Investment Management Risk: 2017 Deloitte Survey

Shedding light on South African risk management trends

Wayne Savage
Partner
FSA
Deloitte

Andrew Warren
Director
AIS
Deloitte

Monique De Waal
Associate Director
FSA
Deloitte

Sifiso Sibiya
Manager
FSA
Deloitte

In the current climate of macro-economic volatility and ever-increasing regulatory focus, asset managers are compelled to enhance their investment management risk identification, measurement, mitigation, and monitoring processes and frameworks.

This article presents the results from Deloitte's recent investment management risk survey. We define investment management risk as the risk of losses arising from errors, negligence, and incompetence on the part of asset managers in charge of financial portfolios. Inadequate management of client assets may have an unexpected financial or non-financial impact on the value of client investment assets or portfolios, and consequently may have an unexpected impact on an investment management firm, its earnings, and its reputation.

Investment management risk mainly arises from:

- Client portfolios that are inappropriately benchmarked or not managed in line with client risk-return expectations as per the agreed mandates
- Unfavorable movements in market variables (such as interest rates, inflation rates, currency exchange rates, equity, or property prices) creating asset price risk in client portfolios, which, if inadequately evaluated or monitored, compromises effective investment risk management activities
- Operational issues stemming from investment management business operations. These include losses caused by inadequate or failed processes, people, systems, or external events in relation to client interaction, client registry, unit registry, and asset registry activities. This includes third-party risk arising from outsourced middle or back office duties or functions

Broadly speaking, an asset manager's activities can be classified as either operational or investment management related. In line with this, our survey comprised the following two sections:

- **Investment management activities**

This section encompasses all processes associated with investment decision-making and mainly includes:
  - Setting the investment strategy (asset allocation and security selection)
  - Investment research and analysis
  - Risk management

- **Operational activities**

This section refers to operational and administration processes that facilitate investment activities and includes:
  - Capturing and storing client data
  - Executing and recording client instructions and transactions
  - Financial reporting

This article should be read in conjunction with our recent publication on investment management risk, *Change is on the Horizon*[1], where we explain investment management risk in greater detail.

1. Objectives of the survey

Our survey examined the level of sophistication of South African asset managers in the execution of investment risk management and operational activities.

Given the lack of formal South African regulations in this regard, the survey was based on the ERM process from "Risk Principles guidance". This guidance was published in February 2009 by the Committee of European Securities Regulators (now ESMA—the European Securities and Markets Authority) and outlines the general risk management principles that underpin the UCITS (Undertakings for Collective Investment in Transferable Securities) regulations. Using this document as a reference, we have determined:

- The level of sophistication of South African asset managers' investment risk management practices
- The state of readiness of South African firms with regards to the adoption of a regulatory regime similar to the UCITS framework

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1. https://www2.deloitte.com/za/en/pages/financial-services/articles/changes-in-the-horizon.html

The output from the survey is grouped into the following themes:

INVESTMENT ACTIVITIES				OPERATIONAL ACTIVITIES
Governance and organization	**Identification and measurement of risks**	**Risk management**	**Monitoring and reporting**	
• Risk management policy • Risk management function and risk management practices • Remuneration • Outsourcing of risk management functions or activities	• Identification of risks relevant to the fund • Risk measurement techniques • Risk models and back-testing • Links between risk measurement and asset valuation	• Risk limits • The effectiveness of the risk management process	• Reporting to the board of directors and the senior management • Monitoring of the risk management process	• Risk governance and organization • Identification and measurement of risks • Risk management • Risk monitoring and reporting

2. Key results and analysis

Generally, the results from the survey indicate that risk management practice levels are well developed and that South African asset managers appear to have made meaningful progress towards UCITS preparedness. There are, however, key gaps that need to be addressed.

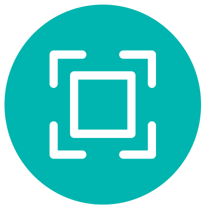
Investment activities

Investment activities are a crucial part of an asset manager's operations and distinguish it from competitors. While we expect each participant's investment activities to be unique, some broad principles should be followed in terms of risk management.

The survey participants for this section represent about R2.7 trillion in assets under management (where the total market size for South Africa is about R4.6 trillion as at December 2017[2]) and manage about 620 funds in total.

We had fair representation across a variety of fund types:

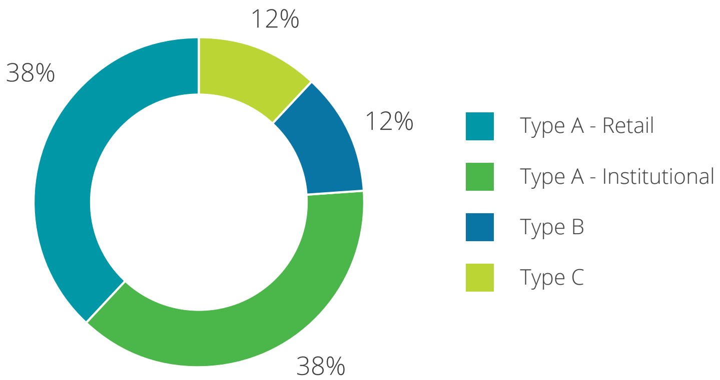
Type A—Vanilla funds
Traditional long-only non-leveraged, single or multi-asset funds. These funds were further segmented between retail and institutional funds.



Type B—Moderately complex funds
Single or multi-asset funds with embedded guarantees.

Type C—Complex funds
Funds primarily based on complex financial instruments or strategies e.g., hedge funds.

Fund type distribution



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The key results from the survey are summarized below in terms of governance and risk management.

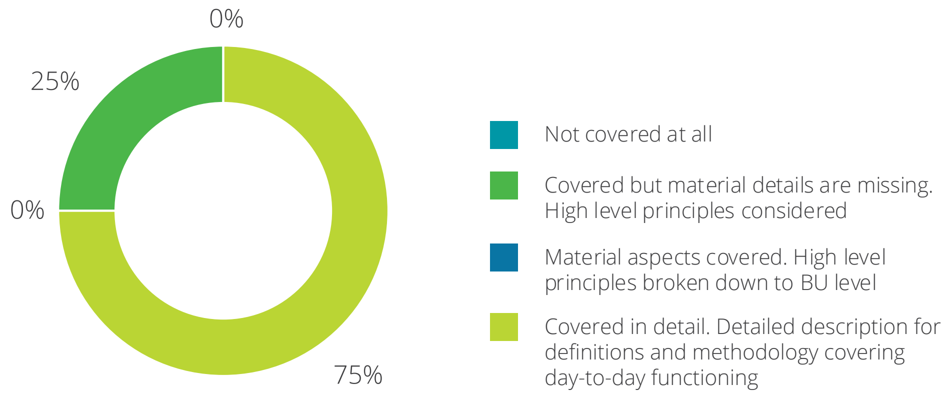
Governance and organization

The ESMA ERM guidance principles state that the risk management policy must establish a robust and transparent framework for managing risks and ensure that there is appropriate segregation of duties, effective utilization of resources, and accountability. Ideally, the risk management policy should be a separate document.

75 percent of firms have a formal stand-alone policy that addresses mandate compliance risk. Of these, 75 percent indicated that such policies establish robust and transparent frameworks for managing mandate compliance risk. This is done by having detailed policies containing:

- Comprehensive descriptions for definitions (i.e. the internal risk taxonomy)
- Methodologies and approaches to identify, measure, mitigate and monitor mandate compliance risks
- Procedures that facilitate the day-to-day application of the risk policy (i.e., exception management, policy breach procedures etc.)

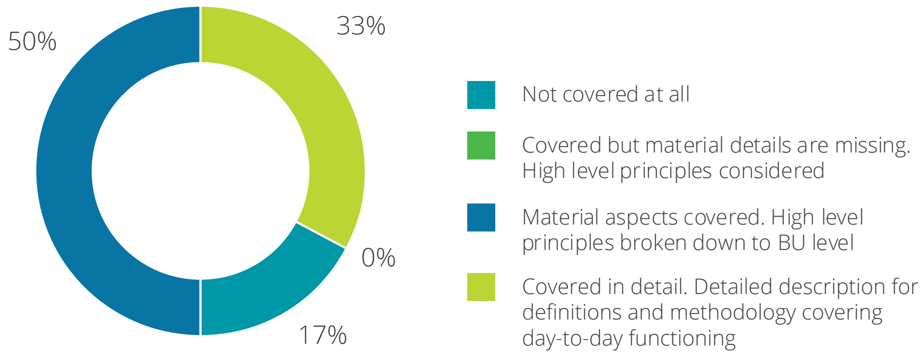
To what extent does the risk management policy establish a robust and transparent framework?



In addition, the following was noted for investment risk within the mandate:

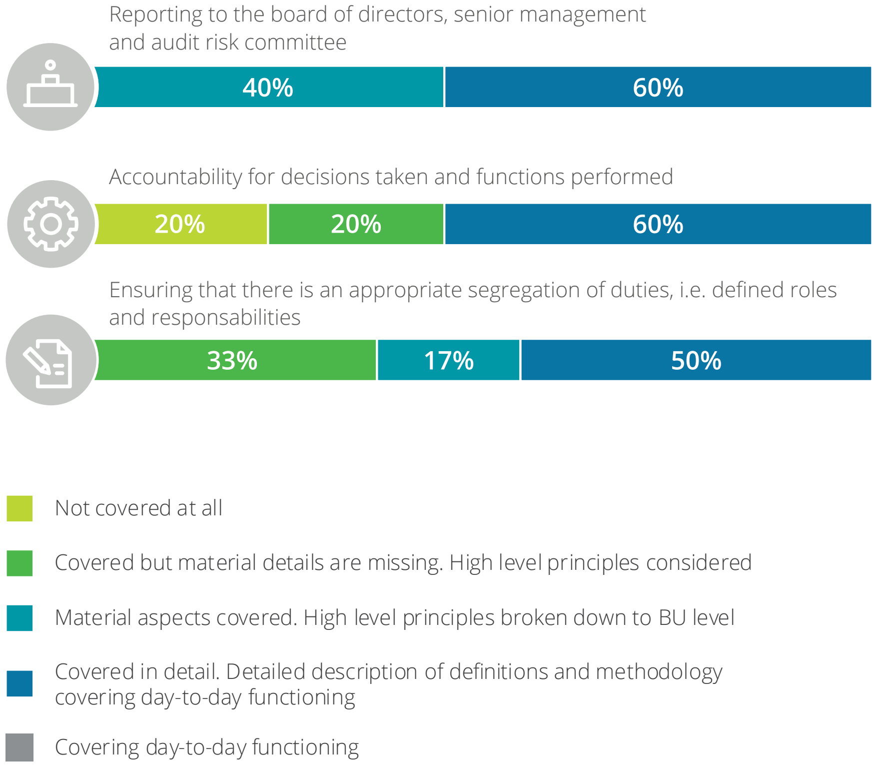
- 83 percent of firms indicate that their policy establishes a robust and transparent framework to identify, measure, mitigate, and monitor investment risks within the mandate
- All participants include an element of risk reporting to the board, senior management and audit committee
- 67 percent of policies ensure that there is appropriate segregation of duties in terms of managing investment risk within approved mandates

To what extent does the risk management policy establish a robust and transparent framework for managing investment risk



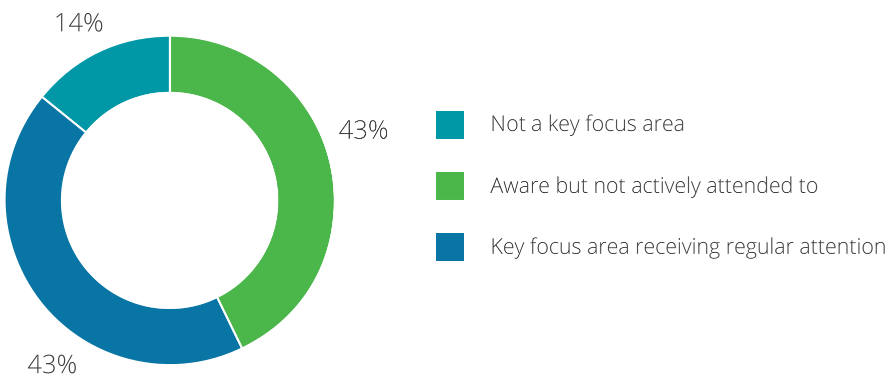
- 40 percent of respondents' policies do not ensure that there is adequate accountability for the risk management decisions taken. This number is concerningly high. A lack of accountability breeds complacency, which is the breeding ground for oversights and unwelcome surprises. South African firms would benefit from aligning their policies with the ESMA guidelines on risk management

Scope of risk management policy : front office



In terms of governance, 43 percent of firms indicate that the board, senior management and audit risk committee are aware of but do not actively attend to investment risk and mandate compliance risk. Due to the increasing complexity of financial markets and expected regulatory developments, there will be an increasing demand for senior management to become more involved in investment risk management.

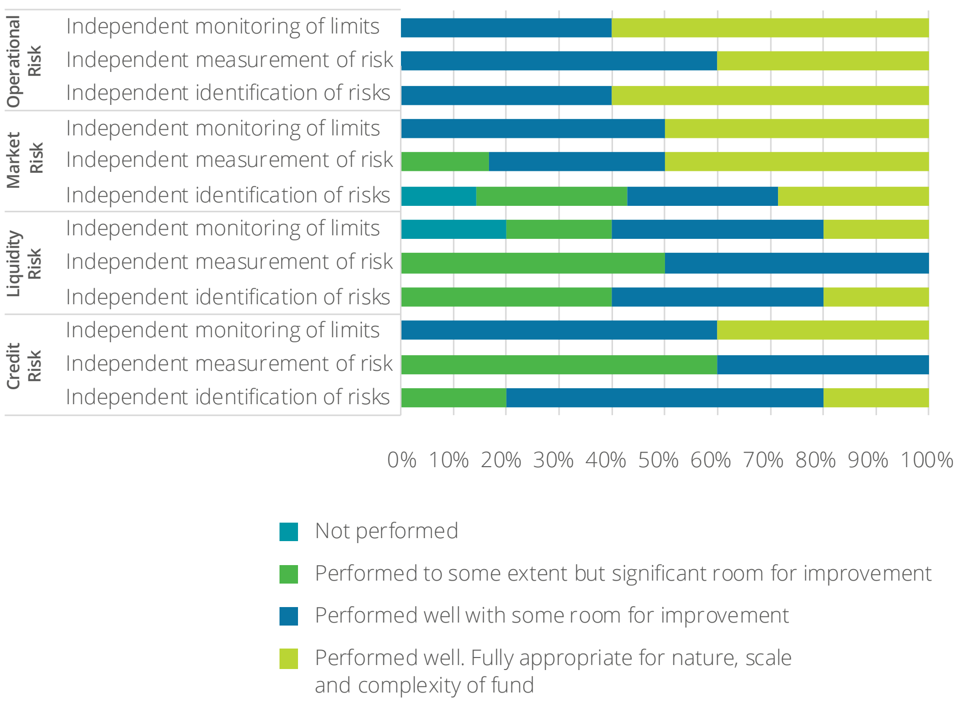
Extent of senior management involvement with investment risk within the mandate and mandate compliance risk?



The ESMA ERM guidance principles further state that the risk management function should be appropriately resourced and should operate in accordance with adequate standards of competence, efficiency, and functional independence (reflecting a fund's nature, scale, and complexity).

All participants indicated that there is independent oversight of investment risk and mandate compliance risk management by their middle office functions. In addition, middle office functions independently validate the performance of various components of the risk management process such as risk measurement, risk monitoring, and risk identification.

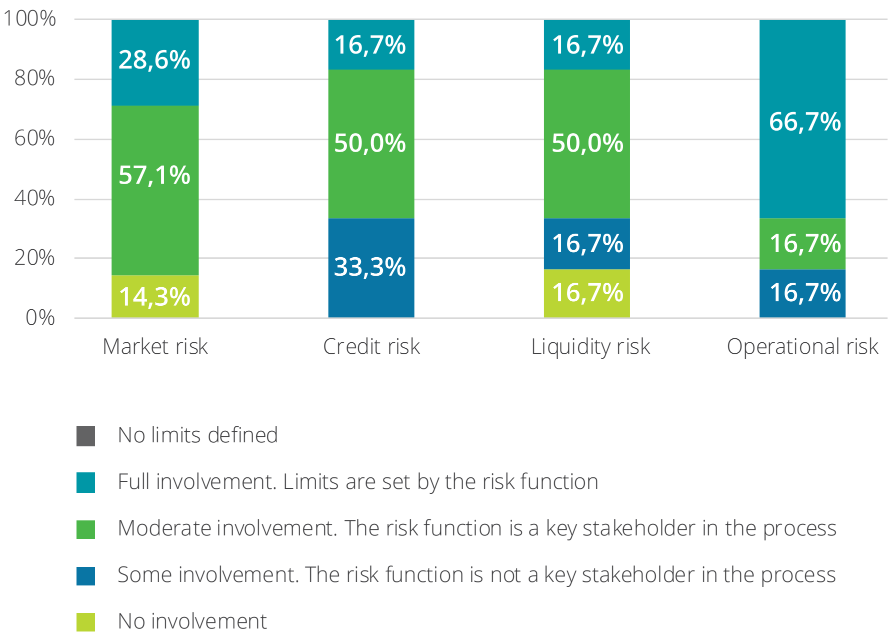
Tasks performed the middle office per risk type



Moreover, all participants surveyed indicated that they use risk limits in their governance framework to manage investment risks. However, the involvement of the middle office in the determination of risk limits differs across risk types.

All participants also indicated that their remuneration policies are structured to ensure that those who are in oversight roles remain independent, and those who are in investment decision roles are focused on clients' interests.

Level of middle office's involvement in determining and monitoring risk limits



Identification and measurement of risks

The ESMA ERM principles recommend that the risk management policy specify suitable the techniques to measure the risks inherent to the investment strategies and management styles adopted for the fund.

Our survey results indicate that a variety of quantitative risk metrics are used to measure risk. Volatility is a popular metric for market risk. This is to be expected because it is easy to calculate, however, more sophisticated metrics may be required in future (e.g., hedge funds are required to use Value at Risk by the FSB[3]).

The preferred metric for credit risk is total exposure per counterparty—also easily calculable and without significant data availability constraints.

The percentage of a security held relative to the total available on a free-float basis is a popular measure for liquidity risk. This measure is easy to calculate, and the required data is easily available.

Lastly, the use of risk maps (a schematic that maps out the expected severity and probability of operational risk events) is commonly used for operational risk. This measure is simple but is heavily dependent on expert judgement.

Risk metrics and frequency

	Market Risk	Credit Risk	Liquidity Risk	Operational Risk
Risk Metrics	• 57%: Asset Price Volatility • 14%: TVaR • 29% Other	• 80%: Counterparty exposure • 20% Credit rating	• 60% : Number of days to liquidate the portfolio • 40%: Instrument level National holding vs Free-float	• 80%: Risk maps • 20%: Other
Frequency	• 57%: Daily • 43%: Monthly	• 50%: Monthly • 33%: Daily • 17%: Quartely	• 60%: Daily • 40%: Monthly	• 100%: Monthly

3. FSB Board Notice 52 of 2015

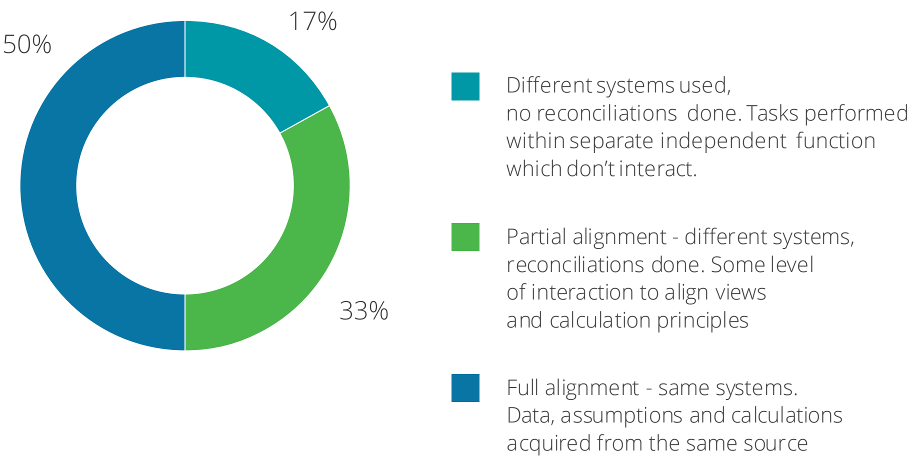
All participants indicated that they have risk measurement frameworks that are appropriate given the nature, scale, and complexity of their funds.

According to the ESMA ERM guidance principles, risk measures should only be computed with up-to-date and reliable data. The risk management function should review and provide appropriate support to the valuation process, especially for complex assets.

Our results show that in terms of systems, half of the participants have full alignment (same systems are used, and data, assumptions, and calculations are acquired from the same source) between their investment risk quantification and front office valuation processes. However, as much as 17 percent use different systems without performing any reconciliations.

In terms of UCITS readiness, most South African asset managers appear to be aware of the regulations and the key requirements underlying its provisions, with many still having a fair amount of preparation work in order to ensure full compliance.

What is the extent of the alignment between the investment risk quantification and the valuation processes?



Operational activities
Operational activities support and facilitate the execution of investment activities and can be classified into two components: client registry and asset registry.

Client registry refers to all sub-activities and processes involved in capturing and storing client information, such as client onboarding, client advice and expectation management, post-sale administration, and data security management. **Asset registry** refers to operational activities that involve executing and reporting at individual and aggregate level, such as calculating returns and fees, capturing contributions and redemptions, accounting and financial reporting, pre- and post-trade management as well as treasury management. Our survey focused only on **asset registry** activities.

The participants for this section represent about R1.5 trillion in assets under management (where the total market size for South Africa is about R4.6 trillion as at December 2017[4]) and manage about 267 funds in total.

In terms of UCITS readiness, most South African asset managers appear to be aware of the regulations and the key requirements underlying its provisions, with many still having a fair amount of preparation work in order to ensure full compliance.

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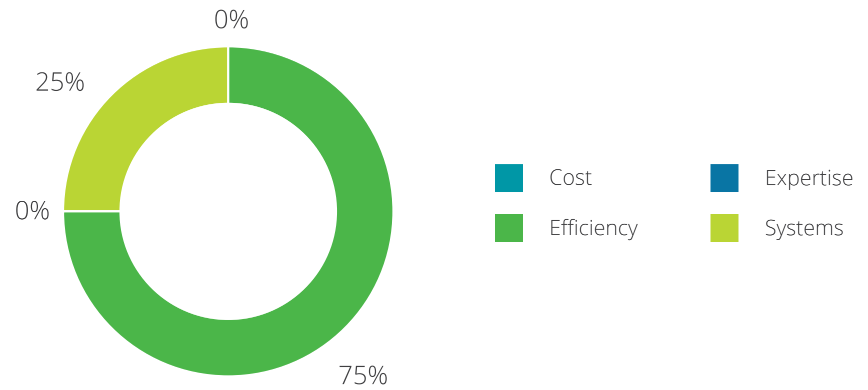
The following key results were observed from this section of the survey:

- All participants indicated that their risk management policy covers risk related to asset registry
- 75 percent of participants indicated that they formally assess registry systems risks on a quarterly basis, while the remaining 25 percent assess these risks on a monthly basis. We expected the frequency of formal assessments to be higher due to the materiality of the risk exposure and frequency with which systems are used
- All participants indicated that they have an independent function or business unit responsible for managing operational risk (which includes asset registry risks). This is to be expected given the specific nature and scale of the operational risks faced by asset managers (i.e., continuous trading, daily reporting on returns and regulatory compliance)
- All participants indicated that they have outsourced some asset registry activities to a third party. The reasons provided for outsourcing were efficiency (75 percent) and not having appropriate in-house systems (25 percent)
- All participants indicated that they formally identify, measure, mitigate, and monitor risks related to outsourcing administration functions or activities to third parties (e.g., Maitland, Silica etc.). Third-party providers' services are generally integrated within asset managers' operational processes and asset managers are materially dependent on them
- 75 percent of participants stated that they perform due diligence on vendors' ability to meet requirements on an on-going basis

Our main concern in terms of operational activities is asset managers' reliance on third parties, where they do not necessarily have close oversight of such parties' control frameworks. Given this, we recommend more frequent monitoring of third parties and the formal inclusion of third-party risk in asset managers' risk appetite framework.

Reasons for outsourcing



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3. Conclusion

A sound investment management risk framework enables a proactive approach to the prevention of undue or extreme losses in client investment portfolios and thus contributes towards long-term performance and client retention. It also creates a platform for consistent risk management.

Based on international regulatory developments, local regulations are expected to become more stringent, and asset managers who prepare for the additional requirements early on will be at an advantage.

To the point:

- Investment management risk is the risk of losses arising from errors, negligence and operational incapability on the part of asset managers in charge of financial portfolios
- South African asset managers appear to have well-developed risk management practice levels; however, there are key gaps that need to be addressed
- 43 percent of firms indicate that the board, senior management, and audit risk committee are aware of but do not actively attend to investment risk and mandate compliance risk
- Asset managers have a strong reliance on third parties for their operational activities.
- 40 percent of respondents' policies do not ensure that there is adequate accountability for risk management decisions