AIFMD for fund service providers

Taking a strategic approach

Financial Services Industry

The Alternative Investment Fund Managers Directive (AIFMD) continues to generate controversy as the detailed implementing measures take shape under the stewardship of the European Commission.

Certain aspects of the implementation remain subject to debate but much of the framework for the new regime has now been clarified.

Fund service providers that proactively respond to the Directive and develop tailored AIFMD solutions will stand the best chance of gaining from the new regime. In this article we take a look at some of the key challenges and potential opportunities AIFMD presents for depositaries and fund administrators.

At this stage in the process we await the European Commission's final implementing measures which are expected by the summer of 2012. EU member states will then have until July 2013 to implement the new regime at national level. Existing managers falling within the scope of AIFMD will have a further year to comply with the Directive, but this timeframe remains extremely challenging given the significant amount of operational change required.

As behind the scenes discussions on the Commission's draft regulation continue, areas concerning fund service providers and depositaries are subject to change. The Commission's position on delegation could have significant impacts for current management company models and outsourcing arrangements. The treatment of collateral under the new depositary liability regime may also be subject to change. In any event, service providers will have a key role to play in facilitating the new regime from an operational and risk perspective. Service providers therefore need to ensure they are prepared for AIFMD as early as possible, not only to meet the requirements of both European and non-European fund managers but also to best position themselves to take advantage of the opportunities presented by AIFMD.

AIFMD for depositaries

Liability

The depositary provisions are among the most controversial elements of the Directive due to the new liability regime and its associated costs. The Directive imposes a form of strict liability on depositaries for the financial instruments they hold in custody, which must be replaced by the depositary without undue delay in the event of loss. The exact scope of assets held in custody and therefore under strict liability remains a contentious area as the implementing measures evolve. At a minimum, assets under strict liability will include transferable securities (including embedded derivatives), money market instruments and units of some collective investment undertakings.

In its advice to the Commission, the European Securities and Markets Authority (ESMA) ruled out the inclusion of OTC derivatives within custody due to the numerous impracticalities surrounding this concept. Cash deposits, private equity shares and financial instruments (including units of collective investment schemes) that are not registered or held in the name of the depositary are also out of scope. However, fund of funds and life settlement funds will be subject to custody and depositaries will need to develop new market practices to maintain accurate valuations and records for holding these types of assets in custody.

The treatment of collateral is perhaps the most contentious point in relation to the scope of the depositary liability. ESMA's advice was to generally exclude from strict liability assets provided as collateral, thereby acknowledging current market practice and the prime broker's role as a counterparty rather than a sub custodian. However, the status of collateral is currently far less clear and could lead to differing treatment depending on whether there is a transfer of title. The inclusion of collateral within the depositary liability regime would have significant implications for interaction between the depositary and prime brokers with resulting changes in market practice.

External event and discharge of liability

Only if an event is 'external', 'beyond reasonable control' and the consequences would have been 'unavoidable' can the depositary discharge its liability. These criteria and their interpretation by ESMA make it more challenging for a depositary to discharge its liability, as the depositary will be liable for the actions of both affiliated and non-affiliated sub custodians. For example, the depositary retains liability for instances of fraud or insolvency within the sub custody network. Accounting errors, operational failures and failure to apply the asset segregation requirements properly at sub custodian level also constitute 'internal events' for which the depositary is liable.

External events under which the depositary could discharge its liability are limited by ESMA's advice to extraordinary occurrences such as natural events beyond human control, acts of State (e.g. nationalisation), war, riots or major upheavals. ESMA has also clarified objective reasons under which the depositary may contract a discharge of liability with the sub custodian and AIF/AIFM but these are also very limited in scope. The depositary must have no other option but to delegate custody duties to a third party (e.g. as a result of legal constraints) or because the AIFM considers that it is in the best interests of the AIF and its investors for the depositary to discharge its liability.

Due diligence

Depositaries will look to exercise a greater level of due diligence over their sub custody networks not only due to the increased level of risk but also because AIFMD lays down detailed requirements in this regard. Depositaries will need to review sub custody contractual arrangements, strengthen their policies and procedures for appointing and monitoring sub custodians and ensure that assets are properly segregated at sub custody level. Even if, for reasons of local law, the segregation measures are insufficient, the depositary must assess what additional arrangements it can deploy to make the assets as insolvency-proof as possible. In the event of loss, the burden of proof will lie with the depositary to demonstrate that the loss could not have been prevented and the level of due diligence required must be rigorous and comprehensive rather than reasonable. This new level of due diligence and compliance burden will come at a cost and will likely require further investment in resources and technology.

Additional duties

In addition to the new liability regime, AIFMD also clarifies the duties and functions of a depositary which include safekeeping, oversight, cash monitoring, due diligence and segregation of assets. Cash monitoring in particular will be a new requirement for most depositaries, involving oversight of subscription and redemption flows. Depositaries will have to take a view on how much risk weighted oversight should be performed on these transactions and a standard market practice may take time to emerge. Depositaries can also expect increased oversight from other depositaries in applying these rules. Cash monitoring duties are similar to the services currently provided by fund administrators and therefore depositaries that do not have a strong fund accounting function may be at a disadvantage.

Pricing risk

The new liability regime will require depositaries to price appropriately for the risk of losing assets in the custody network under the new liability regime and the cost of holding additional capital to cover that risk. Depositaries will need to assess their existing custody arrangements to determine how the risk profiles are likely to change for each asset type and jurisdiction. One key challenge is that the risk associated with any given sub custodian may be difficult to measure and any failure or credit event could result in catastrophic losses for the depositary. Depositaries that respond by applying blanket fee increases to existing clients are likely to face significant resistance from clients, but more importantly, will have significant mis-pricings across their book of business. Over time, this is likely to result in riskier clients gravitating towards the depositary and in lower risk clients migrating to service providers that are better equipped to measure and price risk.

The challenge for depositaries is therefore to develop capabilities to measure and price risk effectively while also pricing in the additional due diligence and compliance responsibilities. This will require the development of an effective risk model using powerful data analytics to accurately assess and price risk, based on a comprehensive set of risk factors and scenarios. Depositaries that can develop effective risk and pricing models will be in a sounder financial position under AIFMD and can use this advantage to achieve true market differentiation.

Market impact

The landscape of the European depositary market is likely to change radically post AIFMD. The increased risk and the associated increase in the level of capital depositaries will be required to hold, may reduce the attractiveness of the fund depositary business. On the demand side, clients may gravitate towards those depositaries with the largest and safest balance sheets, contributing to a smaller number of players operating in the market. We expect to see a greater level of M & A activity within the market as certain players seek an exit strategy while others seek to grow market share. The winners will be those depositaries that are well positioned in terms of scale, capital, risk pricing and global custody networks.

Depositaries should perform a cost benefit analysis of the markets in which they operate and of their existing sub custody arrangements. Certain markets may be identified where it is no longer viable to provide custody services, while in other cases depositaries will seek to revise fees upwards to reflect the new risk levels. Consequently, investing in emerging and frontier markets could become considerably more expensive at a time when appetite for such markets is increasing rapidly. Depositaries that have, or can develop, an extensive sub custody network within their group will be able to use their branch network to mitigate risk. For that reason we may see depositaries establishing new branches to perform custody activities in jurisdictions where previously they relied on external sub custodians. Other depositaries may seek to establish strategic relationships across certain jurisdictions or develop certain specialisations.

For depositaries that develop the right model, there will be real opportunities for growth. The overall size of the market is set to grow as various entities that currently do not appoint a depositary will now be required to do so. This is particularly the case for segments such as private equity and real estate. As private equity shares and real estate will not full under the strict liability regime, acting as depositary for these entities might be particularly attractive to non-EU credit institutions. An EU AIFM marketing a non-EU fund into the EU under private placement must appoint one or more entities to carry out the duties of a depositary under AIFMD. Managers may require additional support from service providers to carry out these functions, which cannot be performed internally. The third country passport, due to come into effect from 2015, will require compliance with the full depositary regime for non-EU funds managed by non-EU managers, creating a new market for depositary services.

UCITS V and beyond

The draft UCITS V Directive will follow AIFMD in seeking to harmonise depositary duties and liability across the EU, in an attempt to eliminate the inconsistencies in depositary rules that were brought to the fore during the recent financial crisis. Both directives will clearly increase the workload, level of liability and costs for depositaries. However, both directives lay the foundations for an EU depositary passport and a common EU depositary market that will enable greater operational efficiencies and facilitate economies of scale. Depositaries will be able to develop common standards, policies and procedures and centralise controls and oversight across EU markets. All of these developments point towards large, well-capitalised, highly efficient and highly specialised depositary service providers.

AIFMD for fund administrators

The term ‘fund administrator’ is never specifically mentioned in the Directive. Nonetheless, investment managers will undoubtedly look to their fund administrator for assistance on various operational aspects of the Directive, particularly with regard to regulatory, investor and risk reporting, liquidity profiling and complex valuations. AIFMD can offer fund administrators the opportunity to provide value added services and enhance profitability at a time when intense fee pressure and market volatility have reduced margins.

Reporting

One of the objectives of AIFMD is to monitor systemic risk and this is to be achieved through reporting to the AIFM’s regulator. Reporting will be required for each fund either on a quarterly, bi-annual or annual basis, depending on the level of assets managed by the AIFM. ESMA has prescribed a 16 page template requiring detailed reporting on investment profile, risk, liquidity and leverage. The time and resources required to complete the form for each fund under management on a quarterly basis will be significant, with costs conceivably running to several hundred thousand euro for medium to large scale managers. In many cases fund managers will look to outsource this complex, operationally intensive process in order to minimise costs and maintain their focus on core activities. Non-EU managers selling into the EU will also be required to undertake this reporting and will almost certainly need assistance from local fund administrators in fulfilling these requirements.

Fund administrators already have access to much of the underlying data required for regulatory reporting purposes and are therefore ideally placed to provide this as an additional service. Success will depend on the administrator’s ability to deliver a competitively priced automated solution which minimises manual inputs and operational risks. New investor disclosure requirements combined with market demand for increased transparency provide scope to develop tailored investor reporting solutions. Operational synergies with other reporting and transparency initiatives such as the US Form PF and European Market Infrastructure Regulation (EMIR) should also be identified in order to maximise efficiencies and future-proof systems insofar as possible.

Risk reporting and liquidity profiling

Much of the UCITS risk management framework has been imported into AIFMD, requiring the application of new, uniform risk management standards on the diverse alternatives sector. This creates a further opportunity for fund administrators to provide additional risk reporting and enhance their middle office and compliance capabilities. AIFMD also requires managers to monitor the liquidity profile of the underlying assets against the redemption policy to ensure they are consistent. Administrators are well positioned to perform this liquidity profiling and to provide analysis for liquidity stress testing.

Valuations

The Directive clarified that the AIFM is ultimately responsible for the valuation of the fund's assets but may delegate to an "external valuer" who is liable in turn to the AIFM. ESMA's final advice has clarified that a third party administrator incorporating values obtained from the AIFM or other sources is not the "external valuer" by virtue of this activity alone. Contractual arrangements between the various parties regarding valuations will need careful consideration as a result of AIFMD. There may be demand for third party administrators to perform the role of external valuer. While this would come with additional liability that some administrators may not wish to take on, others may see an opportunity to provide new valuation services such as esoteric asset valuation.

On the 'front foot'

AIFMD will have far-reaching compliance, operational and distribution implications stretching beyond Europe. Both EU-based and non-EU managers will require increased operational support in navigating this new regime. Service providers will be forced to consider their market positioning and operating model in this new and evolving environment. EU depositaries face a range of new requirements and increased operational risks but this new regime also presents opportunities to gain market share in a growing market. For fund administrators, AIFMD can provide a route to enhance profitability and create a deeper strategic partnership with clients as they address the operational challenges of AIFMD. Service providers that react quickly to market requirements by developing bespoke AIFMD solutions can secure a genuine competitive advantage through these advanced capabilities.

Authors

Brian Jackson, Director, Investment Management Advisory, Ireland

Patrick Rooney, Manager, Investment Management Advisory, Ireland

Michael Booth, Manager, Financial Services Audit, UK