Risk management for wealth and asset management

EY EMEIA survey 2014
Contents

Introduction .......................................................... 1
Executive summary ................................................. 3
Leaps that firms were making during 2013-14 ................. 8
Survey findings ...................................................... 10
Summary of findings: 2014 survey vs. 2013 survey ........... 30
Contacts ............................................................... 32
Introduction

This year’s risk management survey — the sixth in the series and the first including data drawn from the wealth management and private banking communities — comes at a time when global markets are looking to recover following the global financial crisis of 2008. Wealth and asset management sectors are in the regulatory spotlight like never before, with all managers having to find ways of managing new risks, including conduct risk. Larger firms are being challenged by their designation by the FSB/IOSCO as non-bank, non-insurer global systemically important financial institution (SIFIs). Smaller firms, meanwhile, are struggling to remain “business agile” and “future responsive” to both regional and local thematic measures that will impact them during 2014–15. The critical issue here isn’t the challenge of complying with individual measures but the challenge of complying with a high volume of measures simultaneously.

The FSB’s “Guidance on Supervisory Interaction with Financial Institutions on Risk Culture” paper issued in April 2014 set the expectations as far as the regulators were concerned. We found most firms to be reinforcing the “tone from the top” in this year’s survey, particularly in owning the agendas of remuneration, conduct risk and reputational risk. Governance and oversight were not merely seen as risk monitoring roles; they also identified areas where the business was prepared to take risks with a view to converting them to opportunities. Firms reported a general desire for greater transparency and accountability, coupled with closer scrutiny from clients and regulators alike. Wealth and asset managers continued to undergo transformational change from the perspectives of regulation, tax changes, customer interaction, distribution economics, attention to governance, stewardship and shareholders, technology provision, competition for talent and societal expectations. The focus on economies of scale, economies of scope and economies of innovation were important themes — as was the need to make strategic choices.

As far as the wealth and asset manager sectors were concerned, there was considerable publicity around star fund managers in the financial press in April, coupled with high-profile seven-figure regulatory fines from themed areas, such as managing client assets/money. The attitude to risk in the current business environment has been stringent, with formal procedures linked up with the types of risks on the various European regulators’ thematic agendas. A key consideration was managing the cost/income ratio (or CIR, which averages 64% for asset managers and 72% for wealth managers) against likely inflation caused by multiple regulations and other changes over the coming two to three years. Managing the tension between the manufacture of products and their distribution was another, with many firms caught up in a dilemma of managing channel conflict — when to distribute directly vs. proceed via intermediaries.

There was little surprise that there was close focus on remuneration, behaviors, operational risk management 2.0, resourcing bench-strength and the importance of reinforcing cyber security protections as far as both traditional and alternative asset managers were concerned. The intensifying scrutiny of the personal four Cs – compensation, conduct, capabilities and crime – was an important feature of this year’s survey and a relative departure from the themed risk classifications associated with the last five surveys. Another theme was the challenge for IT systems, controls and data management to keep up with the pace of regulations, with new stresses becoming apparent across areas as diverse as investment risk, anti-money laundering (AML), “big data” projects and the use of social networking.

As far as the wealth management and private banking sectors were concerned, the industry was still finding client acquisition and revenue growth challenging against a backdrop of cost containment. Ensuring robustness of systems and controls, boosting training, and reinforcing due diligence and client files associated with suitability disclosures were the mainstay of many monitoring programs. With regulatory reform teams on full alert anticipating the pace and complexity of regional and local regulatory change over the next three to five years, there would be a need for stronger profitability management, particularly for firms operating from a higher cost base. Wealth management and private banking could no longer remain aloof from factors impacting other segments of the financial industry, such as banking and capital markets. “Might” would no longer be right — simpler investment models would carry a lower future cost of regulatory servicing.
Compliance with global, regional and local regulations (and their cross effects) would be the critical consideration as far as most wealth managers were concerned, particularly the need to manage suitability/appropriateness testing as far as clients and products were concerned. Some firms indicated that they might abandon bespoke investment approaches – avoiding riskier investments such as small and medium enterprises (SMEs), targeting exchange-traded funds (ETFs), and building in greater levels of diversification to avoid correlation risk – because many found that trying to build scale around product suitability was impossible. Brand protection and the need to manage reputational risk were also key considerations, with a greater realization that improving operational risk management and controls paid benefits by ensuring that margins and profits would be more sustainable in years to come.

In this new environment, we believe that careful thought about future developments and possible improvements to business risk and operational risk processes should be extremely valuable for both the wealth management and asset management sectors. Given the somewhat different focal points and models between wealth and asset management (e.g., product manufacture for many asset managers and the “know your client” (KYC) distribution for many wealth managers), the results are presented in such a way so as to illustrate the commonalities and tease out the differences between the constituencies.

By way of mechanics, we interviewed 63 CROs, heads of operational risk and heads of compliance/legal/CCOs for this survey. The composition of interviewees represented a selection of large, medium and small traditional and alternative investment management firms (by assets under management, or AuM) operating across Europe, together with a significant representation of bank-owned and independent private bank/wealth management entities. Once again, the result is a range of qualitative “opinion” and quantitative “comparison” findings that form the bulk of this publication, together with conclusions representing “thought leadership” in the sectors.

One-on-one interviews conducted between January and April 2014 gave respondents the scope to offer full opinions once more under conditions of anonymity. We are grateful to them for their patience and considerable support behind this endeavor. Critical conclusions are featured in the Executive Summary and in the 2014 vs. 2013 Comparison template at the rear of the document for ready reference by CROs and other seniors, particularly from the boards or the business.

EY has also added our own view of the leaps that we saw wealth and asset managers making over the last year compared with the steps that organizations still needed to take. We believe this will help firms to improve their compliance management processes still further. This survey complements EY’s sister publication Regulation Management for Asset Management survey, which was published in April 2014.
EY’s risk management for wealth and asset management 2014 survey offers a revealing insight into the unique set of challenges currently confronting our industry’s risk and other control function professionals. This survey compares the views of over 60 CROs, heads of operational risk, legal and chief compliance officers, and COOs from some of the most recognized wealth and asset managers in Europe. By doing so, peer asset managers, wealth managers, private banks, asset servicers and investment banks can draw valuable conclusions from how asset managers of different styles and sizes are coping with the prospect of multiple regulations across the financial industry.

Running a successful asset management business is equally about the need for forward-facing sound risk management and innovation as it is for sound returns and profitability. 2014 was the year that risk management became truly personal. CROs were called upon to help manage a suite of expectations around the four Cs – setting compensation, devising frameworks for managing conduct risk, managing expectations around appropriate capabilities, and building an understanding of how to manage the risks from cybercrime.

Respondents in this year’s survey also commented on how regulatory risk was now considered to be the number one risk. Nearly every firm mentioned challenges it is facing to comply with a torrent of global, regional and local/thematic prudential and conduct regulations. These were applied in the form of rule-making, principles and recommendations, sometimes over varying timelines and sometimes expressed at citizens or entities located cross-border (extra territorially).

There was a clear expectation that boards and CEOs would be expected to provide more concrete sponsorship in the form of a “tone from the top” and play a greater role in driving enterprise-wide risk management, especially among continental European firms. With more than 40 regulations taking effect across the EU over the next three to five years at the very least, firms were acutely aware of the need to manage cross-complexities arising from the numbers and depth of the measures, varying thematic approaches between countries, differential country roll outs, implications for operating models, and positional and transactional tax complications. Further complexities arising in 2014 included the roll out of regulatory technical standards (RTSs) carrying extended time frames for effective “compliance,” and the untested challenges of pricing operational and legal liabilities. Little surprise then how new regulations were perceived as not only boosting transparency but also raising barriers to entry and the single biggest cost increase impacting wealth and asset managers today.

The cost of regulatory compliance and changing attitude of regulators toward breaches created the conditions for some business uncertainty for virtually all the wealth and asset managers taking part in the survey. Although there were areas of selective weakness, indications from the survey suggested that the buy-side firms were reasonably well-prepared in the areas of AIFMD, EMIR (where relevant), front-office controls (bar FX), and, to a far lesser degree, UCITS V, MLD IV and MiFID II. Examples where work needed to be done included mapping politically exposed persons (PEPs) to companies and ultimate beneficial owners (UBOs) post-trade controls (e.g., managing canceled/amended trades and irregular settlement cycle trades), managing reporting requirements under AIFMD/EMIR and, above all, managing expectations around remuneration as mentioned above. In cases such as EMIR, coordinating bodies such as ESMA laid out the broad principles in considerable detail, but left the implementation of the “devil in the details” to be described through compound RTSs at later dates, sometimes with insufficient notice. In addition, this year’s survey also suggested respondents are encountering time pressures from thematic regulatory and client visits, especially in the UK.

There was also a huge focus on conduct risk in this year’s survey, with 84% of respondents indicating this as one of their top five risks. FSB’s guidance set out the main elements contributing to a sound risk culture within a firm. They identified core practices and attitudes, which could be used as indicators of the firm’s risk culture, as well as criteria for assessing the benchstrength and effectiveness of a firm’s culture in managing risks. The FCA, AMF, AFM and other European regulators, meanwhile, signaled particular focus on conduct risk and the drivers of culture, not only in terms of managing conflicts of interests but equally in terms of improving flow controls, upholding the integrity of markets, and intervening earlier in the value chain in order to drive better outcomes for investors.
Responses were more tentative concerning the determination of realistic in the event of a termination of outsourced activity. Many respondents had already devised adequate contingency investment or retail banking entity would be the more realistic agent per se was a realistic outcome, given that the failure of an extensive work completed with the IMA during 2013, there was a bank or transfer agent to which they subcontracted. Following how they would be able to continue in the event of the failure of material functions to third-party agents (TPAs) were deciding in order to address gaps and reforms as needed.

Many of the larger wealth and asset managers who outsourced behavioral economics for client investors, establishing a working consensus of “good practice,” defining policies and procedures, embedding the same through the “use” test, monitoring and measuring proceedings (both qualitatively and quantitatively), documenting service-level agreements (SLAs) and management information in order to provide audit trail evidence when called to do so, practice case study reinforcements, and conducting periodic reviews in order to address gaps and reforms as needed.

Many of the larger wealth and asset managers who outsourced material functions to third-party agents (TPAs) were deciding how they would be able to continue in the event of the failure of a bank or transfer agent to which they subcontracted. Following extensive work completed with the IMA during 2013, there was relative skepticism as to whether the failure of an outsourcing agent per se was a realistic outcome, given that the failure of an investment or retail banking entity would be the more realistic possibility, creating significant potential for banking contagion. Many respondents had already devised adequate contingency plans based upon SLAs that they felt to be viable, robust and realistic in the event of a termination of outsourced activity under any circumstances, including stressed market conditions. Responses were more tentative concerning the determination of risk under stressed market conditions, the commercials around “step-in” or “warm second provider” arrangements or the basis for any consistent direction of travel that global custodians might take to evaluate the liability arrangements to cover cases of fraud and/or insolvency of any end agents such as sub-custodians (per AIFMD/UCITS V).

Operational failures were linked to the potential for reputational risk by some firms—and the corollary was that a firm’s reputation and brand required support through more robust risk management techniques. Although reputational risk was generally seen as the fifth most important risk type in this year’s survey, the results illustrated the inconsistencies surrounding the explicit monitoring, management and response-readiness toward reputational events. We found that reputational risk was usually “owned” by the CEO and/or the board, but the processes were often driven and managed by risk. Respondents commented on how they dealt with reputational risks in different ways, some exercising management through cross-functional and multidisciplinary approaches, while others treated reputational risk more monochromatically, either driven by events or powered by corporate communications. Only 32% of respondents regarded reputational risk in a category of its own, potentially as both an impact and a driver of new risks, and only 61% of firms could scramble to respond to a crisis the same day.

The tail risk of FATCA-like measures being introduced in the US from July 2014 (and potentially elsewhere), coupled with the political will to impose a Financial Transaction Tax (FTT) across Europe prompted senior management to consider tax risk as a key horizon risk. Some respondents thought that FATCA-type measures would no longer result in massive impacts on their business and operating models on account of the intergovernmental agreements (IGAs) in place. While most firms were relatively well-advanced by way of preparations for FATCA, the general level of understanding and preparation to manage the risks arising from the potential introduction of the FTT was comparatively low. Most respondents were perturbed by the prospect of the introduction of the FTT even in a “narrow-scope” form impacting equities and equity derivatives from an “issuance principle” across the 11 participant member states (PMSs) from day one. One of the biggest concerns for respondents was any “cascade effect,” whereby multiple charges would bite if a number of brokers acted in transferring securities between two counter parties.

Specifically, the Firm Systematic Framework in the UK has as one of its elements an assessment of governance and culture, which includes an assessment of the effectiveness of a firm’s identification, management and reduction of conduct risk—spanning areas such as treating customers fairly, managing conflicts of interest (however arising) and structuring remuneration for all staff. The FCA defines conduct risk as “The risk that an entity mistreats its customers, staff or clients, causing them detriment. Historically, it was used within the context of retail customers but more recently, also applicable to non-retail customers and market abuse cases as well.”

Approaches varied considerably between firms on whether to manage conduct risk as a stand-alone compliance-driven controls exercise featuring qualitative outputs vs. adopting a broader risk-based framework inclusive of the business, with quantitative outputs readily available for optimization and evidencing. Firms were considering the implications of the firm’s business strategy, setting the “tone from the top” (typically the board and/or CEO). Setting the firm’s risk appetite, understanding behavioral economics for client investors, establishing a working consensus of “good practice,” defining policies and procedures, embedding the same through the “use” test, monitoring and measuring proceedings (both qualitatively and quantitatively), documenting service-level agreements (SLAs) and management information in order to provide audit trail evidence when called to do so, practice case study reinforcements, and conducting periodic reviews in order to address gaps and reforms as needed.

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1 The Firm Systematic Framework (FSF) replaced ARROW supervision when the Financial Services Authority (FSA) was disbanded and the FCA became operational in April 2013.
2 Reputation is a fragile asset, as much about perception and the perception of behaviors as it is about fact—which means that a reputation can be gained over a considerable period of time, and lost in considerably less time. Reputation is a wider concept than brand alone, impacting ethics, trust, relationships and, above all, the ethos of a firm—by way of its culture, values, integrity and, above all, its confidence behind how these concepts are communicated to clients and regulators. Reputation worthiness derived from brand value or goodwill is sometimes considered at a bottom-up level by corporates, such as by a reputational risk framework (e.g., as offered by COSO or the ABI) and collecting data on media hits (news, blog sites, brand valuations, etc.) to evaluate the likely extent and impacts of reputational consequences.
3 Behavioral economics and the related field, behavioral finance, study the effects of social, cognitive and emotional factors on the economic decisions of individuals and institutions and the consequences for market prices, returns and the resource allocation. The fields are primarily concerned with the bounds of rationality of economic agents. Behavioral models typically integrate insights from psychology with neoclassical economic theory; in so doing, these behavioral models cover a range of concepts, methods and fields. The study of behavioral economics includes how market decisions are made and the mechanisms that drive public choice, such as biases toward promoting self-interest.
Finally, data became the “essential” topic for risk managers this year, from the point of view of generating innovation opportunity, presenting appropriate data on demand, safeguarding data, generating the supporting data to enable firms to conduct back-testing, or simply finding the scale required to manage “big data.” Tensions of opposites needed managing: the push for regulatory transparency vs. the client pull for secrecy and the push for high specificity vs. the pull of managing costs. More firms equally became aware of the key product and solution dependencies on third parties, such as asset servicers and fund administrators, prime brokers, financial market infrastructures and application providers. Given greater regulatory scrutiny around change controls, the effective linkage and future flexibility of systems became paramount. As the need for greater scale was set to intensify globally, it was clear that firms active in multiple investment strategies, across multiple jurisdictions or servicing clients based in multiple domiciles would need to develop master “golden copy” records and address their strategic responses to “big data.”

Managing data was no longer the preserve of operations departments managing market or reference data or filtering stale data – now it’s the lifeblood of innovation value for the business. We also saw a significant shift toward focusing on cybersecurity and social networking, with the leading firms digitizing documentation for “on-demand” retrieval of records for audit and control purposes. Data security (whether concerning the firm, data warehouse, outsourcer or surrounding hacking, impersonations or cybersecurity) was a new concern as reported by 71% of respondents. Historically, the focus was on the quality, robustness and completeness of data. Now the focus was shifting to consider the role of social media, such as Twitter and LinkedIn, in order to provide closer coupling with clients and prevent mis-buying, particularly in the wealth manager sector. Some respondents were skeptical – 51% were focused on ensuring that the channels were versatile enough to carry the appropriate information on financial promotion to clients, while others complained that the 140 characters in Twitter was hardly conducive to carrying effective investment or risk warnings for clients.
The private banking and wealth management sectors experienced unprecedented changes following the financial crisis of 2007–08, and firms had to redefine the ways in which they monitored, measured and managed risks. For example, several private banks were issued large fines for systems and controls failing since 2011. Some of Switzerland’s largest private wealth managers face CHF1 billion revenue shortfalls as a result of double taxation agreements going live with certain EU countries, such as Germany. The wealth management sector has joined other financial and nonfinancial industries in searching for economies of scale, scope and ideas in order to respond to generate growth and profitability in the face of new challenges, such as new demographics, new regulations, new technology paradigms and new entrants.

The sample of 12 firms who took part in the survey displayed cost/income ratios in the range of 54%-84%, with an average value of 72%. The top risks identified by the sample were not dissimilar to the asset manager segment, but respondents described the terms differently — the risk from regulations broken down into terms, such as compliance risk, product risk and suitability disclosure risk, featured alongside other important risks such as reputational risk and model risk. In general, wealth managers placed greater emphasis on aligning the client risk profile with the underlying product risk scorecards and improving their risk management capabilities (risk indicators, controls, registers) to create better alignment with their goals of growing the business, creating sustainable margins and improving the client experience. Firms who demonstrated both client centricity and business agility in order to manage change requests effectively (through system flexibility and efficient data inventory) could likely count themselves among the wealth manager “winners” of tomorrow.

Several of the bank-owned wealth managers mentioned that they were concentrating on shareholder value and enterprise risk management, linking the operating performance of the business with regulatory capital allocation provision. Several of the “pure play” wealth managers commented on how driving revenue growth through investor or client acquisition, professional and relationship referral, and client retention was becoming more opportunistic demographically yet challenging from a regulatory point of view. Both segments commented on how acquiring and retaining top talent (such as private banks or wealth managers or risk and compliance specialists) was a critical differentiator in maintaining the trust and confidence of client investors. This was particularly relevant for private banks and wealth managers wishing to provide high net worth (HNW) and ultra-high net worth (UHNW) clients with the means of managing their wealth successfully — by helping them consolidate it, maximize it, protect it and pass it on. Responding to each of these “high expectation” client segments while managing both sustainable growth and margin was proving to be a longer-term structural challenge.

As mentioned earlier, the cost and the pervasive nature of regulations were making firms think carefully about managing their costs and also how they managed their reach into third countries, including offshore centers. High-profile fines, meanwhile, had been levied on some members within the private bank and wealth management industry from 2011 onward, resulting in remediations and $166 notices issued by the FCA. Most EU respondents commented on the sheer volume of EU-wide/thematic regulations rather than the inherent difficulty of complying with individual measures, particularly in “outcome-based” cases where different firms would struggle to meet the spirit of the measures with precision. Some also pointed out how the financial crisis had also impacted the behaviors of certain types of investors, making some considerably more risk-averse than before and making trust in the non-complexities of the investment vehicles/strategies just as important a consideration as the return on investment in the portfolios.

Regulations such as AIFMD, Dodd-Frank and new tax transparency rules (including bilateral information exchanges, double taxation treaties and abolition of tax amnesties) had already caused firms to evaluate the costs of doing business for clients from certain domiciles or clients wishing to make use of certain investment strategies or products that could no longer be designated as “not non-complex.” Given higher regulatory expectations, not just in the EU, but in Switzerland, the US, Hong Kong and Australia, there was universal indication that firms were focusing on systems and controls and data quality in order to reduce the reputational impacts on their brands. The general sentiment was that all regulatory requirements would need to be treated as mandatory, needing to be funded irrespective of the costs of system or data maintenance, budget constraints, or high cost/income ratios. This left “bank-owned” houses with significant challenges on their hands.

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4 UHNW – Full private banking and wealth management services for clients globally featuring bespoke portfolio services comprising full private banking/wealth management suite of investable products and services for individuals with typically US$20m+ investable assets; HNW – Comprehensive wealth management featuring tailored portfolio services comprising private banking and wealth management, access to select funds and relationship managers/access to portfolio managers supporting VIP clients for typically US$1m-US$20m of investable assets; Affluent – Offshore wealth management featuring managed portfolio services and some tailored portfolio services comprising private banking and wealth management propositions and face to face relationship management for typically US$250,000-$1m in investable assets; Mass Affluent – Mass affluent offshore proposition featuring managed portfolio services and limited mass market wealth offerings and telephony-based service for assets up to US$250,000. Styles typically demarcated as: adventurous, dynamic, progressive, balanced, discovery, cautious, defensive, etc.

5 Target markets for wealth managers varied strongly by country of domicile, given the demographic potential but also other country risk indicators such as political stability, rule of law, transparency, potential for fraud, freedom from corruption, investment freedom, property rights, etc. Wealth managers were often expert at assessing the characteristics, behaviors, lifestyles and personalities per specific sub-segments, such as entertainment and media personalities, sports personalities, wealthy families and family businesses, PEPs, entrepreneurs, corporate executives, privately held SMEs, professionals, oligarchs and individual investors.
Determining product suitability and providing advice to clients were on the regulatory agenda since MiFID I took effect, but they are increasingly a focal point on regulators’ agendas within a more prescriptive sense. Investment strategy and suitability and appropriateness disclosure had always been a fundamental component of ensuring client centricity in some member states, but not all wealth managers tracked their clients’ risk appetites, so there was a real risk of clients continuing to invest in products that didn’t meet their investment objectives. The fines for poor systems and controls documentation or for mis-selling have focused the minds of risk professionals as to the reputational challenges when things go wrong and firms are fined. Some private banks’ share-dealing propositions are now designed to only offer non-complex investment products because they elected not to create an appropriateness test when relevant regulation came into force. Given the likely regulatory direction of travel, some firms carrying the higher CIRs were looking to abandon bespoke approaches because trying to scale suitability had been too much of a challenge.

Firms needed to manage the tension of maintaining client privacy and data protection on the one hand vs. the desire for transparency and the need to meet requests for information from the tax and regulatory authorities on the other. The latter, particularly the FCA, were increasingly adopting the evidential principle that everything needed to be documented (including minutes of meetings). Given that the wealth management industry is primarily driven to trust and relationship management, firms were understandably finding it challenging to record, document, file and retrieve every interaction between a firm and its clients. Some wealth managers were supportive, however, arguing that sensibly structured regulations helped support firms’ requests for greater granularity of KYC information at client take-on and review stages, arguing how such information could help firms anticipate the clients’ evolving risk capacities, appetites and preferences. This in turn could help firms structure the most effective investment strategies for their clients and reduce the risk of product mis-selling or of the investor mis-buying.

Key model differences were apparent between the approaches taken by bank-owned vs. “pure-play” wealth managers in the survey. Both favored versatility (e.g., multi-strategy/manager/asset risk-rated model portfolios and selections), ideally built on open architectures capable of supporting wealth investment offices, investment solution designs, research provision and performance monitoring for Mass Affluent, HNW and UHNW client segments. The differences in approach to portals/customer relationship management (CRM) channels were emphasized when risk managers looked to the future of wealth management per the following three areas:

1. **Investing efficiency**: (e.g., fund wrappers, ETF variants, VCTs/bespoke vehicles, tax-efficient structured products, tax optimization solutions (including amnesties and double-taxation treatments), offshore asset structuring, pensions/SIPPs, annuities and drawdowns)

2. **Insurance and lifestyle**: (e.g., life assurance, general insurance, personal/medical protection, asset/liability planning, valuables and luxury goods protections, prestige solutions)

3. **Fiduciary/legacies**: (family wealth planning and education, family Trusts; estate management, wills and executor services; structuring legacies, including philanthropic legacies)

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Different houses indicated the need for systems and data flexibility to support the following services: 1) wealth solutions (e.g., onshore/offshore Bonds, OEICs/unit trusts/investment trusts, pensions/SIPPs, general insurance); 2) investment solutions (discretionary, managed advisory, self-directed/execution-only structured products); 3) relationship management (investment communications, face time with relationship and portfolio managers, apps, client network events, client education, private banking, treasury deposits, retail savings accounts, loans/overdrafts, mortgages).
Executive summary

Leaps that firms were making during 2013-14

**Managing conduct risk:** 81% of firms cited conduct risk as a significant focus. The FCA has provided ideas on how a firm might begin to assess conduct risk, primarily in its 2013 and 2014 Risk Outlooks, in which conduct risk was identified as having three main causes: 1) **Inherent factors**, which interact to produce poor choices/outcomes in financial markets, featuring supply-side market failures (e.g., information asymmetries), demand-side weaknesses (e.g., inbuilt biases) plus a low financial capability by investors; 2) **Structures and behaviors** (including incentives, conflicts of interest, culture and competition considerations) allowing firms to take advantage of investor shortcomings and/or market failures; and 3) **Environmental factors**, such as economic, regulatory and technological trends, which are key drivers of firm and/or investor decisions.

**Managing investment risk:** 53% of firms claimed that their investment risk function was truly independent, partly by way of qualified headcount located in the second line of defense (2LD) which is able to provide effective independent challenge against bias and conviction decisioning on the part of the portfolio managers. The top quartile of respondents in this regard featured dedicated investment risk individuals with 1) the skillsets to analyze and support portfolio managers and 2) the personalities to challenge the business robustly and evidentially when called to do so. The leading firms provided deep technical analysis into investment risk issues and provided evidence of quality management information from interlinked systems (allowing “single portfolio views” to be drawn) – yet again the critical differentiator between firms in the survey.

**Mitigating counterparty risk:** 30% of firms were able to claim they could break down risk exposures by counterparty and by product/fund within 24 hours of a significant incident developing, such as the failure of a major counterparty broker/dealer and/or a market failure or other source of systemic risk. A further 33% of firms were able to evaluate their counterparty credit risk exposure ex-post (i.e., greater than 24 hours after any incident or situation). More firms found it easier to determine counterparty risk exposure than to perform the same with granularity down to the product or fund level, proportionate to how well systems are interlinked.

**Attending to data management:** 55% of wealth and asset managers claimed that data was managed satisfactorily across their organizations. Many had integrated their systems to deliver single-portfolio views or respond to single legal entity “lookthrough” requests. There was particular focus on data retention, improving the quality of audit trails and documentation, warehousing, cloud technology, treatment of “big data”, cybercrime, and applying BCBS standards for larger firms, particularly the bank-owned wealth managers and asset managers. Regulators such as the FSA, AMF and CNMV were taking a harder look at senior management arrangements, systems and controls (SYSC) and change-control procedures during 2013-14, given the issue of high-profile fines for SYSC failures in areas such as client money management and derivative selling.

**Investing in quality headcount:** 44% of wealth and asset managers who are in the process of increasing the headcount within their risk divisions. Several firms were focusing on the quality and training of those resources as well. Not all firms were counting risk resources the same way – some included risk monitoring, horizon risk monitoring, branch monitoring, guideline monitoring, crisis management, screening/alerts, client risk advisory, conduct risk management, client on boarding or product development. The ratio of operational risk to compliance resourcing varied from 1:1 for smaller teams to 1:2 for the larger firms.
Steps that firms needed to take moving forward

**Rationalize operations:** 64% was the average cost/income ratio recorded in this year’s risk survey for asset managers (vs. 72% for wealth managers). From the prior year, that’s up 1% for the former and equal for the latter, because several firms adopted cost-cutting measures. Wealth managers and private banks were particularly challenged to keep their CIR figures below 70%. Ideas for and managing costs included:

1. Reappraising product ranges in manufacturing
2. Developing common solutions to critical processes such as client onboarding or suitability disclosures to avoid single-threading each regulation
3. Deepening outsourcing routes in the middle-office or front-office support
4. Exploring innovative cost reduction solutions with third-party providers to reduce the total costs of interaction and total cost of ownership, using tools such as social networking

**Upgrade KYC/suitability procedures:** only 37% had taken steps to fully assess the potential impact of the Fourth Money Laundering Directive (MLD IV). MLD IV extends existing MLD III requirements to include higher-risk domestic PEPs, with a stronger focus on family members and close associates of all PEPs linked to companies, and to prevent repetition it also includes more rigorous requirements on the tax information that accompanies funds’ transfers. Other areas for attention concerned the relative lack of risk ratings that were applied to investors, especially by private wealth firms who needed to strengthen suitability and product appropriateness procedures to apply to investors. Additionally, scores needed to be stronger for both wealth and asset managers in understanding how products might be classified across EU jurisdictions.

**Dedicate attention to SLAs and GSAs:** 10.6% of a typical CRO/head of risk’s time was being spent in terms of managing policies and procedures. There was a significant rise in the time allocation to manage policies and procedures, particularly SLAs and GSAs, not least following regulatory interest behind the quality of outsourcing (including step-in rights, liability arrangements under AIFMD and UCITS V to come). More CROs will be working more closely with their compliance and operational colleagues during the year ahead in order to manage legal and fiduciary risks.

**Boost IT future flexibility:** 47% of firms experienced issues with IT flexibility and managing change requests across asset managers and particularly independent wealth managers. Many mentioned that systems, controls and access to quality data were not fully “future-proof” against the need for flexibility in the face of future regulations. Regulators such as the FSA, AMF and CNMV were taking a harder look at SYSC and change-control procedures during 2013–14, given the issue of high-profile fines for SYSC failures in areas such as client money management and derivative selling. The more advanced firms had integrated their OMS/PMS/TCA and risk systems and controls, ensuring compliance all the way up the chain of product distributors across all the countries where they did business.

**Improve cybersecurity across attack surfaces:** 71% of firms cited data security at the firm, data warehouse or outsourcer being a specific concern. Asset managers and private banks alluded to distributed denial of service (DDoS) or malware attacks within some part of their operation, with a further 34% recording interceptions over the last year. Many firms treated cybercrime as electronic fraud and were particularly focused on phishing incidents and impersonations arising from counterfeit identities (via LinkedIn, Facebook or Twitter), bogus websites and boiler-room scams arising in certain country centers. More asset managers (and their parents) need to stay vigilant as to the threat landscape and likely points of attack — whether externally from the front-end/market sites or the back end, such as from key third-party dependencies.
In 2014, managing the volume and complexity from overlapping regional and local regulatory measures, managing risks arising from conduct (of business) and mitigating reputational risks were the prime motivations for asset managers, wealth managers and private banks alike.

There was a “no surprise” element to this year’s survey when the top motivators for the risk management function overall were:

- The desire to avoid reputational impact
- The pace of change/increasing regulatory interests
- Managing complexity from overlapping directives
- The desire to avoid reputational impact (see Figure 1)

A mid-tier asset manager active in Asia-Pacific noted: “The sheer number of regulations is the challenge. The serious areas for focus arise from the rush of key thematic measures that we are experiencing in the UK from the FCA (product governance/front-office controls/outsourcing) where we don’t know how much to focus, and selective areas for focus by regulators in countries such as Korea.”

This level of uncertainty was echoed by several alternative asset managers in this year’s survey. A Swiss hedge fund complained that: “The prime motivation [of the risk function] is to cover the sheer number of regulations and manage the risks arising because many of the measures require interpretation – they are not simply drafted as black-or-white items. Recent examples include the definition of pooled structures, designations of forward FX contracts of under seven days, or legal counterparty treatments under EMIR.” Another hedge fund with strong coupling to Switzerland noted: “The primary motivation is to ensure that the business sees compliance and risk as a ‘critical friend’ that they can approach to point them in the right direction rather than a control function that will put the handcuffs on.”

However, the results for the top three factors for the wealth management and private banking sectors were very different. The top three motivators for this sector were:

- The desire to avoid reputational impact
- The pace of change/increasing regulatory interests
- Thematic concerns with managing third-party Arrangements

This likely reflected the need to protect the brand/underpin client trust and also the need to manage dependencies from third parties in cases where the private wealth manager could exert as much leverage as the larger institutional asset manager firms.

The quotes from some of the private wealth managers reflected the importance of managing reputational risk effectively. One UK-headquartered private bank explained: “Our model consists of cherry-picking quality clients on the basis of a long-term relationship-based model based on family and friends. We are not interested in chasing the hot money. We see regulations in a positive light because the regulations make it easy to ask the awkward questions – around PEPs, UBOs and USFs – and conduct risk (which we regard as a subset of operational risk management) has come at the right time for us because we do not want to pollute the reputation of our brand by taking on the wrong kind of business.”

Regulatory priorities were also reflected in the quotes from some of the wealth management respondents. A Swiss-headquartered private bank mentioned: “A key motivation for us is the sharp escalation in client interest and scrutiny of our policies and procedures from our institutional client base. The culture is increasingly one of ‘Can you demonstrate and evidence?’” Another respondent added: “You need to have a lot of scale to be a wealth manager. There isn’t much margin, and the regulatory overhead is both considerable and growing. It can end up with every client wanting their own custom strategy and lots of client service staff. You end up trying to tap into the 10 or so UHNW individuals or run your operation like a machine.”
Figure 1: what is the motivation for a strong risk management function in your firm?

Key:

<table>
<thead>
<tr>
<th>RM4WAM Survey 2014</th>
<th>RM4WAM Survey 2013</th>
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<tbody>
<tr>
<td>Risk of regulatory change/increasing regulatory interests</td>
<td>93% 85%</td>
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<tr>
<td>To manage complexity from overlapping directives</td>
<td>84% 84%</td>
</tr>
<tr>
<td>Desire to optimize capital and liquidity</td>
<td>56% 52%</td>
</tr>
<tr>
<td>Managing third-party arrangements</td>
<td>52% 44%</td>
</tr>
<tr>
<td>Remuneration focus</td>
<td>44% 44%</td>
</tr>
<tr>
<td>Managing concerns on data/cybersecurity</td>
<td>44% 44%</td>
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<tr>
<td>Corporate restructuring focus</td>
<td>56% 56%</td>
</tr>
<tr>
<td>Increasing client interest and security (e.g., ISDA, IMA)</td>
<td>56% 56%</td>
</tr>
<tr>
<td>Business continuity issues (e.g., terrorism, fraud)</td>
<td>54% 54%</td>
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<tr>
<td>Offering penalized differentiated services to clients</td>
<td>54% 54%</td>
</tr>
<tr>
<td>Extreme event planning (e.g., renomination in Eurozone)</td>
<td>54% 54%</td>
</tr>
<tr>
<td>Concerns on levels of internal losses</td>
<td>54% 54%</td>
</tr>
<tr>
<td>Desire to cope with client asset/money rules</td>
<td>54% 54%</td>
</tr>
<tr>
<td>Awareness/ focus on RRP in some form (parent/firm)</td>
<td>54% 54%</td>
</tr>
<tr>
<td>Desire to avoid a Section 166 fine under the FCA regime</td>
<td>54% 54%</td>
</tr>
<tr>
<td>Future compliance with shadow banking regulation</td>
<td>54% 54%</td>
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</table>

The priority risk pattern showed several departures over the past year (see Figure 2), with increasing prominence given to operational risk, conduct risk, reputational risk and fraud risk. Certain other risks identified as below the top five this year included counterparty credit risk, liquidity risk, country risk and correlation risk. The majority of wealth managers and private banks cited KYC/suitability (regulatory) risks as the area of greatest concern, in comparison with traditional and alternative asset managers, who were looking at horizon risks more expansively over the next three to five years. One large private bank commented: “We are concerned that there are several regulatory directives on the way impacting our efficiency and they are very easy to gold-plate. The pragmatic question is how do we get value from being compliant with the measures e.g., under Basel III.”

The top risk categories keeping CROs awake at night were operational, regulatory and conduct risks, representing something of a change from 2013 priorities.

For example, a large traditional asset manager featuring a significant hedge fund presence drew attention to the developments under the FSB: “The potential capital treatments under the FSB’s new paper for NBNI SIFIs is likely to be one of the most significant horizon risks for us right now, and the thing is that we don’t rightfully know when precisely the measures will take effect.” Another hedge fund qualified the horizon risk as a blurring of jurisdictional effects: “Going forward, I don’t think that you’ll ever be able to define any risk or regulatory provision as ‘local’ again. There are too many extraterritorial implications for that now.”
The prospect of addressing the “unknown unknowns” was a consistent theme for several traditional asset managers. One third-country-headquartered firm commented: “The biggest future focus, which keeps me awake at night, are the unknown unknowns impacting people, conduct and systems, e.g., the prospect of rogue fund managers. There is so much focus on regulatory change and what individual regulators are looking at that firms run the risk of missing the really big consequences, e.g., what is going on at firms that can really bring them down.” Another third-country, bank-owned asset manager expressed a similar concern in the context of investment products, noting: “If we took a future look at risks arising from the ETF market, we would err on the side of going for physical ETFs, not synthetic, and we would offer their use (e.g., active ETF) alongside existing smart β strategies.”

**Figure 2:** Top risk categories mentioned by respondents keeping CROs awake at night

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<tbody>
<tr>
<td>Other Regulatory Risk</td>
<td>86%</td>
<td>1</td>
<td>1</td>
<td></td>
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<tr>
<td>Counterparty Risk</td>
<td>66%</td>
<td>2</td>
<td>2</td>
<td></td>
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<tr>
<td>Operational Risk</td>
<td>93%</td>
<td>1</td>
<td>3</td>
<td></td>
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<tr>
<td>Investment Risk</td>
<td>71%</td>
<td>3</td>
<td>1</td>
<td></td>
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<tr>
<td>Conduct/Mis-selling Risk</td>
<td>81%</td>
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<tr>
<td>Liquidity Risk</td>
<td>70%</td>
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<tr>
<td>Mandate Risk</td>
<td>70%</td>
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<tr>
<td>Reputation Risk</td>
<td></td>
<td></td>
<td>3</td>
<td></td>
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<tr>
<td>Business Model Risk</td>
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<tr>
<td>Market Risk</td>
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<tr>
<td>Tech - Data Risk</td>
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<td>Tax Risk</td>
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<td>Country Risk</td>
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<tr>
<td>Correlation Risk</td>
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<tr>
<td>Legal Risk</td>
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<tr>
<td>Fiduciary Risk</td>
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<tr>
<td>Tech - Systems Risk</td>
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<tr>
<td>Fraud Risk</td>
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<tr>
<td>Misc Risk</td>
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Survey findings
Managing regulatory risk – arising from measures being introduced in stages at a regional level and local thematic measures and requirements to track investor suitability and client indicia – was a consistent feature in 2014.

The sea change in regulatory focus over 2013-14 concerned the rapid rise in thematic measures across each EU member state, and the need for firms to manage a greater volume of simultaneous measures – not just the complexity of each regulation per se. For example, the FCA adopted the principle that if something wasn’t documented, it didn’t exist, and other regulators looked set to follow its lead. Some firms were also struggling to implement the essence of each measure – trying to distinguish regulation (single legal effect, all member states) vs. directive (transposed into the law of each member state) vs. principle (open to different interpretations and resulting in firms implementing regulations in anticipation of a specific outcome or even in the spirit of the statement). A large UK passive manager reflected: “There are far too many local and regional regulations to abide by – too many things to do with the risk of firms executing some of them badly.”

These views were not specific to UK-domiciled firms. A large French asset manager commented: “We are on the receiving end of significant regulatory interest across several fronts. There is huge regulatory interest around culture, regulatory policy changes and managing conflict, while we’ve just seen a huge focus on front-office risk controls. During 2014, we will expect to see more regulatory interest around technology and cybercrime impersonations, fraud and virus attacks in particular.” A Swiss hedge fund manager added: “The variety of types of regulations is a problem. Complying with the evolving UCITS regulations is more an art than a science, whereas the regulatory expectations from FINMA are very exacting. Any new measures are overlays; they do not replace existing regulations. For example, index eligibility is a new topic for asset managers in Switzerland.”

Private wealth managers and private banks faced an additional hurdle (see Figure 3). Although respondents commented that they did not need to focus on implementing such a broad universe of measures as some of their institutional peers, they were nevertheless concerned at the need to comply with several simultaneously. Measures such as FATCA, product measures and MLD IV carried a varying impact on the client onboarding, due diligence reviews and forensics processes. Determining client suitability/appropriateness was seen as fundamental in order to ensure client centricity and align the business conduct to clients’ needs.

Figure 3: top regulation categories receiving special attention for asset managers and wealth managers in 2013-14

Purple text signifies regulations or directives cited by respondents as critical during 2013-14
Black text signifies regulations or directives cited by respondents as critical during 2012-13
Examples of areas for specific regulator focus/thematic reviews included (see Figure 4):

- Front-office controls (in the UK, France, Germany, Italy)
- Inducements (in the UK, Netherlands, France, Sweden, Denmark, Switzerland)
- Execution-only sales (in France, Italy, Belgium, Switzerland)
- Outsourcing (in the UK and Germany)
- Fund charges (in the UK, France, Germany, Sweden)

Besides the thematic measures, most asset managers were concerned about implementing the AIFMD, and preparations for MiFID II were also brought to the fore for the first time. A large German asset manager commented: “AIFMD has had a huge impact on Spezialfonds, which are a classical asset management business. Before, we had UCITS-type regulations featuring VaR/commitment approaches, and now we have significant paperwork trying to cope with AIFMD documentation.” A multi-strategy hedge fund, meanwhile, expressed concerns at the potential liquidity challenges once MiFID II takes effect, declaring: “MiFID II will come onto our radar shortly. We run a multi-asset strategy, and the new measure will have an impact on ABS pricing and liquidity. There's a big focus on TCA and execution here, because of the need to understand trading costs and market impact in particular. We are interested in what MiFID II will do to dark pools, DMA and venue classifications, particularly broker-operated dark pools.”

Finally, the extra-territorial application of regulatory measures was less of a concern in 2014 as compared with last year, but there were still causes for alarm. One large German asset manager commented that: “One of the biggest threats that we face is the inconsistency of the regulations between the US and EU, and across the region of the EU. We are also subject to Dodd Frank as far as remuneration and trading practices are concerned – for example, we have had to struggle with mandatory SEF definitions for US persons, which has needed a huge level of due diligence”. Another US fixed income house expressed concerns at the prospect of regulatory creep by stating: “We are also worried about aggressive regulatory developments concerning restrictions on use of inducements or the introduction of RDR-type measures because we worry about the unintended effects”.

**Figure 4: Issues arising from applying product measures in various countries**

![Diagram showing examples of styles of product regulation across the EU/CH](image-url)
Differences in governance or risk appetite statements over the past year were more stylistic than substantial, but items such as conduct risk and cybercrime risk were seen as integral for many firms.

A risk appetite statement provides an articulated benchmark against which an asset manager’s risk profile can be reported, monitored and managed by the board, the audit/risk committee, the finance committee and the risk assurance committee. The risk appetite statement is a clear identification, documentation and communication of the firm’s capacity envelope, and as such, it is a critical component of a wealth or an asset manager’s overall risk framework. The risk appetite is increasingly a consideration for the end investor as well. As the risk appetites of investors change, both wealth and asset manager segments use the forward projections and modeling of clients’ risk appetites to gauge the validity of investment products and propositions on offer to their clients.

The results from the 2014 survey did not represent a significant departure from last year’s survey, bar the appearance of conduct risk and cybercrime risk (often treated as subsets of operational risk by several firms). One large diversified asset manager commented: “An 18pp risk appetite statement and the corresponding risk frameworks exist – regulators like to see it. Features 10 qualitative standards, e.g., diversified business model and diversified channels. Quantifiable standards are split by risk type. Credit limits and operational procedures feature, and the risk appetite is revised annually.” Another added: “We are interested in linking risk appetite with triggers and tolerances, with a particular focus on distribution areas extending to our retail clients. Our tolerance for risk is 0.7% of revenue.” Some wealth managers could also do better to adopt more risk appetite formalisms of their asset manager peers.

Figure 5: examples or types of risk appetite criteria cited by some wealth and asset manager respondents

- Minimum economic and regulatory capital surpluses
- Maximum earnings or share price volatility
- Cost/income ratio remains below 70%/year
- X mentions in the national press with Y% impact on share price
- ICG uplift provision is below 175% vs. higher of PI/PII/unwind capital
- Minimum excess liquidity to meet peak stressed liquidity requirements
- Seed capital in any fund greater than $Xm and $Ym in total
- Maintenance of minimum credit rating level of AAX
- Credit tolerance limit at X Bank greater than $Ym
- Total currency exposure does not exceed $Ym
- No hard risk limits intentionally crossed
- No dealing errors on transaction exceeding $XXm by value
- Dealing/PM mis-tracing errors identified within 5% movement flagged
- Number of operational incidents does not exceed X/month (including errors/omissions vs. firm or in client’s favor, near misses, etc.)
- Error/loss tolerance set at X% of revenue
- 10% of the firm’s own funds share-capital convertible into liquid assets
- Administration – 99.9% accuracy of NAVs
- All corporate actions or rights issues that remain unresolved EOD with a nominal value over $Xk flagged
- Regulatory compliance – no monitoring delays
- Regulatory compliance – no skilled persons §166 reviews/year
- Regulatory compliance – no regulatory fines tolerated/year
- Upper threshold staff turnover – x% of code FTEs and Y% of control FTEs
- No DDoS attacks/one primary impersonation incident per quarter
- Maximum of three 60-minute IT outages

A further consideration for wealth managers and private banks concerned the alignment of the firm’s risk appetite statement with the need to track the evolving risk appetites of their clients. Some wealth managers indicated their wish to track their clients in this manner, usually at the client onboarding process, tracking variations in client risk appetites by conducting reviews on an ad hoc basis (i.e., per changes of client circumstances) or on an annual, quarterly or even monthly basis. One medium-size private bank commented: “The risk appetite of our clients is not formalized as such, but our processes are designed to ensure that they are consistent with our Code of Ethics and our Conduct Risk Framework, and we capture some qualitative and quantitative information by collecting the information on a ‘product ladder.’”

The notion of reviews to mitigate against product mis-selling was a central theme for many wealth managers. One elaborated: “Our KYC process links in with the corporate risk appetite to the extent that we do not want to adjust or grow our capacity for risk through needing to service professional asset managers. If mis-selling is a risk, it arises according to the size of product and according to size of portfolio. If there are grounds for it, we will go back to the market, determine the degree of uplift on the basis of mark to market or mark to model, and we then compensate the client accordingly.” Another smaller wealth manager said: “The client risk appetite is a central consideration and is up for constant review by our asset managers or financial planners. The target rate of review is 250-300 clients reviewed per year – a rate of just over one client/working day. We know that our loading ratios are too high, and we need to manage this in line with our sector-based investment risk modeling moving forward.”

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7 Typically risk appetite statements must be transparent to top management and the board, with demonstrable processes to illustrate whether risks are commensurate with the risk appetite. They should be augmented by 1) risk control structures, which ensure that any risks taken across the entity, business unit or group do not exceed risk appetite limits in any given day, and 2) well-established stress-testing approaches that determine the expected losses that would be incurred over different stress periods, applied to the strategy as well as the current business. Above all, risk appetite statements need to be powered by management information to enable risk to be monitored by boards and senior management alike against a firm’s stated risk appetite.

Risk management for wealth and asset management EY EMEIA survey 2014

15
Conduct risk could be defined as the risk that an entity mistreats a client (or clients), causing them detriment, but regulators such as the FCA favored a somewhat wider definition, extending beyond unfair treatment of consumers to include behaviors that risk the integrity of the market. Wealth and asset managers were challenged on whether their operating models for identifying, monitoring and managing conduct risk were sufficiently robust and fit for purpose and on who should be allocated responsibility for it. There was no clear answer about “ownership” for conduct risk within each firm because the results varied by investment style or geography of the firm. In general, the compliance function was specified as the “owner/editor” for the conduct risk program in 25% of cases—often using qualitative case study examples. Compared with the risk function as the sole owner/editor in 14% of cases—often using quantitative risk frameworks. Compliance and risk functions appeared in the driving seat together in 27% of cases.

The FCA Risk Outlook Paper issued in April 2014 formed the basis for much of the treatment of conduct risk as far as many wealth and asset managers were concerned. The paper (the second in the series) featured nine key drivers of risk under the categories of “inherent,” “structures and business conduct” and “environmental” risks, commenting that “as with other conduct risks, the culture of firms is the crucial driver of poor outcomes in wholesale markets and can lead to the transmission of detriment to less sophisticated consumers further down the transaction chain.” The relative relevance ascribed to the nine categories are shown in Figure 6, with the results showing how the categories of information asymmetries, managing conflicts of interest, culture and incentives, and regulations/ regulatory policy as the lead categories for focus.

Next, the survey results noted several bases at work when it came to defining the Firm Systematic Framework (FSF) and the Business Strategy Model Analysis (BSMA) favored by the FCA. In the case of firms who preferred a more “traditional model,” a defined list of organizational activities was specified for which conduct risk could be explicitly identified, assessed, monitored and managed on a discrete basis. By contrast, for firms who chose a broader “enterprise-wide model,” conduct risk could be defined centrally (even if the principles would be applied locally). Respondents commented on how the advantage of this approach was the ease of accommodating emerging conduct and regulators’ specific issues, as well as embedding ownership within the business, with only 27% of respondents indicating the presence of a conduct risk driver sponsor in the business. Other respondents indicated that the internal audit function was looking at ISAE 3402 standards to audit conduct risk.

There were many results that varied with regard to the starting position for embedding conduct risk. Some firms preferred TCF or ARROW\textsuperscript{8} principles as departure points (several UK firms); some began with governance (Swiss/German/Dutch firms); and some with their code/statement of ethics (several US firms). Conduct risk was underpinned by an ORM framework used to identify, assess, monitor and manage via metrics (e.g., through the KRIs or the number of loss events/complaints registered) in the majority of cases (see Figure 6), although further linkage through to remuneration and/or outsourcing was only a feature in 49% and 21% of cases, respectively. The importance of reinforcing a conduct risk when new employees join a firm was a relative given (80% of cases) or via training (60% of cases), but the prospect of reinforcement through mentoring and/or regular refreshes via case studies was apparent in only 19% of cases. Deeper thinking arising from understanding or applying behavioral economics (BE) did not feature consistently per the responses at this stage. These will be explored in detail in the forthcoming Regulation Management for Wealth & Asset Management Survey.
Several asset managers invested behind improving their investment risk procedures during 2014. Most wished to get their hygiene factors right to satisfy clients or regulators.

Several asset manager respondents confirmed that managing investment risk was top of mind this year, not least because regulators were beginning to link performance to charges and ongoing suitability due diligence. Improvements were seen across areas such as greater use of quantitative skills, monitoring risk at the aggregate/factor levels, demarcation of “hard” vs. “soft” limits, daily leverage checks for funds with derivatives and greater integration of risk systems. A third-country hedge fund affirmed that: “The driver for managing investment risk is less an issue of independent challenge or avoiding conflicts of interest from developing. It is more driven from the need to get budget approval for risk resourcing per se – this is not just a question of headcount alone but building automated systems and data access too.”

Fifty-three percent of firms claimed that their investment risk function was independent, but this was clear only if there was evidence of qualified headcount located in the second line of defense (2LoD) able to provide effect challenge against bias and conviction decisioning on the part of the portfolio managers. A small wealth manager commented: “Any governance over the investment risk function by the 2LoD needs to understand the way portfolio managers talk, for a control function to walk the talk appropriately.” A large third-country wealth manager concurred by stating: “Investment risk is managed independently in the 2LoD, and there are board-set limits with set forced action levels. We set tolerances for risk budgets around confidence levels around PnL coupled with prior notifications.”

Some firms indicated the need for competency to carry out the function (effectiveness) and hinted at the practicalities of remunerating an independent investment risk function (see Figure 7). The “ideal” approach was to populate the 2LoD control function with individuals familiar with the terminology of the portfolio managers (e.g., tracking error, TAA, expected β, CAPM, Sharpe/Treynor/information ratios, sensitivity indicators DV01/IE01). A boutique asset manager concurred, adding: “There is separate investment risk in the 2LoD actually headed by the ex-Head of the Research team, so we wholly subscribe to the importance of the competency argument.”

Several CROs commented how the appropriate level of remuneration should additionally be an important consideration when attracting (and retaining) appropriate technical skillsets to perform the investment risk function effectively. A large bank-owned global asset manager highlighted the challenge, stating: “The comparison of salary for professionals who wish to conduct investment risk management in the 2LoD is a big issue. We need to task people who have portfolio manager experience, but we’ve found that in practice nearly half of these individuals are called upon to help out with the 1 LoD, while the ORIC (operational risk and internal control) structures still need to be maintained.”

Other firms indicated that achieving a fully independent 2LoD function was either a direction of travel or an aspiration over the coming two to three years. A large German asset manager commented: “Portfolio risk and operational risk functions are involved from the global perspective. The portfolio risk function is not a dedicated 2LoD function – it operates more like a 1.5LoD and supports the portfolio manager functions. We are not managing positions but do set targets for bands of risk factors – risk budgets consist of macro-level guidelines, which are derived from the risk appetite according to acceptable risks, residual risks and risk events for escalation criteria.” Another Scottish asset manager said: “We carry out independent monitoring of investment risk, and we have our own parallel management information and quantitative resources to carry it out. But the team that carry out the monitoring are really part of the CIO team, so the function properly operates as a 1.5LoD in practice.”

Once again, there were disparities in the way that firms managed investment risk. One relatively advanced US-headquartered asset manager described some of the advanced processes in daily use: “Our investment risk frameworks are felt to be quite sophisticated, with daily counterparty risk monitoring and reporting of aggregate positions in large- and small-cap equities and government/corporate/high-yield fixed income. There are moves to apply similar comparability to other asset classes. We perform a review of outliers on a daily basis for business, monthly for the desk heads and senior management, and quarterly for the board. There is also a weekly monitoring of sliced percentage redemptions with defined limits based on the proportion of fund and the illiquidity of underlying assets such as real estate or private equity.”

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4 The ARROW framework was being replaced by new tools such as the Firm Systematic Framework (FSF), which is how the FCA will look at whether a firm is being run in a way that results in the fair treatment of customers and minimizes risks to market integrity; and the Business Strategy Models Analysis (BSMA), which will be used to identify the conduct risks that may be inherent in the business model of the firm.
Survey findings

There was a greater focus on KYC/suitability for private banks/wealth managers and, with the prospect of MLD IV on the horizon, some interesting gaps.

Figure 7: some of the key themes to consider when managing investment risk
(Data does not include private WMs, except column 1)

The comparison of data sets between the private wealth/private banking vs. other asset manager segments was interesting. The results of the survey showed how the former placed more focus on KYC and client onboarding processes per se. This was reinforced through larger scores in evidence showing greater focus on the forthcoming fourth Money Laundering Directive (MLD IV), greater focus on sanctions checks, greater focus on ultimate beneficial owner (UBO) and ultimate source of funds (USF), greater focus on PEPs (both domestic and international) and off-shore entities, applying customer risk ratings, and a specific focus on review arrangements (typically annually) – see Figure 8.

There was greater focus by wealth managers/private banks on TCF principles, product integrity (and new product approvals), clear indications around stating risks in the products, providing clarity on the nature of investment advice, product suitability checks (to ensure these were geared toward each client’s individual circumstances), product substitution or restitution (in the event that a product was inappropriate) and finally root-cause analysis. There was somewhat less focus by wealth managers/private banks on quality of MI for approved/non-approved products (classified as non-complex vs. complex), and notably on the treatment of products vis-a-vis the various EU/CH jurisdictions (see Figure 4).

More work will need to be done with a larger sample size of wealth managers/private banks in order to drill down further in the future. Seventy-seven percent of respondents were comfortable with the new proposed risk-based approach to sanctions under MLD IV, but this figure fell to 44% when considering a risk-based approach (customer risk ratings) for customers/clients. It was clear from the respondents that applying a risk-based approach with a high level of granularity could increase the regulatory burden on firms considerably. A further change under MLD IV would be that tax crimes will be included as “predicate offenses” brought overtly within the scope of the powers and authorities used to combat money laundering. This will contribute to better coordination between AML and tax authorities and remove potential obstacles to international cooperation regarding tax crimes. Some respondents indicated that they would be able to target their resources more effectively and apply preventative measures that corresponded to the risks of particular sectors or activities. An example of the latter concerned real estate funds and managing agents with responsibility for tenants (requiring sanctions checks).
Respondents commented as follows regarding the KYC and on-boarding processes:

“Regulations have proved to be very useful when giving clients the reason why we need to perform deep dives when collecting client information. Ordinarily, our CEO will not be interested in onboarding any client unless there is proper transparency over critical indicators such as UBO and source of funds details. We are interested in protecting our brand above all else.” — Private wealth manager

“We update our documentation every time that we stress test our products. Not only do we want to abide by TCF principles but we are also interested in keeping our C/I efficiencies and ensuring that we stay on the right side of the regulator by maintaining consistency with product labeling, stress testing and providing information to clients.” — Private wealth manager

“KYC is a massive challenge, particularly the lack of change to keep up with developing regulatory measures. We are not good handling client data or data migrations. Examples include LEIs, salutations, addresses, passport identifications, and other documentation using a system called Figaro, and the issues with KYC arise from legacy clients needing to pass several controls, not new clients.” — Private wealth manager

“We need to address the lack of direction concerning house rules on handling client data. We are in the process of conducting a massive cleanup of the back book, addressing loading ratios, thematics, financial crime data and US indicia. Suitability and appropriateness testing to support the delivery and evidencing of advice are an issue, but not a systematic issue. We’ve also done a lot of work under FATCA – thinning out US clients and improving LEIs for US legacy clients, for example.” — Private wealth manager

“We conduct two sets of client reviews – a credit check plus an investment plan review – and these are refreshed at least annually.” — Private bank

“The firm offers a tax planning service to HNW and UHNW clients as part of our financial planning service.” — Private bank

“Stress testing is factored into the product life cycle; we updated documentation to reflect and link into our conduct risk procedures.” — Private wealth manager
With credit scores at a relative post-crisis low, counterparty credit risk was less an area of focus in 2014. Attention was given to OTC derivatives (such as FX forwards) but focus on collateral was greater.

Last year, 71% of firms were taking a more proactive approach to counterparty risk management by increasing the level of monitoring and close scrutiny on the basis of credit ratings, CDS spreads, tier one banking capital ratios, RWAs, ROE values or share price movements. This year, that figure had dwindled to 60%, even as the figure for centralized approval to accept new counterparties stood at 72% – see Figure 9. Meanwhile, 30% of respondents this year claimed that they could be in a position to break down counterparty risk exposures by counterparty and by product/fund structure within 24 hours of an event, a 5% increase on last year’s figure.

The points worth noting in the 2014 survey mainly concerned those surrounding the reporting of exchange-traded and OTC-traded derivatives:

- Not all firms were extensive users of derivatives, but respondents were sensitive to what the regulators in Europe and the US were trying to achieve in terms of transaction reporting as common practices for derivatives “eligible for clearing.”
- Firms were increasingly aware of the regulatory tricurations:
  1. The desire by regulators to track derivatives used for investments vs. hedging vs. speculation
  2. The desire of regulators to apply appropriate risk weights behind CCP-cleared derivatives vs. non-CCP cleared derivatives vs. derivatives not eligible for clearing (treated bilaterally)
- The majority of firms were focusing more on the short-term need to report their transactions to the six authorized reporting facilities by the deadline of 12 February 2014. Most firms were not focused on the need to report positions and collateral six months later. With the exception of LDI and hedge fund firms, most houses were not energized in following which CCPs were being authorized (and when/where/how), how to tackle client clearing or how to optimize their risk capital.
- Given the backdrop of FX manipulation in the markets, it was little surprise perhaps that there were universal concerns in treating the definition of FX spot vs. forwards (in order to apply the correct EMIR procedures for the latter) given the fact that spot FX might typically settle between a cycle spanning two to seven days depending on the country. Some of the respondents were concerned at the lack of consistent legal definitions and the lack of watertight guidance from ESMA. Some complained that Dodd-Frank measures had exempted firms from the need to worry about this issue.
- ESMA has indicated that Europe would need an extra €2.44t in collateral as a result of the new regulations. It was therefore unsurprising that 56% of firms expressed worries about a future scarcity in quality (i.e., pledged as titled and fully fungible) collateral, as opposed to 48% who expressed their concerns in 2013. Thirty percent of respondents were either running (or had run) a “beauty parade” of their brokers and custodian banks to assess the quality and appropriateness of collateral management, execution and prime services. Firms were posing detailed questions concerning collateral pricing, valuation, fluidity, documentation and transformation, under normal vs. stressed vs. extreme market conditions.

Figure 9: views with respect to counterparty risk management, derivatives and collateral

Theme: beauty parade factors
- Relationship strength
- Strength of balance sheet/credit ratings
- 2006-13 CIR
- Footprint/market share
- Concentration risk
- Thought leadership/research
- Lobby potential/activism
- Product coverage
- New product set up
- Cost/fees (fixed/variable flexibility)
- COBAM professionalism
- Interface capabilities
- Quality of valuations/M2M
- SYSC (e.g., limit handling)
- Key person risks
- Quality of E/O resolution
- f/m/b office STP
- Trade capture OMS/EMS
- Trade confirmation
- Collateral management/ transformation
- Asset segregation
- Reporting
- Utilization of standards
- BCP

Risk management for wealth and asset management EY EMEIA survey 2014
This year’s survey pointed toward a greater degree of precision, correlation and professionalism when it came to operational risk management, with significant focus into domains such as remuneration, conduct risk and managing reputational risk. There is a certain amount of correlation between the maturity of an asset manager’s risk program and the number of primary, secondary and tertiary risks that the firm would consider before structuring its risk appetite – the median figures suggested asset managers carrying 10 to 11 years’ worth of quality operational risk data against 12 to 14 risk factors expressed formally within the respondents’ risk appetites.

Respondents commented as follows regarding defining operational risk incidents:

“The easy bit is determining what went wrong; the harder bit is why, and how best to resolve the situation and remediate. We are considering a sensitivity analysis looking at the cost of maintaining the processes for our private clients under greater levels of regulatory scrutiny.” – Swiss private wealth manager

“Our definition of operational incident spans any activity where a process failed, there was a breach of procedure, or something didn’t go as planned. The question is whether we should exclude the big-ticket items arising from incidents (e.g., dealing errors or corporate actions issues) from the rest of the data.” – Large Dutch asset manager

“We classify incidents as active (from the people/process/system consequences of running our business) vs. passive (the consequences of movements in the market or events beyond our immediate control). We look at the positives and negatives in terms of complexity, and we classify error results in terms of a positive, negative or neutral (nil) impact for clients.” – Bank-owned asset manager

“We are very strict about losses, and we ensure that the clients are fully informed and, more importantly, losses restituted. All four risk events are included – losses against the firm, those in the clients’ favor, near misses and operational breaks. On the institutional side, we set three levels of thresholds screened at £1,000, £1–£10,000 and over £10,000, and for our private bank business, we look at everything including the investment service providers. There is also an annual audit process of the ISA3402/SAS70 type to ensure that all processes are tight and robust.” – Third-country private bank

“We cover three categories of OpR events: 1) losses against the firm, including client gains; 2) near-misses; and 3) other incidents. We changed the frequency of reporting to the Risk Committee to bimonthly because we were constantly chasing our tails and at risk of missing the big stuff. We now carry over 10 years of historical data including every near miss. Root-cause analysis is done to look for improvements and make corrections to controls to drive behaviors.” – Bank-owned asset manager

“We count operational risk activities to include any risk-bearing activities that can give rise to reputational damage, such as fines. There are single six-figure events that occur from time to time, such as cancellations. Most of the time, OpR management focuses on the outsourcing dimension.” – German asset manager
The survey found that there is greater precision on benchmarking the financial impacts of operational incidents that were reported internally – a far cry from the “loss events limited to 1% of revenue” conversations recorded in 2009. Some maintained relatively extensive data sets, capturing at least four different categories:

1. Operational incidents or errors against the firm
2. Unintended gains or incidents resulting in the proceeds being awarded in the client’s favor
3. Qualified “near misses” arising from errors and omissions
4. False positives and/or situations arising from mis-transcribing dealing tickets or operational breaks/failures/overdrafts that were corrected or remediated before they qualified as incidents as above many firms were able to provide financial estimates of loss figures⁹ against the various categories that were maintained, but the biggest demarcation was illustrating the data sets relative to internal thresholds for reporting (usually £10,000/€10,000/$10,000) per the four categories – see Figure 10.

Some respondents expressed a significant interest in terms of calibrating their loss-event methodologies against their peers and tying the results back into areas such as conduct. Firms who retained data on unintended gains and qualified near misses were particularly interested in studying how other firms annualized their loss values – whether over a three- or five-year cycle, for example, and whether peers were formalizing a total loss value figure as a target ceiling. Some respondents highlighted challenges in trying to persuade the business to “record all,” and to not be frightened of challenge in the event of anything going wrong.

Best practices consisted of ensuring that breaches, issues, errors, incidents, omissions and complaints were all logged, ideally with little dispersion between the logging of incidents onto systems spanning multiple centers. Only 56% of firms recorded near-miss information in their data sets, and only three firms recorded a complete data set featuring operational breaks and false positives.

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Figure 10: estimated financial impact of operational incidents vs. number of operational incidents reported internally during calendar year 2013

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⁹ The loss threshold figures as stated were compounded, including allowance for significant loss events (e.g., arising from seven-figure dealing errors and/or corporate action losses) by annualizing the results (e.g., a typical US$5m loss for a large firm that occurred at a frequency of twice every five years on average would contribute US$2.5m toward the final amount). Results were highly varied depending on 1) investment styles/models and 2) how the data was counted by each firm.
Other practical comments from some of the respondents were instructive when considering peer responses:

“On the portfolio manager desks, the volumes of errors are low (two or three per year), but there is a lot of market exposure about once per year on average. Pension administration errors have a low loss value, and we are not worried unless there is a scheme error. On the other hand, client order processing features a high volume of errors and occasionally a high value of losses.” – Large US active manager

“There are a good 700-800 OpR incidents per year if we are tracking every loss against the firm, every client gain, every near miss and every operational break – which we do. If we report to the executive on serious client or regulatory issues, the frequency rate will be nearer one per month, plus of course there will be the odd seven-figure error to report once every three to five years in addition.” – Medium US active manager

“Over a three-year cycle, we might see annualized loss events in the £1m–£2m range. If all four categories of incidents are counted, this amounts to recording an incident every working day.” – Boutique manager

“Operational events are a critical measure here: 95% of events have less than a US$5,000 loss value, and 5% of events have 95% of the impact. We need to manage down the amount of time investigating the US$5,000 events and look at expected/unexpected losses and our ratio of the 65–70% of events that result in a loss (as opposed to near misses, etc.).” – Large US active asset manager

“We are constrained by lack of headcount so we don't record client gains or near misses. Our biggest losses arise from a lack of central execution desk and adequate front office controls plus any losses on eligible investments.” – Swiss manager

“Our total compensation cost of £800,000 we feel is at the lower end of the scale because it represents 0.33% of revenue, when the industry benchmark is around 1%.” – Insurance-owned asset manager

“There have been big changes in ORM to reduce the number of incidents to fewer than 100 annually and the loss value to be below US$1m, not including legal settlements. The hardest thing is the difficulty agreeing on KRIs if we want the firm to be forward-looking.” – UK hedge fund manager

The results of this year’s survey also showed that 62% of respondents expressed concern about the comparative regulatory focus from outsourcing risk. As was the case in 2013, the common issue centered around the dependency of traditional and alternative asset managers on a limited number of providers of custody, transfer agency, fund administration or outsourcing services and the concentration risk. With the top four US-headquartered global custodians representing some 73% of the global assets under administration and comprising some 59% of FTEs, regulators shared a concern that if an asset servicer such as an outsourcing provider with a large share of the market were to face financial distress or severe operational disruption, asset managers would not be able to perform critical and important regulated activities, thereby causing detriment to end investors.

The then-FSA in UK wrote originally to several asset manager firms in December 2012, warning that they were not confident that effective recovery and resolution plans were in place for the asset management sector as a whole across the industry. They made reference to the outsourcing of regulated activities and/or activities that were “critical or important” in the support of regulated activities. There was widespread skepticism at the time as to whether the failure of an outsourcing agent per se was the realistic outcome, given that the failure of an investment or retail banking entity would be the more realistic possibility, creating significant potential for banking contagion.
Many asset managers put projects in motion to respond to the concerns raised above by engaging with the IMA and delivering their recommendations in late 2013. One third-country traditional asset manager stated: “We looked at setting up parallel runs with our outsourcing activities, checked MOUs with critical agents, undertook the early stages with step-in arrangements and checked the robustness of arrangements.” However, some entities voiced concerns. One insurance-owned asset manager commented: “The fundamental question that the FCA wants to know is whether we are prepared for the default of our service providers, both financially and operationally. It is difficult to address the hot standby issue because of the cost pressures. If the regulators want to introduce more competition, this will put cost pressure and risk onto asset managers who need to interface with more service providers.”

Some German asset managers voiced a different complaint. One large traditional entity said: “The BaFin is less clear on the standpoint of rules of outsourcing than the FCA — the BaFin have formal rules on reporting, but there is less clarity around the sorts of topics that the FCA are pursuing in the ‘Dear CEO letter.’” The respondent continued: “Higher levels of outsourcing backup will result in higher costs, which will need to be passed back to clients. A further challenge is the climate in which banks and insurers need to provide living wills. Ideally, we are not against a regulator clarifying what services it can provide and the RRP arrangements as a precautionary measure should that entity go into default. As such, the formalized liability and asset restitution arrangements stated under AIFMD and UCITS V actually helps us.”

Several asset managers hinted that the process had yet to tackle the real challenge of managing concentration risk. One traditional manager commented: “Several aspects concerning outsourcing now worry us. We don’t know how the regulator will raise the bar in terms of switching arrangements, step-in rights or liability. We don’t know how high the bar will be raised.” A hedge fund complained the process had given rise to further complexities: “Outsourcing has become a many-headed monster under the FCA’s thematic process. They’ve left it up to the industry to figure out how to deal with outsourcing, and there are lots of competing definitions and approaches. The process is a total mess.”

Private banks and wealth managers displayed a variety of approaches to maintaining SLAs, with some firms maintaining SLAs in use internally across the group. One large private bank commented: “There are intragroup agreements with SLAs signed off between each division; for example, Wealth IT CH signs off with Wealth IT in the UK.” Some wealth managers complained that the process hadn’t removed the intrinsic asymmetries: “Outsourcing never moves at the pace at which we wish it to; even processing change requests for commoditized services (e.g., transfer agency) has proved problematic with some outsourcers,” noted one firm. Another private bank added: “Post merger-integration, we canceled some of our outsourcing arrangements with a large global custodian bank and decided instead to insource our arrangements within our group’s service center based in Zurich.”

In summary, this year’s survey showed that asset managers and wealth managers who felt that outsourcing or concentration risk was an issue had generally:

- Agreed on the definitions and materiality of critical operational functions and investment services/activities
- Revalidated that they were able to monitor and manage the effectiveness of functions carried out against SLAs
- Catalogued external and internal SLAs effectively, particularly in the case of service provision and/or outsourcing from third countries
- Ensured that catalogs featured procedures from competent authorities in third countries

Firms had yet to fully:

1. Model the implications of the same under-stressed market conditions
2. Reach consensus over contingency planning (such as “step-in,” “standby” or “warm second provider” arrangements) in the event of an agent hitting financial problems
3. Evaluate and price in the liability arrangements to cover cases of fraud and/or insolvency of any end agents such as sub-custodians (a la AIFMD/UCITS V)
Many firms treated reputational risk as derived from other risks—a superset, a consequential impact or as the outcome of other risks. Wealth managers and private banks indicated that they were particularly sensitive in order to protect their brands. Some firms saw reputational risks arising from the activities of their parents (e.g., reputational scandals with investment banking parents or parent banks or insurers mis-selling products). Some firms treated reputational impact as a multiplier when assessing/quantifying other risks such as operational risks, while other firms quantified potential losses of client business (new or existing), e.g., redemptions (see Figure 11).

Several respondents attested to the importance of identifying, tracking and managing reputational risk. One mid-tier active asset manager commented that “Reputational risk is taken very seriously here, whether arising from the loss of a big client or the activities of a rogue trader.” A large German fixed-income house qualified that “If it hits the press, it’s a reputation risk and it’s an area for worry. Breach of mandates, litigation and mis-selling are all factors. Reputation risk is part of the risk assessment process, linked to mitigating controls, residual risks and implied risks. A tracking error that is corrected is not a reputational risk consideration, whereas breach of a mandate concerning a mutual fund affecting the public, is.”

Certain segments, such as asset managers servicing SWFs, limited liability partnerships and hedge funds, were all sensitive to the effects of reputational risks. An LLP firm commented on how “Reputation risk is key because the trust and confidence of our clients is critical. Regulatory mis-selling (e.g., currency mis-dealing on forwards) could have a devastating impact on our plan sponsor business.” A mid-tier event-driven hedge fund manager added: “Regulatory censure and fines are the number one reputational risk, and we’ve done a great deal of due diligence to avoid that outcome. There is a team approach with no star individuals. There is a methodology where we identify the key risks (and value the outcomes) then break these down into a multitude of elements that we monitor and manage separately.”

Private banks and wealth managers unsurprisingly were acutely aware of the consequences of incidents that could mar the reputation of the firm and/or impact brands that had taken decades to establish. One large Swiss private bank commented: “Reputational risk is our key risk given that we service some large institutions. We see it as comprising regulatory risk (arising from the failure to anticipate and respond to thematic local and regional regulatory measures), from tax risk (in the light of FTT-like measures developing in various centers around the world) and from counterparty risk (the failure to recognize the impact if/when a counterparty or country fails).

Tax risk and reputational risk converged for the first time in this year’s survey. A firm preparing a LDI strategy commented: “The thing that gives me sleepless nights isn’t actually the FTT but striking the reputational balance within the way we operate for the benefit for our investors vs. being seen to do the right thing by not contributing to tax leakage as a firm.” Swiss respondents were particularly sensitive to these consequences.

Another firm added: “Tax risk is a primary reputational risk, especially from a wealth management perspective, for an asset manager such as us. FTT, for example, is a huge operational headache requiring us to have the correct checks and balances if we are to make the appropriate calculations and not suffer reputationally.”

Reputation management was therefore seen as compound, cross-functional and multidisciplinary, rather than merely driven by issues or powered by corporate communications. A large global asset manager opined: “The management of reputational risk doesn’t occur in one place; several departments are involved (e.g., the COO). Future risks of a macroeconomic, macro-prudential or regulatory nature are picked up on the regulatory reform horizon risk radar on a monthly basis and flow into the analyst teams. A good current example is modeling the effects of FTT, or the cross-regulatory impacts of AIFMD or UCITS V.”

As with previous surveys, there was seldom one single “owner”; critical functions such as the CRO, CCO, COO and CIO were typical drivers, with the boards, heads of business and CEO involved in many cases too. Corporate communications was almost always involved. A mid-tier asset manager commented: “Reputation risk is considered a risk type in view of the potential for litigation; it is a consequential risk as a result of the externalities of OpR especially. The ‘owners’ are the CEO and the legal counsel.” A UK-domiciled wealth manager added: “Managing reputational risk is ‘owned’ by the board but administered through the control functions and the business. We would consider that a breach of client mandates, mis-selling/mis-buying and control failures could each have severe reputational consequences.”

The big differentiators on the scale of agility involved cases where:

1. Firms where the crisis team was immediately identifiable on an ad hoc basis (61%)
2. Firms where a team must “scramble” at short notice (i.e., in media time) in response to an event (21%)
3. Firms where the approach was more reactive or even non-responsive (18%); responding to the Eurozone sub-crisis of 2012 was a good proxy in terms of preparedness.
Of respondents indicated that they were operating even basic methodologies for mitigating reputational risks, such as adopting a reputational risk framework (e.g., as offered by COSO or the ABI) and collecting data on media hits (news, blog sites, brand valuations, etc.).

Of respondents claimed that they actively measured or managed reputation risk at a macro level – for example, by considering the risk-adjusted value of expected future earnings from loss of client business (new or redemptions of existing clients), the risk of loss in the value of a firm’s business franchise (extending beyond the event-related losses), the decline in its share performance metrics, or anticipated reduced expected revenues and/or higher financing and contracting costs.
This year’s survey focused more deeply on the quality and quantity of risk resources across firms and how FTEs were being counted. This was partly in response to wealth and asset managers to benchmark their capabilities against peers, and partly in response to regulators asking more penetrating questions about the bench strength and appropriateness of resources to provide challenge to the business – see Figure 12. There was no “right answer” to the exam question of “What is the optimum size of the risk control function?” in a typical firm, because risk resources were counted differently between firms. Some firms included the following within their risk function headcount: horizon risk monitoring, crisis monitoring, conduct risk, KYC/client onboarding, client advisory, screening/alerts, regulatory monitoring, guideline monitoring and branch monitoring.

Previous benchmarking studies had indicated that anything from 30% to 90% of risk staff possessed greater than five years of risk experience. The size of the asset manager did not seem to influence the depth of experience within the team, but the size of the risk team also showed some correlation with the size of compliance function: approximately 1:1 risk/compliance for hedge fund teams, approximately 1.5:1 and finally nearer 2:1 as team sizes became bigger. Larger risk teams were noted when firms covered more strategies, countries and retail/distribution activity, but the tendency was to fill compliance teams ahead of time because of the growth in regional and local/thematic regulations. The figures above depended on how risk and compliance functions were counted; the compliance headcount was typically more of a feature of the 2LoD, whereas the risk headcount was softer, with a trend showing more of a blurring/sharing with the 1LoD during 2014.

Needing to satisfy the diversity of business lines (e.g., multi-strategy, alternatives or REIM) or country coverage (particularly in Asia-Pacific) was a commanding consideration for deciding team size and capabilities. One large bank-owned asset manager commented: “The extent of staffing footprint is a function of the complexity of our business, which in turn depends on where our products are manufactured, where are the locations of the clients (i.e., how are products distributed) and the geographic location of the trades. Regulators would expect us to maintain more headcount to service retail-classified clients, for example.”

Respondents universally maintained that it was quality, not quantity, which counted, irrespective of the style of the firm, its size by assets under management (AuM) or its geographic diversification. One Head of Business Risk at a large hedge fund said: “The quality of the resourcing and their level of experience is far more important than the mere quantity or footprint. I am keen to ensure that we hire good people with a consulting or process mindset that will help resolve real business problems, not offer theoretical or textbook responses.” Even so, there was notable competition for the talent pool, with another hedge fund CRO adding: “We are busy recruiting and are finding that the rate of inflation in compensation for 2LoD resources is running at 10%-15%/year, and more if you are searching for more senior members.”
The biggest sea change in this year’s survey was the need to monitor and maintain data security, cited as a critical concern by 71% of respondents.

Forty-seven percent of respondents said that it was challenging for the IT function to keep up with the volume of change requests (often arising from regulation) – see Figure 13 – and many experienced issues with system and data flexibility, as well as reporting, audit trails, documentation and data retrieval. The results suggest an increase on the results recorded in surveys from the prior two years with the figures notably skewed toward private banks and wealth managers struggling to keep up with new regulations and tax changes in contrast to their traditional and alternative asset manager peers.

There was an overwhelming awareness among risk professionals that monitoring, managing and maintaining data security was becoming the critical focus. Data was no longer seen as an activity delegated to operations – e.g., managing static (reference) data or filtering stale data – but an essential component of running the business: the lifeblood of innovation and thus the golden source of economic value for the business. Loss of critical data would spell reputational risk. Lack of access to data on demand by clients or regulators could differentiate a leading private bank or wealth manager from one failing in its duty to provide winning client service.

Furthermore, data security – whether concerning the firm, data warehouse or outsourcer or surrounding hacking, impersonations or cybersecurity – was seen as a new concern as reported by 71% of respondents (vs. 49% in 2013). Only 55% of firms in 2014 could attest that their data, systems/controls and MI were fully robust and fit for purpose, slightly down from the 54% figure recorded last year and well down from the 68% recorded in the 2011 survey.
Attention to “big data” proved advantageous when meeting continual change requests brought on by multiple regulations or tax changes over the foreseeable future.

When it came to “big data” management, firms with bank, insurer and especially custodian bank/asset servicer parent firms enjoyed a significant advantage over the equivalent independent entities, with the exception of the minority of independent entities maintaining their own data warehousing facilities. The variation was most marked for private banks/wealth managers and hedge funds. One Swiss hedge fund manager commented: “Our quant team apply quant techniques to operational loss modeling. ORIs (operational risk indicators) are important, focusing on the 10 biggest top-down indicators (changes to the annual risk landscape by way of qualitative criteria, e.g., brand) vs. bottom-up indicators (e.g., operational incidents).”

An asset manager within a large global-custodian group described the situation: “Data is the number one challenge. We operate a warehouse that has critical data such as near misses going back at least 10 years, but we are running an international business with international clients, international products spanning international regulatory regimes and the organizational aspect is truly ‘big data.’ Legal entity data – to determine who is the legal (as opposed to the business unit) counterparty – is our biggest single challenge, and the task varies per country. In the UK, agreements with UK client, broker and stock are all OK, but the meaning might be different in every country where we service clients.”

Wealth managers also found the management of data particularly challenging. An independent wealth manager commented: “KYC is a massive challenge, particularly the lack of change to keep up with developing regulatory measures. We are not good at handling client data nor handling data migrations. Examples include LEIs, salutations, addresses, passport identifications, and other documentation using a system called Figaro, and the issues with KYC arise from legacy clients needing to pass several controls, not new clients.” Another wealth manager concurred, adding: “We need to address the lack of direction concerning house rules on handling client data. We are in the process of conducting a massive clean-up of the back book, addressing loading ratios, thematics, financial crime data and US indicia. Suitability and appropriateness testing to support the delivery and evidencing of advice are an issue, but not a systematic issue. We’ve also done a lot of work under FATCA – thinning out US clients and improving LEIs for US legacy clients, for example.”

Additionally, firms who failed to link their PMS, OMS, CRM or general ledger systems or failed to standardize their workflows according to unique instrument or unique entity identifiers (such as LEIs) were placed at a considerable disadvantage (extra cost/lack of preparedness) when it came to reporting data. The leading firms were also digitizing documentation for “on-demand” retrieval of records for audit and control purposes. The results from the respondents were recorded below for easy comparison. (A 100% figure on the spider-chart indicated that all respondents were able to claim that their firm satisfied the particular condition).

Figure 14: comparing issues arising from IT/systems and data

| Evidence of discrete date warehouses or dashboards (“big data” mgmt.) | Data quality is managed satisfactorily | Specific focus on cybercrime and privacy | Data systems and MI broadly robust (average) | Data taxonomy covering UIs/LEIs in (fully/partly) | Record retention service helpful | Data standards for KPIs, KRIs useful | Data quality program focused on patterns of MI/data structure/rules | Firm has a strong supply of data for data modeling | Firm relies on third-party (or parties) to manage market and reference data | Firm has a governance structure with focus on “big data” |
Summary of findings
2014 vs. 2013 survey

Figure 15 shows a summary of the findings from the 2014 survey in comparison with the 2013 survey in order to illustrate some of the trends underway.

**Figure 15:** comparison of the results of the Risk Management for Asset Management Survey 2014 vs. 2013

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2014 result</th>
<th>2013 result</th>
<th>Delta/comments</th>
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<tbody>
<tr>
<td>% IMs where the CRO has been tasked with helping to devise/administer the</td>
<td>73%</td>
<td>48%</td>
<td>An area that has represented a significant amount of time and effort for CROs and CCOs proportionate to style, LE presence and location of clients.</td>
</tr>
<tr>
<td>remuneration framework</td>
<td></td>
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</tr>
<tr>
<td>Sum total of FCA fines levied on asset manager firms for 12 months to</td>
<td>£51.43m</td>
<td>£17.23m</td>
<td>Tripling in the amount of fines by the FCA, many high-profile: overcharging, poor systems and controls, client money breaches, suitability failing and mis-selling, AML controls, etc.</td>
</tr>
<tr>
<td>April YE</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firms attesting to the importance of the conduct risk function (identified</td>
<td>81%</td>
<td>64%</td>
<td>Significant focus on defining and applying conduct risk by many asset managers and all wealth managers; some country specificities evident, with UK in the lead.</td>
</tr>
<tr>
<td>as one of the top five risks)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firms attesting that investment risk is treated independently of PMs</td>
<td>53%</td>
<td>51%</td>
<td>Focal point; more firms deconstructing their investment activities; finding the right individuals to allow the 2LoD to offer independent challenge is still difficult by way of individuals/system capabilities.</td>
</tr>
<tr>
<td>comparison of the cost/income ratio pre-depreciation over previous</td>
<td>64% (asset</td>
<td>63% (asset</td>
<td>The average CIR figure declined 1% to 64% despite cost-cutting measures; the corresponding average held at 72%, with some firms trending down (cost cutting); the figures were up to 10% higher for the “pure-play” (i.e., non-private bank) wealth managers.</td>
</tr>
<tr>
<td>calendar year</td>
<td>managers)</td>
<td>managers)</td>
<td></td>
</tr>
<tr>
<td>% IMs who claim they can break down risk exposures by counterparty and</td>
<td>30%</td>
<td>25%</td>
<td>Continued improvements behind counterparty risk management recorded over the 2013-14 period, particularly non-bank/insurance-owned asset managers (behind as ex-post in 2013).</td>
</tr>
<tr>
<td>by product or fund intraday</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State of reputational risk “readiness” (by % of firms mobilized to</td>
<td>61% overall (58%</td>
<td>49% (asset</td>
<td>Growing awareness of the reputational impacts from files and other trigger events; private banks, wealth managers and “brand-builders” particularly sensitive.</td>
</tr>
<tr>
<td>scramble in a crisis)</td>
<td>asset managers only)</td>
<td>managers only)</td>
<td></td>
</tr>
<tr>
<td>Trend in risk resourcing</td>
<td>Upward (44% of firms)</td>
<td>Upward (37% of firms)</td>
<td>Upward trend continues, not just in number but in terms of a drive for quality and beyond “OpR” mindset into business risk mindset.</td>
</tr>
<tr>
<td>Average time spent on policies and procedures</td>
<td>10.6%</td>
<td>9.4%</td>
<td>Significant rise in the time allocation to manage policies and procedures, particularly SLAs and GSAs; signifies possible convergence of CRO/CCO/COO functions.</td>
</tr>
<tr>
<td>Average time managing mandate risk issues</td>
<td>9.1%</td>
<td>9.1%</td>
<td>Mandate risk slightly important issue in 2014 among the asset managers’ hot spots; include institutional SWFs and ERISA funds.</td>
</tr>
<tr>
<td>Average time dedicated to training or induction</td>
<td>6.6%</td>
<td>6.3%</td>
<td>Stabilized, reflecting a drive to raise the quality of risk resourcing and the standing of the function (rate was 6.7% in 2009).</td>
</tr>
<tr>
<td>% IMs with systems fully robust/fit for purpose?</td>
<td>52%</td>
<td>54%</td>
<td>Slight decline from 2013: the 44% of firms who have IT challenges compares with the 46% who experienced challenges in 2013 (some sampling differences), with no distinction for WMs.</td>
</tr>
<tr>
<td>% IMs with quality data managed satisfactorily across the organization</td>
<td>55%</td>
<td>54%</td>
<td>Significant focus on data retention, audit trails, warehousing, cloud, “big data,” cybercrime, BCBS standards, etc.</td>
</tr>
<tr>
<td>% IMs focusing on data security and cybersecurity from a risk function</td>
<td>71% (75% for private banks/wealth managers)</td>
<td>49%</td>
<td>Big awareness shift following breaches, losses, impersonations of websites, (spear-)phishing, often following change management activity. Tension between transparency and confidentiality.</td>
</tr>
<tr>
<td>perspective</td>
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</tr>
</tbody>
</table>
## Definitions of specific risk types

<table>
<thead>
<tr>
<th>Risk type</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business risk</td>
<td>Any risk to a firm arising from changes in an asset manager’s business, including the risk that the firm may not be able to carry out its business plan and its desired investment strategy. In a broader sense, it is exposure to a wide range of macroeconomic, geopolitical, industry, regulatory and other external risks that might deflect an asset manager from its desired strategy and business plan.</td>
</tr>
<tr>
<td>Strategic risk</td>
<td>The potential negative impact on earnings due to misjudged strategic decisions or lack of responsiveness to industry changes.</td>
</tr>
<tr>
<td>Market risk</td>
<td>The risk of loss arising from fluctuations in values of, or income from, assets or arising from fluctuations in foreign exchange or interest rates.</td>
</tr>
<tr>
<td>(Counterparty) credit risk</td>
<td>Credit risk refers to the likelihood that a counterparty will fail to meet a contractual obligation that results in a loss in value to the other party. A factor which may contribute to increased credit risk is concentration of assets held with a single counterparty.</td>
</tr>
<tr>
<td>Operational risk</td>
<td>The risk of loss resulting from inadequate or failed internal processes, people, systems or from external events impacting the same.</td>
</tr>
<tr>
<td>Investment risk</td>
<td>The positive or negative deviation from an expected outcome. Asset managers typically regard investment risk as a measure of the expected return given the level of risk tolerance relative to agreed market or internally set benchmarks. Some of these are typically specified within the asset managers risk appetite, often expressed at a corporate as well as at a client level.</td>
</tr>
<tr>
<td>Legal risk</td>
<td>The risk of a client(s) or counterparties taking legal action resulting in protracted litigation, financial loss or reputational damage.</td>
</tr>
<tr>
<td>Country risk</td>
<td>The risk of investing in a country, dependent on changes in the business environment that may adversely affect operating profits or the value of assets in a specific country. For example, financial factors such as currency controls, devaluation or regulatory changes, or stability factors such as mass riots, civil war and other potential events contribute to companies’ country risks.</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>The risk that the firm, although solvent, either does not have sufficient available resources to enable it to meet its obligations as they fall due, or can secure them only at excessive cost (e.g., unable to sell out its positions on demand).</td>
</tr>
<tr>
<td>Regulatory risk</td>
<td>The risk of failure by the company to meet its regulatory requirements or manage changes in regulatory requirements in respect of new legislation, resulting in investigations, fines or regulatory sanctions.</td>
</tr>
<tr>
<td>Conduct risk</td>
<td>The risk that an entity mistreats its customers or clients, causing them detriment. Historically, used within the context of retail customers but more recently, also applicable to non-retail customers and market abuse caused as well.</td>
</tr>
<tr>
<td>Fraud risk</td>
<td>Any risk of loss arising from a staff member, members or third parties acting in an inappropriate or dishonest manner resulting in a financial loss to the firm (e.g., funds stolen) and consequential damages to its reputation.</td>
</tr>
<tr>
<td>Reputational risk</td>
<td>The risk of damage to the firm’s reputation that could lead to negative publicity, costly litigation, a decline in the customer base or the exit of key employees and therefore directly or indirectly to a loss or revenue.</td>
</tr>
<tr>
<td>Tax risk</td>
<td>The tax impact of business risks arising from an organization's ongoing global activity. The uncertainty or risk to the firm by failing to file accounting statements according to the appropriate tax standards or abide by the appropriate tax treaties for the country.</td>
</tr>
</tbody>
</table>
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