

Ethics and Risk Management

USING RISK MANAGEMENT TO ENFORCE ETHICS (AND VICE-VERSA)

Robert Lordi and Andrew Nolan

A portfolio manager takes on the responsibility for the assets of a new customer and fully accepts the customer's mandate to invest in an area that (unbeknownst to the customer) is not an area of expertise for the manager. The manager chooses not to mention this fact to the customer.

This simple anecdote introduces the relationship of ethics and risk. Ethics is breached when the portfolio manager puts aside the customer's trust to invest in an unfamiliar investment area and chooses not to tell the customer. The manager's unethical behavior increases risk for the customer, the portfolio manager, and the company.



A firm cannot effectively manage risk without having a strong ethical underpinning. At the same time, however, business opportunities and resultant risks challenge the ethical underpinning of an organization. The ability to identify and manage business risks is as important to an organization's ethical framework as its ethical framework is to its risk management program. A breakdown in risk management opens the door to ethical misconduct and ethical misconduct increases risk for all parties. As stewards of customers' assets, investment management firms are acutely aware of this interrelationship. To support the ethical

culture of the organization and address risk effectively, they establish systems of internal controls and other risk management measures. This article explores the different risks that investment management companies must address and the attributes that characterize an effective risk management approach.

Understanding Different Kinds of Risks

Anything that could affect a company's ability to meet its business objectives is a risk. The better a company is at understanding its unique portfolio of risks, weighing those risks against opportunities, and managing the outcome, the stronger the company's outlook will be. Moreover, a strong ethical climate will contribute to an effective risk management system—especially in the investment industry, where trust is a prerequisite to the care-taking role that investment managers accept for their clients. However, even in organizations that have solid ethical centers, bad things happen. Why? There are a variety of complex reasons. Often it

is the result of an organization's ineffectiveness in properly identifying and managing its risks. More specifically, in the investment management industry, it is frequently the result of a breakdown in operations, i.e., internal control, that helps to create and encourage an environment where unethical behavior can exist.

Generally speaking, investment firms face two categories of risk: investment risk and operational risk. All other risk types can be classified in one (or both, as in the case of reputation risk) of these two categories.

Investment risk includes all those risks connected with managing portfolios of investment securities. It is affected by macroeconomic variables, such as interest rates, currency movements, and the ups and downs of the stock market. Investment style and strategies are also factors. For example, a particular investment style may fall out of favor in the market. That is risk—just ask any value investor over the past several years. By and large, investment risk is well tended by the industry and appropriately managed. It is accepted by customers who generally understand that exposing their savings to market fluctuations is inherently risky. You rarely see a scandalous news report about an investment manager's less-than-stellar performance or lack of investment integrity. Investment risk is a critical component of an investment manager's risk profile. However, it is not where the majority of the breakdowns occur. Nor is it typically where the breakdowns expose the firm to an ethical breach.

Operational risk is the risk that one or more of the myriad transactions and processes that constitute a business—how the company does business every day, what systems and controls are in place, and the effectiveness of staff and other resources—will malfunction, by intent or by mistake. It is usually a breakdown in operational risk management that creates the catastrophes that keep senior executives awake at night. Consider the collapse of Barings. This had more to do with a lack of oversight procedures than it did a bad investment. Or, consider the Salomon Brothers U.S. Treasury auction scandal. Again, a lack of detective and preventive controls provided the climate for fraudulent activity to incubate. Many examples exist.

Because the industry's business is investments, investment risk has always been watched closely—but too often at the expense of adequate attention to operational risk. This is a mistake, given the fact that operational and control risks have increased substantially in the face of the dramatic industry changes we read about every day: globalization, consolidation, and technological innovation. Even well intending organizations that espouse a strong ethical climate are subject to the pitfalls of human error and personal financial gain.

A Comprehensive Approach to Managing Risk

Bad things can happen in virtually every facet of an organization. Too often, the consequences are not self-contained. A breakdown in one part of the organization—at the trading desk, for example—will have both internal and external ramifications. Therefore, the only effective approach to managing business risk is a comprehensive one that focuses first on the business objectives of the company in order to identify where the most critical risks will lie. With those objectives in mind, the next steps are to identify and prioritize all potential areas of risk, establish systems to manage those risks, and align the different elements within the organization to protect against them.

These elements—objectives, risks, controls, and alignment—provide the framework for a comprehensive approach to understanding and managing risk.



FOCUS ON OBJECTIVES

The starting point is a solid understanding of the organization’s objectives, while taking into consideration its stakeholders’ objectives. These objectives vary by company, but they all begin and end with the trust established by the investment management company’s commitment to its customers. All other objectives will reflect different facets of that commitment. Failure to meet that commitment undermines the entire organization.

IDENTIFY RELEVANT RISKS

Hazards, uncertainties, and opportunities all present risks. “Risk as hazard” is what managers most often mean by the term risk. Examples might include fraud, financial loss, or a lawsuit. “Risk as uncertainty” refers to the distribution of all possible outcomes, both positive and negative. “Risk as an opportunity” implies that a relationship exists between risk and return. For each of these three areas of risk, the role of ethics is implicit—to support a culture that helps avoid hazards, be prepared for uncertainties, and build on opportunities.

ESTABLISH EFFECTIVE CONTROLS

Internal control consists of five interrelated components: control environment, risk assessment, control activity, information and communication, and monitoring. The control environment sets the tone of the organization and serves as a foundation for all the other components of internal control, providing both discipline and structure. Control environment factors include the integrity, ethical values, and competence of the organization’s people; management’s philosophy and operating style; the way management assigns authority and responsibility and how it organizes and develops its people; and the attention and direction provided by the board of directors. The remaining components of internal control take place in the context of—and derive their effectiveness from—the control environment.

ALIGN ALL ELEMENTS OF THE COMPANY

To effectively manage risk, an organization must align all its parts. To what extent are the firm’s objectives aligned with the way it is organized in terms of hierarchy and reporting lines? Do its business processes, systems, policies, and management reporting mechanisms support the achievement of its business objectives? Does the organization have the necessary flexibility and structure to implement its strategy? A company that is well aligned, whose people all act and make decisions with reference to a commonly understood mission and strategy, will be more likely to have a robust risk management system than an unaligned company.

A Question of Implementation

Our experience tells us that the investment management industry is risk conscious. The philosophy underlying risk management is fairly straightforward and most firms have a risk program in place. Unsurprisingly, larger firms tend to have more formally structured systems in place, while smaller firms tend to be less formal. Growing organizations can be particularly vulnerable because the strains of building a business can divert attention and resources away from risk assessment. But risk control matters are not unique to growing organizations. Larger firms often have trouble integrating their risk programs, especially cross functionally and cross regionally. Smaller firms can lack the resources to segregate responsibilities cost effectively. These examples are grossly general and are certainly not intended to be fully inclusive. The point is that there is no “one size fits all” approach to risk management: every company is different and has different business objectives, which means that each company has a unique risk profile requiring a customized risk management approach.

Whether a large player or small, even the best-laid risk plans will be ineffective unless they work in tandem with the company’s ethical culture and behavior. A company’s risk management system, however well designed, won’t work without an ethical corporate culture. A company’s ethical culture is, however, pulled and strained by the pressures of business

risk—the temptation, for example, to buy a stock outside the investment mandate in order to boost return. Thus a strong risk management program, by making it difficult to yield to these temptations, helps to nourish an ethical environment.

Key Areas of Potential Risk

While all aspects of a business, from back office functions to sales and advertising practices, have their associated risks, there are four functional areas in the investment management business that are particularly worth noting. These four areas are especially vulnerable to breakdowns in risk management and internal controls. They are: portfolio management and tracking, trade execution, information systems and technology, and customer reporting. There is inherent risk in each of these areas, especially in portfolio management where big dollars are involved and the potential for abuse is great. The accompanying sidebar describes specific functions within each of these areas that may harbor potential risk for a firm.

Tomorrow's Threshold Standard

It is important to acknowledge the competitive nature of risk management in today's marketplace. Money managers who can demonstrate effective risk management policies and procedures have an edge over their competitors. However, this competitive differentiation may be short-lived. Today's competitive edge becomes tomorrow's threshold standards for doing business. Without solid risk management controls in place, an investment management firm could not only lose its edge in the eyes of the investing public today, but also risk losing its license to operate tomorrow.

Robert Lordi, based in Boston, is a senior manager in our Investment Management Group and project leader for the development of our Investment Management Ethics Practice. He can be reached at (1) 617 443 2914 or robert.lordi@us.pwcglobal.com.

Andrew Nolan, a partner based in New York, was until recently the managing partner of the Regulatory Compliance Consulting Group of our Investment Management Services practice. He can be reached at (1) 212 596 8380 or andrew.nolan@us.pwcglobal.com.



Risk Management: Where to Begin

Our experience with risk management at investment management clients has surfaced four broad areas that typically offer the greatest potential risk. To begin to strengthen risk management and internal controls, focus first on these four areas: portfolio management and tracking, trade execution, information systems and technology, and customer reporting. Some of the specific issues where we see risk within each of these four categories are listed below. This list is not exhaustive; its purpose is rather to illustrate some of the key risks.

PORTFOLIO MANAGEMENT AND TRACKING

- Compliance with investment guidelines
- Compliance with other internal requirements/rules governing investment activities
- Compliance with external regulatory requirements
- Fund and client taxation issues
- Identification and management of appropriate performance targets for each portfolio/manager
- Evaluation of performance relative to benchmarks

TRADE EXECUTION

- Authorization, execution, confirmation, trade capture, settlement, and reconciliation
- Best execution
- Trade allocations
- Soft dollar arrangements
- Security file maintenance (timeliness and accuracy)

INFORMATION SYSTEMS AND TECHNOLOGY

- Security requirements to safeguard client and other proprietary information
- Capabilities of the current systems infrastructure
- Data integrity and maintenance
- Policies on development of new information technology solutions

CUSTOMER RELATIONSHIP MANAGEMENT

- Communications and client reporting
- Management of fiduciary responsibilities
- Fair dealing with clients
- Suitability of investment products sold to the client
- Performance reporting