



IAFE

INTERNATIONAL ASSOCIATION OF FINANCIAL ENGINEERS

“OPERATIONAL RISK MANAGEMENT FOR THE BUY-SIDE”

A Report from the Operational Risk and the Investor Risk Committees

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Summary

The Operational Risk and Investor Risk Committees of the International Association of Financial Engineers (“IAFE”) met in October 2002 to explore operational risk, compliance and reputational risk issues for the investment management community. A panel of representatives from the buy-side community was assembled to discuss these issues.

Operational risk is not frequently discussed on a formal basis in the buy-side community, yet there are regular occurrences of breach of fiduciary trust, unauthorized behavior, operational errors and other examples of operational risk. According to Zurich Financial Services’ database of operational risk events, losses associated with operational risk in the fund community are estimated to be in the range of \$9 billion over the past ten years. And this is just the known amount: the actual amount of losses – which includes those events that never reach the public domain – is probably significantly higher.

The goal of this session was to create a forum for discussing operational risk issues from the perspective of the buy-side community and to spark the beginning of a dialogue on how fund managers can best manage this “other risk.”

Key findings of the discussion include:

1. Operational risk best practices will become the industry standard in the future.
2. Operational risk management is mandated from a business rather than purely regulatory imperative.
3. Managing client relationships and expectations is imperative.
4. Aligning the interests of a business unit with that of the institution as a whole is a powerful method for pushing out ownership of risk to the primary stakeholders.
5. Operational risk poses some challenges in the areas of definition and measurement and thus, it is difficult to capture the attention of senior management.
6. There are a number of important tools for managing operational risk that are emerging from the banking community.
7. Cost-cutting efforts within financial institutions have posed serious challenges to ongoing operational risk initiatives.

Introduction and Overview

The Operational Risk and Investor Risk Committees came together under the auspices of the IAFE in order to tackle the issue of operational risk within the fund community. For the purposes of the discussion, operational risk was defined in the broadest possible terms, encompassing people, process, technology and exposure to external events. It also includes reputational risk and fiduciary breaches, as well as classic examples of “operations” risk. These issues have always challenged asset management firms. The current focus on “operational risk” as the “other risk” has allowed risk managers to discuss these issues from a different point of view and with a more defined and specific vocabulary.

The buy-side community includes hedge funds, pension funds, plan sponsors, mutual funds and other asset managers. Some of these businesses – particularly asset managers – are independent entities, while others are part of larger organizations. Fund managers who are owned by large banking organizations have regulatory concerns that may not drive other types of institutions. For instance, capital requirements under the much-anticipated Basel 2 Capital Accord are anticipated to offer discounts for banks that have regulator-sanctioned operational risk controls in place. This will, of course, affect asset management subsidiaries and business units of banks but may not have an immediate direct impact on independent asset management companies in the United States. *(This is not the case in the EU, including the UK, where European regulators will be adopting Basel 2 capital regulations for all financial institutions.)* However, following operational risk best practices is good sound business practice and can avoid reputational, relationship and “headline” risks. This imperative lives outside the framework of regulatory requirements and guidelines and is driven by business needs.

Key Findings

1. Operational risk best practices will become the industry standard

Ten years ago standard market risk best practices, such as the use of stress-testing and Value-at-Risk analysis, were “exotic” concepts within the fund community. Such approaches and methodologies tend to develop first within the banking community as a result of regulatory mandates, and then filter through the fund community. For instance, many banks originally adopted market risk methodologies as a result of pressure from national and international banking regulators and in response to the market risk amendment to the 1988 Basel Capital Accord. Of course, the most forward-looking institutions realized that managing risk made good business sense.

Operational risk appears to be following a similar pattern: the banks are developing approaches and methodologies as a result of anticipated regulatory requirements under The New Basel Capital Accord (“Basel 2”) that is expected to come into effect in 2006. Basel 2 will levy operational risk capital charges for the first time, and allow discounts for institutions that can demonstrate they have the appropriate measurement and management strategies in place. But once again, a number of banks have recognized that properly managing operational risk is about managing their brand, as opposed to rubber-stamping Basel-related capital requirements. This operational risk outlook is expected to become part of a fund manager’s risk culture, just as market risk best practices were adopted. Ten years from now, formally managing operational risk within a buy-side institution will become a standard operating procedure, in the same way that scenario testing and the use of Value-at-Risk is now standard for managing market risk.

2. Business issues rather than regulatory ones are the real drivers

There have been a number of widely publicized examples of operational risk within the fund community, including a recent case involving Merrill Lynch's management of Unilever's pension fund (as discussed in the attached example) and the lawsuit recently lodged against Alliance Capital Management related to its ownership of Enron shares. Of course, the last thing an asset management firm (or any financial services firm) wants is adverse publicity. This is especially true for public pension funds that are under political as well as financial scrutiny.

The capital requirements that are anticipated to come into effect under Basel 2 are driving a number of operational risk management practices for asset management divisions within large banks. These buy-side operations are currently leading the way, and are establishing some of the best practices that others can emulate. These leading edge methodologies, which include both qualitative and quantitative tactics such as self-assessment and actuarial loss distribution models, will allow banks to qualify for the greatest capital relief. This involves the Advanced Measurement Approach (AMA) under Basel 2 that is predicted free up significant amounts of capital.

The Basel 2 capital requirements provide the nomenclature for managing operational risk and will eventually extend to business practices as well. Several buy-side operations within major global banks are currently working on establishing operational risk cultures within their institutions, and pushing out "ownership" of risk to the business managers. These institutions are focusing well beyond modeling and regulatory issues; they are establishing programs that have strong business justifications. Otherwise, they would be entirely focused on building regulatory capital models that simply meet the minimum requirements under Basel 2. Such "business" strategies involve buy-in from the business unit managers, educational efforts and a focus on establishing cultures of integrity.

3. Managing client relationships is imperative

Ultimately, managing operational risk within a buy-side organization means upholding promises to clients. Breach of fiduciary trust is a major operational risk within this community, and what ultimately leads to lawsuits and “headline risk.” It is crucial – for business reasons – to inculcate a buy-side operation’s employees with an understanding of how important it is to avoid misrepresentation of fact. The damage associated with such misrepresentations has been evidenced recently in high-profile news stories involving mis-selling and the failure of funds to deliver promised returns.

One important method for managing fiduciary risk is to learn from the failings of other firms in order to avoid similar mishaps within one’s own firm. This involves a dissection of key causative triggers and contributory factors associated with a large loss event and an application of its relevant aspects to a firm’s profile. Organizations manage to do this through the maintenance of in-house clipping files of articles involving key loss events or subscriptions to external loss databases. An analysis of high-risk loss events is one way of hitting senior managers “in the gut” and getting them to “do the right thing” by allocating proper resources to operational risk programs. This provides a framework for “debriefings” associated around high-profile events and a forum for discussing the lessons learned with senior management. It is a powerful method of achieving senior management buy-in. And of course, it is preferable to learn from the lessons of others, rather than having experienced losses oneself. This analysis can also serve as a beginning structure for establishing a self-assessment process; a dissection of past loss events provides insight into control, audit, supervisory, and cultural items that should be included in any ongoing self-assessment efforts.

An examination of past loss events can be an effective way for firms to discern root-causes of an event. An institution needs to develop its own vocabulary for categorizing and dissecting loss events. Regardless of how this terminology develops, a focus on causal analysis is where the primary lessons learned can be found. It is important to ask what caused the event and if it could occur within one’s own institution.

4. Aligning interests

It is important to align the interests of each business unit with those of the operational risk management team, and by extension, the corporation as a whole. It has been suggested that there are two motivations that drive results within a financial institution: fear and greed. One method for addressing both factors is to allocate losses back to the business units. It is also a method that encourages ownership of risk at the business unit level. Methods for doing this include the allocation of economic and regulatory capital to each business unit stakeholder. However it is important to take care with how losses are allocated back to the business units and to create a process that is transparent and positive. Otherwise – if the process becomes unduly punitive – the losses will simply be driven underground and it will become more difficult to establish an organization’s risk profile and manage its operational risk.

5. The challenges of defining and measuring operational risk

One reason for the slowness of the buy-side community to undertake formal operational risk programs relates to the fundamental nature of operational risk itself. Its scope is vast and includes a wide range of issues and problems that fall outside of market and credit risk. Moreover, in the area of measurement, firms are more used to the large and more easily accessible types of data associated with market and credit risk. In the case of operational risk, the data is often difficult to find, widely dispersed or not easily accessible. It often has to be analyzed and mined for meaning. Because it is harder to talk about conceptually, it is a greater challenge for senior management to understand and analyze for meaningful clues and patterns.

6. Emerging tools for operational risk

Although it is generally agreed that operational risk does not lend itself to measurement in the same way as market or credit risk, there are models and methodologies used by banking and insurance communities that can be adopted by fund companies. Global banks, for instance, have already built databases of several years' worth of internal losses that can be used in operational risk models, and several industry data exchanges currently are collecting data for benchmarking and modeling purposes. There are models that can be adopted from other industries – such as actuarial models from the insurance industry and scenario models from the power utility industry – that can inform the development of operational risk ones.

Additional tools and approaches include internal and external loss databases, and the establishment of a progressive operational risk culture by the use of communication and educational techniques. For instance, several financial institutions are arranging workshops and distributing newsletters on recent operational risk events and issues within their institutions. These items, along with self-assessment questionnaires and operational risk models and scenario testing, comprise an important marketing cache for an operational risk manager.

7. Maintaining momentum in a cost-cutting climate

Financial institutions of all types are facing significant challenges. These include shrinking revenue flows, increased market volatility and heightened regulatory scrutiny. Firms are consequently adjusting downwards their payrolls, level of spending and budget allocations for all business activities. Risk management departments are often seen as easy targets for cost cutting and are under great pressure to preserve their budgets. The challenges for operational risk management departments are even greater due to the fact that it is more difficult to quantify operational risk than market risk. It is difficult to prove that the absence of a large reputational event has ever saved the organization money. For instance, if Barings had dual controls and proper supervisory procedures in place in its Singapore office, and Nick Leeson never caused an unauthorized trading event of monumental proportions, would the risk management staff have ever been able to document the deterrence of such a devastating event?

The other difficulty in obtaining budgetary dollars for operational risk is that it is not necessarily perceived as a glamorous discipline in the eyes of senior managers. Operational risk managers often discuss issues such as dual controls, regular audits, self-assessment questionnaires and internal data capture. Some of these issues are seen as too detail-oriented by senior managers. These concerns are not always seen on the surface as strategic and business-driven. And the mention of regulatory issues – such as Basel 2 – often contributes to the impression that operational risk is a mundane discipline. The use of past operational risk events and postmortem discussions all help build management support for budgets and financial support. This is an effective method for making operational risks “real” for senior managers. This also implies that an operational risk manager needs the proper arsenal of marketing tools in order to sell the importance of best practices to senior management and business managers.

Some firms are achieving financial savings by outsourcing certain functions. However, although services can be outsourced, risk cannot. This is particularly true for fiduciary risk. A fund is responsible for the fiduciary actions of its employees *and* its outsourcers and will suffer the reputational consequences of a blow-up in either case. Hence, the risk does not disappear when a service function is outsourced. Funds need to actively manage outsourcing relationships to make sure they are not at risk for blow-ups that will cause reputational harm or losses. This is a particular challenge associated with outsourcing agreements. One global bank is managing this risk by having its risk management rather than purchasing department “own” the outsourcing contracts.

Conclusion

A key component in managing operational risk is the establishment of a “lessons learned” culture. This involves a debriefing after a blow-up happens in another institution and a honest consideration on the part of objective parties on whether such an event can happen in one’s own institution. It should involve an analysis of what caused the event and what changes need to be made to avoid a similar event internally.

Fund companies can learn a great deal from the banking community, and there are a variety of techniques and approaches that can be adopted. There is a good business case to be made for doing so even in an institution that will not come under capital guidelines set by the Bank of International Settlements: there is a great deal of value in preserving an institution’s brand and reputation. Fund companies that are unable to justify operational risk budgets due to regulatory requirements will need to work harder to gain the money they need, but there are compelling business reasons to do so. And ultimately, operational risk managers are the salespersons within their firms for the implementation of operational risk best practices.

Although many buy-side companies do not have regulatory mandates to manage their operational risks, their greatest risk emanates from relationships with their clients. Breach of fiduciary duties can serve as one of the greatest threats to a fund management company’s reputation. A firm’s employees need to understand the importance of keeping their promises to clients and how difficult it is to gain the trust that is needed to manage others’ money if reputational issues emerge. This mandates a culture that highly values client relationships, closely monitors its sales literature, and compensates employees based on the depth of client relationships, rather than the generation of fee income. It also means that at its very core, good operational risk management is about “doing the right thing.”

Example of an Operational Risk in the Buy-Side from the Zurich loss database

Event Description: Merrill Lynch management of the Unilever Pension Fund

Causal Factors: Relationship risk, Breach of fiduciary duties

In a relationship risk case, Merrill Lynch and Unilever's pension fund have agreed to settle out of court a USD \$185 million suit on December 6, 2001. This case centers on risk management issues connected with Merrill's management of GBP \$1 billion of Unilever pension money. Merrill and the Unilever Superannuation Fund did not reveal details of the deal, but it has been speculated by people familiar with the case that it was settled for USD \$140,263,200. The case held the promise of becoming a landmark decision for the pension fund industry if ruled on by the courts and was put to rest after seven weeks of court testimony and two years of failed attempts to settle. What distinguishes this case from others is the emphasis on risk controls.

This case revolved around the issue of whether pension managers can be held accountable for their investment decisions – particularly ones that resulted in below average earnings as a result of what is perceived to be risky investment strategy. For instance, one criticism is that Merrill Lynch failed to invest in bank stocks, which were particularly high yielding in terms of equity returns a few years ago. Other complaints against Merrill Lynch include the hand-over by the fund's manager, Carol Galley, to a 27 year-old junior colleague, and the subsequent failure to notify Unilever of the effective change in stewardship. Ms. Galley was also charged with failing to supervise the junior fund manager appropriately. The chief risk officer admitted during court proceedings that the investment risks taken by the junior fund manager were “uncomfortably high.”

It is feared that the settlement could trigger a wave of other court cases, as several have been waiting for the outcome of this one before proceeding forward with their own claims. Looming court actions include a case brought against Merrill's money management subsidiary by J. Sainsbury over management of the supermarket company's GBP 3 billion pension fund. Other possible future claimants against Merrill include AstraZeneca and England's Surrey County Council pension fund.

Merrill Lynch has denied all charges, and settled the case without admitting guilt. The brokerage firm claimed that it ultimately made GBP 200 million for the fund, which might have been less than the expected earnings of GBP 300 million, but still respectable. Unilever's chief investment officer also conceded that she did not read all investment materials closely concerning Merrill's investment strategy. Unilever claimed in its suit, filed in 1998, that it earned less than it was entitled to, due to Merrill's improper risk controls, failure to diversify properly, and to have downside risk protection measures in place. The case has been monitored so closely by the pension fund industry, because it suggests that all money managers would be held accountable when pension portfolios that they manage earn less than stellar returns.

This case is expected to result in a dramatic change for the money management industry, with an increased awareness of operational risk management issues. Fund managers have made significant changes as a result, including increasing risk control efforts, supervisory activities, and examining more closely how their client's funds are managed. One fund manager with a major Wall Street brokerage firm claims that the case highlighted the importance of risk management techniques for her client base – a population that rarely focused on these issues in the past. “Risk Control” is the key phrase to emerge out of the Merrill/Unilever proceedings.

Some fear that the settlement will push fund managers to simply track their investment strategies to index funds, such as the Standard & Poor's 500 Index, in an effort to avoid future lawsuits if their own custom-tailored in-house strategies under-perform the major market indexes. This would lead to a diminishment of investment choices for the very funds that claimed they were the victims of less than stellar management techniques.

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About the Operational Risk Committee

Of all the different forms of risk which can affect firms, Operational Risk can be among the most devastating and among the most difficult to anticipate. Operational Risk continues to receive heightened attention among regulators and market participants, further prompting dialogue and debate on the best ways to identify, measure and manage this important risk.

In response to these developments, the Operational Risk Committee was formed in 2000. Its mission is to promote dialogue among members and the broader risk management community to further understanding, share best practices and promote industry standards regarding Operational Risk.

The committee's mandate is to explore Operational Risk in its broadest sense. Examples of potential topics which may be considered by the committee for initiatives include definitional issues, best practices, quantification, indicators, data issues, governance, culture, technology approaches, effectiveness of existing controls and the interrelationship of Operational Risk to other forms of risk.

The activities of the committee are multi-faceted and are shaped by the interests and energies of its members as guided by its Steering Committee. Specific initiatives include but are not limited to panel discussions, seminars, workshops, white papers, surveys, e-learning initiatives and research projects.

Although the proper definition of Operational Risk has often been the subject of past heated debate, there is generally agreement among risk professionals that the definition should, at a minimum, include breakdowns or failures relating to people, internal processes, technology or the consequences of external events. Operational Risk is a broader concept than "operations" or back office risk. It encompasses risk inherent in business activities across the entire firm and, consequently, its losses have the potential to be of much greater magnitude.

The committee includes individuals with a range of backgrounds, including dealers, end-users, industry advisors, operational risk specialists, technologists, regulators, scholars and others. Individuals serve on this committee in their individual capacities as opposed to representatives of their respective employers or organizational affiliations. Participation and sponsorship of organizations in committee events and activities is open for consideration.

About the IAFE

The International Association of Financial Engineers (IAFE) is a professional society dedicated to defining and fostering the profession of financial engineering. Its primary mission is to help establish and promote industry standards and practices relating to financial engineering theory and practice.

Founded in 1992, the IAFE has grown to include nearly 2,000 members worldwide, representing practitioners, academicians, and students from many financial disciplines as well as professionals from the accounting, legal, regulatory, and technology communities.

Through programs, publications, and original research, the IAFE provides a platform from which its members can discuss and debate the pivotal issues shaping the development of the financial engineering field. In an environment where capital market developments are constantly driven by technological change and shifting market needs, the IAFE strives to serve its membership as the preeminent professional organization for the advancement of financial engineering.