Enterprise Risk Management - Practical Strategies for Superannuation Fund Operational and Investment Risks

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IBR Conferences
OZ SuperRisk 2017

What we'll cover

1. Is an organisation wide risk register appropriate?
2. Mitigating the major operational risks
3. Identifying and managing beyond the "standard" Investment Risks
4. How a sound risk culture mitigates risk

1. Organisation-wide risk register appropriate?

- Yes - Critical - but only as a first step.
- Some risks - high to extreme risk consequence
- Use risk register standard monitoring
- Do deep dives from the single register entry
- Needs full understanding
- Controls need to be comprehensive
- Thorough review annually

2. Mitigating the major operational risks

Murphy's Law

Whatever can go wrong will go wrong

Corollary

Murphy was an optimist

Operational risk definition

- The risk of loss resulting from inadequate or failed
  - internal processes,
  - people, and
  - systems,

  or from external events.

  This definition includes legal risk but excludes strategic and reputational risk.

Source - APRA SPS114

Operational risk - People

Risk	*Risk Management*
Board	Policy Framework Risk Management Framework & Culture Sufficient Resources, Understanding
Management	Policies & Procedures Robust systems & processes with controls Reporting
Team	Recruitment Competencies - Skills, Experience, Training Clarity of Responsibilities & Accountability Key person dependency, Backup Succession planning

Operational risk – Systems

Risk

- In house. 3rd party. Outsourced. Combinations.
- Multiple - Administration. General ledger. Fund accounting. Custody.
- Unit pricing calculation – input, calcs, outputs.
- Reporting incl. attribution

Risk Management

- System development standards
- Change controls
- Internal audit
- Periodic independent, external audit & review of systems & processes, controls, calculations
- Relevant APRA standards as minimum incl S/CPS 231 Outsourcing
- Vendor due diligence
- Close partnership relationships with strong oversight

Operational risk – Process #1

Risk

Errors arising from:

- Policy inadequate
- Lack of clarity on process and data flow
- Poor workflow systems
- Dependency on IT Systems

Risk Management

- Board approved policy and review thoroughly annually
- Document process and data flow end to end. Training. Target full understanding.
- Automate via change control process to minimise human error
- Procedures have warnings on potential errors with clear steps for staff to take through increasingly senior management.
- Well qualified and experienced unit pricing staff.
- Contingency procedures on failure of system(s)

Operational risk – Process #2

Risk

- Errors from manual or intervention prone systems
- Inconsistency or loss of data integrity between systems
- Insufficient or poor communication
  - External
  - Internal

Risk Management

- Automate where possible – for accuracy and time savings
- Reconciliations, Timely checks, Escalations, Decision making.
- Develop strong, open relationships
  - Externally with Members / Investors, Regulators, Service providers, ATO
  - Across internal departments

Financial effect of an operational risk event (unit pricing error)

Risk=Cost of remediation

- Insufficient value in current investor pool of assets to meet investor entitlement, due to effective asset – liability mismatch over error period.
- Cost of internal and external resources including legal and expert fees for investigations and fixing
- Insufficient insurance – own or 3rd party's
- Insufficient capital and/or reserves, especially if "profit for member" not shareholder

Risk Management

- Have capital/reserves including operational risk reserves put aside to meet such losses
- Ability to raise further capital if shareholder owned
- Insurance - own and 3rd party, with multiple reinstatements

3. Identifying and managing beyond the "standard" Investment Risks

- Think differently – think broadly
- Communication risks around investment
- My top 10 Investment Risks
- Top 5 investment related risks for Consumers
- Practical risk management strategies

Definition - Investment risk

The risk that the outcomes of an investment strategy, and its execution, do not meet the goals of the investor.

Top 10 investment risks

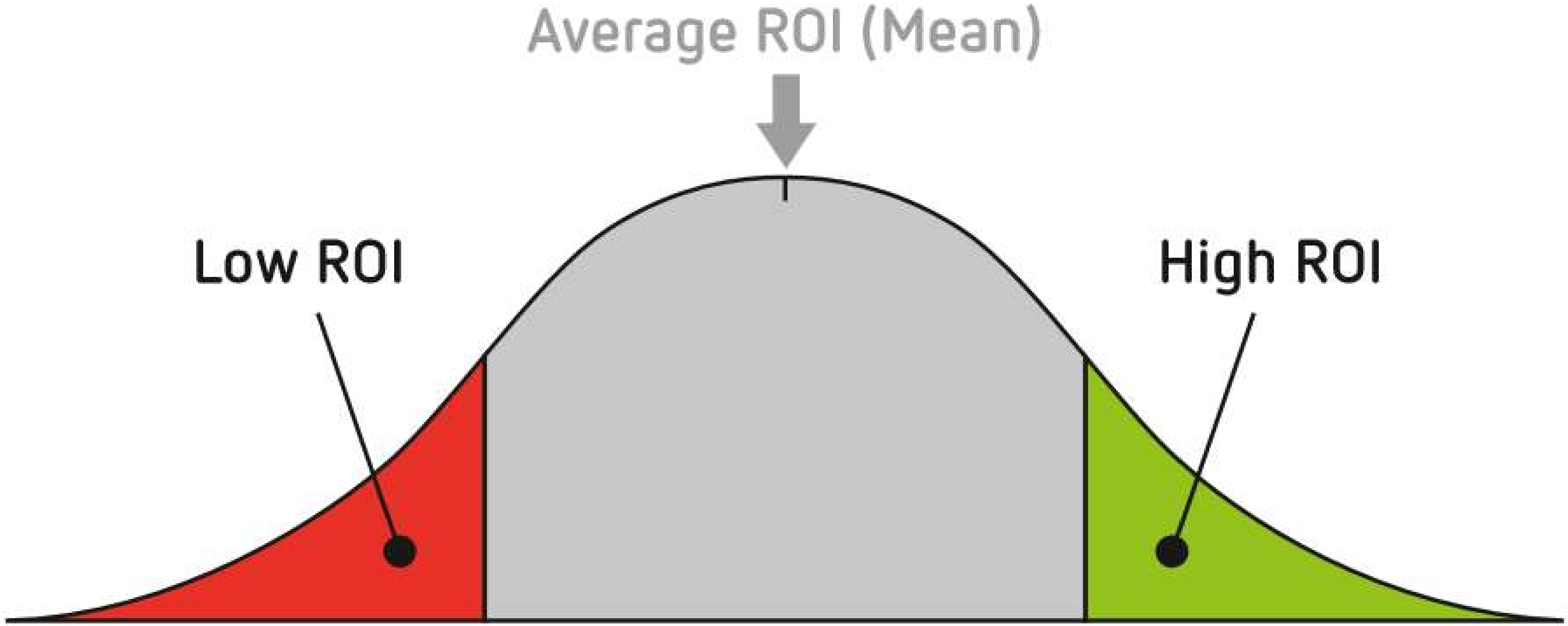
Strategic/Indirect

1. **Failure to understand investor's risk appetite**
2. **Matching risk**
3. Inflation
4. Operational risk
5. Liquidity

Direct

1. Asset allocation
2. Market risk
3. Stock selection
4. Fund manager selection
5. Credit risk

Failure to understand investor's risk appetite



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Matching risk

- Nature and duration of assets to match liabilities = needs (goal) of investor

- Communicate via:
  - Scenarios / “what ifs”
  - For a Super fund - by segment
  - Past and future best estimate

Top 5 risks for consumer to achieve investment goals

1. Not knowing and setting their own clear investment goals
2. Failure to understand their own risk appetite
3. Getting bad advice
4. Insufficient portfolio diversification
5. Paying too much in fees

Risk: Not knowing and setting clear investment goals

- Why?
- What / How much?
- When?
- How do I get there?
- Given limited resources ($) where do I have to compromise?

Definition - Effective communication

Effective communication means being successful in getting the message across - it must be heard, understood and believed by the receiver.

Tailor communication to your target audience

- Tailor communication strategy
- Investor / Trustee / Member - $5K to $50bn
- Board members – range of skills and experience – numerate and not
- Explain in terms relating to the organisation's strategic intent so decisions easier
- Consider levels of investment risk awareness
- Consider investment risk appetite – e.g. charitable trust.

What to communicate?

- That you understand your Board's /investor's specific circumstances, time frames goals and risk appetite
- Which risks matter most and why
- Implications of risk versus return trade-off:
  - price volatility & variability of returns by asset class / option
  - e.g. standard deviation of return, Sharpe Ratio
- Clarity on costs of investment management and reporting services

How to communicate with boards - on investment risks

- Recognise risk = uncertainty & ambiguity
  - Quantitative = distributions of investment returns over time
  - Qualitative = people's comfort with understanding current position, needs and goals + likely future behaviour
- Scenarios past + future; stress + reverse stress tests – encourage discussion
- Communication = education. Share good practice examples, non investment risk analogies
- Keep it simple; pictures, colour, graphs.
- Put time into your communication preparation

Words of wisdom

"To make a million,

start with $900,000."

- Morton Shulman

4. How a sound risk culture mitigates risk

- Organisational culture
  - *A system of shared values and norms that define appropriate attitudes and behaviours for organisational members.* (APRA, O'Reilly & Chapman)
- Risk culture
  - *An organisation's risk culture describes the degree to which its culture encourages or limits the taking of risks and the opportunities that arise from those risks.* (Brown & McGing)

What drives a sound risk culture?

1. Great leadership
    1. Leading by example
    2. Leading people
    3. Leading strategy in line with risk appetite
2. Working environment
    1. Open, inclusive, adaptable
    2. Freedom with responsibility and accountability

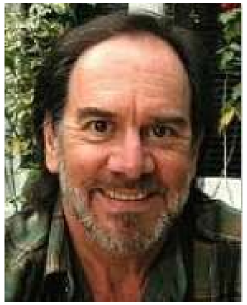
Reducing risk by learning and improving

- Have a culture of being open to learn from others
- Be open minded and curious about complaints – where there's smoke there's often fire
- Learn from others' mistakes rather than your own!
- Adopt an expectation of continuous improvement and innovation in your processes
- Get external, independent reviews of existing processes and calculations periodically

And don't forget …

Gilbertson's Law

"Nothing is foolproof to a sufficiently talented fool."



Arthur Bloch

(Author of Murphy's Law books)

Question time!

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