CENTRL

OPERATIONAL RISK MANAGEMENT FOR INVESTMENTS: A GUIDE

INTRODUCTION

Pursuing an operationally risky investment can reduce its potential returns, which can have a substantial financial impact on an investment firm. It's crucial to identify, mitigate, and monitor these risks.

Here's where operational risk management (ORM) and operational due diligence (ODD) come in.

With robust ORM and ODD programs, investors can effectively assess the operational infrastructure and risk profile of new investments. They can thus understand their risk exposure, take the appropriate action to minimize risk, and maximize returns.

This detailed guide unpacks the critical operational risks in the financial services industry. It also explores the role of ODD in ORM.

WHAT IS OPERATIONAL RISK?

Operational risk refers to the risk a financial organization faces during day-to-day operations. It may result in regulatory compliance issues, legal action, or fines. It can also lead to a loss of customers or damage the company's reputation.

Financial institutions should better understand their operational risk and implement a robust ORM program to avoid such eventualities.

WHAT IS OPERATIONAL RISK MANAGEMENT (ORM)?

Operational risk management is a continuous process of identifying, reducing, and mitigating critical operational risks. This "risk-averse" approach includes:

- Risk identification
- Risk assessment
- Risk measurement
- Risk mitigation
- Risk controls implementation
- Risk reporting and monitoring
- Risk decision-making

Together, these activities enable investment organizations and funds to address critical risks associated with the operations of an investment. They can also decide whether to accept, avoid, control, or transfer these risks.

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Further, with an effective operational risk management program, financial firms can operate effectively in their risk landscape, increase business resilience, and ultimately operate a more secure and successful enterprise.

ORM is typically part of a broader enterprise risk management (ERM) program.

THE 5 KEY TYPES OF OPERATIONAL RISK IN THE FINANCIAL SECTOR

According to the Basel Committee on Banking Supervision (BCBS), operational risk increases the risk of losses for a financial organization. These losses can arise from "inadequate or failed internal processes, people, systems, or external events."

The BCBS definition captures five key sources of operational risk.

People Risk

One of the primary risk factors in a financial company's operational risk landscape is people. Often, human operational risk stems from employee errors.

For example, an employee may enter incorrect data during reconciliations. Or they may share sensitive information with an unauthorized party, which could result in a data breach.

Fraud is another type of human operational risk. This may be internal fraud resulting from:

- Employee theft
- Insider trading
- Intentional misreporting of financial information

External fraud usually results from check kiting or the forgery of financial documents or assets.

Inadequate human capital also increases human operational risk for financial services firms. This risk stems from their inability to attract, develop, manage, and retain competent resources. Poor employment practices or inadequate workplace safety rules also increase operational risk.

Other human risk factors include:

- Lack of segregation of duties, allowing the same people to control multiple processes and perpetrate fraud, theft, or insider trading
- Poor human resources policies and below-average compensation resulting in high employee turnover
- An organizational culture where operational risk is not prioritized or communicated to the rank and file
- Key personnel risk, which allows certain employees (e.g., senior management) to manipulate and misreport financial information to regulators, clients, and other stakeholders

ORM is typically part of a broader enterprise risk management (ERM) program.

Strategies to Mitigate People Risk

To mitigate human-factor risks, financial providers must develop effective risk oversight frameworks and controls. They must also implement intervention practices by:

- Determining high-risk groups
- Analyzing business lines and functions with the most significant inherent risk exposure
- Creating a risk heat map to prioritize risks

These business practices must address the operational risk from each high-risk group. Deliberately develop segregation of duties, especially between investment and non-investment functions.

Organizations must train employees on the need for ORM to drive a risk culture and clearly communicate the consequences of these risks. An incentive structure that rewards employees who help manage and mitigate operational risks also reinforces the importance within the organization.

Process Risk

Sometimes a people risk stems from a process risk. Process risk refers to the risk of losses resulting from failed business processes. It may be present at any stage of a business transaction and affect any business unit.

Mistakes and unethical behavior can often be deterred with robust processes. For instance, a poor pricing process may lead to errors that affect the company's sales, while a broken fulfillment process may affect customer satisfaction and increase customer churn.

Similarly, inaccurate or manual documentation processes may cause mistakes in financial contracts or regulatory reporting, leading to disputes with vendors and other third parties.

A lack of segregation of duties between investment and non-investment functions can result in both human and process risks. Either way, it creates opportunities for employees to behave unethically, perpetrate fraud, and disrupt business continuity.

PwC predicts that assets under management (AUM) will grow from $84.9 trillion in 2016 to $145.4 trillion by 2025. But in this evolving landscape, many financial firms are not scaling their processes or infrastructure to accommodate growth. This can result in process risk and resources constraints, preventing them from achieving higher revenues.

Strategies to Mitigate Process Risk

Process transparency among functions is the key to identifying and mitigating process risk. It's also vital to consider entire processes, from end-to-end, to avoid the segmentation of risk awareness along functional lines or create a siloed risk management function.

Segregation of duties and privileges is critical to keep honest people honest. At the same time, it is also essential for employees to understand how their tasks are impacted by upstream and downstream processes.

Internal controls and optimized business processes will result in fewer mistakes and more effective employees.

Financial organizations should also adopt quantitative process risk measurements and self-assessments. A common, organization-wide risk framework can also be a valuable addition to the ORM program.

Systems Risk

Systems risk arises from failed internal systems, such as:

- Management information systems
- Core banking systems
- Information security systems
- Power backup systems

These failures may occur due to hardware or software failures and cause business disruptions. Further, a lack of proper access and security controls on core operational systems can increase the risk of cyberattacks and data breaches.

Using inappropriate or inadequate systems for a particular asset class also creates systems risk. Each asset class has varying levels of inherent risk and returns, so they need to be managed differently. The alternative is increased systems risk.

Organizations that use spreadsheets, manual data entry systems, and email for communication and collaboration also experience greater operational risk.

Strategies to Mitigate Systems Risk

A centralized platform makes it easier to manage multiple investments and asset classes to effectively mitigate systems risk. It captures relevant data about the performance of various asset classes and compares this data against benchmarks.

Investors and asset managers can also use this information to understand a portfolio's overall exposure, identify potential risk areas, and make better allocation decisions.

Centralized platforms like ODD360 also help mitigate systems risk by providing a single source of truth for ODD data, automated workflows, auto-scoring, portfolio benchmarking, and other powerful features.

Risk Due to External Events

The operational environment of banks and other financial organizations has evolved in recent years due to the globalization of financial services.

The development of complex new products, changes in FinTech and e-banking, increased outsourcing, and an evolving regulatory landscape are also creating unique risk exposures.

Several other operational risk events are also changing the evolving risk profile of financial organizations. These include:

- Economic or political events
- Market risk
- Evolving environmental, social, and governance (ESG) regulations
- Natural disasters such as pandemics, hurricanes, floods, and fires
- Cyberattacks
- Terrorist attacks

Strategies to Mitigate the Risk of External Events

Financial organizations cannot always predict or avoid external risk events. However, they can control external risk by implementing robust ORM strategies, systems, and procedures.

For instance, strong cybersecurity controls can protect the organization from cyberattacks. At the same time, fire insurance and reliable fire safety systems can prevent fires or at least help minimize their potential for damage.

Legal and Compliance Risk

In 1995, Barings Bank collapsed when some fraudulent transactions came to light. In the early 2000s, Citigroup and JPMorgan Chase had to pay out substantial settlements due to their role in the fraudulent events at Enron and WorldCom.

Such legal claims and punitive measures can result in significant operational losses for financial institutions.

These claims and settlements stem from a lack of adequate regulatory oversight processes. Consequently, organizations may fail to satisfy regulatory requirements related to data protection, anti-money laundering (AML), tax laws, human resource laws, etc.

Missing policies and procedures or the insufficient monitoring and internal oversight of existing policies and procedures can also prevent the company from satisfying regulatory requirements.

Finally, employees that are not trained in the organization's legal and compliance responsibilities also add to its operational risk profile.

Strategies to Mitigate Legal and Compliance Risk

To manage their legal and compliance risk, ORM is vital for financial services organizations.

They must also implement robust compliance policies and procedures and ensure that internal and monitoring oversight procedures are in place – not only for these policies and procedures but also for their legal and compliance function.

It's also crucial to stay on top of regulatory trends and developments around AML, KYC (know your customer), customer privacy, and data protection.

Training staff on these developments and the organizational controls around them is vital to maintaining a risk culture.

HOW OPERATIONAL RISKS TRANSLATE TO INVESTMENT MANAGEMENT

Operational risks can have massive repercussions for investment management firms. To minimize these risks, they must identify common risk areas and consider various risk management strategies.

They must also fail-safe their processes by carefully developing and documenting procedures, workflows, and policies.

A reliable ODD process also goes a long way toward effective operational risk management. ODD is crucial to assess the operational risk of potential investments and predict whether they will generate value in the future.

The development of due diligence questionnaires (DDQ) is a crucial component of the ODD process. Investors must also review supporting documents and conduct onsite reviews for a more detailed, well-rounded risk self-assessment.

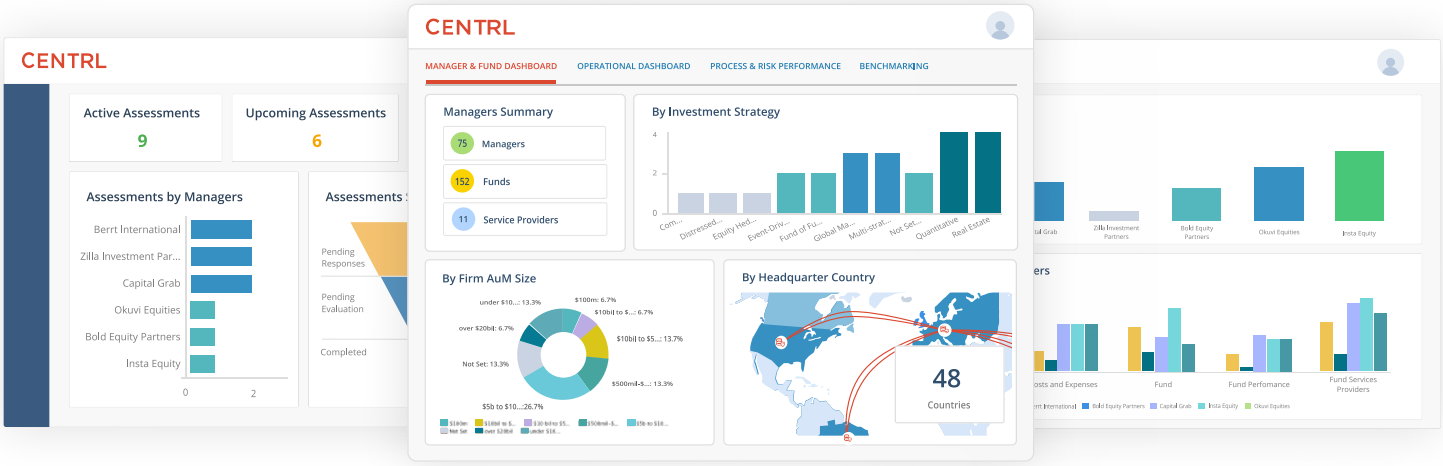
Unfortunately, too many investment management firms still rely on manual processes, spreadsheets, email, and disparate point systems to manage ODD and guide investment decisions. These old-school choices create chaos and increase process complexity.

They also force people to go back and forth on ODD-related communications, affecting collaboration and adding to delays.

Moreover, these legacy systems make it harder to understand an investment's operational risk, thus impacting the final decision and the investment's potential ROI.

The only way to avoid these problems and mitigate operational risk is to adopt ODD automation with a solution like ODD360.

INTRODUCING CENTRL'S ODD360



The CENTRL team predicts that a critical ODD trend in 2022 will be the use of technology like ODD360 in the ODD process. ODD360 is a powerful ODD automation platform.

It provides an intuitive system to manage every aspect of the due diligence process and identify operational risk in potential investments.

ODD360 simplifies workflows and enables investment managers to share DDQs, checklists, and other content. They can monitor and report on the progress of several investments simultaneously.

This purpose-built due diligence platform helps reduce operational risk, improves response rates, and enhances quality. Its centralized source of truth helps enhance team efficiency and generates actionable insights to improve decision-making.

To know more about ODD360, book a demo.

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CENTRL is a leading enterprise risk management company, and provider of ODD360, a multi-party operational due diligence platform used by Investors and Managers to provide a superior Operational Due Diligence process experience. The CENTRL platform is used by some of the largest investment groups across US, Europe, APAC and Latin America. For more information, please visit odd360.oncentrl.com or visit us at odd360.oncentrl.com/demo-request/ to schedule a demo.

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