

ALFI Q&A “RM for AIF under AIFMD”

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Preamble

This document was prepared by ALFI's Risk Management Technical Committee. The working group comprises representatives of asset managers, management companies, securities service firms, audit firms, law firms, and document and information management firms.

This document contains the working group's answers to questions about the implementation and the application of Alternative Investment Fund Manager Directive ("AIFMD") and its Delegated Regulation ("AIFMD-CDR"). The answers are not necessarily definitive and they might not be suitable for every circumstance. **This document is not meant to be an industry standard or a guide to best practice** but it represents the view from a group of market participants. The Q&A has not been validated by any regulator. It does not diminish the Alternative Investment Fund Manager's or Alternative Investment Fund's responsibility to comply with the Luxembourg AIFMD implementation law of 12 July 2013, any further regulatory guidance issued by the CSSF or ESMA's related guidelines and any other European or national law or regulation. This document must not be relied upon as advice and is provided without any warranty of any kind and neither ALFI nor its members who contributed to this document accept any liability whatsoever for any action taken in reliance upon it.

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In order to share the reflections and expertise from the different participating members, it has been decided to structure a dedicated Q&A covering all key dimensions of Risk Management activities under AIFMD (including, e.g. aspects in relation to key risk categories such as, Market risk, Credit risk, Liquidity risk etc. as well as governance/delegation topics).

ALFI's members are welcome to submit a question to the working group, which will review it and consider whether to include it in a future copy of this document. Please send your questions to info@alfi.lu. We will acknowledge receipt of each question but we regret that we may be unable to reply individually to each one.

A. LEVERAGE

1. **What is the difference between the gross “sum of notional” calculation method under UCITS and the “gross” approach under AIFMD? What is the difference between the “gross” approach and the commitment approach under AIFMD? Do both approaches provide same leverage figure if there is no netting/hedging ability for a given portfolio?**

The main difference between the calculation of the “sum of notional” under UCITS and the leverage calculation under AIFMD is that under UCITS, the leverage calculation takes (in addition to the leverage created by efficient portfolio management techniques (such as, e.g., repos)) only the derivative positions in the portfolio into account¹ while AIFMD requires to take all positions that potentially have market risks into consideration and not only derivative positions.

In case no derivatives positions are included in the portfolio, the base value for the leverage as per AIFMD methods is “1” (i.e. 100%) differing from the base value of “0” as per UCITS method. Practitioners may consider that the information on the choice of the base value should be consistent and appropriately disclosed to investors.

However:

- *under the AIFMD Gross Method, “all positions “ refers to derivatives and other instruments **but excluding cash and cash equivalents** in the fund currency; whereas*
- *under the AIFMD Commitment Method, cash and cash equivalents in the fund currency are included in the calculation. In addition, under the AIFMD Commitment Method, the application of hedging, netting and duration netting are allowed if the requirements of the Directive are fulfilled.*

The difference between “Gross Method” and “Commitment Method” leverage computation under AIFMD may trigger results that are unexpected from an economical point of view as the level of leverage using the “gross” approach can in specific cases be lower than the “commitment” leverage (if no netting/hedging is applicable) as per below example.

Example:

As an illustration, let’s consider the scenario where the AIF’s TNA is EUR 100mios. The investments have been made on the one hand in a European equity portfolio for a total value of EUR 150mios and, on the

¹ Please note that in the ALFI Q&A on CSSF Circular 11/512, it is said that “Practitioners may consider providing further information to investors as to whether the investment portfolio (i.e., non-derivatives portfolio) is included in the leverage figure or not.”

other hand, EUR 50mios in cash. The leveraged exposure has been obtained through a bank loan of EUR 100mios.

The leverage computation for this specific scenario is as follow.

Gross leverage

1. Total value of Equity portfolio	EUR 150
2. Cash and cash Equivalent (excluded from computation)	<u>EUR 50</u>

Total assets for leverage computation EUR 150

3. TNA	EUR 100
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Gross Leverage ratio (Total assets/TNA) $150/100 = 1.5$

Leverage based on commitment

1. Total value of Equity portfolio	EUR 150
2. Cash and cash Equivalent	<u>EUR 50</u>

Total assets for leverage computation EUR 200

3. TNA	EUR 100
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Leverage ratio based on commitment (Total assets/TNA) $200/100 = 2$

In this specific situation, applying AIFMD leverage computation rules lead to a Gross leverage that is lower than the leverage based on the commitment approach.

2. What can be deemed as “cash and cash equivalents” that may be excluded from the exposure computation (Art. 7 (a) and (c) AIFMD-CDR)?

Art. 7 (a) AIFMD-CDR specifies that cash and cash equivalents need to be highly liquid, held in the AIF’s base currency, readily convertible to a known amount of cash, subject to insignificant risk of change in value, and provide a return no greater than a 3-month high quality government bond.

An AIFM shall therefore define internally which holdings it subsumes under “cash and cash equivalents” and which criteria it applies to identify them.

This definition may encompass holdings such as cash in the AIF’s base currency (but not other cash accounts in non-base currencies), callable deposits, daily NAV money market funds, money market instruments easy to liquidate under normal market conditions and short term high quality government bonds.

High quality may be understood as being at least investment grade and short term - with the added condition of yielding less than the 3-month (investment grade) government bond in the base currency of the AIF.

The definition in Article 7 (a) excludes:

- *Short term securities that are not readily convertible or lack a market liquid enough to ensure they can be realized at or very close to market prices. Liquidity of the market is to be assessed by the AIFM;*
- *Investments where the realization value is at risk. Further to liquidity considerations, market risk considerations need to be taken into account. This is also to be assessed by the AIFM;*
- *Any investments that are not in the AIF’s base currency.*

B. RISK GOVERNANCE AND RISK PROCESSES, POLICIES AND PROCEDURES

1. To what extent are the risk limits to be set by AIFMs of a different nature than those for UCITS?

Article 44 AIFMD-CDR requires that the AIFM should set quantitative and qualitative limits for all AIF it manages taking account of all relevant risks. As a minimum, risk limits for each AIF shall cover at least the following risks:

- *Market risks*
- *Credit risks*
- *Liquidity risks*

- Counterparty risks
- Operational risks

This risk management requirement completes in practical terms the obligation to identify and monitor all relevant risks.

In practice, it raises questions on the applicability for different market participants due to the diversity of assets, strategies and arrangements.

Efforts should be made to define quantitative limits, whereas qualitative limits and expert judgement may also be a feasible approach to define limits for specific risks, especially if no relevant quantitative risk indicator and limits can be set. Art. 44 (1) AIFMD-CDR requires the AIFM, where for one AIF only qualitative limits are set for all relevant risks to be able to justify this approach to the CSSF.

Setting of limits in the case of hedge-funds, funds-of-hedge-funds or UCITS-like structures may be quite similar (or at least adaptable) to the risk monitoring tools and risk-management common practices as applied within UCITS. Conversely, a simple adaptation of UCITS methods is neither practicable nor adequate for real asset AIF investing in less liquid investments such as, e.g., Private Equity, Real Estate or infrastructures.

Depending on the asset class, also for real asset AIF quantitative risk indicators may be developed and applied (such as, e.g., analysis of performance measures, Cash Flow based analysis, etc.).

Nevertheless, the risk limits may encompass a sound mix of the following:

1. *Investment restrictions as published in the offering documents and prospectus;*
2. *(Internal) quantitative risk limits;*

(Internal) qualitative risk limits and expert judgement information for risk categories not measurable using quantitative limits. The setting of limits per se does not imply that breaches of limits should automatically trigger corrective actions or any escalation procedure to the regulator like in the UCITS universe (e.g. CSSF 02/77). Recital (55) of AIFMD-CDR is clear when it recalls that “Although Directive 2011/61/EU does not impose any investment restrictions on AIFs, the risks incurred by each AIF cannot be managed effectively if the risk limits have not been set in advance by AIFMs...”. The previous statement opposes required risk limits in the sense of the AIFMD on the one hand, and non-required investment restrictions on the other hand.

Risk limits should be seen as the basis for an escalation procedure between the AIFM permanent risk management function, portfolio managers of AIF and the governing bodies of the AIFM. The AIFM shall therefore have such an internal procedure in place for handling of breaches of risk limits and investment restrictions as set by the offering documents and prospectus.

Even if breaches of risk limits do currently not automatically trigger any disclosure requirement towards the regulatory authority, however, as required by Art. 108 (4) AIFMD-CRD, information on limit breaches should be provided as part of the periodic disclosures to investors (e.g., as part of the AIFs annual report).

2. To what extent can the risk management function rely on data from private sources (incl. the portfolio management)?

a. Regulatory principles

AIFMD-CDR:

Recital (54)

It is essential to specify the safeguards to be employed by the AIFM in any event in order to ensure the independent performance of the risk management function, and in particular, that those performing the risk management function should not be entrusted with conflicting duties, that they should make decisions on the basis of the data which they can appropriately assess and that the decision making process should be capable of being reviewed.

Article 43 Safeguards against conflicts of interest

1. The safeguards against conflicts of interest referred to in Article 15(1) of Directive 2011/61/EU shall ensure, at least, that:

(a) decisions taken by the risk management function are based on reliable data, which are subject to an appropriate degree of control by the risk management function;

(b) ...

Article 67 Policies and procedures for the valuation of the assets of the AIF

The policies and procedures setting out valuation methodologies shall include inputs, models and the selection criteria for pricing and market data sources. They shall provide that prices shall be obtained from independent sources whenever possible and appropriate.

b. Interpretation

The data sources for the risk management function are subject to the minimum requirements in terms of safeguards as to their quality/reliability and as to potential conflicts of interest.

On this basis, we understand that the following assumptions hold true:

- *Risk/valuation data can be provided/received from external sources including the portfolio management of the respective AIF;*
- *There is no strict ban on risk data received from non-independent sources. The risk function should ensure an independent review of the 'reliability' of the data received and used;*
- *The receipt of risk data from external parties is subject to plausibility and consistency checks, in particular if the external party is subject to a potential conflict of interest (e.g, related party, portfolio manager)*
- *The review of plausibility of risk data received may focus on*
 - (i) the consistency of data provided,*
 - (ii) the evolution in time of the data (risk factors),*
 - (iii) the traceability (as far as possible) to independent/market data sources (proxies/indices/benchmarks);*
- *In case of use of private/dependent data sources, the risk management function should disclose this to the Board of Directors of the AIFM/AIF. If conflicts of interest are identified, disclosure to investors would be required in accordance with Art. 36 AIFMD-CDR;*
- *The simple receipt of risk data from external parties does not trigger an outsourcing of the risk management function. As stated above, the data shall be subject to qualitative checks and the risk data interpretation/management tasks shall be performed by the risk function of the AIFM.*

3. Risk Management governance – Role and responsibilities for the Permanent Risk Management function and the Conducting officer

a. Conducting officer in charge of Risk Management – Supervision of functions

In the context of the AIFMD and as part of the conditions to be met for the granting of an authorization as AIFM, an AIFM must identify at least two persons to conduct the business (“Conducting officers” - CO)².

In order to duly supervise the conduct of the business at AIFM level, all the key functions of the AIFM will have to be assigned between the conducting officers without generating unacceptable conflicts between the supervised functions. As an illustration, the CO in charge of the Risk Management cannot also be in charge of the Portfolio Management.

² Article 8 1) c of the AIFM Directive states: “the persons who effectively conduct the business of the AIFM [...] and the conduct of the business of the AIFM being decided by at least two persons meeting such conditions;”

In that context, it is our understanding that at least the following functions could be supervised by the CO in charge of the Risk Management:

- *Valuation*
- *Monitoring of Delegates (excluding portfolio management delegation)*
- *Compliance*

b. Permanent Risk Management function – other responsibilities

In the context of the AIFMD, a permanent Risk Management function (PRMF) must be established in line with Art 39 AIFMD-CDR. The PRMF shall be functionally and hierarchically separated from the operating units in line with Art. 42 AIFMD-CDR.³

*However, depending of the type of AIFs as well as the size of the AIFM taking into account the principle of proportionality, the person/team acting as permanent Risk Management function may also have **additional** responsibilities as long as the AIFM is able to demonstrate that safeguards against potential conflicts of interest are implemented (if necessary).*

Considering Article 42 (1) a) and b) AIFMD-CDR⁴, it is our understanding that at least the following roles could also be under the responsibility of the permanent Risk Management function without breaching the independence barriers:

- *Ongoing monitoring of delegates: This will not generate any issues regarding the independence of the Permanent Risk management function and will also contribute to the reinforcement of the Operational risk monitoring;*

Some other roles (mainly for Private Equity and Real Estate) within the AIFM / other group entities: A CFO of a Private Equity / Real Estate company might be selected to act as permanent Risk Management function for an AIFM. This person should have a very good knowledge of the investments structures as well as the cash flows. This would then generate synergies with a role of permanent Risk Management function

³ Article 15 (1) AIFMD 2nd paragraph states that: "The functional and hierarchical separation of the functions of risk management [...] shall be reviewed by the competent authorities [...] in accordance with the principle of proportionality, on the understanding that the AIFM shall, in any event, be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities [...]"

⁴ Art. 42 (1) a) and b) AIFMD-CDR: "(a) Persons engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM; (b) persons engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function."

especially within the PE/RE industry. However, the potential conflict of interest related to the monitoring of operational risk should be carefully covered (e.g., those in relation to the treasury function).