

Why Should Hedge Funds Care about Operational Risk?

A Summary of the Panel Discussion Sponsored by the IAFE Operational Risk held on September 20, 2006

Panelists:

Jill Eicher, Managing Director, Adaptive Alpha
Marina Lewin, Managing Director, Bank of New York
Reiko Nahum, Founder and CEO, Amber Partners
Said Rafat, Managing Director, Fitch Ratings

Moderator:

Charles Fishkin, Director, Office of Risk Assessment, US Securities and Exchange Commission

On September 20, 2006, the IAFE's Operational Risk Committee (ORC) sponsored a panel discussion in New York City entitled, "Why Should Hedge Funds Care about Operational Risk?" This event, which was attended by nearly 300 people, had the largest audience of any event thus far organized by the IAFE's Operational Risk Committee. It was kicked off with an introduction by David Jaffe, Executive Director of the IAFE, who reminded the audience that each of the participants were speaking in their own personal capacities and any views expressed during the session were not necessarily the views of their respective organizations.

The session focused on whether the concept of managing operational risk, in its broadest sense, has value for the hedge fund sector. The panelists represented a diverse cross-section of the industry, including a hedge fund administrator, a credit ratings analyst, and the founders of a hedge fund valuation firm and an analytics company. The session was moderated by Charles Fishkin, the head of the SEC's Office of Risk Assessment. PricewaterhouseCoopers provided the forum for the event and Algorithmics sponsored the post-event reception.

The panel began with a discussion of the "state of play" regarding the overall awareness of operational risk among the hedge fund community and the discipline's level of maturity within the sector. The panelists reached a consensus that the level of awareness has increased due to the institutionalization of the hedge fund investor base, the involvement of global regulators, and the dramatic growth in the industry both in terms of size and complexity. The panel discussed the differing states of maturity within the sector, which includes large fund managers with rich resources to spend on risk management and a universe of much smaller funds.

The panel discussed recent announcements on the part of ratings agencies to offer hedge fund ratings (either on a fund or manager level) and the entrance of new companies into the market offering certification services. There was a discussion of both the pass/fail certification approach and the multi-tier credit agency ratings process. The merits and drawbacks of both methodologies were debated by the panelists.

The discussion turned to the consideration of whether standards exist within the industry in order to conduct consistent analysis of hedge funds and if the discipline of operational risk comprises art or science, or a combination of the two. There was further discussion on whether the work on operational risk undertaken in the banking community and driven by Basel II capital directives is relevant for the hedge fund sector. Opinions on the panel ranged from skepticism of the applicability of Basel II best practices in the hedge fund sector to a suggestion that the sector can gain knowledge from the banking community's approach.

The panel concluded with a discussion of the key operational risks impacting the hedge fund sector and reached an agreement that market volatility, growth, and dynamism create challenges for the identification and management of operational risk.

The following four key risks were identified by the panelists:

- The importance of sound valuations, including independent valuations of portfolios. Valuation risk includes both intentional pricing misstatements to investors and errors and omissions associated with problematical inputs, calculations and inputs.
- Hedge fund fraud, which includes mismanagement, embezzlement and Ponzi schemes, continues to be among the greatest concerns for investors.
- Challenges associated with securing robust and good quality data for the purpose of decision making and risk assessment and management.
- Continuity of operations, both in terms of succession planning and key man risk, and traditional business continuity programs.

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About the IAFE Operational Risk Committee

Of all the different forms of risk which can affect firms, Operational Risk can be among the most devastating and among the most difficult to anticipate. Operational Risk continues to receive heightened attention among regulators and market participants, further prompting dialogue and debate on the best ways to identify, measure and manage this important risk. In response to these developments, the IAFE Operational Risk Committee was formed in 2000. Its mission is to promote dialogue among members and the broader risk management community to further understanding, share best practices and promote industry standards regarding Operational Risk. The committee’s mandate is to explore Operational Risk in its broadest sense. Examples of potential topics which may be considered by the committee for initiatives include definitional issues, best practices, quantification, indicators, data issues, governance, culture, technology approaches, and the effectiveness of existing controls and the interrelationship of Operational Risk to other forms of risk. The activities of the committee are multi-faceted and are shaped by the interests and energies of its members as guided by its Steering Committee. Specific initiatives include but are not limited to panel discussions, seminars, workshops, white papers, surveys, elearning initiatives and research projects.

Although the proper definition of Operational Risk has often been the subject of past heated debate, there is generally agreement among risk professionals that the definition should, at a

minimum, include breakdowns or failures relating to people, internal processes, technology or the consequences of external events. Operational Risk is a broader concept than "operations" or back office risk. It encompasses risk inherent in business activities across the entire firm and, consequently, its losses have the potential to be of much greater magnitude.

The committee includes individuals with a range of backgrounds, including dealers, endusers, industry advisors, operational risk specialists, technologists, regulators, scholars and others. Individuals serve on this committee in their individual capacities as opposed to representatives of their respective employers or organizational affiliations. Participation and sponsorship of organizations in committee events and activities is open for consideration. Individuals who are interested in becoming part of the Operational Risk Committee or would like to stay informed about their upcoming events should contact the IAFE at (212) 317-7479 or main@iafe.org. For more information please visit: www.iafe.org/?id=operationalriskcommittee