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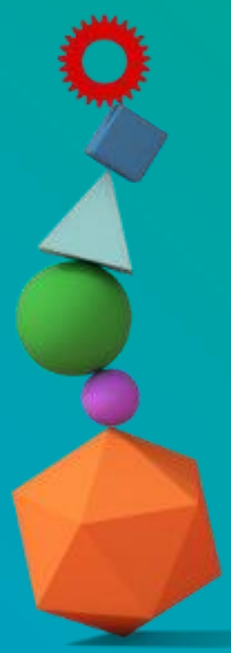
Russia-Ukraine conflict:
Investment management operational risk considerations



Introduction

A lot has happened since Russia invaded Ukraine in February 2022, with much of Ukraine's infrastructure destroyed and people displaced. Western nations have responded by imposing far-reaching sanctions on certain Russian entities and individuals, and no one knows what will happen next in this conflict. Flowing from this situation are certain operational risks that investors and investment managers across the world may need to consider.

Mercer Sentinel discusses some of the key operational risks investors should consider as a result of the ongoing invasion of Ukraine by Russia and the global response.

Key operational risk considerations

Liquidity and going concern risk: Investment managers and portfolios that are significantly exposed to Russian, Belarussian or Ukrainian investments, such as via global or emerging markets strategies, may find that the value of their investments in these locations has been negatively impacted by lack of demand, reputational concerns or destruction of assets. Portfolios with such exposures face the risk of significant redemption pressure from investors, and investment managers may lose some of their assets under management (AUM). As investors could put through large redemptions against funds with significant Russian or Belarussian exposure, or funds managed by investment managers with Russian or Belarussian operations, investors wanting to exit such funds may find it hard to do so because of redemption queues and/or fund trading suspensions. ***Investors may therefore need to understand the extent to which their managers are exposed to Russia to assess if this could put significant pressure on their AUM and to better understand the liquidity arrangements applicable to their fund investments in order to be assured that these risks are being appropriately managed.***

Compliance with the sanctions regime: The emerging sanctions regime is fast evolving, which makes it difficult for investment managers to react quickly to identify and exclude those that are linked to recently sanctioned entities. Identifying all entities that have a Russian connection may not be simple given that certain Russian entities have subsidiaries, affiliates or branches outside of Russia. The question then becomes whether all affiliates should be restricted or just the Russian-incorporated entity. Although they have until May 2022, giving them some time to make the necessary adjustments, investment managers face the risk of not being fully compliant with the new sanctions regime by the deadline. This is further complicated by the potential inability to achieve a timely sell-off of some or all of the exposed holdings at reasonable prices due to trading restrictions or lack of market. ***Investors may want to engage their investment managers to understand how they are set up to comply with the rapidly changing sanctions regime and to process relevant changes to their counterparties and investment portfolios***.

Compliance with investor guidelines and restrictions: As investors grow wary of being associated with investments in Russia and Belarus, some may seek to change their investment guidelines and restrictions to exclude some or all investments linked to these countries from their portfolios. This may require investment managers to exit certain holdings at short notice, which is not easy to do in the current environment, as discussed above. In addition, investment managers face the challenge of identifying which securities to exclude from portfolios in situations where some non-Russian entities may continue to have operations, branches, suppliers or markets in Russia and/or Belarus. ***Investment managers may need to enhance their pre- and post-trade compliance controls and monitoring to help ensure these risks are managed appropriately.***

Investment valuation: Emerging and global market strategies are likely to have some exposure to Russia. Given that markets are closed in Russia and the growing lack of appetite to hold such stocks, some securities may end up with stale prices over a long period. In addition, given the negative views on Russia and investors selling off some of these holdings, achieving consensus on market prices becomes more difficult. Although institutional investors' exposure is limited, private assets with links to Russia, Belarus and Ukraine, which would ordinarily be valued based on models and market assumptions, may now be more difficult to price due to lack of a discernible market, uncertainty and the changing landscape. In particular, infrastructure and real asset investments may be directly and permanently destroyed, hence impaired. Given the security risks, investment teams may not even be able to visit some of these assets. In addition, some income streams would certainly have been disrupted due to a lack of market order and displacement. ***Investors and managers may need to revisit or trigger their fair value and impairment processes, including convening valuation committees and adjusting models and assumptions in relation to the valuation of hard-to-price assets, as appropriate.***

People risk: The situation in Ukraine has deteriorated quickly over the past few weeks and, given its unpredictability, there is a possibility that countries neighbouring Ukraine, including NATO countries, may be involuntarily drawn into the conflict. Investment managers with operations in these countries could find, at short notice, that some of their key human resources are no longer able to work. Poland, for example, is a large outsourcing centre for middle and back-office operations in the financial services industry; a disruption could therefore have significant implications for some investment managers, administrators and custodians. ***Investors may need to assess the extent to which their investment managers are exposed to these countries.***

Trade processing risks: With certain Russian banks being cut off from the SWIFT messaging platform, the communication of trades, settlement instructions and other trade information with entities based in Russia becomes problematic, making it even more difficult for entities to exit positions and/or settle trades in a timely manner. Trade settlement may become more difficult for certain instruments due to unwillingness by some financial firms to settle in Russian rubles amidst a decree issued by Russia for local firms to settle certain foreign-currency denominated balances in rubles. ***Investors may need to engage with their investment managers to determine how they are managing this risk.***

Cyber risk: Since the start of the invasion, the Russian government has experienced several cyber-attacks, potentially by activist groups, resulting in some government websites being unavailable. It is therefore possible that financial services firms, including western investment managers, banks, custodians and others, are at risk of increased cyber-attacks as a result of the overwhelming support for Ukraine by western countries and organisations. ***Investment managers could benefit from reviewing and tightening their cyber-risk defences and ensuring***

that their investment research analysts are appropriately assessing cyber risk when recommending investments. Greater vigilance is needed from not just the managers directly, but also from their outsourced service providers.

Disaster recovery: Businesses with some of their key infrastructure, such as data centres, located in regions directly impacted by the conflict, face the risk of this key infrastructure being destroyed. Before the conflict, many investment firms outsourced certain technology services to Ukraine. Many businesses would have drafted business continuity plans that did not account for such a situation and may therefore be directly affected by the conflict or in a transition phase in order to manage the risk of failure to recover key information. ***Investors may need to engage their investment managers to be assured that their disaster recovery processes are not impacted.***

Outsourcing risk: As with many other risks, given the investment industry's reliance on outsourced service providers for certain functions such as fund administration, custody, technology and other services, the risks investment managers face in relation to the Russia-Ukraine conflict are not limited to how they control their own processes but include the extent to which their outsourced providers are reacting to the same risks. Investment managers could find that they remain exposed to certain risks as a result of their outsourced relationships, irrespective of the managers' best efforts. ***As such, investment managers should consider mapping out their supply chain, understanding how the situation could affect entities in the supply chain and obtaining assurance that these risks are being appropriately mitigated.***

Conclusion

The situation in Ukraine is unpredictable and has far-reaching consequences that affect many industries globally, including the investment industry. Although the industry has weathered geopolitical risks in the past, and investment managers are trying to manage their exposures in the current environment, investors may want to closely monitor the evolving situation. Investors may need to engage the managers they are invested with in order to better appreciate how they are mitigating the risks discussed above.

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March, 2022