Navigating the new operational frontier

Top 10 operational risks: a survival guide for investment management firms

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Every investment management firm knows that even seemingly minor operational oversights or mistakes can have huge repercussions.

That is why operational departments work hard to automate and fail-safe their processes, conduct extensive reconciliations and develop detailed workflows and procedures. A great deal is at stake, and not just in terms of direct financial costs and legal liability.

Operational risk can stem from many sources. The Basel Committee on Banking Supervision defines operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.'[1] The definition considers the full range of material operational risks and lists examples ranging from fraud and data entry errors to hardware failures and floods.

As a provider of customisable operating platforms for investment managers all over the world, SEI views operational risk management as a primary objective. It is critical for investment manager to take a fresh look at common areas of risk, identifying priorities for action, and then considering the variety of relatively straightforward risk-management measures that can be deployed. Broadly speaking, these areas include concerns with personnel, supervision and training; organisational and support issues, including the roles of technology, which can be both a solution and a source of risk in itself; and common weaknesses in reconciliation, legal review and planning.

1 'Sound Practices for the Management and Supervision of Operational Risk', February 2003

While there is no generic checklist for identifying operational risk, our 'Top Ten' can help identify areas of risk that are frequently encountered by those who work in or around investment operations.

1. Complacency

These include flawed business continuity plans, poor recordkeeping and deficient insurance coverage. Other practices that place organisations at risk include hiring inexperienced or under-qualified staff, neglecting to train new employees, disregarding feedback from middle- and back-office staff, operating without an electronic document management system and failing to check employees' work. To tackle these issues, consider better training, tightening up internal procedures and improving communication.

2. The blind leading the blind

Mid-level and senior managers who are unfamiliar with investment operations may rely upon subordinates who are also unqualified for the task at hand. Outsourcing has benefits, but it is not a panacea and brings its own due diligence demands. External operational reviews can help illuminate these risks. To address them, consider ways to improve hiring, promotion and coaching practices as well as strengthening due diligence frameworks.

3. Novices, apprentices and soloists

Problem areas here include small, specialised teams that work in isolation and individuals who assume sole responsibility for a function or relationship, often zealously guarding their 'turf'. Thoughtful attention to organisational design, training and cross-training can promote teamwork and reduce key-person risk at all levels.

4. Dropped batons

Information handoffs between people, departments, organisations and systems are fraught with communication and timing challenges. The most useful tools for identifying potential trouble spots are system diagrams that identify all applications and their interfaces, and workflow diagrams that display hand-offs between teams or departments and between the firm and external counterparties, service providers and clients.

5. Naïve reliance on technology

While automation is a powerful tool for mitigating operational risk, it can create new hazards if systems are not carefully designed and implemented. To reduce those risks, make sure that staff and consultants who deal with operational systems know how to perform automated functions manually and, furthermore, understand their operational context, including system and workflow linkages. Keeping system access permissions up to date, maintaining system infrastructure, and building in thorough audit trails are all high priorities. The importance of written functional specifications and detailed testing cannot be overemphasised.

6. Playbooks

Nonexistent, obsolete or incomplete process-and-procedure documentation is frequently a factor in operational breakdowns. The remedy is workflow diagrams that are kept up-to-date and readily available. Not only are such workflows important in the effort to lower day-to-day risks, they are also useful in new-hire training, system- and process-improvement initiatives and disaster recovery. Firms should also have well-defined issue escalation protocols that take into account both the magnitude and timing of potential impacts.

7. Amalgamated assignments

When designing organisational structures, policies and procedures for the segregation of duties, it is critical to maintain the distinction between the firm and the fund(s) it manages. Operational reviews can help flag potential conflicts of interest as well as opportunities for theft or fraud. Firms may want to consider whether it is appropriate to institute some degree of shadow accounting, whereby investment managers maintain their own sets of books and records for comparison with those of custodians, auditors and independent third-party fund administrators.

8. Reconciliation gaps

Less-than-comprehensive procedures can leave investment managers unknowingly exposed to risks. To reduce that exposure, firms should conduct full reconciliations between their records and those of the custodians and administrators, with provisions for supervisory review and accountability. Full reconciliations include comparisons of cost basis and market value (in local currency terms), security identifiers, and local-currency cash balances; they also entail reconciliation of margin or collateral positions using statements from the party holding the assets.

9. Reading the fine print

Legal documents should be reviewed in detail by attorneys as well as knowledgeable operational managers. When assessing counterparty risk, firms need to identify exactly which legal entity is their counterparty, determine who has regulatory jurisdiction and continuously monitor net exposures as well as the counterparty's creditworthiness.

10. Poor planning and slow response times

Investment management organisations that fail to plan ahead may sustain huge business and operational impacts as a result of the sweeping regulatory, marketplace and competitive changes that are transforming the industry. Against a backdrop of expanding regulatory requirements, clients and investors are pressing firms to increase transparency, accelerate reporting and reduce risks—all while lowering advisory fees. Operational benchmarking can assist in analysing cost structures and the financial impacts of changes in key business drivers. As the line between traditional and alternative managers continues to blur, the former are encouraged to prepare for operational due diligence and the latter, to implement the GIPS® standards.

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In light of the complexities and constant change in our industry, virtually every firm has the opportunity to take risk management to the next level. Operations departments function best when senior managers understand how things are done, provide the resources needed to mitigate risk, recognise that some events are beyond reasonable control and reward operations staff for their successful efforts.

It has been observed that operational risk offers no upside; to use Castle Hall Alternatives' phrase, it is risk without reward. In contrast, concerted and systematic efforts to reduce operational risk promise a clear upside. Not only can they help investment firms build a culture and framework for operational excellence, they create tangible investment value by reducing costs, increasing client satisfaction and reinforcing sound business relationships with trading partners. What's more, many risk-mitigation measures are inexpensive, demanding more in focus and foresight than in hard investment.

In these times of shrinking asset pies and stiff competition, the advantages to be gained through better risk management may be the real low-hanging fruit.

While regulated fund managers are no strangers to managing risk in order to meet stringent regulatory requirements, virtually every firm has the opportunity to take risk management to the next level. By understanding how things are done, providing the resources needed to mitigate risk and rewarding operations staff for their successful efforts, these managers can stay competitive, and meet the evolving needs of regulators as well as their investors.

To the **point**:

- Virtually every investment management firm has the opportunity to take risk management to higher level, taking a fresh look at common areas of risk, identifying priorities for action and then considering the variety of relatively straightforward risk-management measures that can be deployed
- Different organisations have different exposures and tolerance levels to operational risk, depending, for instance, upon their investment strategies, the markets in which they operate and the instruments they employ; thus there is no all-purpose checklist for identifying operational risk, nor is there a single, universally applicable set of mitigation measures.
- Concerted and systematic efforts to reduce operational risk help asset management firms build a culture and framework for operational excellence; they also create tangible investment value by reducing costs, increasing client satisfaction and reinforcing sound business relationships with trading partners
- Many risk-mitigation measures are inexpensive, demanding more in focus and foresight than in hard investment; in times of shrinking asset pies and stiff competition, the advantages to be gained through better risk management may be the real low-hanging fruit

For more detail on this topic, please review SEI's *Ten Operational Risks*, an online guide that catalogs a host of operational pitfalls along with potential ways to remediate them. The guide is available at www.seic.com/OpRisks.

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