protiviti®
Global Business Consulting

Positioning asset managers to withstand economic sanctions

Governments around the globe have engaged increasingly in offensive economic-sanction tactics in response to geopolitical conflicts, social injustice and violations of basic human rights. For fear of not being able to exit positions, leery market participants and investors have been swift to react. The economic ramifications of sanctions extend beyond the borders of the sovereign nations upon which they have been imposed, creating significant disruption that spills over into capital markets. For asset managers, the breadth and depth of economic sanctions have meaningful impact not only for compliance but also on business resiliency, requiring that they position themselves to address sanctions proactively and nimbly.

The ramifications of geopolitical risks and economic sanctions on local and global economies can be material. The Russian and Belarus sanctions have forced many sectors to confront rising raw-material scarcity, supply chain issues, increasing costs and price volatility, and food and energy insecurity. Beyond these widespread effects, the sanctions presented significant obstacles for financial institutions trying to exit direct Russian exposure without running afoul of sanctions obligations. As a result, country risk is a very important consideration in the investment decision-making process and the ongoing oversight of portfolios.

This consideration is particularly relevant in socially minded investment strategies. Environmental, social and governance (ESG) rating firms, for example, were slow to adjust to the breadth and depth of the Russian and Belarusian sanctions, in some cases changing course and downgrading or even suspending scores on previously positive-rated Russian government-linked entities (e.g., Sberbank). In more extreme cases, Russian company ratings were removed from indices altogether.

While rating and index providers had to revisit their methodologies and adjust their ratings, scores and index constituents, asset managers were tasked with reviewing portfolio holdings and exiting positions. Many found they were not proactive enough; liquidity dried up and markets ceased trading before they were able to exit, increasing their legal and regulatory risk. At the same time, investors began to panic and sought to redeem assets with exposure to Russia, prompting asset managers to freeze certain investment strategies.

Impact to investment strategies and the investment universe

Asset managers should revisit investment strategies and consider where and how best to integrate geopolitical, human rights, sovereign governance, and rapidly evolving economic-sanctions factors into their investment selection and ongoing monitoring processes. Investment strategies will be affected differently, depending on the eligible investment universe. Established investment decision-making practices that historically performed well for asset managers have been put to the test, as asset managers increasingly felt pressure from their investors, including incorporating — if they had not already — socially minded factors in their decision-making process.

Asset managers need to consider:

- The adequacy, completeness and accuracy of data available to screen for economic sanctions.
- The timing and frequency of screening during the investment decision-making process and of the portfolio
- The expansion, timing and frequency of economic-sanctions compliance due diligence activities to understand potential exposure to sanctioned entities, people, regions and sectors.
- Whether to expand the scope of due diligence activities beyond sanctioned entities to mitigate potential market risks arising from downstream economic impacts of sanctioned entities.
- The degree of reliance on entity scores, ratings and indexes provided by third parties to evaluate socially minded factors.
- The ability of ratings vendors to react promptly to global economic sanctions and adjust ratings appropriately.
- The information and tools required to conduct necessary research and how best to source them.

Impact to the investment research and rebalancing process

As asset managers globally continued to rebalance investment strategies and exit portfolio positions with higher-than-average exposure to economic outcomes from Russian economic sanctions, volatility and liquidity constraints persisted in impacting portfolio performance. Timely, relevant and clear investor communications were effective strategies for mitigating liquidity pressures and further performance erosion driven by forced sales to meet withdrawal requests by panicked investors but did not completely alleviate concerns. As new sanctions were declared, the risk of unsettled trades increased as individual investors and asset managers scrambled to exit investment positions and, in some cases, global custodians froze incoming funds and assets from correspondent banks with Russian exposure.

While investment decision-making tools and research play an important role in the investment process generally, they are even more important in a dynamic economic-sanctions environment. Asset managers should assess the adequacy of existing resources leveraged to support increased and ongoing due diligence of strategies exposed to economic sanctions, including the potential market impact of rapidly evolving global developments. They should also consider the adequacy of data, the robustness of risk assessment models, and the capacity of existing analysts. The ability to identify investment options and investments to exit is critical to mitigating risk.

Asset managers should take the following actions to position themselves to mitigate risks and respond nimbly to shifting market and investor reactions:

- **Categorise investment strategies by risk:** Identify all investment strategies with increased risk of being directly and indirectly impacted by economic sanctions resulting from geopolitical and sovereign governance actions that affect human rights, energy and food security, and global economic stability. Further identify passive investment strategies referencing third-party benchmarks or deploying complex methodologies to rank, include and exclude holdings in the portfolio.
- **Strengthen the decision-making process:** For active strategies, determine the most effective point at which screens should be identified and implemented to identify economic sanctions and downstream implications for other risks (market, liquidity, volatility, valuation, etc.). For passive strategies, clarify the methodology each rating agency and index provider uses in benchmark tracking or proprietary screens to define the investible universe, and the speed at which they respond to economic sanctions, world and market events. Develop a process to keep informed, on a timely basis, of changes to methodologies used by rating agencies and index providers. Evaluate the need for active portfolio oversight in passive strategies when risk exposures triggered by economic sanctions increase.

  Evaluate the research and investment selection process to assess the adequacy and robustness of the selection screens, data and tools used to identify the relevant investible universe and entities with an above-average exposure and/or dependency on sanctioned (or likely-to-be-sanctioned) entities to operate.
- **Evaluate research resources and set portfolio review milestones:** Assess the adequacy of data and analyst capacity to undertake additional or more robust economic-sanctions exposure analysis in target investments, as applicable, in a timely manner.

  As markets and organisations respond to the direct and indirect impacts of economic sanctions, risk profiles of investments and portfolios change. Establish the frequency with which portfolio investments are reviewed for economic exposure and risks triggered by sanctions, particularly when ongoing regional adjustments to sanctioned parties are expected. Review and assess the adequacy and suitability of established liquidity, volatility and market risk mitigation activities and determine the need for varying tactics based on each investment strategy's sensitivity to broad offensive global economic sanctions. Assess the process for making timely risk-based investment exit decisions to maintain portfolio liquidity levels commensurate with the risk rating of the investment strategy.

- **Hone disclosures strategy:** Evaluate the adequacy, clarity and appropriateness of investor communications and disclosures concerning risk profiles of investment strategies with increased exposure to geopolitical, economic-sanction, concentration, liquidity and volatility risks. Determine when communications should be made, whether communication strategies should differ by investor typology (e.g., institutional, retail, high net worth), the form communications should take (e.g., direct, public, combination) and the frequency of updates. Assess the effectiveness of internal processes to identify emerging risks that may require regulatory disclosures or communication with regulators, particularly in situations where market reaction to economic sanctions results in illiquidity or volatility that affects portfolios, clients and/or overall compliance.

  For collective investment vehicles, evaluate the need for enhanced disclosure around the risks associated with investment strategies with higher-than-average exposures to offensive broad-based economic-sanction strategies implemented in response to geopolitical events.

Conclusion

Ultimately, the impact of economic-sanctions regimes extends beyond the borders of targeted nations, and investment strategies concentrated in sectors and regions they impact will present challenges for asset managers. Where financial systems are impacted, as is the case with the Russian sanctions, liquidity risk in portfolios can be significant enough to warrant freezing strategies. Just as the global pandemic forced firms to enhance their business resiliency preparedness, global economic-sanctions regimes require asset managers to do the same.

About Protiviti's Financial Crime Practice

Protiviti's Financial Crime practice specialises in helping financial institutions satisfy their regulatory obligations and reduce their financial crime exposure, using a combination of AML/CFT and sanctions risk assessment, control enhancements, and change capability to deliver effective operational risk and compliance frameworks. Our team of specialists assists organisations with protecting their brand and reputation by proactively advising on their vulnerability to financial crime, fraud and corruption, professional misconduct, and other financial business risk issues.

Contacts

Carol Beaumier
Senior Managing Director
Risk & Compliance
Protiviti — New York
carol.beaumier@protiviti.com

Bernadine Reese
Managing Director
Risk & Compliance
Protiviti —London
bernadine.reese@protiviti.co.uk

Jackie Sanz
Managing Director
Risk & Compliance
Protiviti — Toronto
jackie.sanz@protiviti.com