

Virtuelles  
Investmentforum  
2020:

# Facing disruption: The evolution of the risk function

Break-Out-Session

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# Agenda

1	The evolution of the risk function at asset managers – PwC Survey	3
2	Model Risk Management	9
3	Liquidity Stress Testing	13
4	Data Management	18
5	IBOR Transition	22



The evolution of the  
risk function at asset  
managers –  
PwC Survey

# Asset Management is going through unprecedented change

Across the sector, competition, client demands and changing regulatory expectations are putting asset managers' margins under severe pressure



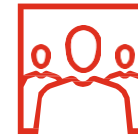
## Buyers' market

The entire industry is facing pressure to reduce both fees and costs. Fees are being pushed down as increased regulation, competition and new entrants disrupt traditional value chains. Meanwhile, institutional investors now have the tools to hand in order to differentiate alpha – for which they'll pay more – from beta, for which they won't.



## Digital technologies: Do or die

Firms are beginning to harness the power of new technologies to help them across the value chain – this includes new client acquisition, customisation of investment advice, research and portfolio management, middle and back office processes, distribution and client engagement.



## Outcomes matter

Investors are demanding tailored solutions to address specific needs - this trend has seen active, passive and alternative strategies become building-blocks for multi-asset, outcome-driven solutions (which will increasingly include environmental, social and governance (ESG) outcomes).



## Funding the future

Asset managers were the first movers in providing capital in areas short of funding, due to banks' regulatory and capital limitations following the Global Financial Crisis. They are becoming more involved in new – and in some instances more available – asset classes, including peer-to-peer lending, trade finance and infrastructure financing.

According to PwC's **22nd Annual Asset and Wealth Management (AWM) CEO Survey**:

**20%** is the expected cut to fees on an asset weighted basis across the mutual fund industry by 2025.

**29%** of CEOs said they expect to merge with another firm in the coming 12 months.

**41%** of firms are seeking strategic alliances or joint ventures to remain competitive.

# Readiness of Asset Manager's Risk functions

As the industry strives to navigate this evolving landscape, we believe few firms have fully considered how their Risk function will need to adapt

## The speed and scale of the industry's transformation is creating particular challenges for Risk functions:

- The risk profile of firms is changing with business model shifts creating new risks;
- Non-financial risks are becoming more prominent; and
- Regulatory scrutiny is focusing increasingly on AM firms with personal accountability rising up the regulatory agenda.

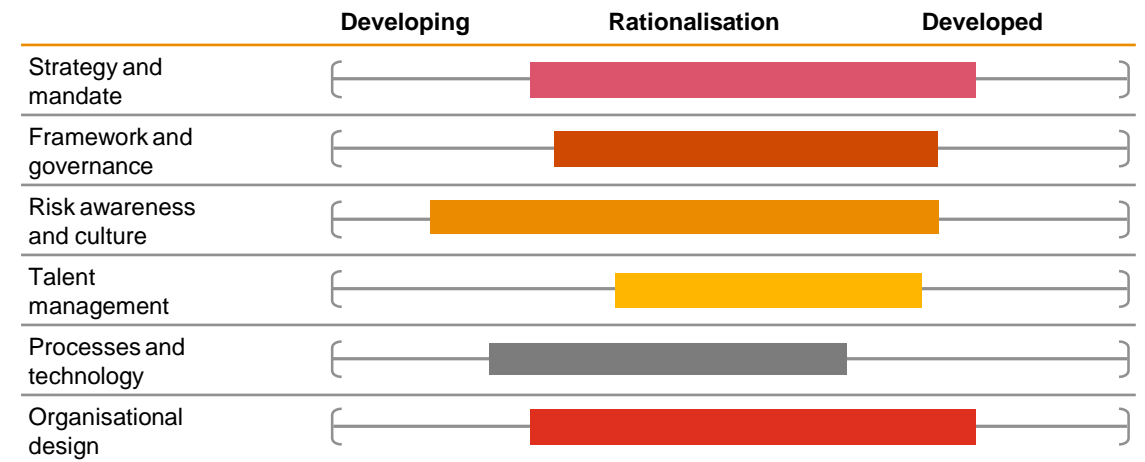
## In order to respond to these changes, the Risk function must adapt.

Our observation – based on our client discussions and data collected by surveying CROs across leading UK asset managers – is that Risk functions are currently at different levels of maturity across the six dimensions of the operating model (Figure 1).

The majority of firms are in the 'rationalisation' phase as they reassess their operating model, driven by the need to clarify their mandate, find cost saving opportunities and improve efficiency.

In the next section, we set out the results of our CRO survey in more detail to explore where Risk functions are today.

Figure 1: Firms' current state of maturity across the six operating model dimensions



### Key:

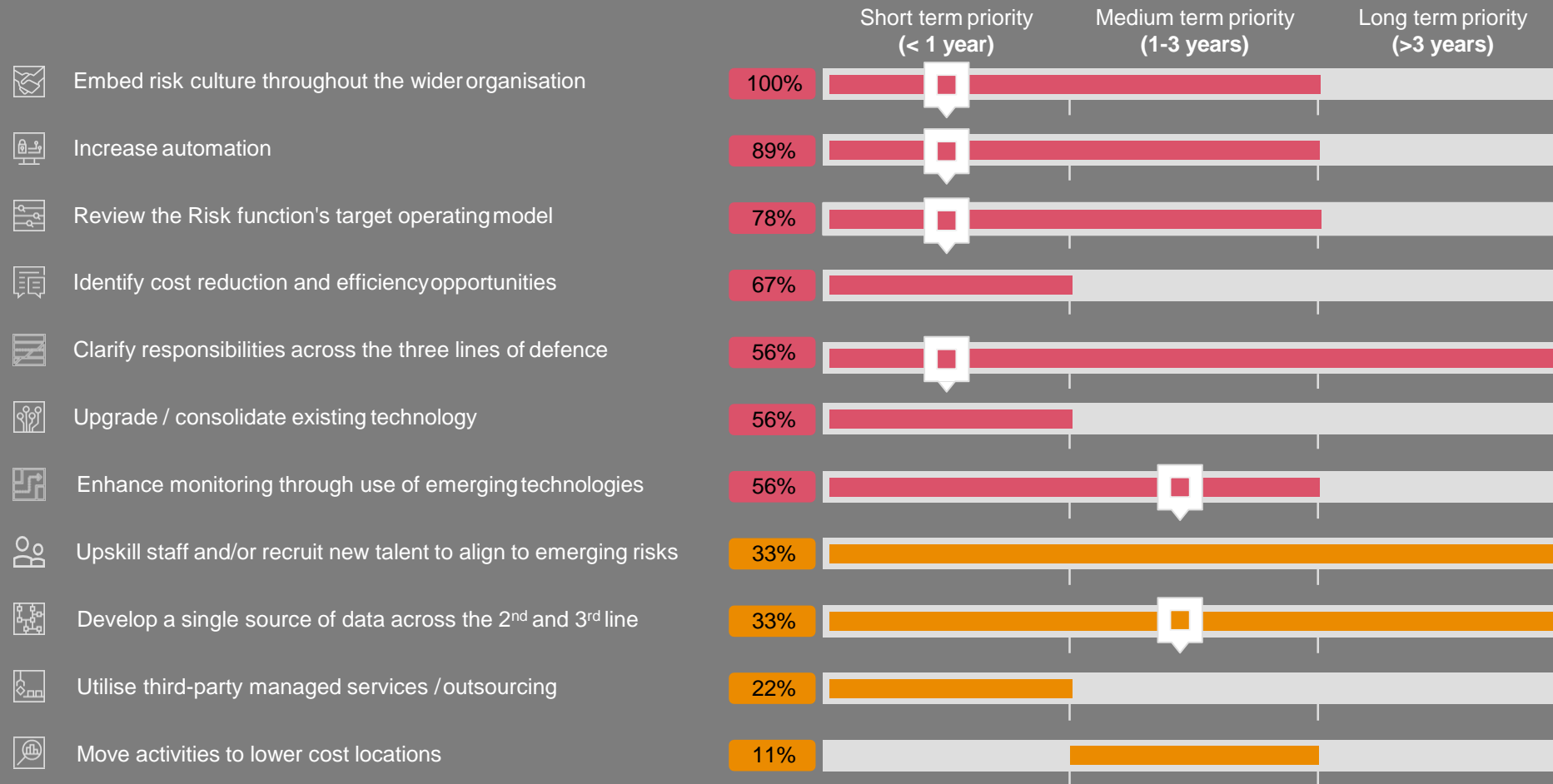
**Developing** – Current state has gaps e.g. policies on culture exist but not embedded

**Rationalisation** – Initiatives underway to upgrade or redefine what has already been developed e.g. rationalisation of the various tactical technology solutions developed over the years

**Developed** – Fully developed environment aligned to current aspiration e.g. talent gaps in data and technology now addressed

# Asset Manager's planned initiatives across Risk functions

Our survey respondents have identified and prioritized a range of initiatives that they plan to undertake over the next five years



# Future challenges for Risk functions

Risk functions will need to strike a balance between retaining independence and partnering with the business

## In our view, the Risk function of the future will:

- have a wider mandate which assists the firm to identify, manage and monitor risk from strategy through to execution
- become leaner as it embraces technology – seizing opportunities to use technology to integrate, streamline and automate processes
- embrace data analytics to help produce insights for both current and emerging risks, allowing the firm to make more informed decisions
- accelerate innovation by engaging in projects at an early stage
- attract a diverse range of skills, provide interesting and exciting roles and opportunities for career progression

## Before embarking on the transformation journey, AM firms will need to consider four key questions:

1. What is our firm's strategy - and how does the risk function help us deliver it?
2. Where is our Risk function in terms of maturity in progressing towards where we aspire to be – and what gaps do we need to bridge?
3. What levers can be pulled and what actions should we take to bridge the gap between where our Risk function is today and where we want it to be?
4. What are our priorities and what does the journey look like?

# Recent Developments

## Corporate vs. Portfolio Risk

- Model Risk
- Reference rate reform
- Sustainability

## Automation / Cost pressure

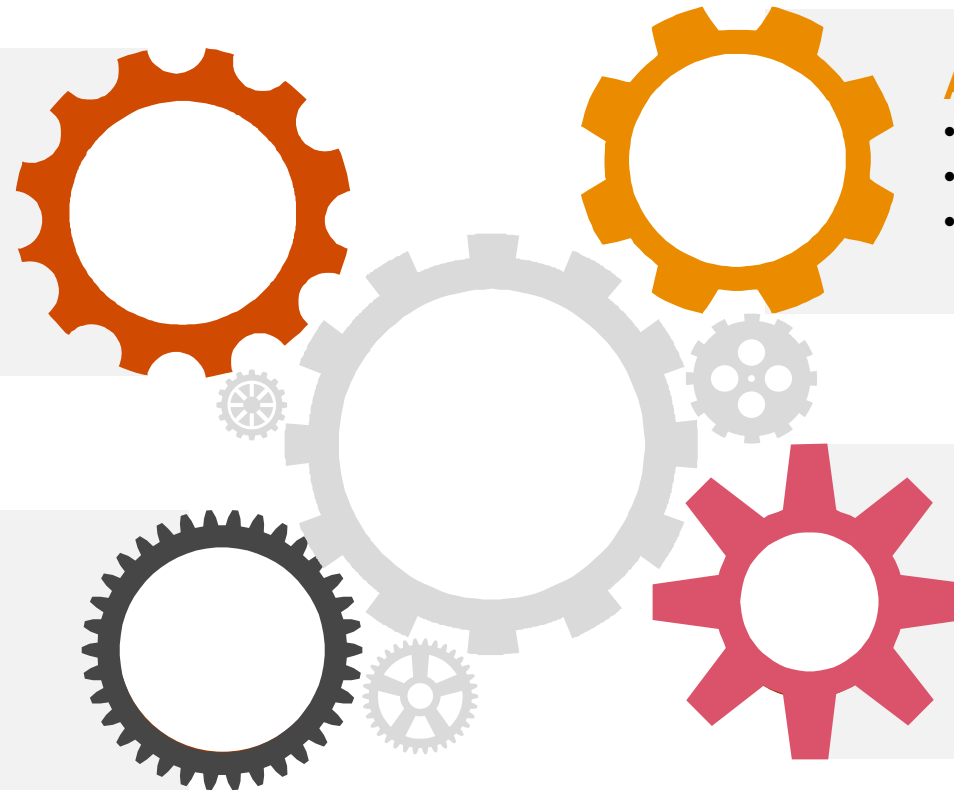
- RPA for report generation
- Digitization
- Data Quality

## Sustainability

- ESG factors in risk management
- Climate scenario analysis

## Liquidity Management

- availability of new tools for steering redemptions (e.g. swing pricing)
- ESMA's Liquidity stress test



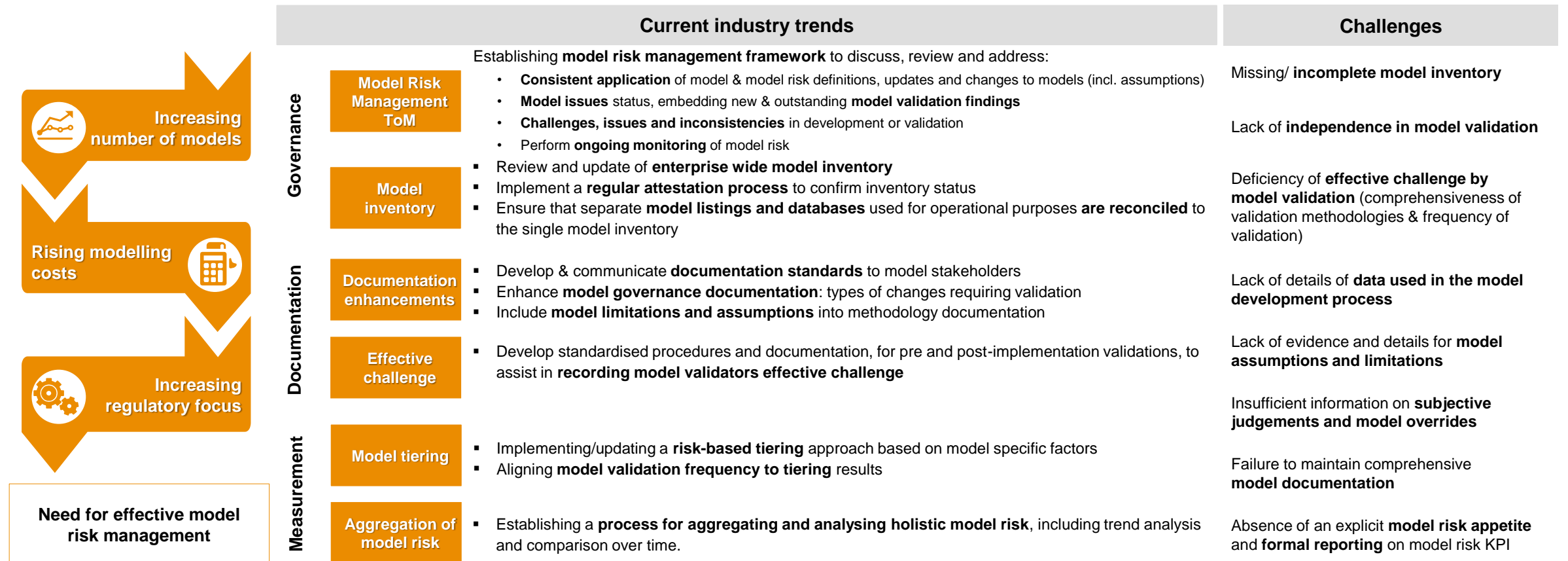


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Model  
Risk  
Management

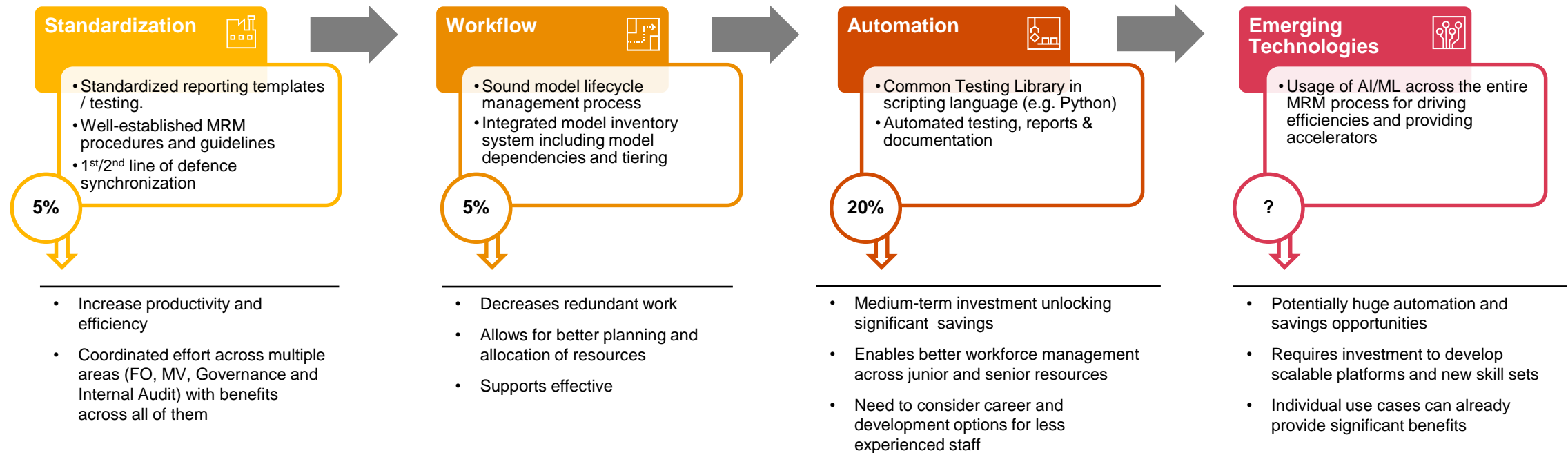
# Current market developments

Challenges, trends and regulatory concerns with respect to model risk management are rapidly emerging



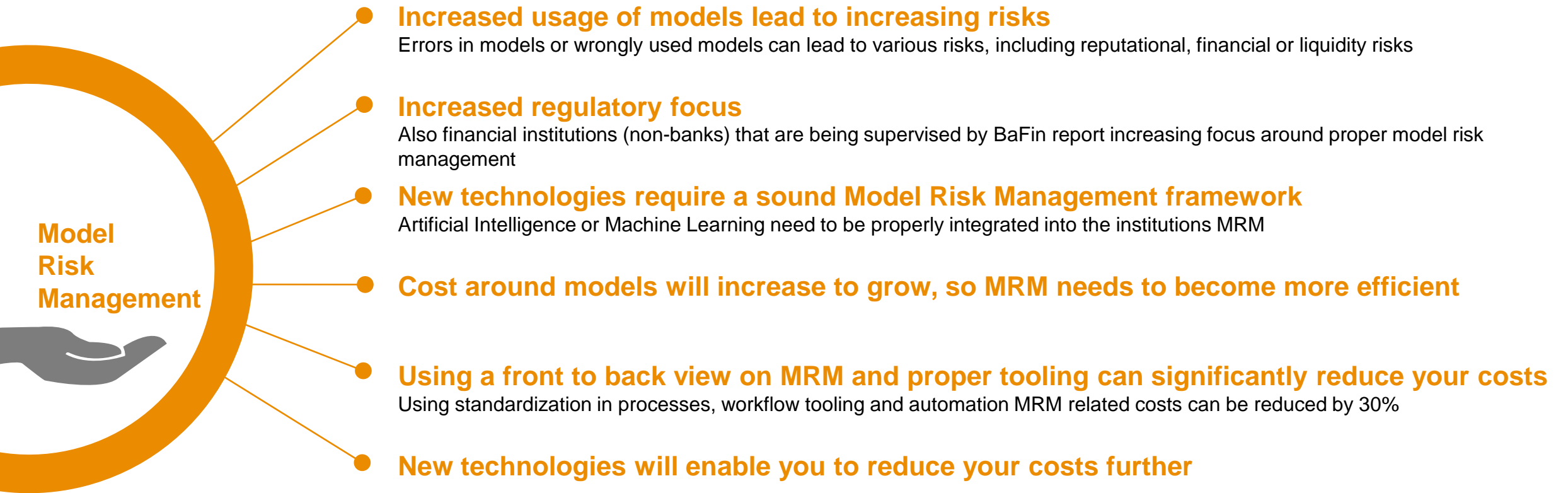
# Driving Model Risk Management Efficiencies

Up to 30% reduction in operational costs (mid-term)



- Rethinking the model lifecycle management can unlock and even amplify these benefits across the end-to-end processes
- Complementary to cost savings, these investments will further lead to significant enhancements in model performance and the controls environment

# Key Takeaways



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Liquidity  
Stress  
Testing

“

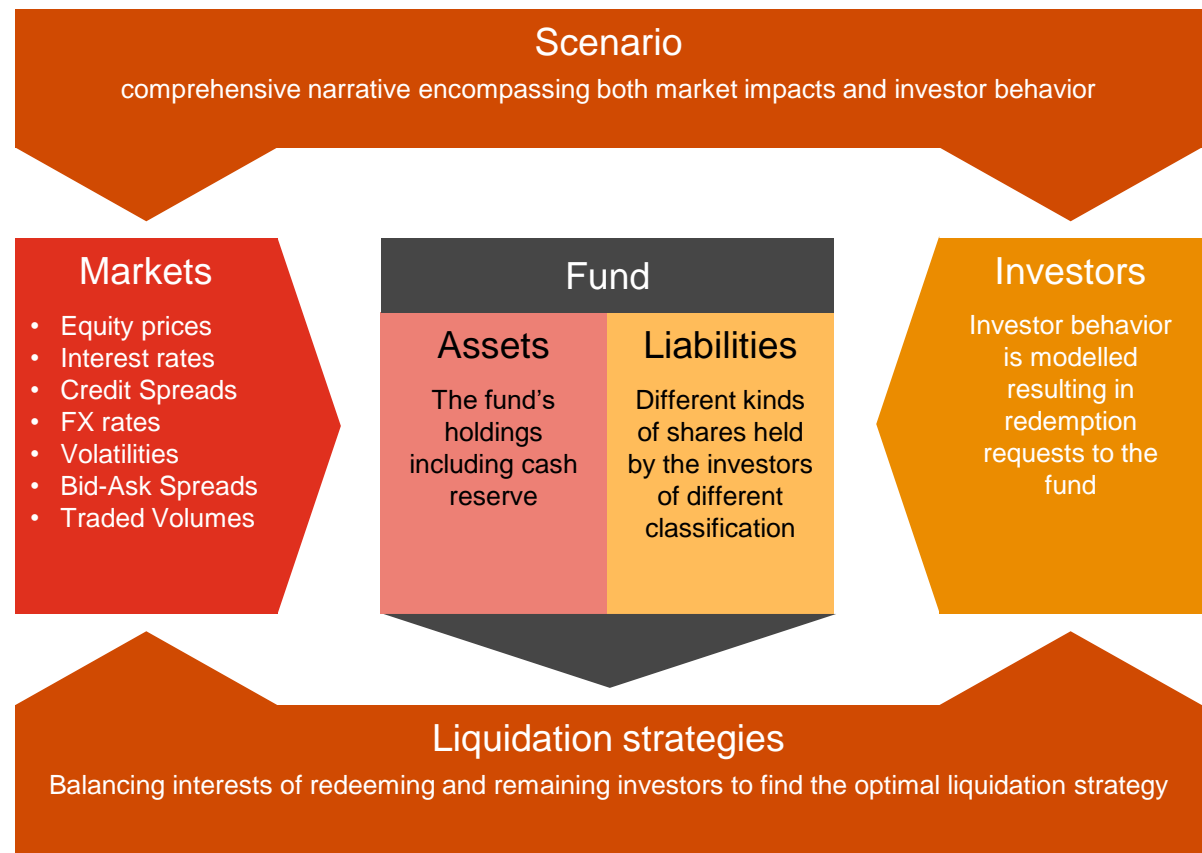
... Corona hat die Aufseher aufgeschreckt und ihnen lange Versäumtes in Erinnerung gerufen: Die Liquiditätssteuerung von Fonds ist nicht überall krisenfest.

**Börsen-Zeitung**, 16.5.2020



# Schematic overview of the liquidity stress testing mechanism

Starting from a stress scenario, suitable liquidation strategies balance the interests of redeeming and remaining investors



## Development of appropriate scenarios

- Development of a comprehensive liquidity stress testing framework
- Scenario: comprehensive narrative encompassing both market impacts and investor behavior
- Translation of the narratives (story lines) of macroeconomic stress scenarios into changes in relevant risk parameters

## Simulation of asset liquidity

- Simulation of asset liquidity under normal and stressed conditions
- In addition to common risk factors, such as the price and volatilities of equities, interest rates, credit spreads and FX rates, liquidation cost and time needed to liquidate securities are to be considered
- Assessment of liquidation cost and time should be determined by asset type, liquidation horizon and the size of the trade

## Simulation of investor behavior

- Redemption requests by clients are typically the most common and important source of liquidity risk
- Investor behavior differs across investor types, investor concentration, investor location and investor strategy

## Liquidation strategies and KPIs

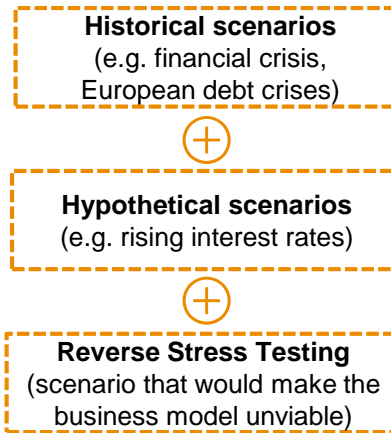
- Choose the appropriate asset liquidation strategy for each fund
- Combine the outcomes of assets and liabilities liquidity stress, take into account common metrics to estimate the overall impact on fund liquidity

# Overall Framework – ESMA LST

## Complexity within the components of the LST framework

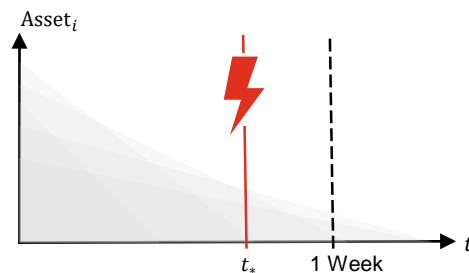
### Scenarios

- Integration in risk management framework and consistency among funds
- Determining LST processes and LST policies, which should be in line with the contingency planning and interact with the portfolio management function
- Separate functions, ensure independence, and manage conflicts of interest



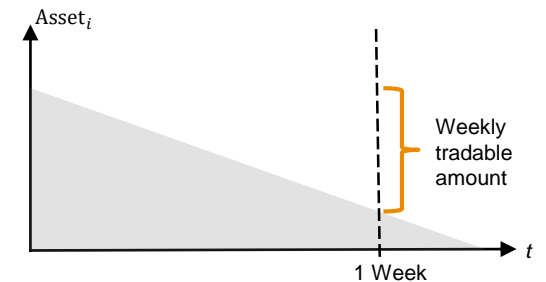
### Liquidation Strategies

- Finding a suitable liquidation strategy for every fund in each relevant scenario (e.g. waterfall vs. slicing approach)
- Ensuring compliance with both the fund's investment policies and regulatory requirements
- Exploring different liquidation pathways in order to find the optimal liquidation strategy in each scenario



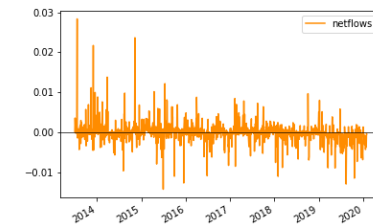
### Assets

- Classification of assets in liquidity buckets (e.g. HQLA, according to Basel III)
- Gathering market data such as traded volumes, bid-ask spreads, order-book information, etc.
- Finding a common model for deriving time to liquidation and liquidation costs for each asset

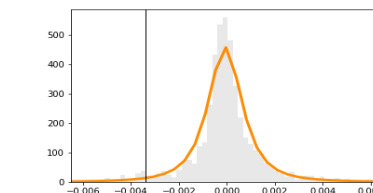


### Liabilities

- Model the investors' redemption behavior in each scenario
- Estimation of elasticities using expert elicitation frameworks
- Modelling redemptions using both historically high levels of redemptions and hypothetical levels from appropriate model distributions



Using shocks from specific historical events



Calibration of net flow distribution using an appropriate model distribution



# Key Takeaways



## Liquidity Stress Testing

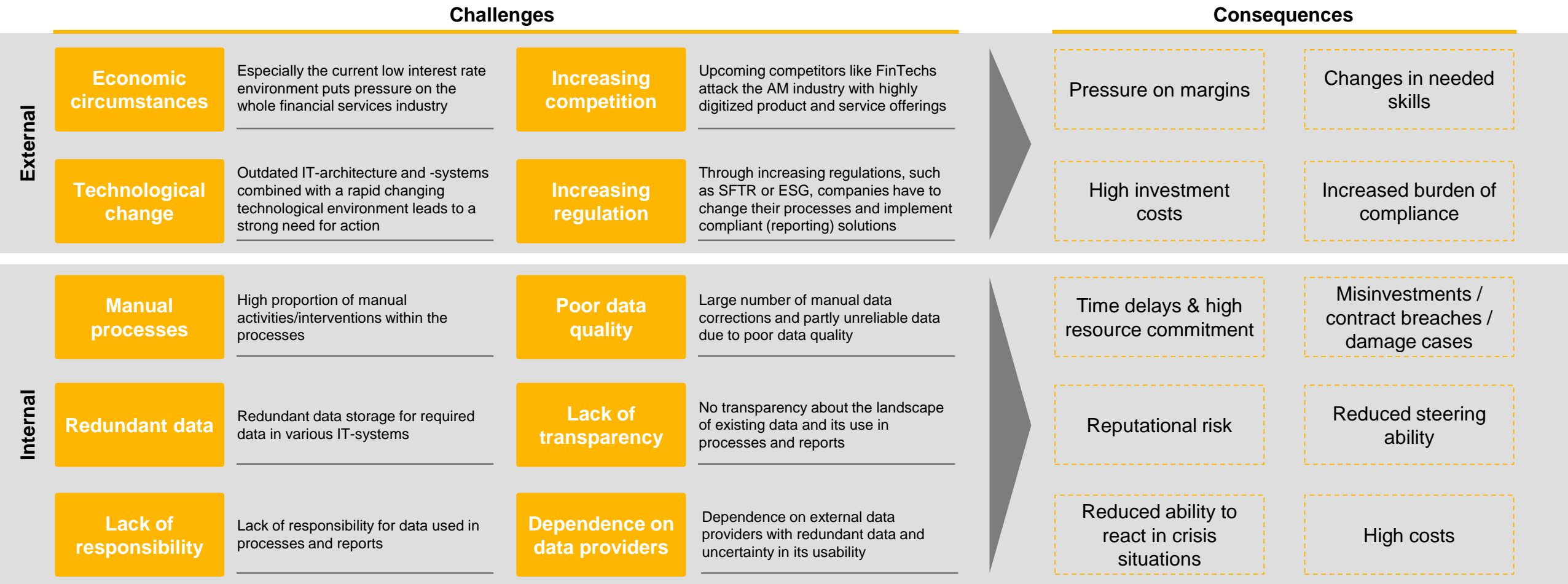
- **Recent high outflows have revealed the importance of effectively managing liquidity risks**  
The more transparent potential liquidity risks are within your funds, the easier you will make it through crisis.
- **There are tools to steer redemptions in exceptional market conditions**  
Redemption gates and swing pricing may now be applied to funds domiciled in Germany.
- **LST is to be integrated in your risk management framework (ESMA)**  
There is the regulatory requirement to conduct liquidity stress testing combining effects on assets and liabilities.
- **Results of LST can be used to calibrate your liquidity measures**  
Liquidity stress test results are not just for the regulator. They help detect vulnerabilities and apply reasonable measures.
- **As always, the devil is in the details!**  
Developing reasonable models for the stress effects on funds' liabilities is not an easy task. Neither is the simulation of suitable liquidation strategies for your funds.
- **We are happy to discuss the status quo and the target picture for the management of your liquidity risks.**

4

Data  
Management

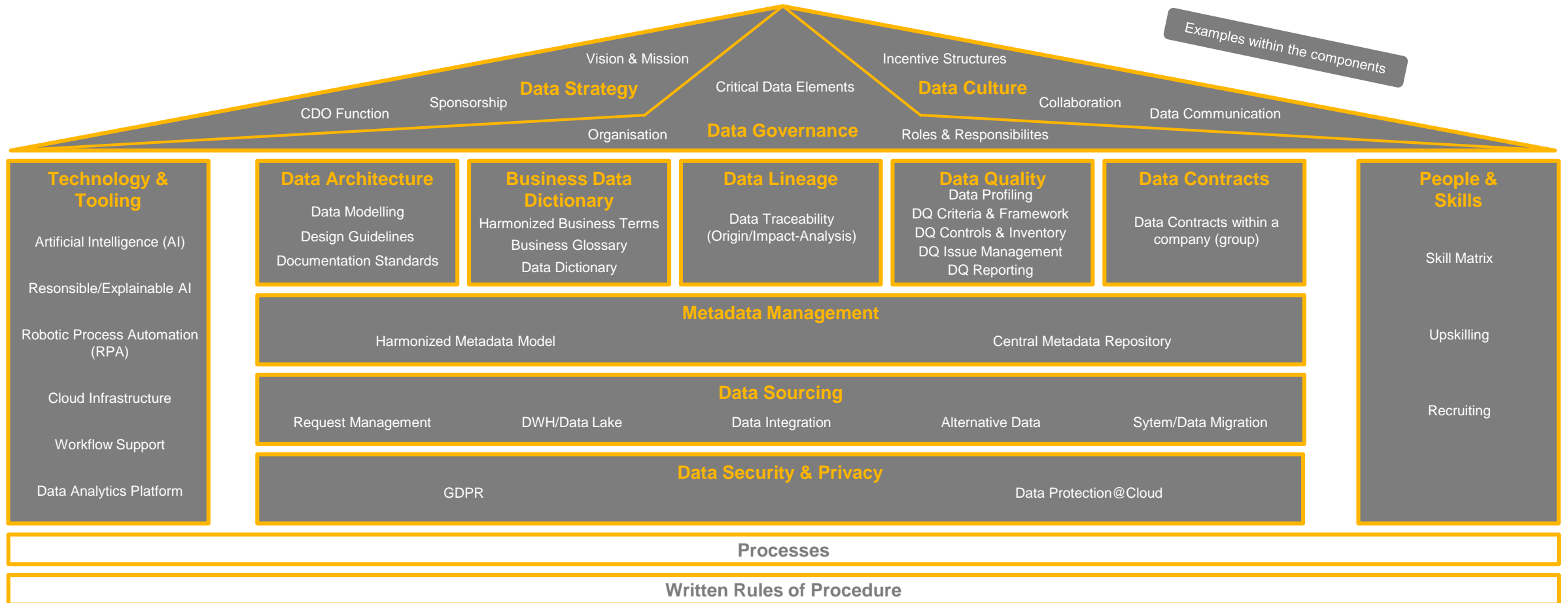
# Challenges in the Asset Management industry

The AM industry faces multiple challenges, which to an large extent are technology and data related

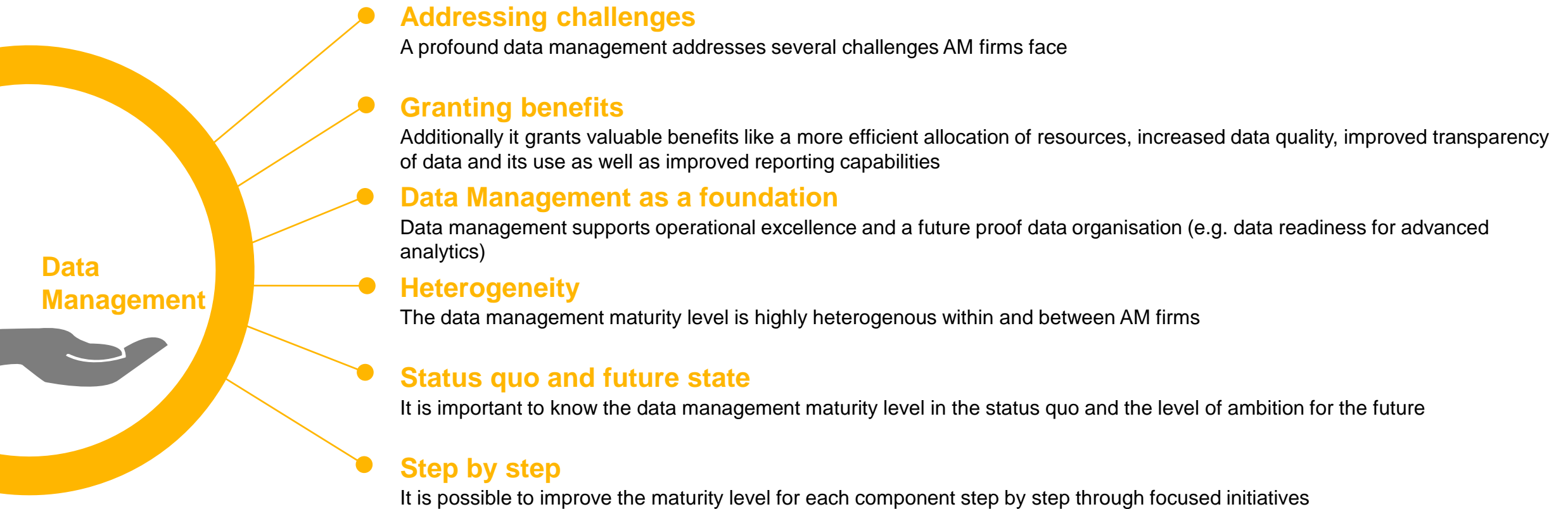


# Data Excellence Capabilities

A profound data management supports mastering several of the present challenges and additionally grants valuable benefits



# Key Takeaways

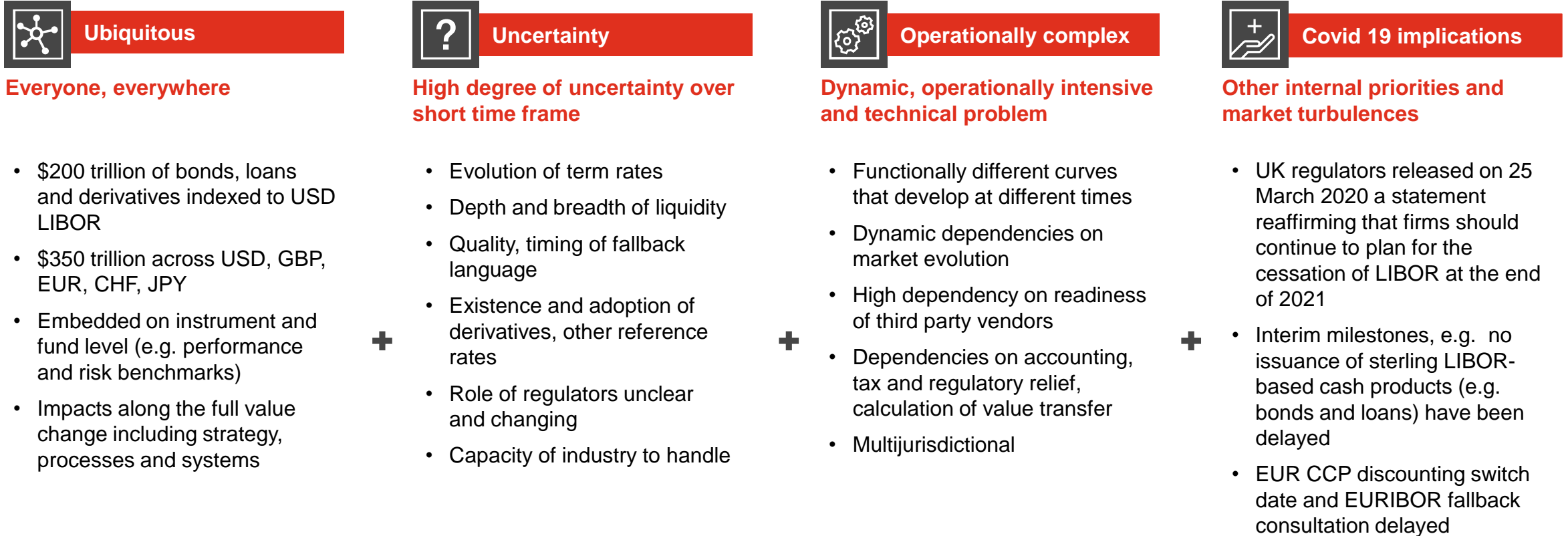


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IBOR Transition

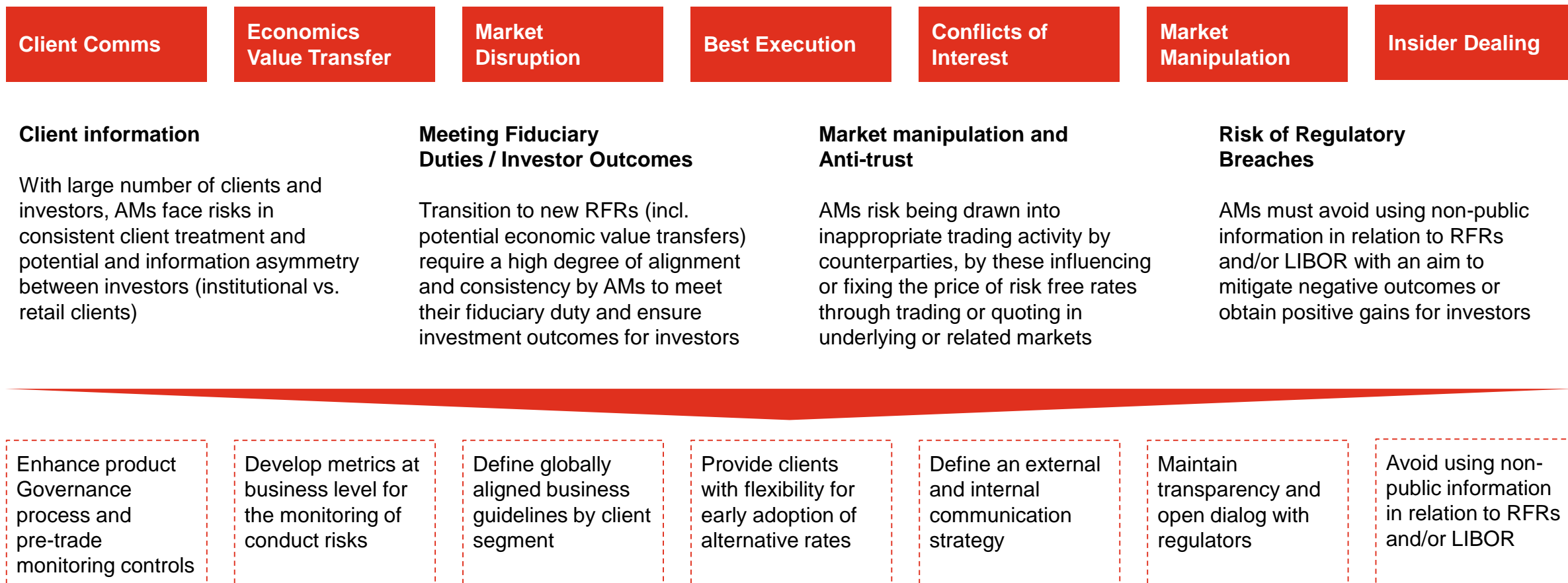
# What makes the transition away from IBOR so hard?

Majority of asset managers have now mobilised and are about to complete impact assessments and start the implementation



# Why is conduct risk relevant to your IBOR transition project?

A recent PwC survey across UK asset managers showed that 86% of respondents have embedded conduct risk within their IBOR transition project





# Key Takeaways



## IBOR Transition

- **UK regulators stand firm on cessation timeline** with some interim milestones being delayed due to Covid-19, the FCA reiterated previous statements on LIBORs likely cessation by the end of 2021
- **New RFRs are published and liquidity is building up**  
The trading in RFR linked products is on the way of building up liquidity with SONIA volumes being the most advanced followed by SOFR; €STR trading as just began
- **Regulators push for adoption of new RFRs**  
WGs and regulators push for the adoption of new RFRs through increasing haircuts and communicating interim milestones for changing market conventions (e.g. loans, cash products)
- **Ongoing uncertainty and transition challenges persist**  
Discussion around term rates (forward vs. backward looking) and fallback language together with the operational readiness of vendor systems impose challenges for asset managers
- **IBOR transition in the focus of regulators**  
Communication with regulators with regards to IBOR transition including conduct risk has increased in frequency as the 2021 deadline approaches

Wir verabschieden uns und hoffen, Sie werden auch bei den nächsten Webcasts dabei sein! Bei Fragen oder Anmerkungen sprechen Sie uns bitte jederzeit an.

Vielen Dank für Ihre Aufmerksamkeit!



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