



UCITS risk management as a precursor to risk management for alternative funds

How should this impact the Internal Auditor's agenda?

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Agenda

- Oversight of Luxembourg investment fund market
- Risk governance requirements under UCITS IV as a basis for AIFMD
- Role of Internal Auditors
- Q & A



Luxembourg Fund Industry: At a glance ...

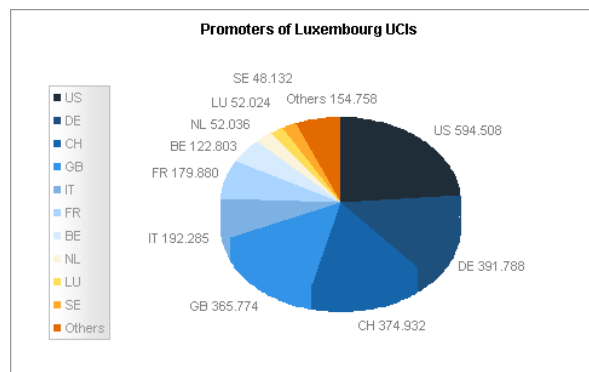
- 3,854 investments funds
- 13,525 fund units
- EUR 2,528.9 billion in assets under management
- More than 47,000 distribution agreements for Luxembourg UCITS

Figures as at 31 March 2013

Source: CSSF



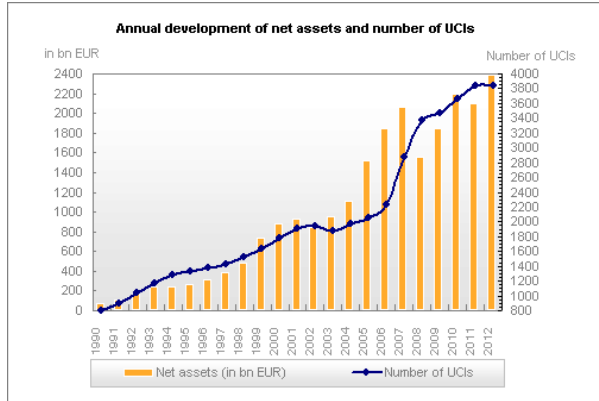
Luxembourg Fund Industry: At a glance ...



Figures in EUR billion as at 31 March 2013 Source: CSSF



Luxembourg Fund Industry: Funds/Net Assets



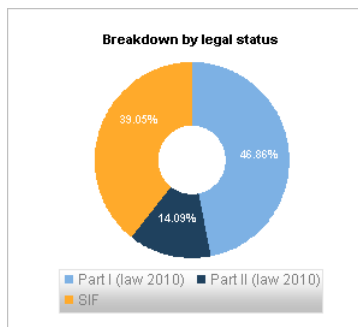
Figures as at 31 December 2012

Source: CSSF

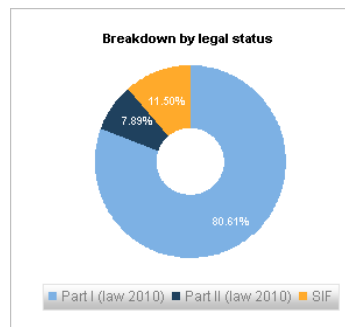


Luxembourg Fund Industry: Part I/Part II

Number of funds



Assets under management

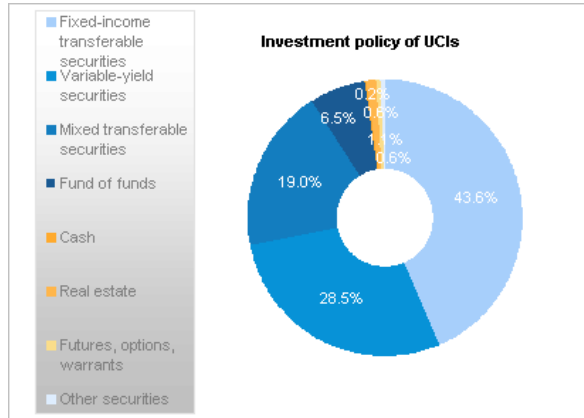


Figures as at 31 March 2013

Source: CSSF



Investment Policy of Luxembourg Funds



Figures as at 31 March 2013

Source: CSSF



UCITS 20 December 1985	UCITS III 21 January 2002	UCITS IV 13 July 2009
	Driving Forces	
Permit cross-border offering of open-ended investment funds to EU investors	More asset classes eligible (bank deposits, units of other UCIs, money market instruments and use of derivatives)	Permit industry consolidation, improve efficiency and increase investor protection
	Benefits	
<ul style="list-style-type: none"> Harmonization of investor protection rules Marketing through simple notification process - passport 	<ul style="list-style-type: none"> Widening of investment power and product offering in UCITS Enhanced Risk Management Procedures 	Principal amendments to UCITS regime: <ul style="list-style-type: none"> Simplified notification procedures KII EU-wide fund merger regime Management Company Passport Master-Feeder structures

Source: ALFI

CESR Risk Principles 2009

CESR/ESMA Technical Risk Standards / Risk Governance



Scope of Risk Management under UCITS IV

- Covers Fund **Administration, Investment** and **Distribution** activities
- Challenge considering that Investment and Distribution activities are generally outsourced, often parts of Administration as well
- Obligation to provide independent risk management oversight
- Obligation on defining internal risk limits in addition to regulatory limits
- Fund risk profiles, calculation of **volatility** (VaR), VaR back and stress testing, **global exposure, leverage, counterparty risk**, Synthetic Risk and Reward Indicator, etc.



Permanent Risk Management Function under UCITS IV

- Implement risk management policies and procedures
- Ensure compliance with the UCITS risk limit systems, including statutory limits concerning global exposure and counterparty risk
- Advise the board of directors on the identification of the risk profile of each managed UCITS
- Report to the board of directors on (i) consistency between risk levels and the risk profile agreed for each managed UCITS, (ii) compliance of the UCITS with risk limits and (iii) adequacy and effectiveness of the risk management process
- Report to the conducting officers on current risk levels incurred by each managed UCITS and actual or foreseeable breaches to limits
- Review and support the arrangements and procedures for the valuation of OTC derivatives



Regulatory Risk Management under UCITS IV

- Formalisation of risk management policies, procedures and processes
- Clarification of internal fund risk governance and of the roles and responsibilities, with specific focus on conducting officers
- More detailed regulatory limits in terms of global exposures and VaR
- Obligation to improve risk disclosures to investors via SRRI / KIID:
move from risk disclaimers to risk disclosures
- Contribution of sector to develop industry guidelines (ALFI & ALRiM):
 - Best practice proposals for the organisation of the **Risk Management function**, guidance for the **risk monitoring of outsourced/delegated functions**, industry work paper on **collateral management**
 - Guidelines on **liquidity risk management**
 - Principles for **sound stress testing** practices



Types of AIF

- Definition as per Directive 2011/61/EU:
Collective investment undertakings, including investment compartments thereof, which:
 - Raise capital from a number of investors, with a view to investing in accordance with a defined investment policy for the benefit of those investors; and
 - Do not require authorisation pursuant to Article 5 of Directive 2009/65/EC
- ➡ **Non-UCITS (Units for Collective Investment in Transferable Securities)**
- Examples:
 - Commodities and Commodity Derivatives
 - Hedge Funds (long/short, distressed securities)
 - Private Equity / Venture Capital
 - Real Estate



AIF Risk Considerations – Why?

« Recent difficulties in financial markets have underlined that many AIFM strategies are vulnerable to some or several important risks in relation to investors, other market participants and markets. »

« Although the activities of the AIFMs [] are unlikely to have individually significant consequences for financial stability, it is possible that aggregation causes their activities to give rise to systemic risks. »

(Directive 2011/61/EU)

AIFM Directive applies generally to:

- **EU AIFMs** managing EU AIFs or **non-EU AIFMs**
- **Non-EU AIFMs** managing EU AIFs
- **Non-EU AIFMs** marketing in the European Union **EU AIFs** or **non-EU AIFs**



AIF Risk Considerations

- **Liquidity**
- **Valuation / Pricing** (non listed instruments)
- Operations
- Market / Interest rate
- Leverage to increase arbitrage returns
- Counterparty / Credit
- Legal / Tax
- Settlement
- Capital
- Professional liability
- Pre-investment due diligence
- Duration / Term of commitment
- Lack of investment benchmark



Key Aspects of AIFMD

- « Investment management function » performed by an AIFM includes at least (i) portfolio management and (ii) risk management
- AIFMD is a manager directive (not a product directive) with focus on:
 - Operating requirements: governance (including delegations), conduct of business, conflicts of interest management, capital
 - Management requirements: **liquidity, leverage, valuation**
 - Risk management
 - Transparency
 - Depository liability



Key Aspects of AIFMD

- Challenge considering that Investment and Distribution activities are generally outsourced, often parts of Administration as well
- AIFMD imposes detailed rules on risk limits and policies which need to comply with the strategy communicated to investors
- Obligation to provide independent risk management oversight via a risk function which is functionally and hierarchically independent from operating units, including from portfolio management (subject to principle of proportionality, and still challenging for some types of and small AIFMs)



Risk Management under AIFMD

- Implement an appropriate, documented and regularly updated due diligence process in relation to investments
- Identify, measure, manage and monitor on an ongoing basis the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio
- Ensure that the AIF risk profile corresponds to the size, portfolio structure and investment strategies and objectives of the AIF, as communicated to investors



Risk Management under AIFMD

- Set maximum level of leverage by considering (i) AIF type, (ii) investment strategy, (iii) sources of leverage, (iv) relationships with other financial services institutions which could pose systemic risk, (v) exposure limit to any single counterparty, ...
- Employ a liquidity management and monitoring system, including stress testing
- Ensure consistency between the AIF's **investment strategy, liquidity profile and redemption policy**



Permanent Internal Audit Function under UCITS IV / AIFMD

“Member States shall require management companies / AIFMs, where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of collective portfolio management activities undertaken in the course of that business, to establish and maintain an **internal audit function which is separate and independent from the other functions and activities of the management company / AIFM.**”



Permanent Internal Audit Function under UCITS IV / AIFMD

“The internal audit function (...) shall have the following responsibilities:

- to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the management company/ AIFM's systems, internal control mechanisms and arrangements;
- to issue recommendations based on the result of work carried out in accordance with point (a);
- to verify compliance with the recommendations referred to in point (b);
- to report in relation to internal audit matters.”

“ensure that their senior management receives on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.”



Possible focus of Internal Audit Function

AIFMD project governance

UCITS / AIF internal governance arrangements

- **Structure** at conducting officer and board level, composition of company and fund boards, clear allocation of non-conflicting responsibilities
- **Arrangements regarding central administration**
 - Human and IT resources ("substance" to ensure proper management of funds)
 - Delegations
 - Agreement with depository



Possible focus of Internal Audit Function

UCITS / AIF internal governance arrangements

- **Arrangements regarding internal governance**
 - Accounting policies and procedures
 - Set-up of Internal Audit, Compliance and Risk functions
 - Conflicts of interest policy, including inducements
 - Complaints policy
 - Best execution policy
 - Remuneration policy
 - Personal Account Dealing policy
 - Marketing of funds to retail and professional investors and disclosure requirements
 - Information to authorities concerning the investment strategies (for AIFs) and the main instruments / markets in which they are trading and on principal exposures and concentrations of AIFs
 - Major shareholding disclosures and reporting obligations resulting from AIFs exercising control over a non-listed company



Possible focus of Internal Audit Function

UCITS / AIF operational arrangements

▪ **Outsourcing arrangements**

- Outsourcing policy
- Initial and on-going due diligence on outsourcers (Administration, Distribution and Investment)
- Regular oversight and performance reporting
- Positive assurance on the proper performance of the delegated functions
- Clarity around indemnities (cf. special case of depositories)

«The depository should be liable for the losses suffered by the AIFM, the AIF and the investors. This [AIFM] Directive distinguishes between the loss of financial instruments held in custody, and any other losses. In the case of a loss other than of financial instruments held in custody, the depository should be liable in the case of intent or negligence. Where the depository holds assets in custody and those assets are lost, the depository should be liable, unless it can prove that the loss is the result of an external event beyond its reasonable control.»



Possible focus of Internal Audit Function

UCITS / AIF operational arrangements

▪ **Valuation of assets**

- Responsibilities, valuation committees
- Reliance on external valuer (registration and professional guarantees)
- Valuation model validation, policy and procedure
- Independence of asset valuation and NAV calculation process from portfolio management
- Controls over the selection of valuation inputs, sources and methodologies
- Escalation channels for resolving differences in values for assets
- Publication of NAV, frequency and disclosure to investors



Possible focus of Internal Audit Function

UCITS / AIF operational arrangements

- **Risk management**
 - Responsibilities, risk management function
 - Reliance on external expertise
 - At least yearly review of risk management process / systems
 - The qualitative and quantitative risk limits for each AIF shall, at least, cover (a) market risks, (b) credit risks, (c) liquidity risks, (d) counterparty risks and (e) operational risks.
 - Investment due diligence process (compliance with investment strategy, objectives and risk profile)
 - Process to measure, manage and monitor each investment position (AIF) and the overall effect on the portfolio, including use of appropriate stress testing
 - Compliance with regulatory limits (UCITS) and definition of internal risk limits, including maximum level of leverage



Possible focus of Internal Audit Function

UCITS / AIF operational arrangements

- **Liquidity risk management**
 - Alignment of investment strategy, liquidity profile and redemption policy
 - Due diligence requirement when investing in assets with limited liquidity
 - Impact of concentration on liquidity
 - Use of an appropriate liquidity management system for AIFs which are not unleveraged and closed ended
 - Regular assessment of liquidity risk via stress testing to consider exceptional liquidity conditions
 - Review of liquidity management systems and procedures
 - Disclosure of % of AIF assets which are subject to special arrangements arising from their illiquid nature



Conclusion

- Regulatory obligation for risk management has existed for **UCITS** and **SIFs** and will exist for **AIFs**
- Risk Management governance arrangements need to cover all risk types affecting fund administration, investment and distribution activities (no limit to risks outlined in regulations !)
- Enhanced focus on outsourced activities
- More emphasis on pre-investment risk due diligence for AIFs and, sometimes, involvement of key shareholders in investment decision process
- Internal Audit is key partner in assessing the holistic risk management and internal control scope under UCITS and AIFMD