Where do we go from here?

The maturation of operational due diligence of outsourced investment management in Australia.

Philip Hope
Partner
Assurance & Advisory
Deloitte

Mark Archer
Director
Assurance & Advisory
Deloitte

Jenna Mollross
Manager
Assurance & Advisory
Deloitte

Operational risk is typically defined as a failure of people, processes, and systems. There are numerous potential opportunities for an operational breakdown within an investment management company, as in any business.[1]

Although definitions vary slightly, the term operational due diligence (ODD), in our view, refers to an analysis of an investment manager's operational capabilities and the ability of their infrastructure to support the execution of their investment thesis. The purpose of the analysis is to identify the levels of residual operational risk within the investment management company, with the ODD process reviewing qualitative aspects of an investment management company—such as organizational structure, personnel, governance, policies and processes, business continuity planning, and service provider monitoring.

ODD considers the risk of loss stemming from issues related to middle and back-office functions. Such losses could be incurred from issues such as an incorrect valuation of a fund's investment portfolio, poor business continuity processes resulting in potential loss of trading capabilities, or poor monitoring of cash movements. ODD also considers the cultural aspects of a firm, including incentivization structures, as well as risk management and compliance reporting processes, to ensure adequate transparency across the end-to-end operations of the fund manager's organization.

Historically, investment due diligence has been the main focal point when looking at making an investment decision or when reviewing existing investments. A focus on the performance return drove the thought process of a large majority of investors throughout the late twentieth century. This attitude changed somewhat due to a number of high profile events in 2008–2009.

1. APRA Insight, Issue One 2014

Evolution
ODD has come to the forefront as a result of some high profile events over the past 10 years, with the Madoff case in the US and the Weavering Capital case in the UK demonstrating the need for increased operational scrutiny and ODD practices. Both the Madoff (2008) and Weavering Capital (2009) hedge fund failures were the result of weak middle and back-office procedures (including cash controls) and poor corporate governance structures. It has been observed that many of the red flags that were present in the Madoff scheme were operational in nature.

Furthermore, many recent failures of hedge funds where no fraud was present can be attributed to unmitigated operational risks that were inherent in those funds. Consequently, many individual and institutional hedge fund investors saw the lessons from the Madoff Ponzi scheme as an opportunity to refocus their attention toward ODD to prevent red flags from going unnoticed again.

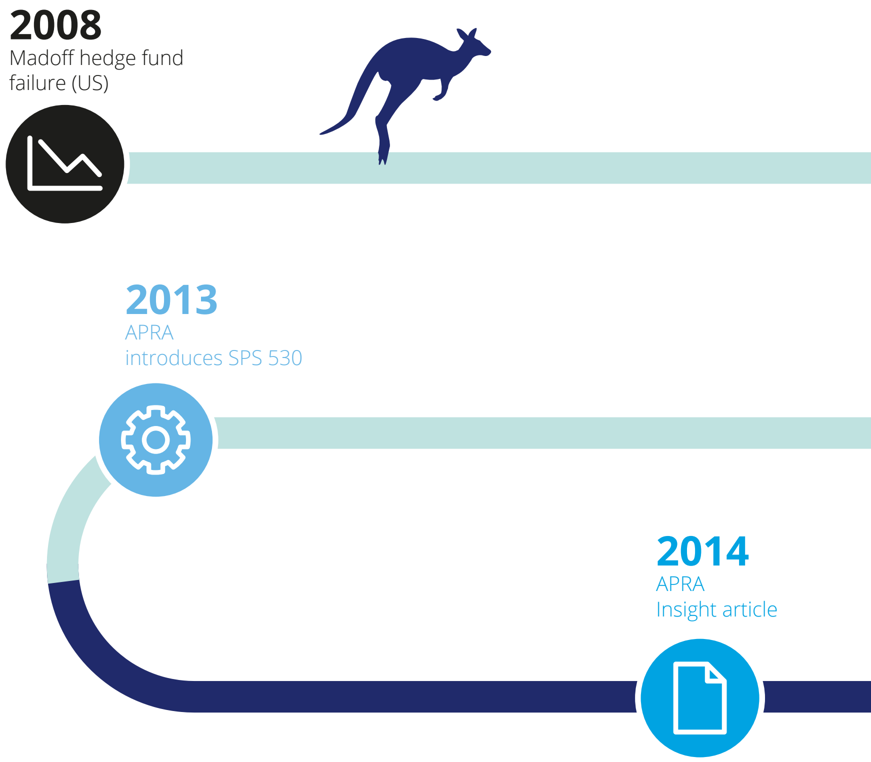
Seeking to ensure that similar events did not recur, the Securities and Exchange Commission (SEC) and its UK counterparts soon introduced significant improvements to their oversight by enhancing safeguards for investors' assets and improving their risk-assessment capabilities.

In particular, since the Madoff scandal broke, the number of reviews of hedge funds' cash management policies and controls, transparency in reporting, and the role of service providers has increased substantially. However, there is still room for improvement in terms of scope. Information technology infrastructure, personnel turnover, and the quality of overall operations management are frequently overlooked operational risk areas.[2]

In Australia, ODD has historically been underdeveloped compared to the US and the UK, with more focus on investment due diligence practices. The primary reason for this is that the Australian investment market is predominately built on compulsion as a result of the superannuation guarantee charge (SGC), the requirement for all Australians to contribute to superannuation. The Australian investment market initially started off small with industry super funds being the genesis of growth in the investment market, whereas US market growth was driven by insurers and fund managers, so it has historically been more developed.

Australian regulatory environment
Recent Australian regulatory developments have resulted in the "Stronger Super" regime. This introduced the perspective that superannuation savings are being managed for members, with the Australian regulator emphasizing the principle that registrable superannuation entities (RSEs) act in the best interest of the members in managing retirement savings.

In developing the Stronger Super regime, the regulator has taken cues from global developments and cross-functionality across industries with a focus on best practices across the globe. This has led to the introduction of ODD considerations in the Australian market.



2. Corgentum, "The Madoff Effect - An Analysis of Operational Due Diligence Trends", June 2010

The Australian regulator—the Australian Prudential Regulation Authority (APRA)—has been heavily involved in the development of ODD in the Australian market. Supporting the enhancement of the fiduciary and governance obligations under the Stronger Super regime, APRA developed a new regulatory standard in 2013: "Prudential Standard SPS 530: Investment Governance" (SPS 530). SPS 530 contained three key elements, none of which were new in terms of expectations of the fiduciary duty of an RSE, but were now enforceable by virtue of a prudential standard. These three elements are:

- Increased emphasis on liquidity management
- Requirements for stress testing
- Implicitly an effective ODD process as part of investment strategy implementation

Performing operational due diligence also provides insights into the risk culture and approach to risk management of the investment management company. This will include its ability to effectively measure and manage risk and to enact its stated investment strategy and approach.[3]

In 2014, APRA published an article on ODD in its bi-annual Insight publication that effectively communicated the regulator's expectations for ODD to be performed on investment management companies by RSEs.

The Insight article highlighted that "unlike investment risk, operational risk does not provide a risk premium and hence bearing operational risk is unrewarded. Nevertheless, the level of operational due diligence undertaken by RSE licensees is often not as intensive or extensive as that which is applied to investment due diligence. What is also critical is the interaction between these various functions, as activities do not occur in isolation—problems in one area will impact on other areas. For example, valuation errors will lead to incorrect performance measurement, rendering it difficult for the manager (and hence RSE licensee) to understand which decisions are improving or detracting from returns." [4]

The Insight article noted that APRA's expectations in relation to ODD were "reinforced by the requirements of 'Prudential Standard SPS 530 Investment Governance' (SPS 530) and 'Prudential Standard SPS 231 Outsourcing' (SPS 231). Furthermore, 'Prudential Standard SPS 220 Risk Management' (SPS 220) emphasizes the obligation to have an appropriate risk management framework addressing all material risks." [5]

APRA has since reminded the industry that, as part of its ongoing supervision and risk assessment, it will assess RSE processes undertaken for the purposes of managing investment risk, which will include, where warranted, an assessment of the processes around the operational due diligence of investment management companies.

3. APRA Insight, Issue One 2014
4. Ibid
5. Ibid

Industry response

In 2015, two industry bodies—the Australian Institute of Superannuation Trustees (AIST), which represents RSEs, and the Financial Services Council (FSC), which represents fund managers and RSEs in the retail superannuation space—each convened a working group of representatives to develop an ODD guidance note.

These working groups were developed in response to APRA's disclosure of its expectations of RSEs in relation to ODD on investment management companies and, in particular, the Insight article published in 2014.

In 2016, AIST published its first version of the ODD guidance note, with a revised version published in February 2017 following stakeholder feedback. The guidance note covers the nine distinct aspects of an investment management company that are to be considered by an ODD review.

The guidance note reinforces APRA's view that "appropriate attention must be given to operational risk policies and processes but also to the risk culture within an investment management organization."

The AIST guidance note promotes the "manager-engaged" model, with the obligation for the cost burden of ODD reviews to be carried by the fund manager as a prerequisite for a superannuation fund to allocate, continue, or renew a mandate with that fund manager. The manager-engaged model was chosen by AIST in order to achieve some degree of scale in the industry with fund managers able to provide copies of outsourced ODD reviews to multiple superannuation RSEs rather than having each RSE undertake its own ODD review.

The AIST guidance note observes that "the ODD review process must be conducted by an appropriately qualified, reputable, competent firm that is independent of the investment manager/product" and notes that "APRA expects that any RSE relying on the ODD conducted will need to be satisfied of the skill and independence of the firm conducting the ODD."

Emphasizing that the ODD review process is "not a 'tick the box' exercise," AIST notes that it expects the ODD provider will express "an independent validation of the investment manager's attestation regarding its policies and practices and that the ODD review process will include a mix of desktop policy reviews, questionnaires and detailed on-site due diligence." The expectation is that the investment manager will provide the ODD report to the RSE(s) for assessment and alignment to their own risk appetite.

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Outlook

The publication of the ODD guidance note raises the bar for the Australian investment market, with a maturing ODD model a positive step toward more thorough due diligence and alignment with the regulatory developments of our global peers. AIST will have a continuing role to play in the space with future iterations of the guidance note predicted to capture changes to expectations, perspectives, and analysis in the market.

It is possible that the current framework will evolve into a two-model system: manager-engaged versus RSE-engaged ODD reviews. Some of the larger Australian RSEs will continue to undertake their own ODD analysis and will use the information provided by the manager-engaged ODD reviews to supplement their assessment process.

There is also the potential for the ODD framework in Australia to resonate with our neighbors in the Asia Pacific region. Where there are less developed Asian markets, the ODD approach adopted in Australia may drive due diligence or investment expectations across Asia, particularly given Asia Region Funds Passport (an initiative to facilitate the cross-border marketing of managed funds across participating economies in the Asia region).

For global fund managers, the introduction of Australian market ODD obligations will bring us closer to the market standards and expectations currently in place in the US and UK. Where a super fund RSE may have mandates with internationally-based fund managers, the ODD expectations will remain in place but will likely be at least partially met by existing regulatory obligations in their local market, in particular in the US and UK.

To the point:

- Operational Due Diligence (ODD) is an analysis of an investment manager's operational capabilities and the ability of their infrastructure to support the execution of their investment thesis.
- Operational risk is typically defined as a failure of people, processes, and systems.
- Operational risk does not provide a risk premium.
- APRA has communicated its expectations for ODD to be performed on investment managers by Responsible Superannuation Entities.
- For global fund managers, the introduction of Australian market ODD obligations will greater align the standards of Australia to those of the US and UK.