New Risk Management Paradigms for Asset Managers

**Point of view**
The financial crisis has caused deep reflection by regulators, asset managers and investors as to the effectiveness of risk management and compliance in its current form. Effective risk identification, and the management of qualitative risks such as operational, IT, legal, compliance and reputational risk is now understood to be as important as quantitative risk modelling. Financial institutions are now starting to organise their risk management around a core of common principles across business units, products and portfolios, instead of silos for each requirement.

Institutional investors are increasingly asking about the risk management function and are assessing the governance structures in place. Firms that are proactive about risk management and regulation, and are transparent with investors will have a competitive advantage.

It is possible to improve the efficiency and effectiveness of risk management and compliance functions while simultaneously lowering costs. The cost of risk management and compliance functions is only a fraction of the true cost of risk and compliance activities.
**AIFMD**
The Alternative Investment Fund Managers Directive (AIFMD) is introducing sophisticated risk management obligations on those impacted

- Imposes requirements in relation to governance, risk measurement and disclosures, and a requirement for a functionally and hierarchically separate risk management function;
- Imposes approximately 169 separate obligations on AIFMs, and the CBI has stressed the importance that firms employ effective governance arrangements to ensure that these statutory obligations are being met;
- The CBI’s AIF Rulebook describes 16 Managerial Functions of the board, 4 of which specifically address risk management;
- The boards of management companies have fiduciary responsibilities to investors in relation to risk management. However under AIFMD, risk management responsibilities are imposed on the designated AIFM, creating practical challenges for boards, which may not be the designated AIFM;
- New AIF outsourcing models are emerging, each with its own nuances, relationship dynamics and risk management issues. A key challenge for directors and senior management is to understand where the risks arise in the AIF’s particular business model and how they can obtain assurances that outsourcing risk is properly managed. The CBI has meanwhile indicated plans to review outsourcing arrangements at fund service providers in 2014.

**UCITS**
Meanwhile, UCITS IV imposes a number of prescriptive risk management requirements:

- Management Companies must establish a permanent risk management function and are required to maintain a risk management policy, which addresses all material risks, including market, liquidity, counterparty and operational risks;
- UCITS that use derivatives must prepare a Risk Management Process to demonstrate the means by which the risk profile of the UCITS will be monitored, measured and managed, and file this with the CBI.

---

**Current issues**

**External**

- Swiftness of change in the financial markets
- Lack of investor trust, where transparency is deficient, and a subsequent increase in demands for transparency and disclosure
- Highly visible frauds involving asset management businesses
- Regulation:
  - UCITS imposes prescriptive risk management requirements;
  - AIFMD imposes principle-based requirements;
  - Impact of other regulations such as FATCA, CRD IV, MIFID 2, Solvency II and Dodd-Frank must be assessed –implications and compliance obligations must be considered in the design of a robust risk management framework

**Internal**

- Need to strengthen the linkage between risk management strategy and business objectives
- Inability to identify, prevent or plan for risk events leading to reactionary rather than proactive risk management
- Inability to aggregate different types of risks across products and portfolios—silo approach to risk management

**The practical impact for you**

- Investors are cautious about investing in products
- Increased regulatory oversight
- Increased and more sophisticated governance responsibilities and compliance obligations
- Operational and resourcing challenges – for example in achieving the required independence of the risk function under AIFMD
- “Surprise” issues and potential for adverse reputational impact
- Manual and sometimes time-intensive risk processes and reporting
- Reactive and “ad-hoc” risk monitoring, with some risks over controlled, and others under controlled.
- Duplication of effort across products, portfolios and risk management silos
What’s needed? New Focus and an Enterprise-Wide Approach to Risk Management

Enterprise risk management (ERM) is a disciplined, holistic forward looking approach to risk management which focuses on governance and controls across business functions, allowing those charged with governance to obtain a realistic overview of the totality of the risks they face, whether credit, market, regulatory, compliance, legal, operational, outsourcing or financial risk, and formulate an acceptable response strategy. This principles-based approach to risk management combines qualitative and quantitative risk assessment techniques to best determine the likelihood and impact of potential risks.

Benefits of an Enterprise approach to risk management

• A more effective, integrated risk management organisation at the business unit level using shared processes, technologies and information repositories;
• Increased transparency, which facilitates effective risk oversight by boards and senior management, by giving them a full and complete picture of all applicable risks, as well as the mechanisms, processes and controls for the ongoing identification and management of risk;
• Improved coordination among risk and compliance functions;
• Development of an enterprise-wide internal controls assessment and testing program which is rationalised and unified, causing less impact on business unit resources;
• Increased management focus on skilled resources and talent management;
• Enhanced oversight and controls around fund valuations;
• More effective and efficient use of information to satisfy compliance requirements, and for more effective board reporting;
• Ability to react efficiently to new regulatory and compliance obligations as they emerge;
• Facilitates more effective identification of outsourcing risks and enhanced oversight of outsourcing arrangements and delegates.

Components of an Effective Risk Management Framework

- Reporting
- Governance & Organization
- Policies & Procedures
- Risk Measures & Limits
- Internal Processes & Controls
- Infrastructure & Technology
- Market Risk
- Liquidity Risk
- Credit/Counterparty Risk
- Valuation Risk
- Operational Risk
- Regulatory/Compliance/Legal Risk
- IT Application/Infrastructure/Cyber Risk
- Outsourcing Risk
- Fraud Risk
- Tax Risk

What risk management issues need to be considered?
Questions for directors and senior management to consider

**Organization and Governance**
- Is there adequate experience, independence, accountability and segregation of duties involved in the oversight and management of risks?
- Does the existing structure allow for an enterprise-wide view of risk management?
- Is the board properly informed of risks and mitigating controls?

**Risk Management Process**

**Risk Appetite, Strategy and Asset Allocation**
- Is our risk appetite / tolerance clearly defined, communicated and understood?
- Are our strategies and asset allocation processes aligned with our risk appetite?

**Integrated ERM framework**
- Are roles and responsibilities across the three lines of defence clearly defined, differentiated and understood?
- Do the three lines of defence collaborate to support an efficient, integrated, holistic approach to risk management?

**Risk Identification and Assessment**
- Have we identified all relevant and material risks?
- Is our new product approval process adequate to identify risks and ensure proper controls?

**Risk Measurement and Analysis**
- Do we have sufficient risk measurement tools and processes?
- Is management able to aggregate risk exposures, identify concentrations, and manage risk as a portfolio?

**Risk Mitigation, Control and Monitoring**
- Do we have an effective process to escalate risk issues?
- Are our limit structures and management practices adequate?

**Reporting and Performance Measurement**
- Do current risk reports facilitate timely and informed management decision making for board level and senior management?

**Periodic Review**
- Do we objectively assess the effectiveness of our risk management function?
- Are we executing our risk management strategies effectively?
- Are our processes consistent with industry leading practices?

**Culture**
- Does our culture and “tone at the top” support sound risk management practices?
- To what extent are incentive structures and talent management promoting the “right” behaviours?

**Infrastructure**
- Are policies and procedures adequately governing risks and operational controls?
- Are outsourcing risks appropriately identified, mitigated, monitored and controlled?
- Are our support systems appropriate given our growth strategy and complexity of the investments and type of risks?
PwC Capabilities

We can assist you, leveraging our dedicated services aimed at addressing your particular risk management needs and responsibilities.

<table>
<thead>
<tr>
<th>PwC Services</th>
<th>Description</th>
</tr>
</thead>
</table>
| Enterprise Risk Management (ERM) Assessment / Due Diligence procedures on behalf of the board or senior management | • We can benchmark your ERM framework relative to industry leading practice, tailoring the review according to the nature of the asset manager. The review will identify the policies, processes and procedures which do not meet leading practice standards, and areas where there may be room for improvement.  
• PwC can help you assess the effectiveness of your ERM program. Key considerations might include: What are the trends in errors or losses over a period of time? Have there been any unexpected types of risks or issues? How ‘accurate’ have risk indicators, risk measures and reporting been over a period of time? |
| Regulatory Diagnostic or Gap Analysis on behalf of the board, manager or senior management | • PwC can benchmark your ERM program and processes against regulatory requirements to assess compliance obligations and the strategic implications for your business.  
• In the context of AIFMD, for example, the diagnostic would consist of mapping the Level 1 and Level 2 guidance to your current ERM operations and clearly identifying the changes needed to become AIFMD compliant. The gap analysis will identify the processes and procedures which do not meet the regulatory standards and provide an initial understanding of the size and scale of the task ahead.  
• We can help identify risk management operating model solutions which are tailored for your size, structure, priorities, constraints and business strategy, to achieve regulatory compliance efficiently, including advice around risk management outsourcing considerations. |
| ERM Design and Implementation Support | • PwC can support you in designing and implementing the aspects of your ERM framework that need to be put in place or upgraded.  
• We will support you in the preparation of an action plan and implementation roadmap that establishes clear steps to adapt your current operating model to address issues and gaps identified, including clear descriptions of the policies, procedures, controls, IT solutions and resourcing solutions to be implemented.  
• This might for example include:  
  - Drafting of risk management policies and procedures;  
  - Set up of your Governance structure;  
  - Analysis and selection of risk management tools;  
  - Definition and structuring of risk reports / dashboards;  
  - Identifying and assessing possible risk management operating model options, and project managing the implementation of the chosen option. |
| Valuation Controls | • PwC can assess controls around valuation-related processes including, independent price verification, sources of valuation data and methodologies, model controls and governance, and P&L generation. |
| Third Party Assurance / Internal Audit Services | • PwC can conduct independent, third party function and process level risk assessments, including assessments of your outsourcing arrangements.  
• We can help facilitate internally delivered risk and control self-assessments.  
• We can help you develop internal audit testing programs around key risk controls (e.g., use of models, content and quality of risk reporting and information). |
| Ad hoc advice and assistance | • We can assist you in various ways, ranging from, for example, on site day to day project management support, document review, project assurance and the delivery of training.  
• We can introduce you to potential risk management outsourced service providers in the local market and / or perform due diligence on potential third party providers on your behalf.  
• Specific tailor-made advice around, for example, market, credit, operational, liquidity and funding risks including methodologies, limit structure, reporting content, etc. |
| Governance | • Assess / develop risk management governance and reporting structures including board oversight and reporting process.  
• Assessment of the structure of the board for risk management oversight.  
• Advice in implementing a Risk Committee that brings together senior Risk, Compliance and Internal Audit individuals, advising as to its composition, defining its mandate and accountabilities, and specifying a reporting and monitoring plan.  
• Advice in implementing a system for the assessment of the board and individual director performance.  
• Create a full and complete “matrix” of all applicable risks to the fund or management company, including a critique of the structures and mechanisms in place for managing and monitoring these risks.  
• Assistance with preparing for CBI PRISM inspections including preparing for interviews with the CBI.  
• Define and / or challenge the company’s risk appetite. |
How PwC Can Help

PwC has developed its approach to Enterprise Risk Management through extensive experience assisting asset managers and other financial services companies assess their risk management processes. The key to this approach is our proven evaluation methodology.

A suggested approach

**Step one: Current State Analysis**
- Evaluate current operating model lessons learned, and regulatory/other requirements
- Analyse activity/“demand” drivers
- Identify and prioritise rationalisation opportunities
- Develop risk and control matrix tailored to investment products and processes

**Step two: Future State Design**
- Develop preliminary draft of target operating model
- Conduct management validation meetings and working sessions
- Refine operating model description
- Document business case
- Identify key control issues and gaps

**Step three: Implementation Roadmap**
- Define and prioritise implementation initiatives
- Identify key risks and success factors
- Draft transformation roadmap and plan
- Prioritise issues and recommendations based on levels and assessment of gaps relative to industry practice

Would you like to discuss this further?

Contacts

**Jane Conroy**
Governance, Risk and Compliance
+353 1 792 6041
jane.conroy@ie.pwc.com

**Dervla McCormack**
Asset Management Advisory Consulting
+353 1 792 8520
dervla.mccormack@ie.pwc.com

**Fiona Lehane**
Asset Management Advisory Consulting
+353 1 792 8657
fiona.lehane@ie.pwc.com

**Ken Owens**
Asset Management Assurance
+353 1 792 8542
ken.owens@ie.pwc.com

**John Healy**
Market Risk and Valuations
+353 1 792 8828
john.healy@ie.pwc.com

**Olivia Sweetman**
Asset Management Advisory Consulting
+353 1 792 8152
olivia.sweetman@ie.pwc.com

www.pwc.ie/assetmanagement

© 2014 PricewaterhouseCoopers. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. 05068