Mercer

welcome to brighter

a wider lens

Time to broaden your focus on risk

A business of Marsh McLennan

Risk management has always been a top concern for financial services professionals, but in recent times, its position within an investor's governance framework has significantly expanded. Today, institutional investors need to be aware of more than just the investment risk within their portfolios — with the oversight of processes, operations and third-party providers added to the mix.

In Europe, the Institutions for Occupational Retirement Provision (IORP) Directive makes it clear that pension schemes need to identify, measure, monitor, manage and report on potential risk exposure from processes both within the scheme and elsewhere.

Other asset allocators, such as wealth managers, platforms and family offices, face similar pressures from internal and external stakeholders alike.

The concept of broadening your focus to encompass this wider set of risks may sound simple. But the scope and complexity can make it difficult to navigate all the processes regularly taking place within the operations of asset managers, custodians and other third-party providers.

Without a plan, system and resources dedicated to managing this broader risk, investors can unwittingly expose themselves to increasing costs, concerns and threats to their reputation — and the damage can be irreparable.

Now is the time to address all the risks you face — and begin to build resilience.

Nonfinancial risks

A recent Deloitte survey[1] found that "Almost all respondents considered their institutions to be extremely or very effective in managing traditional financial risks, such as market (92%), credit (89%), asset and liability (87%) and liquidity (87%). In contrast, roughly one-half of the respondents said the same about a number of nonfinancial risks, including reputation (57%), operational (56%), business resilience (54%), model (51%), conduct and culture (50%), strategic (46%), third-party (40%), geopolitical (35%) and data integrity (34%). Financial institutions should consider adopting a holistic approach to managing nonfinancial risks."

[1] Deloitte. *Global Risk Management Survey, 11th edition,* 2018, available at https://www2.deloitte.com/content/dam/Deloitte/de/Documents/risk/Deloitte-Global-Risk-Management-Survey-11th-Edition.pdf.

1. Prove yourself

Although failing to make a required investment return remains a significant concern, the operational risks around portfolio management also present expanding challenges.

When approaching broader risk management, investors face three main obstacles:

Groupthink: Internal reviews of operational risk lack independent validation. Rather than challenging to improve or produce the right outcome, groupthink commends existing processes that may have critical flaws.

Limited expertise: As investors delve into a wide range of opportunities to optimise investment performance, allocations to new illiquid and private market asset classes present unique operational risk considerations. Working with managers operating in different geographical jurisdictions, under separate regulatory regimes, adds layers of complexity that require specific knowledge to assess and manage.

Cost constraints: Investors may assume service providers are acting in their best interests, and relying on these providers may seem like a cost-effective way to manage risk. But many providers see themselves as responsible for delivering only the service they promised; managing *your* risk may not be one of their priorities.

Be aware that regulators and key stakeholders can demand to see evidence of appropriate and efficient risk management, so it makes sense to create a formal process to facilitate it.

Once a course of action has gathered support within a group, those not yet on board tend to suppress their objections — however valid — and fall in line. Groupthink is especially likely if the team is led by an overbearing or overconfident manager who wants to minimize conflict, delay and challenges to his or her authority.

– Harvard Business Review, Managing Risks: A New Framework (June 2012)

2. Add value with cost management

The search for returns is a continuous journey, and managing costs along the way can add significant value. But transparency is key. Showing where and when expenses are incurred — and how much has been paid — gives investors a view on their portfolios' worth, enabling them to control, challenge and make changes to their investments should they need to.

Cost reporting is not consistent across all asset classes or providers.

Encouragingly for investors, in implementing MiFID II initiatives that aim to improve fee disclosures and calculation methods, local regulators have thrown their support behind the drive for cost transparency.

At Mercer, we also welcome this unbundling of fees but caution that this is just the first step.

Cost reporting is not consistent across all asset classes or providers. Investors and allocators may struggle to understand both the explicit and implicit fees and charges their activity incurs.

It is also important to recognise that investment management and performance fees only comprise one component of total fund expenses. There are many additional costs not subject to the same transparency requirements. As a result, the way managers treat total expenses — and how they pass them on to investors — may vary considerably.

Costs need to be transparent and comparable to lower both expenses and risks.

Another point to consider is that changes in manager allocations can be costly — both from a timing perspective and because your portfolio may be out of the market during a transition. Additionally, beware of layered custodian fees that make costs difficult to unravel, accurately benchmark and challenge.

We believe costs need to be transparent and comparable, which can lower both expenses and risks.

3. Know what you have — and what you need

Risk management and investment oversight staff are responsible for managing an increasing number of risks. Relying on existing staff to monitor and challenge a whole range of threats, some of which may be outside their core competency, can put additional stress on an organisation.

Although allocators are typically well-equipped to select external managers appropriately aligned to their investment objectives, they often lack the necessary expertise to assess operational risks, which is where problems can frequently occur.

A diverse portfolio, spanning several asset classes and geographies, requires specialised, expansive knowledge of operational processes and controls. Only the largest investors are likely to have the resources to develop this capability in-house.

For example, derivatives, increasingly used in sophisticated portfolios, have specific operational requirements for effective implementation and control. Although new portfolio launches also demand an immediate resource, it is only for a finite period.

Another common area that can strain internal resources is oversight of asset transitions, as minimising costs and market impact is crucial. Moving assets from one manager to another is not a daily event and can create a high-pressure environment in which in-depth expertise is critical for immediate resolution. For internal operations staff focused on regular, daily functions, resolving complications from such infrequent, technical activities may be immensely challenging, leaving an investor facing increased risk and cost.

Getting the right external support from on-demand experts who can act as an extension of your in-house team is a valuable strategy that does not increase fixed costs. Working with specialists allows internal resources to focus efforts on the areas where they add the most value and provide assured governance to senior stakeholders.

4. Don't fall victim to a false sense of security

The millions siphoned off through Bernie Madoff's Ponzi scheme in the late 2000s cast a spotlight on the importance of conducting proper operational due diligence as well as targeting investment performance. The event focused investors' minds on their hedge fund portfolios, but many fail to maintain the same strict focus on other asset classes, such as long-only funds. Although not as dramatic as the Madoff scandal, several recent episodes have demonstrated how both retail funds and UCITS products are no less at risk from weak operational controls, particularly in areas such as liquidity management, compliance oversight and cybersecurity.

Similarly, managers of private market strategies have not yet been subject to the same degree of due diligence and external challenge from investors, perhaps because of their recent pivot towards the mainstream. However, within many of these strategies lie risks across multiple levels. Assets are invested through complex, multi-layered, special-purpose vehicles that often demand expense authorisation and cash payments.

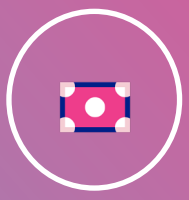
Investor scrutiny of operational processes and controls should be applied across all asset classes and not limited to those perceived to present the most investment risk. Careful scrutiny will enable investors to demonstrate a robust investment governance process to stakeholders and regulators and keep operational control at the top of manager agendas. Complacency can erode controls and increase risk.

Mercer Sentinel's top 10 areas for asset manager risk assessment:


Governance and organisational structure


Human capital


Regulation, compliance and audit


Fund structures


Risk control


Transaction execution/ implementation


Valuation and administration


Technology


Business continuity and disaster recovery


Third-party relationships

About Mercer

Mercer is a leading global provider of investment advice and solutions, helping to improve client outcomes and enhance their operating models. Mercer Sentinel is the specialist operational risk consulting unit of Mercer Wealth. We help our clients improve operational risk management by meeting challenges across investment processes and controls, asset transitions and custodian relationships.

Contact us

If you would like to discuss how we can support you to meet your operational risk challenges, please reach out to your Mercer representative or contact:

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