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Investment management spotlight

Global risk management survey, 11th edition

Reimagining risk management to mitigate looming economic threats and nonfinancial risks

Executive summary

Investment management firms are today confronting a series of substantial risks that will require a rethinking of their traditional approaches to risk management. Global economic growth has been reduced by weak economic performance in Europe coupled with a Chinese economy burdened with increasing debt levels and slower growth. Economic storm clouds remain on the horizon in the form of tensions over tariffs between the United States, China, the European Union (EU), and other jurisdictions. The lack of a final Brexit agreement between the EU and the United Kingdom provides an additional source of uncertainty. The length of the present bull market has led many to expect the inevitable next turn in the market cycle.

The investment management market has also become more challenging as the growth of low-cost, passively managed investment products—such as index funds, mutual funds, and exchange-traded funds (ETFs)—has placed active managers under additional pressure to generate alpha and improve the customer experience, while reducing operating costs. As a result, firms are increasingly using third-party providers as strategic partners to reduce costs by outsourcing business functions that are not central to their unique value proposition for customers. There has been increased interest in employing robo-advisers, powered by cognitive technologies, to provide automated investment recommendations. The use of advanced analytics, coupled with alternative data sources, holds the promise of improving alpha.

There is also increased interest among firms in new business models. Digital identity technologies have the potential to improve the customer experience by moving from a traditional closed model to open platforms, where data on customer assets is shared among different members of the investment management ecosystem, with authorization from the customer. This shift to open platforms would have important implications for the investment management business and the risks it faces.

Regulators are developing approaches to the regulation of fintech firms that leverage new technologies to introduce innovative products and business models. In addition, complying with evolving regulatory requirements regarding the use of customer data will be an essential component of adopting a more open model for investment management.

Given the significant financial losses and reputational damage they can cause, both financial institutions and regulators are focusing more intently on the management of issues such as data management and nonfinancial risks such as cybersecurity, regulatory, and conduct and culture risks. While the pace of US regulatory change has slowed, a number of regulatory developments continue to emerge both in the United States and other countries. In addition, for some regulations that have recently been implemented, such as the European Union's General Data Protection Regulation (GDPR), the broader implications on financial services organizations are still being assessed.

Investment management firms have the opportunity to gain competitive advantage by reengineering their risk management programs to meet these challenges, from employing the latest technologies and alternative data sources to increasing their focus on nonfinancial risks. Deloitte's *Global risk management survey, 11th edition*, the latest edition in this ongoing survey series, includes responses from 46 investment management firms on their risk management practices and challenges. Five key takeaways emerged for investment management firms:

- Heightened concerns over rising fee pressures and changing client preferences
- Leveraging advanced analytics and alternative data
- Challenge of managing risks from third parties
- Confronting growing cybersecurity threats
- Responding to new regulatory requirements

Heightened concerns over rising fee pressures and changing client preferences

The investment management marketplace has been turbulent, with the rapid expansion of passive investing, customers seeking a wider range of solutions including alternative strategies, and the growth of digital investing platforms such as "robo-advisers." When investment management respondents were asked to name the top three emerging risks about which their firms are most concerned, they most often cited *fee pressure* (51 percent, with 22 percent ranking it as No. 1) and *changing client preferences* (51 percent, with 16 percent ranking it as No. 1). See figure 1. Close behind was *growth of digital investing platforms* (43 percent, with 14 percent ranking it as No. 1).

The growing popularity of low-cost passive investment products has placed downward pressure on fees, and it will be important for active managers to have a coherent business model and pricing response to this trend. Increasing the efficiency of their operations will be central to this effort through such approaches as leveraging advanced technologies and outsourcing selected processes to third parties. Active managers will also need to be able to deliver differentiated products that generate strong returns relative to passive investments. Fee disclosures are becoming more transparent, and investment management firms will need to generate strong alpha to justify their charges to investors.

To combat margin compression, firms continue to focus on enhancing activities that drive value creation, such as developing products and solutions that offer premium investment quality while meeting changing investor preferences. As part of this effort, firms are working to enhance the client experience by crafting a mix of technology solutions and human advisers appropriate for each customer segment such as mass market, mass affluent, and high net worth. In addition, firms are analyzing the cost of value-protective activities (e.g., compliance and operations) to identify opportunities to reduce expenses while maintaining, or even improving, service standards. Increasing the efficiency of value-protective activities can enhance the competitive position of an investment management firm and allow it to be more agile, while maintaining an acceptable level of risk.

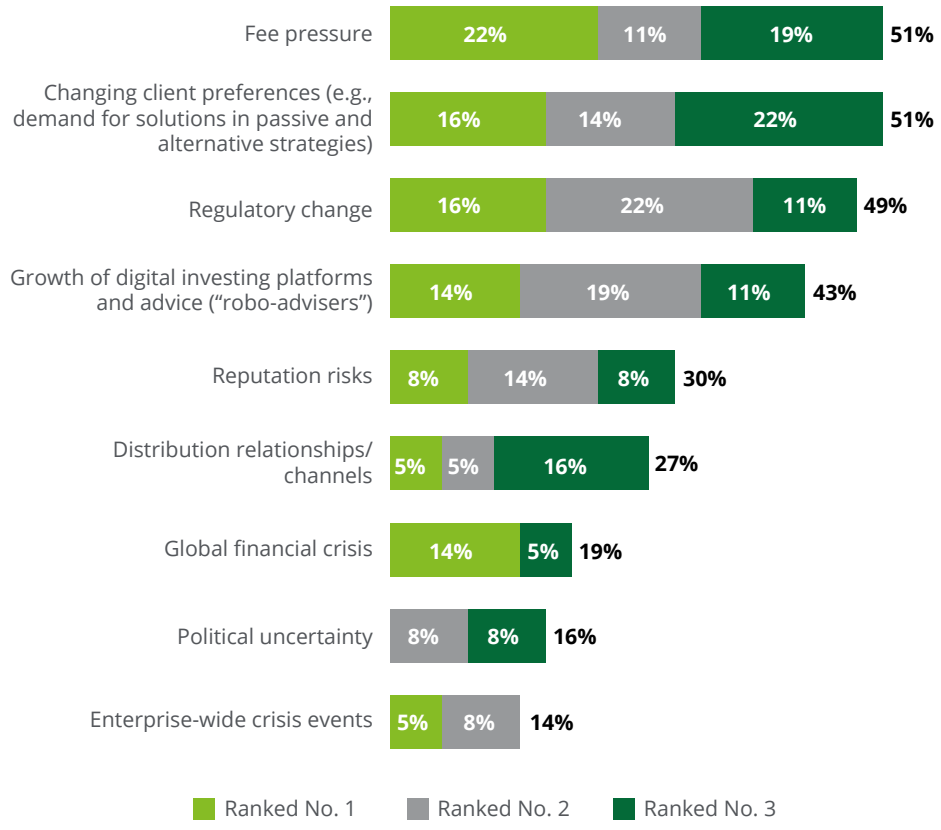
"We are embracing AI and predictive analytics, for example, in areas like monitoring customer behavior and potential fraud issues as well as applying robotics to automate manual policy processing tasks."

— Senior risk executive, major insurance and asset management company

Figure 1

Which are the top 3 emerging risks about which your firm is most concerned, with respect to its investment management business?

Base: Organizations that provide investment management services



Leveraging advanced analytics and alternative data

To contain operating costs, introduce innovative products, and generate alpha, investment management firms are looking to deploy emerging technologies and employ a wider range of data sources. Advanced technologies—such as robotic process automation (RPA), big data, cloud computing, cognitive analytics, machine learning, natural language processing, and blockchain—can assist investment managers in generating returns as well as improve both the efficiency and effectiveness of risk management. Advanced technologies can provide faster access to key insights and information to improve decision making and enhance business value for investment managers by evolving the focus from hindsight (i.e., what happened), to insight (i.e., what should we do), and then to foresight (i.e., what will happen).

Firms anticipate enhancing their data and analytics capabilities to improve performance in a number of areas (see figure 2). Respondents most often said this was extremely or very likely for *portfolio management* (74 percent), which is understandable because generating strong portfolio returns is a central objective of active investment managers. The other areas cited often were *client engagement* (66 percent), *operations* (e.g., back and middle office) (56 percent), and *product innovation* (54 percent).

Yet, many investment management firms will require enhancements to their data governance and IT infrastructure to achieve the benefits offered by advanced technologies. Data and technology were the issues most often rated by respondents at investment management firms as extremely or very challenging for their firms: *use of alternative data in investment and operational processes* (e.g., social media, payments, crowdsourcing, geospatial, cognitive analytics) (54 percent), *data management and availability* (53 percent), and *IT applications and systems* (47 percent).

"The information explosion creates the need for more quants, data scientists, and analysts in the risk group of the future. We will need to change the makeup of our team to bring on professionals who have these skills and are digitally native."

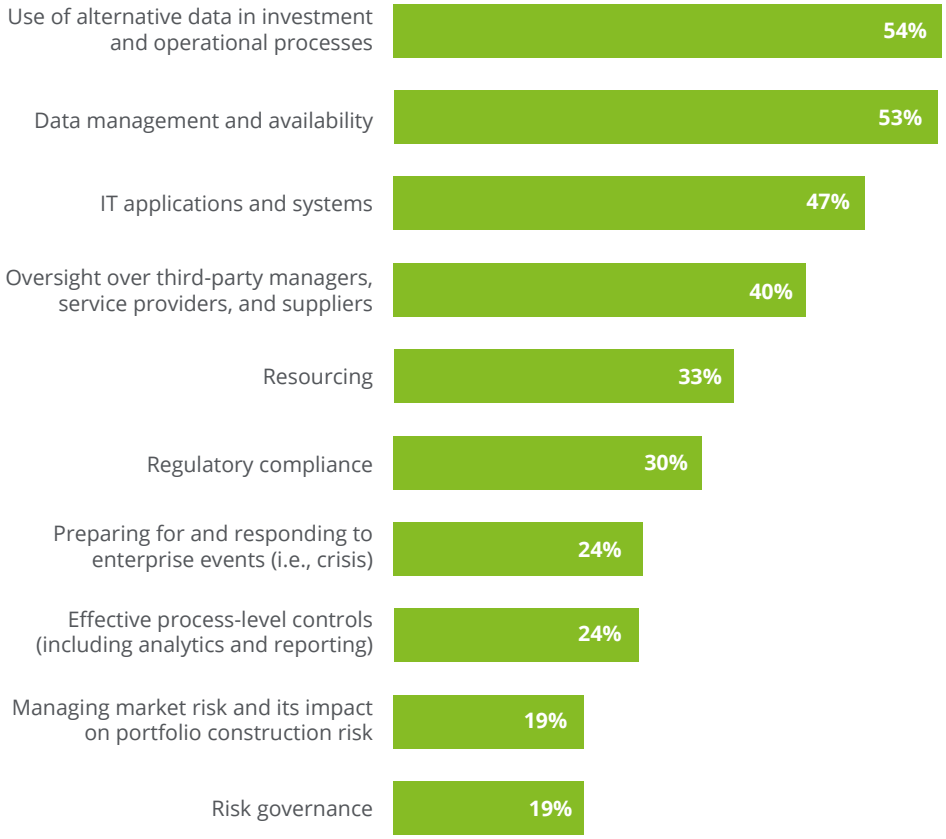
— Chief risk officer, major asset management company

Figure 2

In managing risks in your organization's investment management business, how challenging is each of the following?

Base: Organizations that provide investment management services

Percentage responding "extremely or very challenging"



Challenge of managing risks from third parties

While individual mutual funds inherently contract for their required services, their sponsoring investment management firms are also increasingly outsourcing whole or discrete operational processes to third-party service providers. Outsourcing can reduce operating costs, while often providing access to innovation or talent. It also creates distinctive risk management issues. Third parties are not under a firm's direct control, and they often subcontract work to additional vendors, making it more difficult to manage risks such as fraud, cybersecurity, data privacy, and business disruption, among others. In addition, if a third party or one of its subcontractors fails to execute its responsibilities, or engages in inappropriate conduct, the investment management firm could violate regulatory requirements and suffer reputational damage.

Three quarters of investment management respondents considered oversight of their firm's third-party service providers to be challenging, with 40 percent saying it was extremely or very challenging. Regulators have been focusing more intently in this area, and 49 percent of respondents said that they considered *increasing oversight over third-party service providers regarding the availability and timeliness of data* to be extremely or very challenging.

Many investment management firms said they review the higher-risk third-party relationships annually, with this being most common for intermediaries (46 percent), administrators (45 percent), and application technology vendors (44 percent). Going forward, firms may find that more frequent monitoring is required to effectively manage risks from their third-party service providers.

Confronting growing cybersecurity threats

There has been increased attention to the importance of managing cybersecurity risk across all financial sectors, including investment management. The losses from cyberattacks were an estimated US$445 billion across all industries in 2016, up 30 percent from three years before, and banks and other financial institutions are prime targets of hackers.[1] The number of cyberattacks against financial institutions is estimated to be four times greater than against companies in other industries.[2]

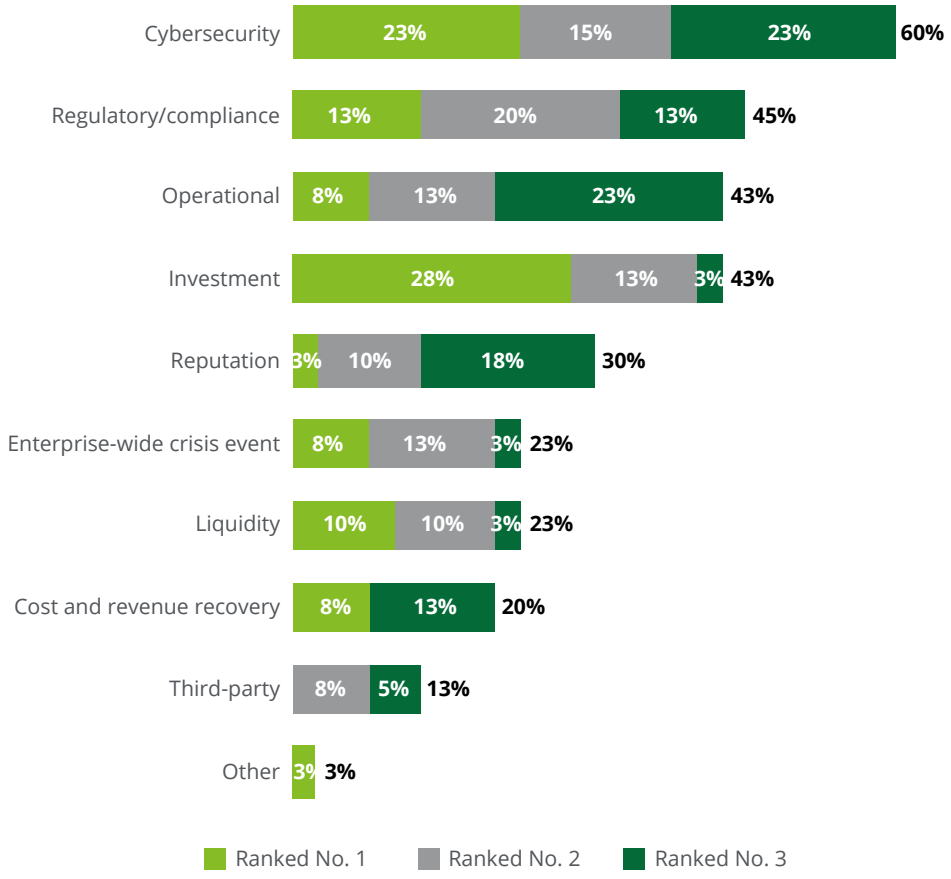
Cybersecurity was named most often by investment management respondents as one of the three risks posing the greatest challenges (60 percent), including 23 percent who ranked it No. 1. (Figure 3) This is a notable change from Deloitte's survey two years ago, when 28 percent of investment management respondents considered cybersecurity to be one of their three greatest challenges and only 3 percent ranked it as No. 1.

Regulators have increased their focus on cybersecurity, requiring that firms be able to demonstrate their controls in this area have been robustly developed and thoroughly tested. To meet the threat, firms are likely to supplement their cybersecurity professionals with an increased use of predictive analytics and automation. Rather than simply respond to hacks and breaches after they have occurred, analytics can predict and screen threats and take automated corrective actions before cyber incidents take place.[3]

Figure 3

Over the next two years, which are the three risk types that you believe will present the greatest challenges in your organization's investment management business?

Base: Organizations that provide investment management services



Responding to new regulatory requirements

The wave of new regulations put in place in the wake of the global financial crisis appears to have crested. While 45 percent of investment management firms named *regulatory/compliance* as among their three most challenging risks, this was down from 81 percent in Deloitte's survey two years ago (see figure 3) Yet, a variety of new regulations require investment management firms to continue to expand programs in order to comply including MiFID II and liquidity risk management regulations and guidance (e.g., as issued in the United States, the United Kingdom, Canada, India, China, and Hong Kong).[4]

One of the regulations that is placing important new requirements on global investment management firms is the EU's GDPR, which took effect in May 2018, and applies to all firms that collect information from EU citizens. Among other provisions, GDPR requires firms to obtain consent from consumers before collecting their personal data and to provide them more control over how their information is used. Initiatives to increase data privacy have also been underway in India and China, and in California in the United States. Regulatory initiatives to strengthen oversight of conduct and culture have been initiated in a number of countries around the world including the United States, the United Kingdom, Australia, and Hong Kong, among others. In addition, enforcement activities continue to cause additional regulatory pressure points for investment managers, in such areas as conflicts of interests, disclosures, allocation of fees, and use of soft dollars for research.

Conclusion

Investment management firms are engaged in a fierce battle to maintain market share and margins as active and passive managers compete for customer investments by offering innovative investment products and an enhanced customer experience. This competition is taking place in a broader environment marked by an array of impending economic perils and growing nonfinancial risks. Navigating these currents successfully will require investment management firms to take fundamentally new approaches to risk management—leveraging advanced technologies; increasing their focus on nonfinancial risks, such as cybersecurity risk and third-party risk; and maintaining the flexibility to adapt to an evolving regulatory environment.

Global risk management survey, 11th edition

Global risk management survey, 11th edition is the latest edition in Deloitte's ongoing survey series that assesses the state of risk management in the financial services industry and the challenges it faces. The 2018 survey findings are based on the responses of 94 financial institutions around the world, including 46 investment management firms. These investment management firms represented a range of sizes as measured by their assets under management: 26 percent with less than US$10 billion in assets under management, 26 percent with US$10 billion to less than US$100 billion, and 48 percent with US$100 billion or more. To view the full report, please visit https://www.deloitte.com/insights/globalrisksurvey.

Endnotes

1 James Lewis, *Economic impact of cybercrime—No slowing down*, McAfee, February 2018, https://www.mcafee.com/enterprise/en-us/assets/reports/restricted/economic-impact-cybercrime.pdf; Stacy Cowley, "Banks adopt military-style tactics to fight cybercrime," *New York Times*, May 20, 2018, https://www.nytimes.com/2018/05/20/business/banks-cyber-security-military.html.

2 Warwick Ashford, "Financial institutions on high alert for major cyber attack," ComputerWeekly.com, February 11, 2016, https://www.computerweekly.com/news/4500272926/Financial-institutions-on-high-alert-for-major-cyber-attack.

3 Tom Davenport and Adnan Amjad, "The future of cybersecurity: Analytics and automation are the next frontier," Deloitte Insights, September 26, 2016, https://www2.deloitte.com/insights/us/en/topics/analytics/future-of-cybersecurity-in-analytics-automation.html.

4 For a discussion of regulatory issues in the investment management industry, see Deloitte's report *Navigating the year ahead: Investment management 2018*, Center for Regulatory Strategy, December 2017, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-regulatory-investment-management-outlook-2018.pdf.

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