Risk management within AIFMD for private equity and real estate funds

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In a nutshell

- The AIFMD framework marks a major development for private equity and real estate funds with regard to risk management requirements
- The interpretation and implementation of these requirements raises a number of questions and challenges in relation to governance, roles and responsibilities and risk measurement techniques
- Identification and close monitoring of risks in private equity and real estate investments require specific expertise and expert judgment which cannot be expressed through the quantitative risk indicators commonly used in more traditional financial asset classes
- A meaningful and appropriate risk monitoring and reporting process can increase transparency and disclosure for the ultimate benefit of investors and AIFMs, turning client servicing into asset growth

Introduction

The Law of 12 July 2013 implementing the Alternative Investment Fund Managers Directive (AIFMD) in Luxembourg and the EU Commission Delegated Regulation 231/2013 (Level 2 Regulation) set up the new regulatory framework for Alternative Investment Fund (AIF) risk management, with many of the implementing measures and authorisation processes now in place. While compliance gaps for AIFM already in line with UCITS regulations have proved to be limited (with the notable exception of regulatory reporting, remuneration and risk management of illiquid assets), compliance may be more challenging for pure alternative players such as private equity, infrastructure and real estate managers, for which most of the AIFMD requirements, are completely new.

Among the challenges faced, risk management requirements for private equity and real estate raise many questions and concerns within the industry, along with regulatory reporting, which is characterised by risk metrics and risk-related data. Identifying and implementing appropriate risk measurement techniques and procedures for those very specific asset classes is likely to represent a challenge for risk managers, on top of the organisational and independence requirements relating to risk management.

This paper aims to present in detail the challenges faced by private equity and real estate managers in meeting AIFMD risk management requirements and the potential solutions available going forward. It is structured in three parts: governance and organisation (strategic level), risk identification, measurement and documentation (tactical level) as well as risk monitoring and reporting (operational level).

Governance and organisation

Organisation

Most private equity and real estate managers have to adapt their organisation to incorporate a permanent risk management function that in most cases did not exist at the time of AIFMD implementation. This function should have full escalation and whistleblowing capacity with respect to the governing body, while being hierarchically and functionally independent from portfolio management activities. Defining an independent line of reporting may involve strategic reshaping of the organisation to ensure the independence of risk management up to the governing body of the AIFM. Possible solutions include recruitment and the merger or outsourcing of functions, all of which present pros and cons.

Recruiting an experienced risk manager with appropriate industry specialisation offers significant benefits, as he will be able to provide insightful support in setting up the function and ensuring compliance with independence and ongoing risk monitoring and management requirements without an additional workload being created. However, appropriate profiles in the market might limit this solution to a small number of players.

Combining risk management with the compliance function on the basis of the proportionality principle, if approved by the regulator, has the obvious advantage of not incurring extra costs. Training and delegation of certain aspects may be required in case of lack of time or experience.

Outsourcing part or all of the risk management function is the last option. The AIFMD regulatory framework defines the extent of delegation for the portfolio management and risk management functions. As it is clearly aimed at avoiding 'letter box' entities, the substance of the management companies will be in the spotlight. Outsourcing will have to be carefully analysed as outsourced activities should not exceed by a substantial margin the functions performed by the AIFM itself.

Roles and responsibilities

Once created, the roles and responsibilities of the risk management function should be clearly stated. The minimum regulatory requirements are:

- The implementation of effective risk and liquidity risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks to which each AIF is or may be exposed, including through the use of stress tests
- The monitoring of the risk profile of each AIF and its compliance with the risk limits set in accordance with Article 44 of the AIFM Regulation
- The notification in a timely manner to the senior management of the AIFM when it considers that the AIF's risk profile is inconsistent with these limits or sees a material risk that the risk profile will become inconsistent with these limits
- The provision of regular updates to the senior management of the AIFM, outlining the current level of risk to which each managed AIF is exposed and any actual or foreseeable breaches of any set risk limits, the results of stress tests and scenario analyses

To achieve these objectives, the risk manager could benefit from close interaction with other functions (i.e. portfolio management, valuation, internal audit and compliance) and from their specific expertise. The monitoring of investment risks and the various risk analyses performed by portfolio managers and the valuation function could serve as very good basis for the risk management function to be reviewed and challenged, and complemented where necessary with additional independent analyses. Despite relying partially on other functions' output, the risk manager should cover the whole risk management cycle that encompasses pre-investment risk, risk measurement, risk monitoring, stress testing and reporting.

In order to formalise and organise the risk manager's roles and activities, it is necessary to define a comprehensive job description detailing activities as well as the content, frequency and recipients of reports .

Risk identification and measurement

Risk management policy

The risk management function has to operate based on written procedures, with the risk management policy being the core document detailing its structure and operations in terms of risk governance, risk profiling, risk limits, risk measurement and monitoring techniques as well as risk reporting content and frequencies. The risk management policy should be carefully prepared, as it will be scrutinised by the regulator as part of the authorisation process, and will be periodically reviewed.

Risk identification

Unlike vanilla asset classes such as listed equities and fixed income securities, private equity and real estate investment funds have a limited risk management culture, with most of the investment and risk management expertise being concentrated at the level of the portfolio management team. The key role of the risk manager is to identify all the risks that the managed AIFs are, or might be exposed to, and to assess their significance. Common risks faced by private equity and real estate funds relate to funding, financing, concentration, valuation, key people, governance, etc. Some risks may be related to the nature of the investments, with a direct or indirect impact on their valuation, while others may affect the portfolio or the fund only. The regulator has clearly stated that the risk profile assessment is the first and most critical step to be addressed. From a regulatory standpoint, considerable emphasis is put on the appropriateness of the actual risk profile of the fund and the risk profile disclosed to investors.

Pre-investment risk analysis

As private equity and real estate investments are by nature illiquid and designed to be held over a long period of time, selling part of the assets is rarely a possible solution for risk management purposes. In this context, the most critical risk analysis occurs before the investment decision. Such analysis requires in-depth understanding and identification of risks to which the investment may be exposed, such as regulatory, tax, country, political or market risk, and all risks relating to the financing structure, valuation or growth.

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Measuring such risks requires specific skills and knowledge of the industry and of the targeted investee or property, and is only achievable through a comprehensive due diligence exercise. What could or should be the role of the risk managers in the investment process? Should it be challenging or reviewing the due diligence? As a party independent from the pre-investment phase, the risk manager could be of valuable support to the AIFM's governing body in ensuring each step of the due diligence has been thoroughly executed.

Risk measurement techniques: valuation risk, performance risk and beyond

How to measure risks associated with private equity and real estate investments as well as their evolution has been and will remain a very live issue. The lack of quantitative data and the illiquidity of these investments make it very difficult to come up with a short-sighted risk measurement framework such as the Value-at-Risk metric commonly used in the UCITS and liquid financial instruments world. Quantitative risk indicators such as changes in value or volatility of relevant market data (e.g. exchange rates and interest rates), microeconomics (e.g. tenant default rates and rent hikes) and macroeconomic indicators (e.g. GDP growth and inflation rate) can obviously help risk measurement and monitoring, but in light of the very specific nature of those assets, capturing all material risks of private equity and real estate funds and their proper monitoring requires going beyond setting up a handful of periodically updated key risk indicators. Indeed, many risks can materialise in different ways and have a significant impact on a private equity or real estate business (including but not limited to taxes, regulations and competition), meaning that qualitative monitoring and assessment remain the best line of defence. However, such defences require in-depth and close interaction of risk managers with portfolio and asset managers. Some risks may lie within the valuation process itself, such as discount rates and business plan assumptions, and could require close oversight from the risk manager. Risk measurement techniques should enable the risk manager to measure the most material risks at investment and fund level. Going forward, more advanced risk modelling techniques could enable risk managers to combine the various risk indicators in order to derive an assessment and monitoring of performance risk through estimated distributions of internal rates of return over a given time horizon (e.g. IRR@Risk).

Stress tests

Stress testing requirements introduced by the AIFMD are a new (and possibly challenging) factor for many private equity and real estate managers. The results of stress tests are one of the elements that have to be included in periodic reporting to competent authorities, hence the attention paid to them. The implementation of a stress testing framework can be described in four stages: the previously performed risk identification process, definition of scenario, execution of scenario and analysis of results. The definition of scenario could benefit from the involvement of all stakeholders, from portfolio managers to senior management, as a guarantee of appropriateness and integration within the investment decision process. Scenario execution may be performed using a top-down approach, decomposing the fund in relation to a set of exogenous risk factors, or a bottom-up approach, stressing the valuation of each investee or property under a common scenario and deriving the NAV of the fund. The stress testing exercise can, in most cases, leverage from the work already performed in the valuation of private equity or appraisal of real estate properties, by taking a forward-looking view. This work should enable an assessment to be made of the impact of adverse scenarios on the NAV of the fund. Comments on stress test results are also expected to be provided in the periodic regulatory reporting.

Risk monitoring and reporting

The regulatory framework provides no practical guidelines on the frequency or template for the risk management reports required to be submitted to the governing body of the AIFM. Reporting frequency could of course consider frequency of NAV calculation or of Board meetings, and should be at least on an annual basis, but data availability on underlying assets might challenge the ability to provide meaningful reports at a high frequency. The content of the reports should enable senior management to get an understanding of the current risk profile of the fund and of its evolution, including valuation risk, compliance with internal and regulatory risk limits as well as the results of stress tests. It may provide trends and an events update on underlying assets along with any significant risk realisation during the reporting period. Being independent from portfolio management, the reporting provided by the risk manager may enable senior management to take appropriate corrective actions when needed, such as currency or interest rate hedging, or to monitor more closely the evolution of certain risk exposures, such as distance to breaching covenants, political or fiscal risks, exit risks, etc.

Why go beyong regulatory requirements?

This article has tried to illustrate the potential challenges private equity and real estate managers face when implementing AIFMD risk management requirements. In relation to the primary objective, i.e. regulatory compliance, AIFMs can also leverage their risk management function to enhance governance and transparency for senior management, monitor performance risk and meet growing investor demand with regard to risk disclosure.

Improving internal transparency

As described above, we believe a well-structured and independent risk management function will:

- Improve internal risk management skills and capabilities
- Facilitate communication and knowledge transfer between portfolio managers, risk managers and senior management
- Enhance risk oversight, awareness and transparency, including valuation and performance risks
- Help to identify potential shortcomings with regard to future regulatory requirements

Enhanced transparency and communication could also help AIFMs meet the growing concerns of investors on risk-related matters, as well as regulatory reporting requirements.

Meeting investors' expectations

Investors' standards and expectations regarding transparency and disclosure (the 'transparency gap'), as well as general public scrutiny, are likely to increase as real estate and private equity investments become increasingly prominent and visible. That will make sound and effective risk management a genuine marketing argument in a challenging and competitive environment. Delivering value-added risk management reporting to institutional investors could be an opportunity to bridge the transparency gap, helping to shorten the increasingly lengthy fundraising and due diligence processes, and to turn client servicing into asset growth.

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