THE

# Frontier Line

**Thought leadership and insights from Frontier Advisors**

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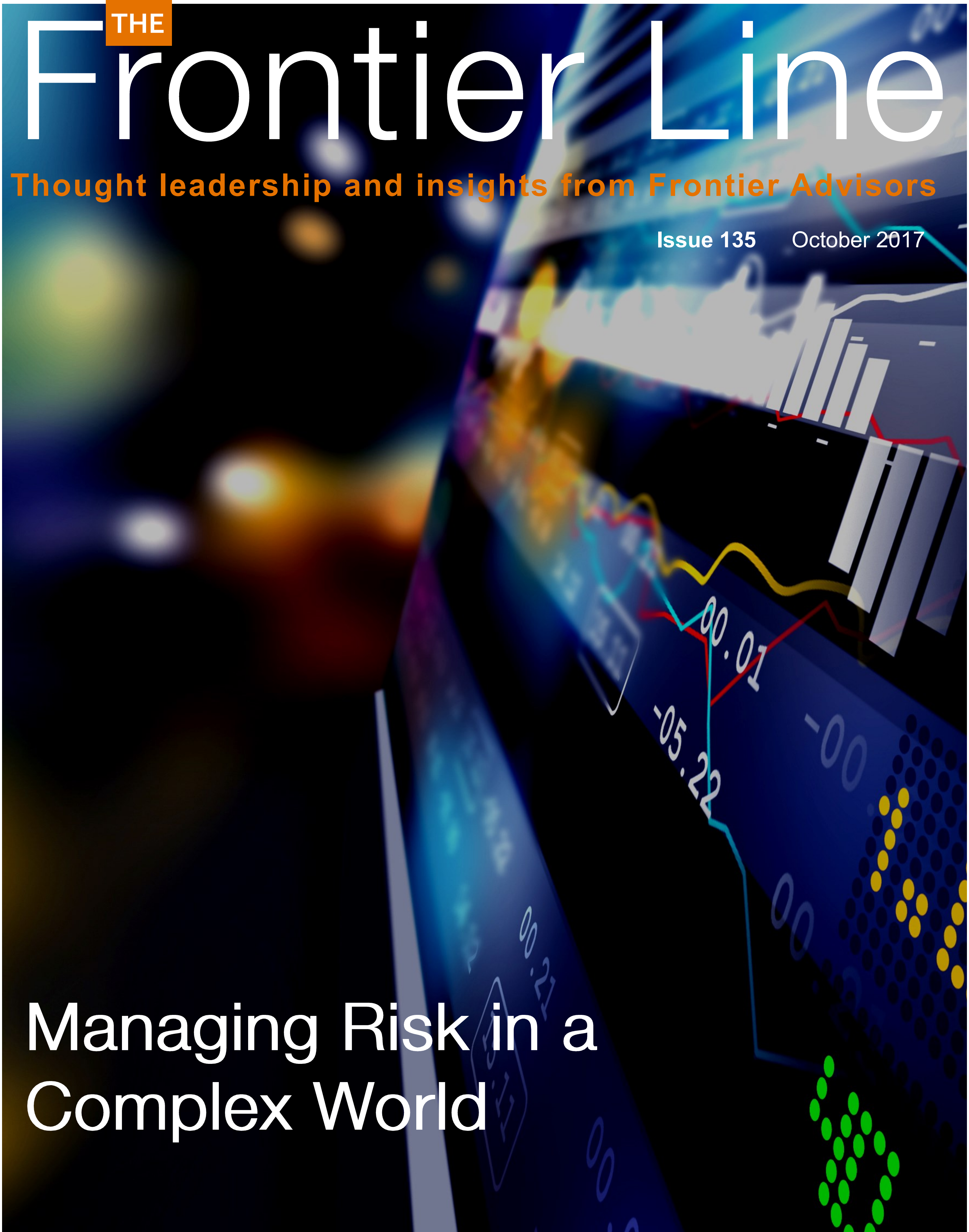

# Managing Risk in a Complex World

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# Frontier Advisors

*Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $260B in assets across the superannuation, charity, public sector and higher education sectors.*

*Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.*


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# Managing risk in a complex world

*As institutional businesses continue to grow at a rapid pace in size and complexity of investment portfolios, it is important that internal processes and policies maintain the same pace. Risk management is an important element of portfolio monitoring and management for all institutional investors. It should be a flexible, dynamic and tailored process, constantly adapted to support the evolution of the investment portfolio, and operating environment.*

The Board is ultimately responsible for having a risk management framework that is appropriate to the size, business mix and complexity of the business. The risk management strategy should therefore be Board approved, however the responsibility for regular monitoring may be delegated to the Board Risk Committee or the Investment Committee, for example, provided necessary authority and reporting structure to the Board is in place.

Well-designed and informative portfolio monitoring and management tools can be a valuable way of helping busy Directors and Executives monitor current and emerging risks and risk trends.

The ability to present key information accurately, concisely, and in a timely manner is something that we prioritise in our analytics and we recommend that risk management tools focus on the key financial and non-financial metrics, derived from the Fund's strategic and business plans, to maintain appropriate focus. This will enable them to be used in a fit-for-purpose manner, with the appropriate emphasis on supporting the achievement of business and strategic plans.

In recent Frontier Lines, on the topic of risk management, we introduced our Enterprise Risk Management Framework[1] as a way to think about risk in a holistic and structured way. In this article, we consider how institutions can design and implement risk management strategies to cover all aspects of risk, from operational governance to specific investment and market risks.

1. Frontier Line edition 112 Enterprise Risk Management Platform for AA Owners Part 1; Frontline edition 113 Enterprise Risk Management Platform for AA Owners Part 2; Frontline edition 127 Enterprise Risk Management Platform for AA owners Part 3

# Risk management for APRA-regulated superannuation funds and non-APRA-regulated investors

*APRA-regulated superannuation funds have a number of specific requirements when it comes to risk management, and a number of these are good practice for non-APRA-regulated investors to consider as well. A key area of concern for APRA is the gap that currently exists in the superannuation prudential framework in relation to core operational governance aspects. Lifting operational governance practices can enhance risk management strategies.*

Suggested methods to improve operational governance include the following;

- Strategic and business planning processes with appropriately constructed indicators or key performance metrics;
  - Do the indicators reflect what is trying to be achieved?
  - Is the business strategy appropriate relative to the membership base and/or stakeholders?
- Business initiatives that clearly link the delivery of quality, value for money outcomes for beneficiaries over the long term;
  - Assessment of beneficiary outcomes is a fundamental input.
- Rigour in operational decision-making, monitoring and transparency of fund expenditure, setting of fees and costs and the use of reserves;
  - This is particularly important in relation to the use of members' money.
- Policies and procedures to establish, implement, monitor and review the business plan and achievement of strategic objectives.

A strong risk management framework will identify a number of key risk indicators and key performance indicators based on the context of the individual Fund's circumstances and its strategic and business objectives.

# Focusing on what is most important

*An investor's risk management framework, including its unique strategic and business objectives, can be used to develop tailored risk and/or performance indicators.*

For superannuation funds looking more specifically at investment and market risk, a further important consideration is whether the chosen risk and/or performance indicators will be assessed at the total Fund level and/or the individual Option level. From APRA's perspective, key metrics should relate to quality member outcomes and future sustainability of the Fund with a view to being able to identify areas of focus for remediation or improvement. We believe that this approach has merit for non-APRA regulated investors, as it is equally important to consider key metrics based on quality outcomes for stakeholders/beneficiaries.

Importantly, risk and/or performance indicators should remain flexible and dynamic, depending on changes to the investor's circumstances and/or the market in it operates in. Key indicators can change from time to time, therefore risk monitoring and management also needs to have a flexible approach.

A register of material risks can be a useful monitoring and management tool and will typically include the following information.

- What is the Board's risk appetite (this may differ depending on the risk category)?
- What level of risk is the investor willing to accept in pursuit of achieving its strategic objectives (this should clearly link to the strategic and business plans)?
- What risks do you want to monitor?
- What is the basis of measurement for the risk (and, for superannuation funds, is this assessed at the Fund level and/or the individual Option level)?
- What are the key indicators at different levels (typically there are different indicators for different levels i.e. acceptable, warning and unacceptable)?
  - As part of this process, there should be an action plan for each "level" of risk. For example, an "acceptable" level is tabled for noting at the Investment Committee, a "warning" level would require a brief report and discussion at the Investment Committee with any further actions to be determined by the Investment Committee, and an "unacceptable" level would constitute an immediate escalation to the Board.
- What is the likelihood of the risk event occurring and what are the estimated consequences of a breach in the risk tolerance level?

On the following page, we provide an example of what we think is a useful template to document and manage an investor's risk management framework. This supports the development of a risk management framework that is robust, tailored, flexible, understandable and easy to prepare. The clearer and more succinct the risk information, the easier risk assessment and monitoring will be for the Board.

## Risk management framework template

| Material Risk Category | Risk Appetite Statement | Board's Risk Appetite | Key Risk Indicators | Basis of Measure | Key Risk Indicators | | | Likelihood of event and estimated consequence of a breach of risk tolerance |
|---|---|---|---|---|---|---|---|---|
| | | | | | Acceptable | Warning | Unacceptable (Action Required) | |
| Type of Material Risk | Consider the boundaries and expectations for how much risk the investor is willing to accept in pursuit of its strategic objectives<br><br>Include a link to the investor's Strategy | e.g. None/ Low/ Medium/ High | What risk do you want to monitor? | Risk measures should be expressed as a measurable limit where possible, not-withstanding that for some risks measures a more quali-tative measure might be appropriate<br><br>**NB:** For superannuation funds, this could be assessed at the fund level, the MySuper/default Option level and/or the individual Option level as deemed appropriate | Target level of acceptable risk | +/- x % of the acceptable level | A "material" deviation from acceptable level | Consequence may be financial and/or non-financial |

# Using the right tools for the job

A holistic, structured and forward-looking risk management framework is an important element of portfolio monitoring and management. A well-developed plan allows key decision makers to monitor key performance and risk indicators, to identify risks as they emerge and to manage them appropriately. We would argue that such a framework is now a “must have” in order to successfully face an increasingly complex and dynamic investment, regulatory and competitive landscape, and this is reflected in the legislation that affects many of our clients.

A risk management framework should include an array of different tools, tailored to satisfy individual requirements. In response to the rapid growth in the size and complexity of investment portfolios, Frontier’s Quantitative Solutions Group has designed a number of bespoke Risk Dashboards that enable key decision makers to focus on the most relevant financial and non-financial metrics based on the Fund’s objectives, and it’s business and strategic plans. Please let your consultant know if you are interested in finding out more.

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**About Frontier Advisors:** Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.