Emerging template for risk management

By **Samuel Won**, founder/managing director, **Global Risk Management Advisors**

In my previous article, "Why risk management now", I discussed why institutional investors have begun to take a more formal approach to the risk management of their investment portfolios. I noted that the major drivers of this trend for endowments, foundations, pensions and family offices include concern about fiduciary risk, adoption of best practices of leading institutional investors, and recognition that their investment consultant and/or asset managers cannot play this role because of a conflict of interest.

In this second installment of my two-part series, I will outline and share the template that many leading institutional investors are using to establish a framework for more formal risk management.

Samuel K. Won is the founder and managing director of Global Risk Management Advisors, Inc. (www.grmainc.com), an independent risk management advisory firm that provides institutional-quality risk management advisory and implementation services to asset managers and institutional investors.

RISK MANAGEMENT FRAMEWORK: "FOUR ESSENTIAL PILLARS"

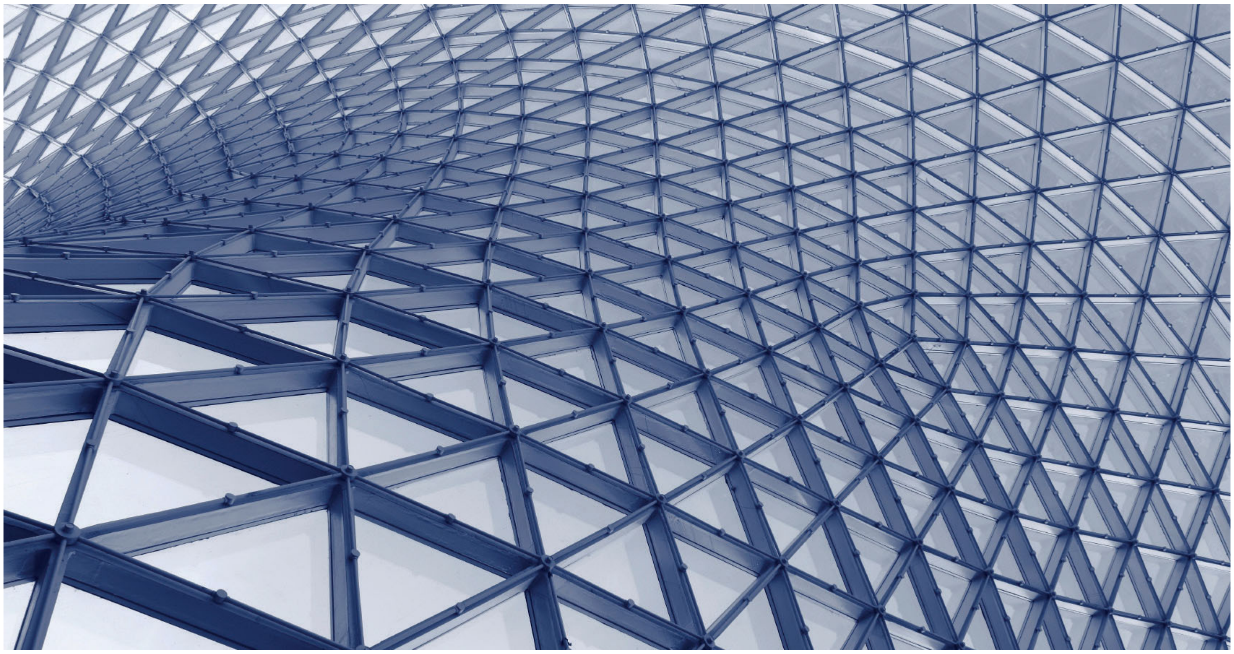
There are four primary pillars that comprise the risk management framework:

1. **Risk management infrastructure:** Many institutions have begun to consider selecting a risk measurement system so that they can quantify and monitor their investment risks, such as liquidity and concentration risks, and perform risk-based analyses such as value-at-risk ("VaR") and stress testing. However, even those that have some capabilities to measure market risk in their liquid portfolio (e.g., long-only equities, fixed income and hedge fund investments) struggle with how they should measure, evaluate and aggregate their overall investment risks including illiquid investments such as private equity and real estate.
2. **Risk management processes and controls:** Institutions have begun to realize that they should have more formal processes and controls for risk management. One such process is incorporating risk parameters for investing so that they can take more of a risk-based approach to managing market risk and allocating assets. In addition, institutions are looking to set risk management limits and/or triggers for and other benchmarks for monitoring and managing their investment risks (e.g. drawdown limits, liquidity constraints).
3. **Risk management governance:** Institutions are looking to improve their governance for risk management by enhancing their investment policy statement, which for most institutions is currently devoid of any tangible references to risk management. Many institutions that are putting in place a risk management program are including in their investment policy statement a detailed description of how they are measuring and monitoring their investment risks, what their parameters for risk management are, and the role of the staff, investment committee and/or board in the risk management governance process.
4. **Risk management education and training:** Institutions that are taking a more formal approach to risk management have shown strong interest in educating and training their staff, investment committee and board on matters related to risk management. These institutions are now becoming aware that without risk management training they are challenged to make intelligent risk management decisions, given the ever-growing complexity of their investment portfolios and increasing allocations to complex investments such as alternative investments.

SOUND RISK MANAGEMENT: WHAT IS THE STARTING POINT?

Even institutions that understand they must have a framework that includes the aforementioned "four pillars" often do not know where to begin. An institution that wishes to have sound and sustainable risk management program must start by putting into place the elements that comprise the governance and strategy. Specifically, the starting point elements that are requisite to building the risk framework are as follows:

- **Risk-based investment policy statement:** An institution should have an investment policy statement that speaks to the risk management governance, processes and controls by which the institution operates for measuring, monitoring and managing its investment risks.
- **Risk parameters:** An institution should have in place parameters for measuring and monitoring its investment risks (e.g., drawdown limits,



EVEN INSTITUTIONS THAT UNDERSTAND THEY MUST HAVE A FRAMEWORK THAT INCLUDES THE AFOREMENTIONED "FOUR PILLARS" OFTEN DO NOT KNOW WHERE TO BEGIN

volatility targets and risk-based limits for monitoring and assessing market and credit risks). Without these parameters, an institution has no basis by which it can monitor and manage its investment risks. Risk parameters are critical for an institution to do risk-based asset allocation and any kind of tactical or risk overlay strategy because without these risk parameters in place an institution has no ability to determine whether the risks associated with an investment's expected potential returns exceeds their appetite or budget for risk.

- **Risk defeasance plan:** It is remarkable how few institutions still have no clear plan for risk defeasance in the event of a market crisis that would have adverse impact on their investment portfolio. No institution can legitimately claim to be doing risk management unless they have a clear plan for risk defeasance when the next major financial crisis or market dislocation occurs. For example, this plan should include a clear roadmap of how the institution will obtain liquidity during the crisis that takes into account any liquidity restrictions the institution may have with the funds in which it is invested.

WHY RISK MEASUREMENT ALONE IS NOT SUFFICIENT

Although some leading institutions are attempting to put into place the "four pillars" in order to have a complete and sound framework, many more institutions are mistakenly under the impression that just implementing better risk measurement for their investment portfolio constitutes adequate risk management. This approach puts the proverbial "cart before the horse" by allocating time and monies on selection and/or implementation of risk analytics before putting in place a sound framework for risk management. In other words, an institution should not begin to implement and utilize a risk analytic system before they have a framework for risk management that includes strategy, governance plan, process and controls and education/training for staff, investment committee and the board.

It is very clear that there is still a dangerous lack of understanding about what institutions should be doing for sound management. At best, most experienced investment professionals and major institutions still have only a limited understanding of how to apply and integrate it into their investment process. In the next few years, we expect to see much more widespread adoption of this template, making the "four pillars" the universal and requisite standard for risk management for institutional investors. ■