# Risk Management for Asset Management Companies

# INTRODUCTION

The Securities and Exchange Commission of Pakistan (SECP) has issued Guidelines for Risk Management Systems and Controls for Asset Management Companies (AMCs) through its Circular No 15 of 2018.

These Guidelines seek to help AMCs establish risk management and control framework. The Guidelines are scalable in that their extent and sophistication can be adjusted in light of the scope, product mix, size and complexity of the entity.

## RISK MANAGEMENT SYSTEM

Risk management, in the specific context of AMCs, is the process of identifying, assessing and monitoring both enterprise and portfolio risks in order to minimize unanticipated losses and uncompensated risks and thus optimizing the risk/reward ratio. A risk management framework identifies the scope of risks that the entity is exposed to, the processes and procedures to manage these risks and the individual responsibilities of the risk management function. An effective risk management framework includes Risk Governance, Risk Management and Process and Procedures, Portfolio Risk Management and Operational Risk Management

## RISK GOVERNANCE

This refers to the creation of checks and balances through organizational structure. Following are the key considerations in Risk Governance:

- **Roles and responsibilities** should be clearly defined in writing, including authorities to lay down policies and approve deviations therefrom. BOD is responsible to understand the risks faced by the entity and consider and approve a risk management framework. Senior management is responsible to develop and implement the framework. Line managers and operational personnel are responsible for compliance to the policies and procedures under the framework. Portfolio managers are responsible to maintain the portfolio risk levels in line with representations made to the clients.
- **Policies and Procedures:** A risk management policy should be established and duly approved. The policy should identify owners of different risks, principles and methods for periodic monitoring of risks, set out the interface between risk and investment management processes, and the method and frequency of risk management reporting to Senior Management and BOD.
- **The Risk Management Function** should be established as a separate unit with a defined structure. The function should be independent of operating units where allowed by the scale and complexity of the entity. Where a separate unit is not practicable, specific safeguards should guarantee that the function is carried out independently. The function should have the necessary skills and expertise and should be responsible for implementation of and reporting on the risk management policy to Senior Management and BOD.
- **Risk Management Committee** is a Board-level committee constituted to oversee and ensure the effectiveness of the risk management function.
- **Reporting to BOD and Senior Management** should be ensured through an efficient internal reporting mechanism, with periodic written reports to the Board laying down in-depth information about the risks faced by the organization and the framework's ability to meet or address them.
- **Segregation of functions** should be ensured to enable appropriate checks and balances between the front office and back office and other areas of the entity. Depending upon the size and complexity of the entity a middle office function may or may not be practicable, however, it should be ensured that the team bringing in new clients and the team evaluating them should be segregated. Similarly, trades should be verified and valued by people segregated from the people making trades.
- **Understanding and managing risks** should be every individual's responsibility and should be an integral part of the entity's culture.
- **Internal Audit** function should be established and operating effectively under the auspices of a Board Audit Committee or a similar process. The function should cover the effectiveness and integrity of risk management framework, compliance with risk management policies, and the investment risk management process.
- **Compliance** matters should be addressed and monitored by a named individual and he or she should make regular reports to the Senior Management and the Board.

## RISK MANAGEMENT PROCESS AND PROCEDURES

The main objective of the risk management process and procedures is that actual level of risk incurred by entity is consistent with the risk profile defined by the BOD. The risk profile of the Collective Investment Scheme (CIS) should cover the risks resulting from its investment strategy and the interaction and risk concentration at portfolio level.

Risk management process is a set of following actions:

- Identification of Risks: All risks relevant to the CIS should be identified. The risks arising from overall investment strategy, the trading style and the valuation process adopted by the entity should all be taken into account. The identification process should be periodically revamped and updated in light of evolving market conditions and product strategy.
- Assignment of Risk Limits: The process should result in provision of risk limits for each appropriate unit of the entity, in consistency with the overall risk profile determined by the BOD.
- Exception Reporting: The process should have a robust system where any breaches of the risk limits are stringently monitored and reported.
- Monitoring: The function should periodically report to the BOD in terms of the efficacy of the process, any deficiencies and remedial measures already taken or required to be taken.

## INVESTMENT RISK MANAGEMENT

- Market risk: This risk includes interest rate risk (movements in interest rates may affect returns and projections), equity and real estate risk (resulting from movements in market values of assets), and currency risk (resulting from adverse movements in exchange rates affecting any assets or liabilities or cash flows denominated in foreign currencies). The risk should be addressed through appropriate measurement and monitoring mechanisms.
- Liquidity risk: This risk comprises of liquidity exposure of individual instruments as well as mismatch between the liquidity of the portfolio compared to the positions offered to investors. This should be addressed through liquidity risk management policy, continuous monitoring of liquidity profiles of CIS, and periodic review and testing of contingency funding plans.
- Credit risk: The two types of relevant credit risks affect individual securities, and credit worthiness of a counterparty. This needs to be addressed through reliance on credit agencies, internal rating systems, and monitoring of overall portfolio with reference to exposure to counterparties.
- Concentration risk: A portfolio concentrated within a few sectors and lacking diversification can affect the liquidation capacity of a portfolio at mark to market prices and can hamper the growth of the portfolio at a strategic level.
- Leverage risk: Risks to a portfolio with respect to borrowing of funds and instruments with embedded leverage need to be monitored, tracked and controlled.

Investment risk should be measured and controlled through the use of metrics such as standard deviation, tracking error, expected shortfall, downside semi-standard deviation and value at risk. It is important that all these metrics should be employed in conjunction with each other to develop a full picture.

For performance measurement and monitoring, every portfolio should have a defined benchmark or objective. The AMC should employ sufficiently advanced and structured techniques and tools to measure and monitor each risk against its entire portfolio. The risks should be quantified wherever possible.

The AMC should also stress test its portfolio by anticipating and evaluating scenarios and events that are not usually measurable by conventional models. These tests should develop scenarios which envision market shocks and unexpected movements in price correlations and market liquidity. These tests should not merely be based on historical conditions but also incorporate future events.

The AMC should also consider and monitor valuation risk with respect to its portfolio and the valuation methods should be according to the existence or otherwise of a ready market. It may constitute a valuation committee to oversee the risk, which would be responsible for approving overrides of prices, determining appropriate methodology for securities for which a ready market does not exist, approving valuation models and assumptions, and determining fair value of assets whose valuation is not possible through any of the other methods.

# OPERATIONAL RISK MANAGEMENT

There are various types of operational risks that need to be monitored and addressed. These risks include all aspects of errors and mistakes that can occur during the normal course of business or during a disaster. The key to effective monitoring and addressing of such risks is a process that tracks various risk elements over time, identify early warning signs and ensure that problems are dealt with at an appropriate level of management according to their severity.

- **Availability of adequate systems, process and resources.** Technology has enabled industry standard and proprietary systems that can facilitate the asset managers' ability to keep a closer eye on various risk areas. It is important for an AMC to periodically assess its systems, processes and resources in terms of adequacy and scope.
- **Management of model risk.** AMCs should periodically assess the vulnerability of their risk models and measurement techniques. This can be accomplished through back-testing and stress testing the models employed and proactive monitoring of market conditions, validity range and limitations of risk measurement.
- **Disaster recovery and business continuity.** All AMCs should have a contingency/business continuity plan to enable continuity of business in case of severe disruption. This should include provision for offsite backups of key systems and information, details of suppliers and service providers to assist in event of a disaster, and necessary infrastructure and human capital redundancies.
- **Effective records management.** For an AMC, it is important to establish and maintain a records management program that addresses the creation, identification, retention, retrieval and disposal of its records. The AMC may want to consider any obligations resulting from litigations, regulations or inspections. The program should be realistic and tailored to the organization. Awareness of employees should be ensured through training. It should be periodically tested to ensure its effectiveness, and periodically adjusted to changing circumstances.
- **Effective system security.** AMCs are in possession of sensitive information with respect to clients and employees. The entity has a fiduciary duty to maintain confidentiality, as well exposure to privacy and secrecy regulation and risk of reputational loss in case of breaches. . The ambit thus extends to not only preservation of confidentiality but a timely notification of breaches to the same. System security includes the following aspects
- **Physical security.** This aspect is focused on safeguarding locations, assets, information and health and wellbeing of employees and other personnel with appropriate physical safeguards.
- **Network security.** The corporate network should be safeguarded against malicious software attacks, leaks and loss of data, and unauthorized access. The controls may include firewalls, proxy servers, content filters, antivirus, anti spam, software patch management, remote access security and monitoring of network parameters. Application level controls may include multi-factor authentication and encryption.
- **Information security.** This includes physical and digital safeguards over the information collection, storage, transmittal and distribution. Generally access to any information should be granted on a strictly need to know basis. The security can be ensured by awareness trainings, change management, implementation of information security policy, application level encryption, event logging and control testing.

**Fiduciary responsibilites.** AMCs should ensure discharge of their fiduciary duties to clients including acting in their best interests, treating them fairly and with due care, through spelling out fiduciary obligations in legal documentation and ensuring their compliance through explaining them to employees and clients and building them into the entity's culture. In case the fiduciary obligation is being breached in a particular transaction, such action, decision or conflict should be considered and appropriately disclosed.

**Risks pertaining to subadvisors, custodians and outsourced service providers.** AMCs often outsource certain functions to third parties including subadvisors, custodians and other service providers. These may perform operational, accounting or record keeping functions for the entity. It is critical for an AMC to ascertain on a continuous basis, the review of capabilities of third parties with respect to risk management, operational, legal and other relevant standards required for the function they are performing. This may be accomplished through due diligence of the third parties' risk management controls.

**New products and strategies risk.** It is important for an AMC to ensure that its new products and strategies meet regulatory requirements and strategic goals. This can be accomplished through written policies for product development and a new products committee/management committee that includes representatives from front office, operations, systems, risk management, legal and financial control functions. This will ensure that any issues likely to arise are timely addressed and the viability of the same can be judged.

**Reputation risk.** Reputation is critical to any business. In many cases the damage caused to investors in reputational matters can far outweigh the importance of the matters. This risk is inherent to all activities, processes and functions of an AMC. To monitor reputational risks on a continuous and proactive basis, senior management must develop and implement clear ethical standards and a risk conscious culture.

## HOW BDO CAN HELP

BDO can assist with:

Enterprise risk management
Business process gap analysis
Preparation of risk registers
Business process reengineering
Establishment of a risk management infrastructure.

For information on how BDO can assist you in your Risk Management System, please contact:


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