as a result of the occurrence of Pillars 1 or 2 risks and the consequent loss of business. The effect of this reputational damage is one of loss of existing or new business similar to the Pillar 2 scenarios.

When assessing the impact of the materials risks we have therefore attempted to identify:

- The firm's ability to withstand a claim under Pillars 1 or 2 above; and
- The firm's ability to withstand loss of business as a result of the occurrence of Pillars 1 or 2 risks.

Impact of Pillar 1 risks:

Single claim from a client

The firm devotes considerable effort to ensuring that COLFS is fully up to date with regulatory issues. Breaches could occur but there have been no errors to date.

A potential risk could be the management of a partner's investment in one of the LLPs on a different basis to that agreed with the partner. COLFS takes great trouble as operator to ensure that its client LLPs only accept investment from qualified partners and that the investment partners agree specific mandates when they join a LLP. Furthermore a Director of COLFS attends the Investment Committee of Therium and thereby ensures that a proper investment process is carried out on behalf of the partners of the LLPs. The risk of a claim on any of these fronts is therefore judged to be low and although it is difficult to quantify as a result, would be unlikely to exceed £100,000.

Since COLFS's inception compensation payments to clients as a result of dealing errors have been zero and it is expected to remain so.

Pillar 2 risks

By their nature, Pillar 2 risks result in the gradual erosion in the capital base of the business through sustaining trading losses as a result of exposure to business, strategic or reputational risks flowing from operational risk failures.

In our quantification of Pillar 2 risks we have started by modelling a number of scenarios to explore the extent to which a sudden downturn in business would impact upon business profitability. The scenarios examined are:

- The loss of the firm's largest clients representing c.80% of revenues.

The budgeted profit and loss projections are set out in Appendix 3.

Capital Planning and Stress and Scenario Tests

Capital adequacy projections for twelve months ahead are reviewed every quarter. COLFS is a subsidiary of COLG which is itself a quoted company and capital can be increased as necessary from COLG's resources.

In the unlikely event of capital pressure on COLFS as a result of any of the Pillar 1 or 2 risks set out above, COLFS would seek to manage its capital position and maintain or restore capital ratios by undertaking the following sequence of activities:

1. Reducing variable and fixed costs within COLFS.
2. Raising further capital.

Pillar 1 risks are judged to be a maximum of £100,000 and this is within the capability of COLG to make good COLFS' capital position. Since COLFS' operating costs are wholly variable it will be able to accommodate Pillar 2 risks through reducing its costs in line with any reduction in income. The capital position is therefore considered to be fully adequate. In making any decision involving the allocation of capital to new ventures or in the return of surplus capital to COLG, we intend to ensure that sufficient capital is retained to meet the risks set out in the modelled scenarios.

Stress and Scenario Tests

The stress and scenario testing has been based on a forward projection of the current year's budget over a three year time frame. As explained above the scenario modelled for Pillar 1 risk is an assumed "worst case" situation in which the firm sustains a £100,000 claim which in turn results in damage to COLFS' reputation and significant loss of clients. For the reasons given above COLFS is resistant both to the capital claim and to the subsequent reduction in income

Challenge and the Adoption of the ICAAP

This ICAAP has been reviewed and challenged by the Directors. Each of the material assumptions have been examined in detail and "signed off" by them.

Adoption of the ICAAP

The adoption of the ICAAP encourages an increased focus by the business on robust capital management and the adoption of economic capital disciplines to ensure that the risk adjusted return on capital of any new venture or investment strengthens the company's capital position and does not increase the risk of breaching the capital limits. This translates into two specific procedures within the firm to follow the ICAAP principles:

- The establishment and documentation of minimum capital targets.
- Review of future strategic and business plans against minimum capital targets.

- Review of any individual investment against the ICAAP process.

The ICAAP is reviewed annually by the Directors and form part of the strategic and operational planning process.

Appendix 1

Operational Risk Framework

The following sets out the framework used by COLFS to identify, assess and manage operational risks. The risks summarised below are those considered to have a potential high or medium impact on the business.

DEFINITIONS:

Potential Impact of Risk:

Description	Impact Level
Failure might result (in isolation or in combination with other failures) in a loss to the company of greater than £100,000 or severe loss of reputation or business.	High
Failure might result in loss of between £50,000 to £100,000.	Medium
Failure might result in cost to business of up to £50,000 in loss or cost to rectify	Low
Unlikely to occur	Zero

Residual Rating:

The residual rating is a subjective assessment of the likely impact of the risk AFTER the controls and mitigation have been put in place taking account of the likely impact of the risk and the perceived effectiveness of the controls and mitigation.

Risk	Impact Rating	Management	Overview	Residual Rating
Failure of LLP /LP to correctly record or follow client mandate	H	• Documented procedure for client take on • .	• Independent check and sign off of client take on • Completeness check – Independent check and sign off of audit trail following annual review	L
New Product Risk leading to loss of reputation	Low	• New products developed with input from compliance staff. • TCF principles embedded and regular training programme	• External compliance review.	L

Risk	Impact Rating	Management	Overview	Residual Rating
Failure to reconcile LLP/LP cash reconciliations.	M	• Therium to retain this responsibility. • CAML to retain this responsibility	• Periodic check by Compliance.	Zero
Compliance breach due to inadequate or inaccurate compliance advice or support.	L	• Quarterly meeting to review service level. • Annual review of monitoring programme to ensure that any recent regulatory changes have been considered.	• Independent review of Documentation	L
Fraudulent manipulation and siphoning of income/capital	High	• COLFS check on quarterly LLP / LP accounts. • .	• Auditors.	Zero
		•	•	
Claim due to breach of data protection.	L	• Controls over input storage and retention of data in all forms.	• Periodic review by Directors.	L
Failure to identify money laundering.	M	• COLFS check on KYC procedures for each LLP • All staff trained on ML.	• Review by ML Officer and Compliance Consultants • Training provided	Zero
Health & Safety risk from staff or clients due to failure of adherence to regulations or procedures.	L	• Full procedures agreed with landlord.. • Regular monitoring of compliance and reminders of procedures.	• Review by Directors – .	Zero

Appendix 2

Pillar 1 Calculation

The Pillar 1 calculation assumes a combination of factors including claims for small losses/recompense below the insured retention level combined with two major failures for which the retention level £50,000 each applies.

It is assumed that there may be additional cost to rectify a problem (e.g. investment in new technology) but that this would be accommodated out of revenue. On this basis the amount relating to operational risk has been assessed as follows:

Risk	**Loss description**	**Impact**
Credit risk	Loss as a result of default	NIL
Market risk	Counterparty failure	NIL
Operational risk	Assumed failure of "small" risks	£50,000
Estimated maximum "hit"		£50,000

Pillar 1 Plus has been selected as the appropriate measure for the capital required for the business.

This consists of E50,000 plus three months of fixed costs.

At current exchange rates the regulatory minimum is equal to £40,000.

Three months fixed costs are about £5,000 taking our ICAAP to £45,000.

Appendix 3

Pillar 2 Calculation

COLFS's financial year end is 31st March and a three year plan has been prepared for the financial years to 31/03/2017. This plan has been used as a basis for a projection of income and expenditure until March 2017. The projection covers income and the major expenditure categories.

It does not assume:

- A significant acquisition (none is currently planned).
- A major shift in the mix of business, which is unlikely. It assumes that the current pace of organic growth can continue. Revenues are budgeted to stay constant, staff costs at 0%, compliance and other costs at 10%. It does not assume any expansion of the business operations into products or areas that will increase the operational risk profile of the business and result in a requirement for a higher level of capital reserves.

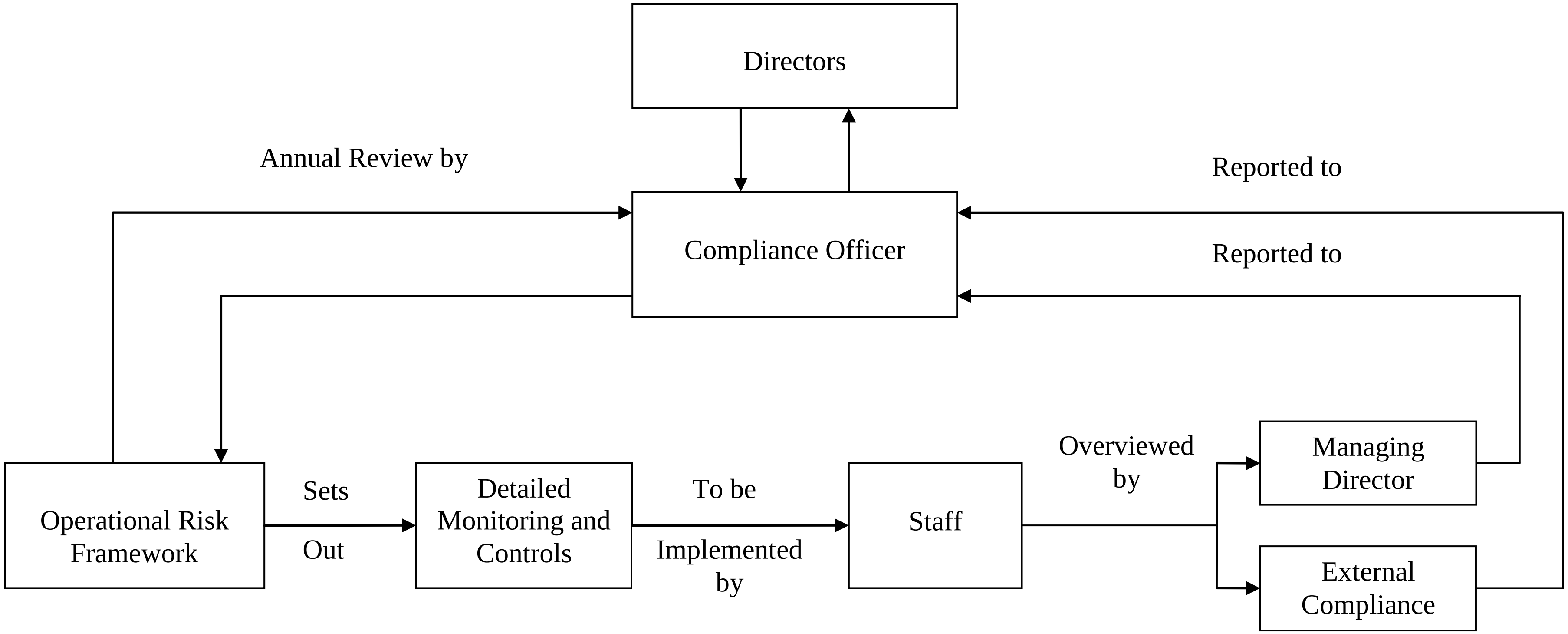
The basic P&L projection is as follows (£k):

	2012/13	2013/14	2014/15	2015/16	2016/17
Revenue	32	50	60	70	80
Administration	20	20	25	30	35
Compliance	6	6	6	6	6
Professional Fees	2	2	2	2	2
Operating Costs	28	28	33	38	43
Operating Profit	4	22	27	32	37

Appendix 4

Risk Monitoring

The following diagram provides an overview of the overview and control procedures in place at COLFS:



Appendix 5

Statement of Risk Policy

Overview

All of the business revenue arises from the provision of operator services to a number of LLPs and LPs and from compliance reviews on marketing material issued to qualified investors. As a result, it does not include financial planning, tax advice or the broad based sale of products or services to the retail market. It is recognised that this limited scope of activities confers benefits in terms of limiting the compliance requirements and risks to those related to investment management.

Policy

As a general principle the firm seeks to limit its operational risks as far as possible through:

- Limiting the scope of its activities to those it can control and considers within its threshold of competence.
- Having in place effective risk monitoring procedures to minimise its exposure to all operational risks whether internal or as a result of outsourced activity.

Risk Mitigation

In all cases, the firm will seek to mitigate risk where it is practical and cost effective to do so. A pragmatic and proportionate approach will be adopted and the firm does not seek to mitigate all possible risks at whatever cost. There may be circumstances in which an extremely high cost of mitigation outweighs any potential loss that might occur from the risk. In these cases risk will only be mitigated where there is a regulatory reason for doing so.

The approach to risk mitigation (in order of priority) is:-

- To embed procedures and controls into the firm's processes and procedures that prevents risk events occurring.
- To ensure that all risks are identified and monitored as part of the firm's operational risk procedures.
- To ensure that the firm's senior management are alerted to problems at an early stage.
- Where risks can be more effectively mitigated by an external overview then the firm will engage external parties to supplement its own, internal monitoring and control procedures.
- Where a residual risk remains, then the firm will seek to insure against this risk where it is possible to do so.

Appendix 6

Capital Projection

On the basis of the forecasts the company is expected to have adequate capital for the period under review.

Appendix 8

Capital Adequacy Stress & Scenario Testing

As it is not possible to envisage a worse scenario that the current one, where the company currently has modest revenue, it was not considered relevant to model scenarios where FUM are reduced by withdrawals. In that event the company would have to seek another backer or manage the closure of the business.