

FOCUS ON OPERATIONAL RISK

Georges Archibald and Sanjay Pani of J.P. Morgan focus on the role of the fund administrator in mitigating operational risk and explain how hedge funds that have implemented the required operational infrastructure in an effective and compliant manner are well placed to attract investment

In response to the recent credit crisis and fraud cases, investors and regulators are increasingly demanding greater transparency into hedge fund operations. Investors have been hurt by industry-wide poor returns, while at the same time, regulators are requiring better management of the systemic risk exposed during this past crisis. These and other investor and regulatory pressures have changed the hedge fund landscape and have made operational risk of paramount importance to the industry.

In a landmark Capco study of 100 hedge fund failures, 50% failed due to mismanaged operational risk. By addressing the need for operational risk management, hedge fund managers can simultaneously satisfy investor and regulatory demands.

WHAT IS OPERATIONAL RISK?

In June 2000, the Risk Management Group of the Basel Committee defined operational risk as:

The risk of loss from inadequate or failed internal processes, people and systems, or from external events.

According to the 'Financial Risk Manager Handbook', operational risk can be reviewed in three main categories:

- **People:** Employee fraud, employee error and employee lack of knowledge
- **Processes:** Accounting, settlement and transaction error
- **Technology:** Data quality, system compatibility and programming error

It is important to consider that a lack of appropriate controls in the various types of operational risk makes a hedge fund more susceptible to error, fraud or loss that could cause investors to depart or cause regulatory censure. In order to mitigate operational risk, policies and procedures must be implemented to create a culture of risk awareness. One important process hedge funds can employ is to implement a straight-through-processing (STP) framework for their middle- and back-office functions. This way, a hedge fund is addressing the three aspects of operational risk – implementing a process with automated technology to eliminate people risk. Automatically processing a trade throughout the trade lifecycle eliminates manual intervention, which can lead to processing errors or increase the risk of fraud.

Outsourcing operational processes and technology to a hedge fund administrator with expertise in STP of



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front- to middle- to back-office operations can achieve these goals, as well as help the hedge fund reduce costs and alleviate resource constraints.

IMPENDING REGULATION

In the US, hedge funds are subject to the new Dodd-Frank Wall Street Reform and Consumer Protection Act. If a fund has assets of \$150m or more, it will be required to register with the SEC. Separately, by way of the AIFM Directive, private funds domiciled or marketed in the EU will also need to be registered in order to market to investors in an EU country. Having a deep understanding of its operational risks will help build a framework for a hedge fund's required policies and procedures, as codified in its compliance manual. A firm's adherence to the manual will help ensure operational success, as well as ensure compliance with regulatory guidelines.

A positive byproduct of the increased scrutiny of operations is that it will help identify hidden operational hazards embedded in a firm's practices. The firm must discover these potential operational dangers before they are uncovered by the market, regulators or potential whistleblower employees.

CREATION AND IMPLEMENTATION OF POLICIES AND PROCEDURES

All US-registered funds are now required to have a chief compliance officer (CCO). Among the core responsibilities of the CCO is the creation and implementation of policies and procedures. On the operational side, the CCO will need to focus on the hedge fund's trading practices, valuation methodology, error rates, hedge fund accounting and custodial practices, along with disaster recovery.

As a check on the validity of the policies, procedures and compliance programme, funds will also be required to do an annual review, and are encouraged to maintain an audit trail, which will be used by regulators, as well as senior management of the firm.



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Moreover, a constant focus on acceptable trading practices is now imperative for all staff, especially given the recent regulatory focus on insider trading and use of expert and other information networks. In addition, there is now more regular use of surveillance and whistleblowers to uncover potential trading and other violations. Accordingly, training should have a strong focus on a code of ethics, enforcement mechanisms and audit trail to ensure adherence to the firm's policies and procedures.

OTHER RISKS THAT HEDGE FUNDS NEED TO CONSIDER

It is imperative that there be a deep understanding of both market risk and credit risk as these two categories often overlap with operational risk. Market risk is the risk of loss due to movements in financial markets, while credit risk is the risk of loss due to the fact that counterparties may be unwilling or unable to fulfill their contractual obligations. The following example shows how these three categories of risk overlap:

- A firm trading a complex security (market risk) with a frontier market bank (credit risk) where best practices for complex security valuations are not in place (operational risk), causes the firm to lose millions of dollars. If the firm had implemented policies and

procedures with respect to complex valuations, it could have identified the potential risk across these different risk categories.

- Working with a blue-chip administrator with complex valuation techniques and a robust new market/instrument policy could have helped mitigate the issue.

THE ROLE OF FUND ADMINISTRATORS IN REDUCING OPERATIONAL RISK

The industry trend of independent valuation by an established blue-chip administrator will help satisfy investors' appetite for operational due diligence. Administrators have standardised many of the middle- and back-office functions, making it more cost-efficient, scalable, and less risky to outsource operations. Some administrators increasingly offer a full range of services throughout the hedge fund operation value chain, adding incremental levels of value and expertise. Furthermore, hedge fund managers are branching out into other strategies outside of their core offering for diversification benefits and can rely on their administrator for operational guidance. No longer only imperative to CFOs and COOs, CCOs will want to ensure that fund and asset valuations, financial and risk reporting, and custody are in line with the compliance manual.

MANAGING OPERATIONAL RISK LEADS TO A COMPETITIVE ADVANTAGE

Much of the bounce-back in asset flows over the past year has been allocated to larger hedge funds with well-designed operational infrastructures. Despite the view that taking on market risk may bring more reward, taking on incremental operational risk potentially delivers major pitfalls. Accordingly, hedge fund managers, who can diagnose operational risk across their front-, middle-, and back-office operations, and prove the proper policies and procedures are in place and adhered to, will have a significant competitive advantage over managers who are not as focused. Third-party administration provides the core framework for allowing this to happen. ■