JUNE 2021

Operational Diligence: Due for a Change?

Too expensive, too subjective, and often not risk-based: That's ODD

The world has changed since dedicated operational due diligence ("ODD") has become commonplace for institutional investors...Has the discipline kept pace?

Dedicated operational due diligence processes have largely evolved only in the last 15 years or so, catapulted from best practice to market practice by the case-study fraud and blow-up catastrophes that followed the 2007 – 2008 financial crisis. Like most control functions (compliance, audit, etc.), improving efficiency is not a core objective of ODD; by its nature it is designed to help pause, to consider, to, well... help control. Operational risks, in this case.

Unlike compliance and audit functions, however, ODD has evolved organically among its practitioners: There is no regulator, no American Institute of CPAs (AICPA) or global equivalent, no real governing group to develop and oversee standards. To some extent, natural evolution has helped ODD approaches start to coalesce relatively quickly – a decade or two is not a long time for an entire discipline to begin to standardize. On the other hand, much of ODD's normalization can be linked to its never-ending expansion than to thoughtful implementation or efforts to find efficiencies in approaches. But as ODD is tasked with an ever-broadening mandate (more asset classes, more potential risk factors, at greater frequency), the inevitable trade-offs should be considered in order to help optimize the significant industry-wide resources allocated to ODD exercises.

As I see it, the three biggest challenges currently facing ODD as a discipline – its expense, its subjectivity, and its shift from a risk management-focused discipline – to a role that ties heavily to audit support) are those promulgated by processes that have evolved (or, in many cases, have not evolved) in response to increases in interest and demand. ODD is largely facilitated through de-centralized collection of large volumes of information from investment managers about how they operate and control their businesses; this information is then generally qualitatively assessed according to idiosyncratic views of risk standards and best practice. The overarching framework guiding what information to collect and assess (and from who and how often) is largely set by considerations often more administrative in nature than focused on optimizing risk reduction.

Series Introduction

Operational Diligence: Due for a Change? is a periodic series of thought and opinion pieces released by Aon's Operational Risk Solutions and Analytics ("ORSA") group. It draws on the anecdotal experience of ORSA's team along with the data and analytics generated by the group's Operational Risk IQ platform. The series shares insights from a practitioner's lens, often with a contrarian sensibility that challenges conventional thought on how the operational due diligence ("ODD") process should be implemented. As part of ORSA's broader effort to help identify and quantify operational risks among investment managers, the series aims to get industry participants to think critically about operational risk and ODD approaches and collectively learn ways to decrease risk exposures to operational factors.

Look for our next installment . . . Is on-site due diligence overrated? (Or just over-weighted?)

Empower Results®

Put another way, thousands of investors are asking thousands of investment managers hundreds of questions, evaluating responses in one of the industry's last black boxes, and doing so in a manner which cannot ultimately demonstrate concrete or optimized risk mitigation. What could possibly go wrong?

While I am encouraged to see some movement toward approaches that consider how technology can ultimately help resolve some of these concerns, many of these efforts focus on the experience of just one specific type of participant in the ODD process. For example, some asset owners and technology providers are working to digitize operational due diligence content and questionnaires. Digitized questionnaires are great tools for asset owners or intermediaries charged with collecting and assessing the information but ignore the fact that investment managers still must supply similar responses to other clients and prospects. Another effort focuses on creating standardized questionnaires that create mechanisms for content consistency. Standardized questionnaires help investment managers by consolidating their efforts in responding to normalized questions, but this approach has limited value to investors and intermediaries who are still saddled with interpreting responses that themselves are not normalized (and, not to mention, often ignore the purpose of a specific question entirely to either describe how "seriously" a manager takes the issue or otherwise merely reference a 30-page supplemental policy that needs to be sifted through in order to determine how a specific process is actually implemented).

So, what, then, is the path forward? The best solutions will find value for asset owners, intermediaries, and investment managers alike. While "diligence" will always be a part of ODD, the over-arching goal of recognizing and reducing operational risks in our industry requires engagement and some level of symbiotic participation across the range of parties involved in the process. Beyond that, the first step in addressing limitations is often acknowledging that a problem exists.

The Aon team has been focused intently on developing solutions that consider how the ODD process can be improved across the range of market participants. This article series attempts to consider and acknowledge the limitations present in the current ODD environment. In it, we will tackle some of ODD's most conventional and dogmatic thinking from a critical lens: Are there actually drawbacks to on-site due diligence? Are longer ODD reports really better? Can the opinions of subject matter ODD experts be objective? Combined, these efforts to develop solutions and acknowledge limitations will make ODD work more accessible, less subjective, and more risk-based.

"Thousands of investors are asking thousands of investment managers hundreds of questions, evaluating responses in a black box, and doing so in a manner which cannot ultimately demonstrate concrete or optimized risk buy-down. What could possibly go wrong?"

About the Author

Rian Akey is the Global Head of Aon's Operational Risk Solutions and Analytics ("ORSA") group. He believes ODD work has become too expensive, too subjective, and often not risk-based and wants to change that. Rian believes that bringing more transparency, objectivity, and resource optimization to the industry's ODD efforts is the best way to improve outcomes for all of its participants, with a primary objective of decreasing risk exposures to operational factors. He has conducted operational due diligence reviews of hundreds of investment managers globally across all asset classes on behalf of some of the world's most sophisticated institutional investors. He has been involved in operational due diligence efforts for more than fifteen years, most recently building Aon's Operational Risk IQ platform and ORSA's operational due diligence ("ODD") program that supports Aon Investments and its clients.

Meet ORSA:

Aon’s Operational Risk Solutions and Analytics Group (“ORSA”)

ORSA is a specialist practice focused on identifying and reducing business and operational risks within the operating environments of investment and financial market participants. We seek to provide objective, fact-based guidance and advice with the goals of reducing operational risks across a broad range of business functions. In addition, we seek to actively improve the efficiency of operational risk management services to provide cost-effective and timely solutions

How does ORSA address the expense and subjectivity of ODD while prioritizing a risk focus?

- Scalable automation in collecting and processing information creates pass-through efficiency
- Toolkit approach helps clients right-size services and optimize resources
- Operational risk analytics help drive objective and consistent decisions
- Patent-pending data-in/data-out methodology accommodates qualitative assessment without compromising objective inputs
- Services focus on risk consulting rather than report-writing; portfolio-wide coverage combines audit support needs with risk management focus

ORSA’s services range from traditional pre-investment ODD to operational analytics and monitoring:

Whether a client needs a comprehensive review of an investment manager it has never allocated capital to previously or a holistic risk assessment of a large multi- manager portfolio (including analytics and a risk reduction plan), ORSA’s team has global experience assessing operational risks across a range of investment managers across all asset classes.

ORSA’s Operational Risk IQ Platform creates a symbiotic framework for all ODD process participants:

Asset owners, investment managers, and financial intermediaries (like investment consultants) are all participants in the ODD process. Our Operational Risk IQ platform considers the resource commitment of each contributor to create and offer cost effective due diligence and business risk & intelligence services across the industry.

Disclaimer

This document has been produced by Aon's Operational Risk Solutions and Analytics ("ORSA") group, a division of Aon plc, and is appropriate solely for institutional investors. Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial or investment advice and action should not be taken as a result of this document alone. Consultants will be pleased to answer questions on its contents but cannot give individual financial or investment advice. Individuals are recommended to seek independent financial advice in respect of their own personal circumstances. The information contained herein is given as of the date hereof and does not purport to give information as of any other date. The delivery at any time shall not, under any circumstances, create any implication that there has been a change in the information set forth herein since the date hereof or any obligation to update or provide amendments hereto. The information contained herein is derived from proprietary and non-proprietary sources deemed by Aon to be reliable and are not necessarily all inclusive. Aon does not guarantee the accuracy or completeness of this information and cannot be held accountable for inaccurate data provided by third parties. Reliance upon information in this material is at the sole discretion of the reader.

This document does not constitute an offer of securities or solicitation of any kind and may not be treated as such, i) in any jurisdiction where such an offer or solicitation is against the law; ii) to anyone to whom it is unlawful to make such an offer or solicitation; or iii) if the person making the offer or solicitation is not qualified to do so. If you are unsure as to whether the investment products and services described within this document are suitable for you, we strongly recommend that you seek professional advice from a financial adviser registered in the jurisdiction in which you reside. We have not considered the suitability and/or appropriateness of any investment you may wish to make with us. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction, including the one in which you reside.

Aon Consulting, Inc. is a wholly owned, indirect subsidiary of Aon plc.

Aon Consulting, Inc.
200 E. Randolph Street, Suite 700
Chicago, IL 60601
ATTN: Aon ORSA

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For more information, please visit aon.com.

For more information

Please contact your Aon Investment Consultant or one of ORSA's solutions experts:

Rian Akey
Global Head of ORSA
rian.akey@aon.com

ORSA@aon.com

Empower Results®