PILLAR 3 DISCLOSURES AND CAPITAL ADEQUACY REPORT

Introduction

The European Capital Requirements Directive introduced a revised capital adequacy framework aimed at implementing a more risk sensitive framework for the calculation of regulatory capital.

The framework consists of three 'pillars':

- Pillar 1 sets out the minimum capital requirements that firms must meet for credit, market and operational risks. These comprise base capital resources requirements, credit risk and market risk capital requirements, and the fixed overhead requirement.

- Pillar 2 requires firms to analyse the risks to the business and then consider whether the risks are mitigated to an acceptable level. If the risks are not adequately mitigated, then capital should be allocated against those risks.

- Pillar 3 complements Pillars 1 and 2 and improves market discipline by requiring firms to disclose information on their capital resources and requirements, risk exposures and their risk management policies.

Disclosures

Heritage Capital Management Limited (Heritage) is regulated by the Financial Conduct Authority (FCA) in its investment business, which includes the management of clients funds. Heritage is not part of a group. The disclosures set out below cover Heritage's risk management objectives and policies, and the processes for managing material risks.

As a regulated firm, Heritage is required to produce a consolidated return to assess its capital resources and requirements. These disclosures are required to be made at least annually. The financial year end of Heritage is 31 December and the required disclosures are made as soon as practical after the finalisation of its annual report and accounts. These disclosures are published on the firm's website (www.heritage-capital.co.uk).

Business Risks

Heritage takes a conservative approach to risk management, recognising the importance of understanding the risks to the business, and implementing systems and controls required to mitigate them. The firm conducts an assessment of the business risk to which it is exposed on an annual basis, though given the size and nature of the firm no separate risk management function is considered necessary in respect of the firm's own balance sheet. Matters arising from the review are considered and mitigating or remedial action is taken where appropriate.

We maintain professional indemnity insurance cover for losses, errors and fraud of £6 million with Endurance Insurance, which is well in excess of the minimum level set out by the FCA . Our current assessment of our key operational risks suggests that we are not at material risk of breaching our insurance limits.

The potential risks to Heritage's business and how these risks would impact the firm's capital adequacy are set out below.

- Credit risk covers the risk of loss due to a debtor's inability to pay. This risk covers the failure of banks or counterparties, the failure of a client to pay fees, the failure of a client to pay funds for an investment and the failure of a fund to pay redemption monies. Heritage has exposure to counterparty credit risk in relation to its own balance sheet, being:
    - Exposures to market counterparties (e.g. banks) where Heritage cash is held or through deposits. This risk is currently minimised as Heritage only uses highly rated counterparties for its banking relationships.
    - Fees receivables from clients. The firm regularly monitors amounts due from its clients and has appropriate credit control procedures in place.

- Market risk is the risk that the value of assets will decrease due to a change in value of the market risk factors. Common market risk factors include asset prices, interest rates and foreign exchange rates. As Heritage does not trade on its own account, does not hold any investments or foreign currencies, and holds its cash with highly rated banks, it does not have any significant market risk exposure. Heritage as an investment management company is indirectly exposed to market risk, including funds under management and management fee income. A significant fall in markets will reduce the management fee income from our assets under management but, although our profitability may be significantly affected, Heritage should remain within its prudential capital requirements.

- Operational risk is the risk of losses resulting from inadequate internal processes, people and systems, or from external events. The management of operational risk is formalised in a number of ways including documented procedures and compliance manuals, and the assessment of third party providers. The firm conducts an assessment of the operational risk to which it is exposed on an annual basis. Whilst no separate risk management function is considered necessary in respect of the operational risks which the firm faces given its size and the nature of the risks faced, risk management remains a key function of the firm's business and mitigating or remedial action is taken where appropriate.

- Regulatory risk and Brexit. The regulatory environment continues to grow more complex with MiFID II, GDPR and the challenges of Brexit. Heritage ensures that it meets new and ongoing regulatory obligations which will impact both the firm and the investment vehicles operated by it. Regulatory changes may affect the products and services the firm offers, to whom it may offer them and the fees it is able to charge. The uncertainty over Brexit may also bring additional disruption, but it is not expected to have a significant impact on our business.

- Competition Heritage operates within a highly competitive environment with both local and global businesses, many of which have greater scale and resources. Regulatory and business changes have resulted in a greater focus on fees and charges. Failure to compete effectively in this environment may result in loss of existing clients and a reduced opportunity to generate new business which may have a material adverse impact on the firm's finances and growth. Heritage has a long established and well diversified client base who appreciate our conservative approach to investment management.

- Key employees People are a key part of our business and the stability of our investment and operational expertise is important to the success of our business. This risk is mitigated by the fact that these individuals are also the owners and managers of the firm. Heritage takes appropriate steps to manage expectations and minimise the loss of good quality staff as this may result in the loss of funds under management. We also invest in our employees through training and qualifications.

- Risk of poor fund performance The firm's revenue is reliant on the size and performance of its funds under management. It is also harder to attract new clients during periods of underperformance in a fund, which may impact the ability of the firm to grow. As such, the risk posed to the firm relates to underperformance resulting in a decline in revenue and ultimately the risk of loss of clients and redemptions from the funds managed by the firm. This risk is mitigated by the below average risk profile of the firm's funds under management, its conservative investment approach, its diversified and well established client base and is further mitigated by the excess capital maintained within the business.

- Suitability and conduct risk It is a key aim of the firm to ensure our clients understand the products and services we offer and for us to ensure that the products deliver what a client expects. All our investment processes are documented, which enables clients to clearly understand how we manage assets. These documents are supplemented by summary monthly fund factsheets, and other reports and literature which are available on our website or on request. We produce quarterly investment newsletters and portfolio valuations for all clients.

- Client concentration and redemption risk Heritage has a well diversified range of clients encompassing high net worth individuals, pension funds, companies and trusts. Our largest client represents approximately 6% of the firm's funds under management and, accordingly, our concentration risk and impact on the firm's earnings is low. Clients can make redemptions from our largest Guernsey investment fund monthly, whilst our UK Investment fund has daily liquidity. This may mean that in times of poor performance, assets under management may fall increasing the potential volatility of our earnings.

- Cybersecurity and information technology risk Heritage is dependent on its IT infrastructure and systems. A successful cyber-attack could result in the loss of data, disrupt our ability to service our customers or the loss of clients' funds. Heritage uses specialist external consultants to manage, review and test our IT infrastructure and security. Staff awareness and training is an important part of our defence against attack.

Capital Adequacy

Heritage's objectives in managing its capital are to safeguard the firm's ability to continue as a going concern in order to provide returns for shareholders, to meet its regulatory and working capital requirements, and to keep an appropriate standing with counterparties. The directors review the firm's assets on a quarterly basis to ensure that operating capital is maintained at the required levels.

The directors consider capital to comprise of cash and net assets. In order to maintain the capital structure, the firm may adjust the amounts of dividends paid to shareholders, which will increase cash and reduce capital requirements. The FCA regulates the activities of the firm and imposes minimum capital requirements. The total capital requirement for the firm is the base and variable capital resource requirement (the Pillar 1 requirement) and any additional requirements identified during the Internal Capital Adequacy Assessment Process (the Pillar 2 requirement).

Capital Requirements

The firm's Tier 1 capital is set out in the table below.

	31 December 2018 (£)	31 December 2017 (£)
Called up share capital	50,000	50,000
Share premium	27,000	27,000
Retained earnings	562,304	959,693
Capital resources	639,304	1,036,693

The company does not include within its Tier 1 capital any intangible assets, revaluation reserves, deferred tax assets that are dependent on future profitability or dividends that have been declared by the Board.

Heritage uses its Pillar 1 requirement as the regulatory capital requirement to monitor capital levels against internal risks. During the financial year ended 31 December 2018 the company maintained surplus capital resources at all times to satisfy the minimum capital resources.

The Pillar 1 variable capital requirement for Heritage is calculated as the higher of:

- the base capital resources requirement of EUR 125,000 (ie £112,300)
- the sum of the market and credit risk capital requirements (see table below), and
- the fixed overhead requirement of 25% of the firm's relevant annual fixed expenditure (excluding certain categories of discretionary or variable expense).

Heritage has elected to adopt the FCA standardised approach to market risk. Under this approach the market risk capital requirement is calculated as 8% of the firm's total risk weight exposure to accounts receivable at 31 December 2018 of £337,962 (ie £27,037).

Heritage has also elected to adopt the FCA standardised approach to credit risk. Under this approach the credit risk capital requirement is calculated as 8% of the Group's total risk weight exposures. Heritage uses the simplified method of calculating risk weights and applies the risk weightings of 20% for bank account balances of £529,846 and 100% for accounts receivable of £337,962 at 31 December 2018 (ie £35,514).

The following table summarises the Pillar 1 credit risk assessment:

	31 December 2018 (£)	31 December 2017 (£)
Market risk	27,037	37,057
Credit risk	35,514	49,084
Total risk (i)	62,551	86,141
Fixed overhead requirement (ii)	265,060	237,593
Pillar 1 requirement Higher of i or ii above	265,060	237,593

No adjustments are considered necessary for the Pillar 2 capital requirements relating to concentration risk, interest rate risk, liquidity risk, business risk, reputational risk and regulatory risk.

As at 31 December 2018 Heritage has a Tier 1 capital surplus of £374,244 and a solvency ratio of 141%. The capital resources detailed above are considered adequate to continue to finance the firm over the next year. No additional capital injections are considered necessary and the firm expects to continue to be profitable.

Internal Capital Adequacy Assessment Process ("ICAAP")

ICAAP is reviewed at least on an annual basis, or more frequently should there be a fundamental change to our business. ICAAP considers the various risks inherent in our business, and how those risks are managed to ensure that the risks are manageable in terms of their potential impact should they occur, including their impact on our Capital Resource Requirement. Given the firm's small size and the nature of the risks faced, the assessment is based upon the results of the existing risk management controls and reporting which are used to assess the firm's exposure to extreme events.

Remuneration Code

The FCA has implemented a Code on Remuneration (Code) as required by the Capital Requirements Directive and the Financial Services Act. The purpose of the Code is to ensure firms establish, implement and maintain remuneration policies, procedures and practices that are consistent with, and promote, sound and effective risk management.

The firm must produce a report annually on the remuneration policy and practice for directors and employees termed Code Staff. Code Staff are those "who perform a significant influence function, senior management and risk takers whose professional activities could have a material impact on a firm's risk profile".

Heritage is required to disclose aggregate information on remuneration in respect of its Code Staff, broken down by business area and by senior management and other Code Staff. The small size and lack of complexity of its business is such that Heritage only has one business area, being investment management. Heritage had 3 senior management Remuneration Code staff during the financial year to 31 December 2018, being the Significant Influence Function holders of the firm's regulated activities under the Code, whose aggregate remuneration for the year ended 31 December 2018 was £63,138 (2017 - £56,087).