Global risk management survey, ninth edition

Operating in the new normal: increased regulation and heightened expectations

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Utilizing the ninth edition of Deloitte's global risk management survey of financial services firms, we will explore investment management trends.

The investment management sector is diverse, comprising not only large and boutique stand-alone asset management firms but also subsidiaries of diversified banks and insurance companies. Depending on their structure, investment management operations can be subject to a variety of requirements imposed by regulators for the parent banking or insurance company.

Respondents from investment management firms were asked how their organization assesses investment risk. Performance attribution against a benchmark (97 percent) is by far the most common approach. Other measures are employed by half or more of investment management institutions: mandate breaches (72 percent), absolute return (69 percent), and Sharpe ratio (50 percent).

Investment management firms are typically strong in managing market risk since this is central to their business. Many are now addressing risk management areas where they may not be as strong, such as IT applications, data management, and oversight of the extended enterprise. Respondents were asked to rate how challenging each of a series of issues is for the investment risk management function in their organization.

Risk technology and data

The technology and data used to monitor and manage risk continue to be top priorities and concerns for investment management firms. In the period following the global financial crisis, many asset managers' investments in risk technology reflected a best-of-breed approach, addressing gaps in coverage and the depth of risk analytics across asset classes and products through the use of multiple risk engines or service providers. Increasing the depth and coverage of risk analytics addressed one need but inadvertently created additional issues by increasing the sources and volume of risk data. The proliferation of risk data has challenged the ability of asset managers to aggregate risk measures and exposures across multiple products, funds, and strategies to achieve a holistic view of risk.

Further magnifying this challenge is the demand by regulators for additional data and reporting by asset managers. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) established detailed requirements for reporting liquidity, risk profiles, and leverage. U.S. pension funds are now subject to accounting regulatory changes that have prompted a need for significant enhancements in data quality and analysis. Additionally, recent remarks by a member of the Board of Governors of the Federal Reserve in the

United States point to the focus of both the Financial Stability Board (FSB) and the Financial Stability Oversight Council (FSOC) on assessing the magnitude of liquidity and redemption risk within the asset management sector as a tool for macro-prudential regulation.[1] This will require many asset managers to invest in their capabilities around liquidity risk measurement and monitoring.

Some institutions have invested in data warehouses in an effort to improve the availability and quality of risk data, but they have faced the challenge of making sure the data placed into them are "clean" and accurate. Some organizations have not implemented error-detection processes or assigned responsibility for data quality when creating their data warehouses. As a result, data governance is emerging as an important focus for investment managers, and some organizations have created a chief data officer position to help address it.

With the increasing complexity of risk data infrastructure and the focus of regulators on risk technology and data, it is not surprising that significantly greater percentages of respondents said they consider these issues to be extremely or very challenging for their investment management activities than was the case in 2012. The issue most often rated as extremely or very challenging was IT applications and systems (55 percent up from 23 percent in 2012), while data management and availability was cited third most often (42 percent up from 35 percent). Although 30 percent of respondents considered risk analytics and reporting to be extremely or very challenging, 88 percent said it is at least somewhat challenging, an increase from 71 percent in 2012.

1 Daniel K.Tarullo, "Advancing macroprudential policy objectives," speech at the Office of Financial Research and Financial Stability Oversight Council's 4th Annual Conference on Evaluating macroprudential tools: Complementarities and conflicts, January 30, 2015, http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm.

2 May Jo White, "Chairman's address at SEC Speaks 2014," February 21, 2014, http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.VPsR_-Eeo4s.

3 Securities and Exchange Commission, "SEC adopts money market fund reform rules,"July 23, 2014, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679#.VPtmheEeo4s.

4 Nicholas Elliott, "AIFMD complicates pursuit of capital," Wall Street Journal, July 23, 2014, http://blogs.wsj.com/riskandcompliance/2014/07/23/the-morning-risk-report-aifmd-complicates-pursuit-of-capital/.

5 Financial Industry Regulatory Authority, "2015 regulatory and examination priorities letter," January 6, 2015, https://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602239.pdf.

Regulatory compliance

With greater scrutiny from regulators, 48 percent of investment management respondents considered regulatory compliance to be extremely or very challenging, up from 29 percent in 2012. Investment management firms have been subjected to a variety of new regulatory requirements. The SEC is paying greater attention to investment managers and funds, including introducing expanded stress testing, more robust data reporting requirements, and increased oversight of the largest institutions.[2] In 2014, the SEC also amended its rules to require a floating net asset value for institutional prime money market funds.[3] In Europe, the AIFMD introduced new regulations governing the marketing of funds and deal structure for private equity and hedge funds operating in the European Union.[4]

These and other new regulations affect a wide range of risk management issues for investment management firms.

Governance and accountability

Regulators expect investment management firms to implement strong governance of their risk management programs.[5] Investment management firms need to clearly define the roles, responsibilities, and decision-making authority across the three lines of defense to help ensure there are no ambiguities that can create gaps in control or a duplication of effort. In particular, stand-alone investment management firms may need to reexamine the role of the boards of directors of their funds, their committee structure, and the process in place to identify and escalate key risks.

Investment compliance monitoring

Investment management firms can benefit from an investment compliance monitoring program. Such a monitoring program can help identify and address any breakdowns in controls used to comply with regulatory requirements, operational inefficiencies regarding trade monitoring, inconsistent or inadequate processes used to monitor client portfolios, and inconsistent data usage or poor processes to integrate new data.

Conflicts of interest

Reducing conflicts of interest among investment management and other financial institutions is a priority for regulators around the world. The SEC announced that one of its examination priorities for 2015 would be to assess the risks to retail investors, including such issues as fee selection, sales practices, suitability of investment recommendations, and products offered by alternative investment companies.[6] In January 2015, the OCC issued a handbook for use by its examiners regarding conflicts of interest among banks that offer investment management services.[7]

In Europe, the Markets in Financial Instruments Directive (MiFID) II requires that investment firms put in place organizational and administrative procedures with a view to taking "all reasonable steps" to prevent conflicts of interest.[8] In an effort to increase transparency for clients, in December 2014, the European Securities and Markets Authority (ESMA) recommended to the European Commission that portfolio managers should only be able to accept broker research when they pay for it directly or from a research account funded by a specific charge to their clients.[9]

6 *Ibid.*

7 *Office of the Comptroller of the Currency, "Asset Management Comptroller's Handbook: Conflicts of interest," January 2015, http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/conflictofinterest.pdf.*

8 *European Securities and Markets Authority, Final Report: ESMA's technical advice to the commission on MiFID II and MiFIR, December 19, 2014, http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf.*

9 *Deloitte, MiFID II: Product governance and unbundling dealing commission, January 16, 2015, http://blogs.deloitte.co.uk/financialservices/2015/01/mifid-ii.html.*

In the United Kingdom, the Financial Services Authority requires that investment management firms must manage conflicts of interest fairly and that their boards of directors must establish effective frameworks to identify and control conflicts of interest.[10]

Conflicts of interest can affect nearly all aspects of investment management, including product development, client on-boarding, portfolio management, personal trading, and managing service providers. Investment management firms may need to enhance their processes to identify, record, analyze, and disclose conflicts of interest. Since conflicts of interest can arise as regulations change and a firm's products and strategies evolve, it is helpful to conduct a compliance review at least annually to identify any new conflicts of interest that may have arisen.

Client onboarding

In Deloitte's experience, many compliance violations can be traced back to the client onboarding process. "Know your customer" and customer classification requirements are incorporated into numerous regulations including MiFID II, European Market Infrastructure Regulation (EMIR), the Dodd-Frank Act, and the Foreign Account Tax Compliance Act (FATCA).

In August 2014, the Financial Crimes Enforcement Network (FinCEN) published proposed rules that would enhance customer due diligence requirements to identify and verify the identity of an institution's customers and beneficial owners.[11]

As investment management firms and their products become more complex, it can be difficult and time-consuming to monitor whether guidelines have been followed as new clients are acquired. In some institutions, business functions or lines of business may be segregated, making it difficult to access complete information on client accounts.

Investment management firms need an integrated structure that provides clear authority for and transparency into decision-making; cross-functional participation in product development; a strong technology infrastructure that supports analytics and monitoring of client and product profitability; and strong governance and oversight of the onboarding process. Given the complexity of the task, institutions can benefit from automated compliance systems that work in tandem with strong manual oversight when setting up accounts for new clients.

Investment management firms may need to enhance their processes to identify, record, analyze, and disclose conflicts of interest

10 *Financial Services Authority, Conflicts of interest between asset managers and their customers, November 2012, http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf.*

11 *DavisPolk, "FinCEN's proposed rule to enhance customer due diligence requirements for financial institutions," September 30, 2014, http://www.davispolk.com/fincen%E2%80%99s-proposed-rule-enhance-customer-due-diligence-requirements-financial-institutions-%E2%80%93-comments/.*

Model risk

Regulators are scrutinizing the models used by financial institutions, including investment managers. The SEC charged several entities of one firm with securities fraud for concealing a significant error in the computer code of the quantitative investment model that it used to manage client assets.[12] Model risk can arise in a number of different areas, including investment decision making, trade implementation and monitoring, exposure management, and performance evaluation. Institutions should examine the oversight of their models and the responsibilities, policies, and procedures; validate models; employ ongoing monitoring programs; and increase the rigor of their process for developing models.

Extended enterprise risk

Managing the risks from third-party service providers across the extended enterprise is a growing concern. Third-party service provider oversight was considered to be extremely or very challenging for the investment management risk function by 41 percent of respondents, almost double the 21 percent in 2012. Third parties can pose risks for many different risk types such as cyber, financial, credit, legal, strategic, operational, and business continuity.

Adverse events in any of these areas can damage a firm's reputation, undermining its ability to attract and retain clients and assets under management. The potential negative impacts of a risk event at a third party can quickly extend to an institution's reputation and are only magnified today as social media and globalization catapults news around the world at lightning speed.

The impact of third parties on cyber security is a particular concern. Cyber threats continue to increase, and third parties are often their point of entry.

One analysis across multiple industries found that attackers gained access through third-party systems in 40 percent of data breaches.[13]

There are a number of reasons for the increased focus on extended enterprise risk. Although the use of third parties by investment management firms is not new, it has become increasingly pervasive and complex as the emergence of unbundled services has created more diverse options to outsource specific functions or sub-functions. As firms continue to search for efficiency and focus on their core competencies, the expanded use of third parties is appealing to more areas of the business.

12 *Securities and Exchange Commission, "SEC charges AXS Rosenberg Entities for concealing error in quantitative investment model," February 3, 2011, http://www.sec.gov/news/press/2011/2011-37.htm.*

13 *Ponemon Institute LLC, 2013 cost of data breach study: Global analysis, benchmark research sponsored by Symantec and independently conducted by Ponemon Institute LLC, May 2013. Analysis performed on 277 companies globally in 16 industry sectors after those companies experienced the loss or theft of protected personal data, https://www4.symantec.com/mktginfo/whitepaper/053013_GL_NA_WP_Ponemon-2013-Cost-of-a-Data-Breach-Report_daiNA_cta72382.pdf.*

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Resourcing

Resourcing the investment management risk management function was considered to be extremely or very challenging by 33 percent of respondents (roughly similar to 29 percent in 2012). Managing resource constraints is a perennial issue, and investment management organizations are increasingly shifting to risk-based resourcing, which allocates resources to key areas based on strategic risk assessments. This approach can maximize impact and value by taking a holistic view of where the organization faces the greatest risk and where additional resources can help meet its strategic goals.

It can also identify gaps in skills and inform hiring decisions to more effectively manage key risk areas.

Risk governance

Many investment management firms are examining the role of the board of directors in overseeing risk, including which issues and decisions should be referred to the full board. They are also considering which management committees should be established to manage risk and how to implement an effective process to identify and escalate key risks.

While 24 percent of respondents said risk governance is extremely or very challenging for their investment management function, 85 percent described it as at least somewhat challenging.

To the point

- This report presents the key findings from the ninth edition of Deloitte's ongoing assessment of risk management practices in the global financial services industry
- Survey participants that provide asset management services represent a total of US$5.6 trillion in assets under management
- To read the full report, please go to http://d2mtr37y39tpbu.cloudfront.net/wp-content/uploads/2015/05/DUP_GlobalRiskManagementSurvey9.pdf