



# IMPLEMENTING A RISK-BASED OVERSIGHT MODEL

INSIDEOPS: Insights for operations  
leaders in asset management

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**There are myriad reasons why operations executives in asset management firms should consider developing a risk-based oversight model. For some firms, the catalyst may be a new service provider relationship, which presents the opportunity to upgrade and modernize an existing oversight model or establish a new one.**

**For others, it may be the realization that a shadow model no longer aligns with the firm's circumstances or addresses the firm's business objectives. Regardless of the rationale for oversight model transformation, a risk-based oversight model can strike the right balance between operational risk and efficiency in most cases.**

A risk-based oversight model attempts to reduce costly rework by focusing on service providers' high-risk processes and outputs. Areas for oversight in this model comprise "value-added" activities—processes that validate and enhance service provider outputs.

## OVERCOMING COMMON CHALLENGES

Firms face many challenges when implementing a risk-based oversight model. For asset managers that are moving from an in-house model to an outsourced model or transforming from a shadow model, the impact on people should not be underestimated. As staff members transition from "doers" to "reviewers," their skillsets and mindsets must evolve to accommodate their new roles. In this context, increased communication and a strong working relationship with the service provider become critical.

Our experience has shown that the most common challenges associated with risk-based oversight model implementation could be effectively addressed with a five-step approach:

1. Assess the current state
2. Complete a risk and activity analysis
3. Repurpose operations staff
4. Implement the oversight model
5. Evaluate continuously

## Assess the current state

Before transitioning to a risk-based oversight model, chief operating officers (COOs) should assess the current state of the in-scope functions to provide a foundation for developing the future-state oversight model. A full assessment should be conducted, including an analysis of any changes in the underlying conditions and/or reasons for the current approach. Reviews of different asset types in the investment book, trading frequency, one-off financial reporting requirements and service provider capabilities should also be performed.

In most instances, the circumstances and situations that prompted organizations to move forward with legacy oversight models will have evolved. Even if existing processes are well documented, it is valuable to confirm and validate that nothing has changed since the last series of reviews.

These current-state reviews can also be used to assess key attributes that will impact the new model's development, including the complexity of the investment manager's account structure and investment book. A workstream dedicated to confirming the service provider's capabilities and approach, including the level of automation and straight-through processing, should be established. That will help determine high-risk areas and the appropriate degree of oversight required to confirm service provider quality.

## Complete a risk and activity analysis

A risk and activity analysis should be performed to determine which oversight activities are necessary to limit risk and confirm the quality of service provider outputs. That will involve identifying outsourced functional areas and their operational risk points. Review activities should reflect the risk inherent in each function; areas with greater operational risks should receive a higher degree of oversight, and more robust and timely review.

The analysis should take into consideration all of the factors that could impact the risk profile of a function, including the level of automation, the experience of the people performing the work, transaction volumes, the potential impact of an error for a given activity, and the complexity of the account structure and investment book. All of these factors—and others—can affect how oversight activities should be performed. The diagram on the next page details how oversight activities could increase with complexity.

Understanding the details of the service provider's processes and controls is another integral part of risk and activity analysis. In order to direct where oversight activities are focused, COOs must evaluate each of the service provider's processes and outputs. A strong working relationship between investment managers and their service providers is necessary to support a collaborative approach. Because the service provider may not be aware of the investment manager's strategic decisions and operational changes, the manager should take the lead in communication and planning.

## Repurpose operations staff

An essential element of success for any oversight model is the ability to properly transition from an in-house processing and/or a shadow accounting's processing-centric environment to an environment focused on selective reviews of service provider outputs. That requires asset managers to recast their operations staff from "doers" that produce outputs to "reviewers" that analyze outputs.

Cultural resistance to change is bound to complicate the switch from performing tasks to reviewing tasks. Overcoming these barriers takes strong leadership and requires management's commitment. The role of oversight "reviewers" requires more domain experience than that of legacy "doers," since a deeper level of understanding is required to determine whether a service provider's output is correct and achieves the firm's functional objective.

In addition, a solid knowledge of the downstream impact of errors is mission critical. A pricing error on an individual security may appear immaterial on the surface. However, when the size of the affected position and range of the pricing error are taken into consideration, the resulting net asset valuation (NAV) error may impact performance reporting and capital activity. As risk-based oversight models are implemented, management will need to assess whether existing staff members have the requisite skillset and experience required to execute the model.

## OVERSIGHT BASED ON RISKS AND COMPLEXITIES

| Key Attributes    | More Oversight ←   | → Less Oversight  |
|-------------------|--|---|
| Account Structure | <ul style="list-style-type: none"> <li>• Side Pockets</li> <li>• Complex Fee Calculations</li> <li>• One-off Reporting Requirements</li> </ul>       | <ul style="list-style-type: none"> <li>• Domestic and International</li> <li>• Large Investor Pool</li> <li>• Daily Valuations</li> </ul> |
| Investments       | <ul style="list-style-type: none"> <li>• OTC Derivatives</li> <li>• Level 2 and 3 Valuations</li> <li>• Frontier Markets e.g. Hedge Funds</li> </ul> | <ul style="list-style-type: none"> <li>• Domestic</li> <li>• Single Investor</li> <li>• Monthly Valuations</li> </ul>                     |

Source: Accenture

### Implement the oversight model

To successfully transition to a risk-based oversight model, firms should establish an implementation plan that outlines and prioritizes major initiatives that will facilitate the redesigned environment. The implementation phase should also include an estimate of the resources required to execute those initiatives in the desired timeframe.

Before the model “goes live,” policies and procedures detailing oversight tasks, tolerance levels, responsible parties and oversight activity frequency must be documented. It is also important to establish service provider and investment manager accountability through service-level agreements. Effective service-level agreements clearly outline responsible parties, timeframes, metrics and escalation policies for service provider outputs and items required from the asset manager, such as trade files.

### Evaluate continuously

New risks will surface almost daily. Firms must understand that establishing and maintaining a risk-based oversight model is an ongoing process. Communication is key.

The investment manager and service provider must continuously work together to identify new risks and establish processes that provide effective oversight. The service provider should also keep the investment manager aware of any new service offerings or tool enhancements that have been made available to clients. Investment managers and service providers should meet at least semiannually to discuss strategic initiatives, such as new service offerings, fund launches and technology implementations, and more frequently to discuss tactical items, such as open issues, service scorecards and monthly close status.

## CONCLUSION

Transitioning to a risk-based oversight model can be challenging. Firms must perform significant work up front, including evaluating the current state, and performing a risk and activity analysis. Once the oversight model has been implemented, risks and activities must be continuously evaluated. Since the asset manager and service provider are partners in this initiative, effective communication between organizations is key.

Nevertheless, the rewards of effectively implementing and maintaining a risk-based oversight model are substantial. A successful initiative will help enable investment managers to achieve the cost savings, scalability and efficiency that drove the initial outsourcing decision.

### OVERSIGHT BASED ON ASSET POSITIONS AND VALUATIONS

| Key Metrics | More Oversight  | ←————→  | Less Oversight   |
|-------------|---|---|--|
| Positions   | <ul style="list-style-type: none"><li>• Daily Position Reconciliation</li><li>• Collateral Tracking</li></ul>   | <ul style="list-style-type: none"><li>• Daily Position Reconciliation</li><li>• Corporate Action Reviews</li></ul>  | <ul style="list-style-type: none"><li>• Daily Position Reconciliation</li></ul>                              |
| Valuations  | <ul style="list-style-type: none"><li>• Independent Valuation Calculations</li><li>• Investor Liquidity Verification</li><li>• Fee Calculations</li><li>• Profit/Loss Allocations</li></ul> | <ul style="list-style-type: none"><li>• Review Price Tolerance Exceptions</li><li>• Examine Top Price Movers by Asset Type</li><li>• Compare Cash In/Out vs. Capital Activity</li></ul> | <ul style="list-style-type: none"><li>• Compare Performance vs. Benchmark</li><li>• Reconcile Cash</li></ul> |

Source: Accenture



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