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InsideOps | Insights for Asset Management Operations Leaders

Transitioning to a Risk Based Oversight Model

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Operations executives at many firms wrestle with the pros and cons of shadow accounting. We generally believe that in most instances the cons of shadow accounting outweigh the pros and recommend implementing a risk-based oversight model.

A risk-based oversight model attempts to reduce costly re-work and places additional focus on reviewing the service provider's high-risk processes and outputs. Reviews in this model are comprised of "value-add" activities – processes that validate and enhance service provider outputs.

Due to cultural changes as staff members transition roles from "doer" to "reviewer," instituting a risk-based oversight model can be challenging. Because constant communication between organizations is the key to success, it is important to have a strong working relationship with the service provider. Our experience has shown that this five-step approach is effective when instituting a risk-based oversight model:

1. Evaluate the Current State

2. Risk and Activity Analysis

3. Repurpose Operations Staff

4. Implement Oversight Model

5. Continuous Evaluation

Evaluate the Current State

Before transitioning to a risk-based oversight model, COOs must assess the current state of their middle and back offices to objectively justify whether a shadow accounting model is warranted. It is necessary to conduct a full assessment, including an analysis of any changes in the underlying conditions and/or reasons for the initial shadow accounting decision. Reviews of different asset types in the investment book, trading frequency, one-off financial reporting requirements and service provider capabilities should be performed to evaluate changes in the firm's circumstances.

We find that in most instances the circumstances and situations which prompt organizations to move forward with legacy, full shadow models have changed. Current state reviews should also be used to assess the complexity of the investment manager's account structure and investment book. This will help determine the degree of oversight needed to ensure service provider quality.

Risk and Activity Analysis

To determine oversight activities required to limit risk and ensure quality service provider outputs, investment managers must perform a risk and activity analysis. This analysis requires investment managers to first identify the outsourced functional areas as well as their operational risk points. Review activities should be established to mitigate risk points. Greater operational risks should receive a higher degree of oversight. The complexity of the investment manager's account structure and investment book has an impact on the types of oversight activities performed. The below diagram details how potential oversight activities must 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 investment manager should take the lead in communication and planning.

Oversight Based on Risks and Complexities

Key Attributes	More Oversight ⟷		Less Oversight
Account Structure	• Side pockets • Complex Fee Calculations • One-off Reporting Requirements	• Domestic and International • Large Investor Pool • Daily Valuation	• Domestic • Single Investor • Monthly Valuations
Investments	• OTC Derivatives • Level 2 and 3 Valuations • Frontier Markets E.g., Hedge Funds	• Equity and Fixed Income • Foreign Positions • High Trading Volume E.g., Mutual Funds	• Equities • Domestic Positions • Low Trading Volume E.g., Separately Managed Accounts

Source: Beacon Consulting Group

Repurpose Operations Staff

An essential element to success for any oversight model is the ability to properly transition from shadow accounting's processing-centric environment to an environment focused on performing selective reviews of service provider output. This requires investment managers to recast their operations staff from "doers" (producing output) to "reviewers" (analyzing output). Human factors can present barriers to effective oversight - 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.

Implementation

To successfully transition from a shadow accounting to a risk-based oversight model, investment managers must establish an implementation plan that outlines and prioritizes major initiatives facilitating the redesigned environment. The implementation phase should also include an estimate of the resources required to implement the recommendations in the timeframe desired. Before "going live," policies and procedures detailing oversight tasks, tolerance levels, responsible parties and oversight activity frequency should 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 investment manager (e.g. trade files).

Continuous Evaluation

New risks surface almost daily. It is critical to understand that establishing and maintaining a risk-based oversight model is an evolving process.

Communication is key. The investment manager and its 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 new service offerings and enhancements to tools available to clients.

We advise investment managers and service providers to meet semi-annually in order to discuss strategic initiatives relevant to both organizations. These initiatives may include new service offerings, fund launches or technology implementations. They may also support a push to meet more frequently to discuss tactical items such as: open issues, service scorecard and monthly close status.

Conclusion

Transitioning to a risk-based oversight model from shadow accounting can be challenging. It requires significant work to be performed up front, such as evaluating the current state and performing the risk and activity analysis. Once the oversight model has been implemented, the need to continuously evaluate risks and activities will be ongoing. Since the investment manager and the service provider need to partner in this initiative, effective communication between organizations is key. The rewards of successfully implementing and maintaining a risk-based oversight model are substantial. A successful initiative will allow investment managers to achieve the desired 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	• Daily Position Reconciliation • Collateral Tracking	• Daily Position Reconciliation • Corporate Action Reviews	• Daily Position Reconciliation
Valuations	• Independent Valuation Calculations • Investor Liquidity Verification • Fee Calculations • Profit/Loss Allocations	• Review Price Tolerance Exceptions • Examine Top Price Movers by Asset Type • Compare Cash In/Out vs. Capital Activity	• Compare Performance vs. Benchmark • Reconcile Cash

Source: Beacon Consulting Group

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