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Risk Management:

Back Offices Support Front-Office Growth, Reducing Risk, Supporting Product Development

NEW YORK — Managing operational risks right from the point of trade inception in the investment front office can encompass many tasks, not least of which is identifying where the risk itself lies, no matter where the post-trade processing activities take place. Some ostensibly post-trade risks appear to be embedded in front office practices. Others remain latent and undetected due to the lack of full understanding of business processes.

"A lot of senior managers at investment firms either didn't understand operational risks or knew they were out there and sizable, and were scared to death of them," says Holly Miller, Vice President and East Coast Region Manager at **Citisoft**, an investment management solutions subsidiary of **Satyam Computer Services Ltd.** "The solution was to get rid of it by outsourcing. But many of them weren't aware that they hadn't really outsourced the risk. We are now seeing many firms taking a more proactive view by evaluating and assessing what their risks might be from an operational perspective.

Operational risks added by the advent of new regulation should be seen as opportunities to enable change, allowing asset managers to continue to grow, according to Chandresh Iyer, Managing Director at **Citigroup** Securities and Fund Services. "Market demand is creating a need for new products, as is the changing structure of the markets," he says. "Where Reg NMS or MiFID looks for greater transparency and automation, asset management firms can think about what they do best and what's their core competency — and leave the operational and technological needs to specialist providers. The growth is driven by scalable platforms, scalable infrastructure, and a flexible infrastructure."

A faster-paced trade processing environment has increased risk, because it cuts down the time available to catch errors, observes J. Brant Arseneau, Vice President, Financial Services, at **Corpus Inc.**, which owns **Lab49**, a technology consulting services provider. "If you go from T+3 [trade date plus three] down to T+1 and an event happens, it will be very costly," he says. "That could ripple, if it involves a highly structured hybrid, through the market, and cause a

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lot of trouble. In many ways, T+3 is good because it gives a nice amount of time to fix these things."

Larger firms are confronting small and mid-sized firms, as well as hedge funds, by requiring increased levels of operational risk management, according to Nilesh Nanavati, President of **Advanced Financial Applications**, a trade order processing provider. "A lot of small funds need to scale up," he says. "To do that and satisfy investor requirements, they're addressing their operational risk management issues. Regulations are driving them to look through their entire process and see where the processing risks are. They are increasingly using different types of operations management systems to address those issues."

The result is greater interest in automating operational processes to manage the operational risk, according to Nanavati. This translates into trade order compliance management system purchases, he explains. Small and mid-size hedge funds, in particular, are looking for the right technology to better handle sending allocations to their prime brokers, according to Nanavati. The process in which prime brokers export data to clients in time for the next trading day has some breaks — making it an area in which more hedge funds are using trade order management technologies to address operational risk, he explains.

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Firms that set out to handle operational risk themselves, without outsourcing parts of operations, often end up turning to a combination of in-house and outside IT infrastructure, according to Yusuf Jafry, Chief Technology Officer and a co-founder of **Risk Integrated**. "They will do more generic infrastructure in-house because they have teams for that, but they'll still go outside to boutique providers for consultancy support and even the software itself," he says. "The issue is whether the IT departments have the expertise to put these things together. There's a lot of importance placed on [in-house] builds. Regulators will pour over it with a fine-tooth comb."

Documentation is key to preparation of policies and procedures. "Until you know what you have, you don't know where the risks are."

Some firms are looking to strategic partnerships to mitigate operational risk, according to Iyer of Citigroup, which offers Asset Manager Solution (AMS), a product that serves managers' operational needs, providing transparency and risk reporting tools. "A partner should bring financial strength and a balance sheet to absorb losses around operating risks, a very robust set of controls and procedures, and scalable infrastructure to keep up with growth," he says. "One of the biggest aspects of growth is that back-office operations enable front-office growth. The complexity of products, instruments, markets and asset classes is growing exponentially. To support that growth, we need a very flexible infrastructure operationally. That means having the right people, platform, and a robust compliance system."

Accessibility of operational risk management systems may only be half the battle, observes Iyer, pointing to an AMS user as an example. "We had a mid-size asset manager that realized there was only one person in their company who knew how to manage their technology and run it," he says. "Even though they had access to the technology, they didn't have sufficient resources to support it. Their best option was to outsource to us. Even though there is technology available, many times it becomes cost prohibitive for an asset manager to maintain and manage."

To prepare to better manage operational risk, counsels Peter Delano, Senior Analyst, Investment Management at consultancy **TowerGroup**, firms must give the governance process an important role. "Whether it's centralized or decentralized, firms that are succeeding have thought about how they're approaching managing operational risk," he says. "They are putting a governance process in place to have a risk management methodology. They are not just thinking about how to go about doing this, but they actually think about a structure and approach."

Documentation is key to preparation of policies and procedures, according to Delano. "Until you know what you have, you don't know where the risks are," he says. With documentation and processes in place, the approach to risk management, through prevention, is the next step.

"It starts with a risk-based approach, looking at the possibilities with the highest financial, reputational or regulatory risk," says Delano. "We see firms using technology to automate their controls — rather than performing a manual review of post-trade compliance, they want to automate controls. Prevention is key. You avoid the issue before it happens."

When firms understand what they find and document, they can better monitor their investments, thus reducing risk for their clients.

Documentation also prepares firms for audits, to not only show they're preventing issues from arising, but also that they prove this with data, explains Delano. Transparency follows from preparation and documentation, because when firms understand what they find and document, they can better monitor their investments, thus reducing risk for their clients.

Once firms have a handle on their governance processes, they can also benefit from implementing solutions with resilience, redundancy and reliability, explains Arseneau of Corpus Inc. "These [resilience, redundancy and reliability] must be implemented and managed from an application layer of the systems right down to where they are plugged in," he says. Lab49 promises these attributes in its fault-tolerant systems that can accommodate demands of some users that their systems are not out of service for more than 30 seconds in an entire year.

The need for an integrated operational platform that can support complex, multi-asset investment strategies has never been greater.

DST International (DSTi) and **Northfield Information Services, Inc.** have approached the operational risk problem by partnering and combining their historical and multi-factor solutions into a single risk platform.

"We go to customers with choices on how the integrated enterprise risk platform will work and get buy-in on different routes they want to go with it," says Marcus Ansell, President, DSTi. "They are complementary because different risk methodologies work well for different kinds of assets and management styles. A derivatives manager or highly active fixed-income manager may have complex strategies where assets are being changed all the time. Derivatives typically don't have a historical set of behavioral data that can drive a historical multi-factor type of analysis."

With a variety of risks for firms small and large to consider in their trading operations, they are finding themselves with a dizzying array of choices in systems to identify the risks and those that can reduce those risks. The need for an integrated operational platform that can support complex, multi-asset investment strategies has never been greater. ❑