

## Investment Management Review

A Quarterly Update for the Investment Management Industry

# The Future of Risk Management

The background of the page features a large, close-up photograph of an orange traffic light lens on the right side. The lens has a textured, concentric pattern. In the lower-left foreground, there is a blurred orange and white striped barrier, suggesting a construction or safety zone. The overall lighting is warm and focused on the traffic light.

The crisis events of 2008 exposed a number of flaws in the investment management industry's approach to risk. Now risk managers and regulators alike are developing a new set of principles and practices to master risk wherever it arises.

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**Jervis Smith**

Managing Director  
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Nothing demonstrates better the change in attitudes since the collapse of Lehman Brothers than the intense interest now being shown in risk issues. “Before the fall of 2008,” says Wylie Tollette, Senior Vice President, Investment Risk and Performance at Franklin Templeton, “we would have meetings with clients and prospects once a quarter. Now it’s once a week. That gives you a sense of how much interest there is in this topic.”

Worldwide, regulators are recalibrating their approach to risk. In Europe, investment managers face big changes with the advent of the Alternative Investment Fund Managers Directive (AIFMD) and UCITS IV. On both sides of the Atlantic, regulators are committed to reducing the risk in over-the-counter (OTC) derivatives by moving trading onto exchanges and clearing into central counterparties (CCPs). In market after market, reporting requirements for institutional investors are being tightened.

“Even without the pressure from regulators,” says Christian Skylar, Global Head of Risk and Performance at Marshall Wace, “there is pressure from investors. Not only do they want more information and more transparency, but they want improved reporting and new metrics. The industry needs to develop more adequate risk indicators. What drives correlation between assets? How can we be protected when there is a sudden jump in volatility? Liquidity risk is now a big deal – but there is no universal model to measure it. All of this needs building into a new model,” he stresses.

Right across the investment management world, risk professionals are groping their way toward a new set of tools for analyzing and measuring market risk. “The key is to find tools that are forward-looking, that can be more useful to managers,” says Mr. Skylar: “The capital allocation pricing model on which everyone depended for measuring expected volatility and returns is no longer relevant. Take the Sharpe ratio. Before the crisis people were assuming an average risk-free rate of return of around 4%. Now it is clear the risk-free return is zero.”

At Franklin Templeton, Mr. Tollette says that while risk models have a role to play they are just a “starting point for the discussion.” It is possible, he says, to go in a lot of different directions with risk modeling: “But unless it improves your

knowledge of the risks and results in something that is actionable by the investment managers it is not much help,” he says. “The real problem in the past was that risk managers failed to get their message across in a way that was intelligible to the average human. The communication element is crucial to the risk management function.”

The key, he suggests, is the way in which risk management relates to the investment management process. “There are a lot of different approaches,” says Mr. Tollette. “Risk management can be seen as compliance – a type of risk police – where the risk managers sit at the back and send reports out to the traders telling them they’ve reached a certain exposure limit.” Such a reactive approach, however, falls short of the mark, he insists.

“Risk management should be integral to the investment process. We believe in getting risk built into the process in advance. We work with the investment analysts, getting them to think about risk in the portfolio construction process. We call it the ‘three Rs.’ We believe in taking risks that are recognized, rational and rewarded,” he says. “If you understand the risks you are taking, they cannot surprise you. If you are rational you will avoid pitfalls such as overconcentration. And if you run a performance attribution exercise you will be able to tell whether you have been properly rewarded for the risks taken.”

## Complexity and Illiquidity

The increasing complexity of the markets – particularly in derivatives – poses an extra challenge. Mr. Tollette says Franklin Templeton has a cross-functional complex securities committee, which includes legal, tax and investment experts, to evaluate new strategies and securities. “It helped us avoid leveraged ETFs and auction-rate securities,” he says.

The crisis demonstrated that when complexity went hand-in-hand with illiquidity it could be especially damaging. “For the first time people started to ask what the assets were really worth,” says Jervis Smith, Head of Client Executive, Global Transaction Services, EMEA, Citi. “Valuation has become one of the key issues,” says Mr. Skylar: “In particular, the link between risk and OTC valuations is now a big subject.”

Market illiquidity poses a big challenge to the pricing of complex OTC instruments. Investors have become wary of relying on counterparties for their pricing while modeling often fails to take account of the quality of the underlying instruments. Increasingly, they are turning to specialist valuation services to minimize risk. "It can make the difference between being sued and not being sued," says Mr. Smith.

## Counterparty and Collateral Risks

The biggest fallout from the Lehman affair clearly concerned counterparty risk – and in particular issues of collateral ownership and valuation. Prompted by the scale of these issues in an OTC derivatives market put at around US\$600 trillion (and nearly three times the size of the world's bond, equities and exchange-traded derivatives markets combined), legislators and regulators are now moving to force all trading of "standardized" OTC derivative instruments onto exchanges or electronic trading facilities and require them to be cleared through CCPs. The move is effectively supported by every country in the G20, which has set a deadline of end-2012. Interest rate swaps will be the first instruments to be affected.

"Unquestionably, CCPs will reduce risk," says Rajen Shah, Global Head of Collateral Management, Global Transaction Services, Citi, "but there are a number of problems, too." First, he says, for users there is the issue of cost: "Initial margin will be required. With existing bilateral contracts, there is only variation margin to put up. And since CCPs will restrict the type of collateral they take to cash or government securities, many buy-side institutions will have to sell assets to raise cash for their initial margin."

The post-CCP landscape will also be highly complicated since only "standardized" OTC instruments will be centrally cleared. Many other OTC derivatives will continue to be traded and cleared on a bilateral basis and firms will still have to manage those transactions as they do now. At the same time, says Mr. Shah, other regulatory changes are likely to increase the need for regular reporting.

"In many ways, these reforms make life more, not less, complex for buy-side firms," he says: "There will be as many as eight different CCPs and there will be multiple

clearing agents for each one. In many cases, investment managers and pension funds will want more than one clearing agent per CCP – so there is a lot to manage." The changes are expected to give added impetus to a trend that has been apparent for some time as buy-side firms outsource collateral management.

## Managing Cash

In the wake of the Lehman collapse, counterparty risk was also perceived to be a major issue for depositors. The sense of panic over what to do with cash may not currently be as intense as it was at the peak of recent market turmoil, but good risk management still requires a structured approach to cash. Hugo Parry-Wingfield, Head of Liquidity and Investments, EMEA, Global Transaction Services, Citi, says there is a three-step process investors should adopt to drive out risk from the cash management process.

The first, he says, is to enhance the visibility of cash: "It is critical investment managers know where their cash is. As they move into ever more markets and instruments, there is likely to be a growth in number of accounts. It also becomes more difficult to track where cash is in the settlement chain. But without perfect information, how can you hope to manage your counterparty exposures, manage your currency requirements or mobilize your cash to maximize efficiency?"

The key, says Roger Brookes, Cash Client and Sales Management, Global Transaction Services, Citi, is quality of information. "Clients are often dealing with out-of-date information. The important thing is to know where cash is now, not where it was yesterday. Firms need to get SWIFT 942 intraday messages, which are triggered every time there is a movement. Real-time information is vital," he says.

The second step is to consider one of the automated techniques developed for corporate treasuries to concentrate or notionally pool multiple cash holdings so that they can be managed on an aggregated end-of-day basis to extract full value from them. This can be especially important for multicurrency investors where unexpected spikes can occur and long positions in one currency can be used to offset short positions in another. An automated service also ensures that where sovereign or other issues arise in a particular market, cash can be moved out quickly.

The third step, says Mr. Parry-Wingfield, is for firms to revisit their cash investment practices. "The focus must be on concentration risk," he says. The problem is that diversification brings its own challenges, particularly where investors are restricting themselves to highly liquid, short-term options. There is the issue of evaluating and monitoring counterparties and determining limits with each. And a lot of operational time and effort can be taken up booking and settling trades where liquidity is retained on a short basis.

## Managing Brand Risk

With the increasing convergence of long-only and alternative funds and the advent of UCITS IV and the AIFMD, investment firms face greater regulatory challenges than ever before. The mushrooming growth of "newcits" has been described as "an accident waiting to happen," with many retail investors unclear as to the risk profile of the funds they invest in.

"Not all hedge fund managers have experience of the reporting requirements of UCITS," says Robert Hennessy, EMEA Head of Fiduciary Services, Global Transaction Services, Citi, "and it is vital they get good advice before launching newcits products." And all firms, he stresses, including existing UCITS promoters, will have to look again at the way they measure and monitor derivative risk once UCITS IV takes effect next July.

This is because the new regime does away with the distinction between sophisticated and non-sophisticated funds currently part of UCITS III. That, in turn, means that Value at Risk (or an equivalent advanced risk measurement methodology) will need to be used where UCITS engage in

complex investment strategies which represent more than a negligible part of their investment policy; or have more than a negligible exposure to exotic derivatives; or where the commitment approach does not adequately capture the market risk of the portfolio. Otherwise, the less costly commitment approach will be adequate. This will require firms to be more cognisant of their derivative risk and to tailor their derivative risk measurement methodologies accordingly.

"The Committee of European Securities Regulators has recently published guidelines on risk measurement for UCITS," says Mr. Hennessy. "They are tightening the rules and requiring stress tests to be carried out on a regular basis, at least once a month and more frequently for rapidly changing portfolios. That compares with a quarterly frequency at present."

There is upside to all this. In a recent industry survey conducted by the consultancy CREATE-Research, and sponsored jointly by Citi Global Transaction Services and Principal Global Investors, one theme to emerge was that "the winning model of this decade will have a fiduciary overlay." That overlay would better align the interests of asset managers, their professionals and their clients – by, for instance, countering behavioral biases that have cost clients dear in the past, stopping asset managers from selling products that are not fit for purpose and ensuring that the gains and the pain are shared equitably.

"Success in the future may require firms to go beyond what they are legally obliged to do," says Mr. Hennessy, "by applying an extra level of due diligence. This implies a new philosophy in which duty of care is paramount." ■

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