AIFMD: KEEP CALM AND RISK-MANAGE

Risk profiles of alternative investment funds are completely different than those for Ucits products. This is an issue vital to the success of the AIFMD brand, say Norddine Bennani and Dominique Marchal, of Bennani & Marchal Associates.

NEW ASSET CLASSES, new risks to monitor, new regulatory requirements: the Alternative Investment Fund Managers Directive (AIFMD) surely brings its share of challenges, especially on the risk management front.

Conventional methods in place for Ucits are not applicable, but analytic methods exist to allow independent, objective risk assessment. An innovation process is necessary to take advantage of the opportunities offered by AIFMD.

So, risk managers, no need to panic. Deep breath. Keep calm and risk-manage.

The AIFMD paves the way for investments in non- or hardly transferable assets, such as loans, private equity, real estate or infrastructure. This is truly innovative since European regulated vehicles have only been authorised to invest in transferable securities so far, as the Ucits requirement for high liquidity only enabled the synthetic replication of illiquid assets risk-return patterns, typically through the use of total return swaps. Investment in illiquid and long-term assets broadens the scope of opportunities for investors.

FINE BALANCE: Risk management requires independent, objective, measurable and verifiable analysis.

ROBUST RISK MANAGEMENT

However, there is no such thing as a free lunch for fund promoters. One of the primary conditions to benefit from facilitated distribution and the creation of an internationally reckoned AIFMD brand, in the vein of Ucits, is the setup of robust risk management functions. Nine months within the AIFMD implementation period, it seems fair to say that the quest for consensus and best-practice has only started.

Qualitative assessment based on expert judgement? Full-fledged Value-at-Risk as for Ucits? None of the two approaches feels quite right. The first step should be to recognise the specificities of a risk management process, and of the asset class involved.

Risk management requires independent, objective, measurable and verifiable analysis. The debate between a qualitative versus a quantitative approach is sterile as both are complementary and required.

Their relative importance will evolve during the life-cycle of the investment, a characteristic of long-term, illiquid assets.

Alternative investment fund (AIF) strategies, with the exception of long-short or market neutral hedge-funds, have a completely different risk profile than Ucits. Market risk methods measure the impact of market/economic events on the price of assets. It is hard to see how this is relevant when the assets are not publicly traded, and when the very notions of price or even fair value are not clearly defined.

To make things worse, identifying risk factors can turn into a daunting task when it comes to AIFs. The list of risk factors is largely standardised for Ucits and hedge funds, and will essentially be covered by market available information in terms of prices or rates for the major asset classes. This is, however, a completely different story when it comes to alternative assets. It is no simple task to identify key risk factors in the universe of private equity and real estate, and there is no guarantee they will be publicly available or even observable.

SYSTEMS OVERHAUL

In case of outsourcing of portfolio management, the risk management function has to be retained within the management company. This structure has implications for the information flow, which will add even more constraints to the design of a bottom-up risk management framework. Portfolio managers and general partners of private equity funds will typically be somewhat reluctant to provide the required detailed information about their investment strategy. They will be wary to reveal too much about their secret recipe.

So, what are we left with? With new challenges come new analytics methods and a complete overhaul of mainstream risk management systems. Looking for available and reliable information sources is a good place to start.

To take into account the possibly poor information contents of interim valuations, a top-down and cash flow-based approach seems reasonable and effective.

Bottom-up methods would require complete and detailed information about each investment, which might not be available to the risk manager, especially when outsourcing, if available at all. Therefore, bottom-up approaches are very difficult to implement, and in many cases simply not applicable.

Top-down methods also protect the independence of the AIF manager's risk management function from potentially biased sources of information. Indeed, cash flows are under the close monitoring of depositary banks. Their use provides a natural mitigation of model risk.

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Top-down quantitative risk analysis on realised and projected streams of cash flows receives the support of academic research and best practices in the management of private equity and real estate.

Top-down quantitative methods are efficient at complementing expert judgements in the monitoring of relevant financial risks required in the AIFMD and subsequent regulations.

They provide the necessary structured framework and indicators for the monitoring of credit/counterparty risk, liquidity risk, and systematic risk.

Their starting point owes to specific benchmarking techniques, mixing performance analysis and risk assessment.

These methods can typically provide the building blocks for an objective framework, which in turn should allow defining the risk profile and the risk limits of a specific fund. This is ultimately no more than what is required by regulation, with no exception foreseen, whatever the asset class. The answer will certainly have to be proportionate, with the right balance between quantitative and qualitative assessment in the risk management process.

But it is clear that a "too opaque to quantify" argument has little chance to hold. Quantitative analysis will be what distinguishes risk management from pure compliance requirements.

BACK BONE OF COMMUNICATION

Top-down quantitative analysis based on cash flows paves the way towards a rigorous yet achievable framework for measuring performance and managing risk. It will allow the continuous monitoring of risk, with consistent analysis across time and benchmarking within specific peer groups. As important, it could become the back bone of the communication between risk managers, portfolio managers and board members throughout the life-cycle of the fund.

The next challenge is to train risk managers to think outside of the Ucits box, as risk management of illiquid assets is no place for one-size-fits all ideas. No need to panic, yes, but no one said it was going to be easy…

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