Independent internal control reviews in Asia

What are the benefits to asset managers?
Like their counterparts throughout the world, Asian asset managers face a growing challenge to deliver investment performance while maintaining their focus on governance and risk management. Institutional investors in many markets now expect firms to provide them with evidence of a strong internal control environment, especially in the middle and back offices functions.

To meet these goals, asset managers in Asia are increasingly turning to independent verification of their internal controls. Across the region, internal control reviews are emerging as a crucial way to strengthen asset managers’ business models and enhance their growth prospects.

Conversations with clients tell us that many firms still have unanswered questions about internal control reviews. In this short paper we aim to answer some of the most common queries such as “what’s involved?”, “why are my competitors having one?” and “when is the best time to have one?” as well as the most important of all: “What are the benefits?”
Internal control reviews are increasingly standardized across Asia

Most control reviews at Asian asset managers are based on the International Standard on Assurance Engagements 3402, Assurance Reports on Controls at a Service Organisation (ISAE 3402). Issued by the International Auditing and Assurance Standards Board, ISAE 3402 provides a common reference point for independent control reviews across the region.

An internal control review under ISAE 3402-based guidelines typically covers an asset manager’s financial reporting and operational controls. It involves reviewing an asset manager’s overall business environment, documenting and reviewing its control objectives, identifying potential areas of risk or weakness, making improvements to address those weaknesses, and performing tests of controls.

Once an asset manager has conducted its first control review, it is typically repeated each year. Where key activities have been outsourced, the results of a separate review of the "subservice organisation" can usually be included with those of the asset manager, providing it has been conducted to the same standard.
The practicalities may be straightforward, but why are Asian asset managers commissioning independent reviews of their controls?

The first and most obvious reason is that institutional investors are asking for them. In mature markets such as Australia, investors expect firms to conduct an independent review as a matter of course, but institutions across the region increasingly prefer independent verification to relying on contractual compliance. From an investor’s standpoint, independent reviews complement asset managers’ own three lines of defence of line management, risk management and internal audit.

The second reason follows logically from the first. An independent review helps asset managers to demonstrate the strength of their control environment to potential investors. This is an effective differentiator from competitors that cannot provide similar evidence of good governance and risk management.

The third reason relates to the internal benefits of an independent control review. External reviews help firms to perform effective and probing self-assessments. They enable management to look at an organization’s control environment with fresh eyes, and to measure themselves against industry best practice. This in turn helps firms to identify potential cost savings and remedy any control weaknesses.

The fourth benefit is cultural. An independent review can help to keep all employees focused on the same page in terms of the importance and quality of internal controls. This boosts the effectiveness of management oversight and helps staff to devote more time to other areas of the business.
Until recently, small and medium sized Asian asset managers have been much less likely than their larger counterparts to commission internal control reviews. In the past, these firms’ typical clients were less inclined to demand independent verification of controls. For instance, high net worth individuals are often happy to rely on personal trust and reputation when assessing an asset manager’s control environment.

This situation is changing. Key investors across Asia are becoming more demanding of small and medium sized asset managers. Private banks, local public sector investors and even family offices are increasingly likely to require a third party review of internal controls. As institutional investors develop more direct relationships with asset managers, they often favor firms that can demonstrate the quality of their controls.

These changing demands are driving more use of independent control reviews among Asia’s boutique and alternative asset managers. A review enables fast growing firms to build a control environment that is fit for growth, rather than developing it in a piecemeal way. This helps firms to get ahead of the growth curve and avoid the risk of developing pressure points or other internal weaknesses as they expand.

For firms like these, an independent review of internal controls can also be a significant source of competitive advantage. Independent reviews represent a powerful marketing tool – something currently being exploited by a growing number of Asian asset managers. They allow small firms to differentiate themselves against additional competitors, and put them on a level playing field with larger rivals when seeking institutional mandates. As international capital flows into Asia’s major investment hubs, conducting annual internal control reviews will rapidly become standard industry practice.
Investor expectations are not the only factor driving demand for internal control reviews. Regulation is also playing a significant role, although this is rarely a question of compliance.

Asset managers in most Asian markets currently face no mandatory requirement for independent control reviews. Even so, there is no question that many asset managers are coming under pressure from regulators to strengthen their internal controls. Hong Kong offers a good illustration. A steep increase in the number of on-site inspections conducted by the Securities & Futures Commission (SFC) over the past five years has put a much stronger focus on control quality. A range of new and revised guidelines from the SFC are adding to this scrutiny. These include the Anti-Money Laundering Ordinance of 2012, tighter requirements over the reporting of short positions and inside information, and greater focus on Responsible Officers’ qualifications. In this environment, it is no surprise that asset managers in Hong Kong are increasingly finding internal control reviews a useful compliance tool.

Similar factors are at work across Asia. In Singapore, the broadening of Fund Management Company (FMC) regulation during 2012 and 2013 means that many more asset managers are finding their risk management and internal control frameworks under supervisory scrutiny. The changing regulatory atmosphere in Japan is also leading to growing demand for internal control reviews. And firms across the region are finding that independent reviews can help them to ensure they are compliant with extra-territorial regulation such as FATCA and Dodd-Frank.
Internal control reviews are increasingly expected – and even demanded – by Asian investors of all sizes. They reassure existing clients, support firms’ internal governance efforts, and are an increasingly important tool in the hunt for new institutional mandates. Regulators across the region are also inclined to view them as a source of reassurance and a sign of good practice.

Smaller firms aiming to punch above their weight often find independent control reviews to be a useful source of differentiation from their competitors. Larger, more complex asset managers can also benefit from the effects of a centrally co-ordinated review that helps to improve standardization and consistency across several jurisdictions.

In short, Asian asset managers of all sizes are finding independent reviews a highly effective way to demonstrate the quality of their controls and governance, and so to attract above-average levels of net inflows. As internal control reviews become increasingly important to growth, firms that fail to harness this tool could be handing a competitive advantage to their rivals.

Conclusion

Every Asian asset manager should consider the benefits of an independent review