

Risk Management in the AIFMD era

Research survey 2014

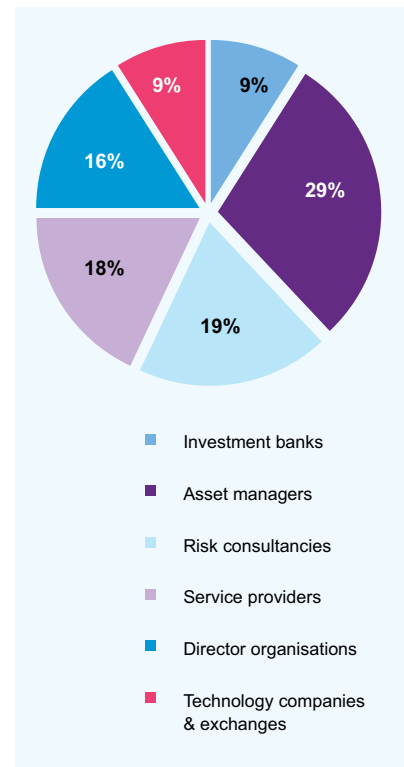


Introduction

The objective of this research study was to explore how risk management in Europe's alternative asset management industry is evolving as the AIFMD era begins. From February to May 2014 IFI Global's Research Department interviewed 80 firms involved in risk management in the European investment banking and fund industries for this purpose.

One of the principal reasons given for the AIFM Directive's introduction is to develop strong and professional standards of risk management in the alternative investment industry. Given this objective this study sought to find out how well prepared the industry is to meet the risk management challenges of AIFMD.

As well as surveying both large and small alternative managers the research study also sought the views of leading European based investment banks, risk consultancies, fund administrators, director organisations and technology companies. The breakdown of firms interviewed was:



- Asset managers interviewed ranged from those with AUMs in excess of \$1 trillion through to \$50 million. 44% of managers have long only as well as alternative funds. 56% were dedicated hedge funds. 17% were fund of funds.
- Consultancies interviewed included organisations dedicated to risk management in the investment industry as well as two of the big four global accountancy companies with risk management consultancy services for fund managers.
- The service providers were third party fund administrators all of whom, with one exception, are multi domicile.
- 61% of the directors organisations interviewed are multi domicile. Directors based in Dublin, Luxembourg, Malta, Guernsey and Jersey were interviewed.
- Banks interviewed are well known investment banks in London.

Contents

Summary	4
Risk management vs risk measurement	6
Judging a firm's risk capability	10
Separation of risk management from portfolio management	14
Risk expertise board issues and AIFMD	17
Operational & regulatory risk	19
Conclusion	22



Summary of the findings

- Hardly any of the managers interviewed plan to hire additional risk officers as a result of the arrival of AIFMD. Only one of the asset managers surveyed said that they are doing this. Larger managers that responded have well-resourced and sophisticated risk management departments. As a result they can largely take AIFMD in their stride. Many of the smaller managers interviewed seem to be overwhelmed by the regulatory Tsunami that they face and are not able to increase their risk management resources as a result.
- The approach taken by larger managers to risk management, those with AUMs in excess of \$1 bn, seems to be significantly different from the boutiques. These differences might well be growing. The boutique managers interviewed are multi-tasking risk management with other functions.
- Paradoxically, AIFMD might end up being a net negative for real risk management. Some boutique managers are adhering to the letter of the law but not the spirit of it. However investors perceive alternative funds regulated by the Directive to somehow be 'safer' than offshore funds. The degree of multi-tasking envisaged by a number of the smaller managers surveyed is not healthy for real overall risk reduction. As many respondents pointed out, risk reporting is not the same thing as real risk management.
- Fund boards are not ready for AIFMD's risk management requirements. This may well be the most surprising finding of the survey. No one interviewed thinks that there are enough people with risk management experience available to serve on the boards of hedge funds, particularly those funds falling under the supervision of the AIFM Directive.
- Risk management is often being confused with risk measurement by fund boards, in particular, and by some managers too, according to interviews that were done with many risk consultancies. The new regulatory environment, with its emphasis on extensive risk reporting, is one of the reasons for this.

Summary of the findings

- The larger the organisation interviewed the greater emphasis that there is on risk management as a broad and holistic concept encompassing various elements in addition to market risk. At these organisations there is less emphasis on a “tool-driven” approach to risk management, as one interviewee called it, and more on risk-monitoring and anticipation of future problems.
- Operational and regulatory risk are the areas of greatest concern for the majority of survey interviewees. Regulatory risk, in particular, is a growing problem. The survey found that operational risk is the area of risk management that has traditionally been discussed least. The reason for that is almost certainly because it is the most difficult to quantify or to measure. Nonetheless operational risk is becoming more embedded in risk calculations at the larger organisations interviewed.

Risk management vs risk measurement

Larger fund managers and investment banks interviewed stated that risk management needed to go through a re-appraisal following the market crisis. Their view is that the market crisis occurred because it was assumed the worst case scenario was based on what had happened in the past rather than a set of circumstances that hadn't yet evolved. This has made larger managers more forward looking. "Risk management is in the process to moving from what is essentially an ex-post function to a more ex-ante-based function. Measurement means historical numbers; it is another part of performance disclosure whilst risk management is forward looking – in other words anticipating what might happen and what to do about it," said a large alternative and long only manager.

There was broad acceptance by interviewees that the sequence of events that lead to the market crisis took everyone by surprise. Many of the more experienced risk professionals interviewed said that one of the lessons is that trouble can arise when everyone in the industry does risk management the same way, which used to be common and still can be the case today. For example it is thought that too much reliance on VaR analysis can cause systemic risk.

Today there is a widespread view that risk management is much broader and more complex than risk measurement. Time and again senior risk professionals from investment banks and large managers surveyed said that the real skill is in making sensible judgements about the future. One interviewee said that 95% of the risk management function at his firm is now forward looking. Scenario stress testing has become standard.

Allied to this is a dismissive attitude to risk measurement. It is just a set of historical numbers that are produced by "monkey machines," said one risk manager. Those who hold this view say it should be more of a part of performance disclosure than

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Risk management vs risk measurement

risk management. There was much criticism of the overall quality of standard risk reports in the industry today, particularly with regard to their lack of sophistication. Those that said this don't believe that risk reporting has developed far enough since the market crisis. They added that risk reports are not very different from what was being produced 10 years ago. What really has changed in risk management, since the market crisis, is the sophistication and knowledge of those that interpret the data - and what this information is then used for. Improvements suggested include data that has a predictive dimension to it.

A number of interviewees from the risk consultancy sector that were surveyed said that managers confuse risk management with compliance. They suggested that in the long only UCITS world risk management is, to some significant extent, a compliance function as you are mainly monitoring a VaR number.

Increasingly forward looking risk management includes analysis of operational and regulatory issues as well as other areas beyond market risk. To date the focus of risk management has been on investment risk side of the business. But there is a growing view that risk management is much broader than market measures. "Risk management used to mean market risk, and often one size fits all market risk. Now people are much more aware that they need to have a risk management service that is more driven by strategic requirements, strategy and risk positioning," said one of the leading risk consultants.

Many asset manager interviewees in what might be termed the forward-thinkers group also look at enterprise-level risk, which is defined as operational risk, linked to strategic risk within the business, including governance.

The boutique managers surveyed do not do as much forward looking risk analysis as the larger managers. The larger the



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Risk management vs risk measurement

manager the more resources available for this task. A number of those in this category made the point that forward looking analysis is difficult to do in their areas of market. For example, one said that they invest primarily in illiquid assets, and forward looking risk management is difficult to do here.

Smaller managers were criticised by some consultants surveyed for not paying enough attention to risk management. One said: “Risk management remains relatively taboo; they know that they have to do something, but they not know how to tackle it, or they know how to tackle their core market risk but they don’t know how to tackle the whole spectrum of risk. They are very reluctant to admit that they have navigated through their industry without a proper understanding of risk management.” Another said: “The asset management industry does not have sufficient forward looking analysis. And this is not because they have an aversion, it’s just that when you have always done something a certain way you will make sure you do the same thing again.” Consultants believe that asset managers need a more granular and predictive risk management model.

Time and again smaller managers interviewed said that are already overloaded with substantial increases to their cost base because of regulatory Tsunami. The implication was that they were not intending to devote much more time or resources to risk management (other than what is required of them by AIMFD, particularly in terms of reporting).

The larger the organisation interviewed for this study the greater emphasis that there tends to be on risk management as a broad and holistic concept encompassing many elements in addition to market risk. At these organisations there is less emphasis on what one consultant called a “tool-driven” approach to risk management and more emphasis on risk-monitoring and anticipation of future problems through scenario role playing.

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Risk management vs risk measurement

The institutionalisation of alternative investment, particularly the quantum leap forward in due diligence standards that accompanied this, is the reason for the heightened interest in risk management, in addition to the lessons learnt from the market crisis. Increasing regulatory scrutiny has more recently become another reason.

“it’s just that when you have always done something a certain way you will make sure you do the same thing again”

Judging a firm's risk capability

The survey asked respondents whether there is a way of judging the success of a firm's risk management capability on the overall functioning of their organisation. Is there any way of demonstrating the effectiveness of a manager's risk department? And how much due diligence should investors do on managers' risk capability, including on the boards of its funds?

Survey respondents said that investors should receive detailed answers to the following questions before making allocations:

1) How much are the risk managers paid relative to the firm's portfolio managers and senior management?

A number of interviewees said that the simplest and most effective way of finding out how serious a fund manager takes its risk management responsibilities is to find out how much the risk managers are paid relative to the firm's portfolio managers and senior management. Many of those surveyed said that discovering where the most senior risk officers sit in the company's hierarchy is important, along with reporting lines to the management committee.

2) How extensive are the resources that are devoted to risk management?

Many suggested that investors should look at the overall resources that are devoted to risk management relative to other areas of the firm, in addition to the remuneration question raised above. This should include use of consultants and systems employed.

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Judging a firm's risk capability

3) Is there an independent director on the boards of a manager's funds that has risk management experience? Has the manager made an effort to find independent directors with risk experience or to provide risk training for their boards? Does the board have access independent risk data?

A boutique manager interviewed talked about what he called the "challenge" of making sure that everyone is aware of the risk management issues, including those on the board of their fund. He added that the risk culture should come from the board.

4) To whom does the most senior risk officer at the firm report and how separate is this from portfolio management?

Separate reporting lines up the firm's senior management and board are viewed by many large interviewees as critically important. (See page 14 for more on separation). But a boutique manager said that the criteria for success is that the risk people work closely with the fund management team. "I think that things can get very bad if risk managers are solely responsible for changing a portfolio's composition. I think effectively the impact of the risk management team is its influence on fund managers, and avoid confrontations." A large manager said: "The criteria for success is a free segregated structure, where you have some kind of independence which enables you to manage and monitor risk without having the fear of disrupting another area of the business. In terms of risk managers and portfolio composition changes, I think to the extent that these risk limits will breach our portfolios, risk managers will inform portfolio managers and suggest that they change portfolio composition, to make sure that the activity is within certain tolerances. The VaR is a really good example; there have been situations where the VaR has reached the limits, and portfolio managers had to rebalance portfolios to make sure that they all work within the same tolerance."

"I think what's happening with the regulatory side is fine but it doesn't help the organisation to get an overview; they are still struggling with that"



Judging a firm's risk capability

5) How is operational risk managed?

Operational risk is the area of risk management that most survey respondents said requires more attention. But it is also the area of risk management with the greatest variety of approaches taken along with varying degrees of seriousness in terms of its importance across firms. Consultants say investors should ask more questions about how operational risk is managed.

6) Is there a risk management culture embedded across the organisation?

Investment banks, in particular, that were interviewed made the point that the most critical measure of success is getting a risk culture embedded across the organisation. Some implied that this has been a real and hard won challenge to change the organisation's culture. "Risk is our front line of defence. The notion of embedding a risk culture across the organisation is something that we're very focussed on right now". Another bank said the criteria for success is if the risk department is the first port of call. This interviewee added: "I quite often wish we weren't the first port of call. But it is better to be that way."

A risk consultancy interviewed that has large number of large asset manager clients talked about the importance of instilling a company-wide risk management culture – across departments and multiple asset classes: "the ability to aggregate across the firm is somewhat lacking. I find that having worked with risk more or less for 15 years I don't think the industry has made a lot of progress. It is at a standstill and I think what's happening with the regulatory side is fine but it doesn't help the organisation to get an overview; they are still struggling with that. You can focus on some of these key things like liquidity risk, counterparty risk, collateralisation products; you can do all this but ways of actually aggregating something that an executive management team can actually use and that can guide them in the right direction – that is something that the industry really needs to work on".



Judging a firm's risk capability

7) Is the risk management team's influence on portfolio management decision making demonstrable?

Investors are advised to find out whether risk departments have the power of veto and/or what influence they have on portfolio management. They are also advised to find out how the risk and portfolio management departments work together in routine, day to day situations.

8) What risk systems are used and how integrated are they across the firm?

Risk consultancies said that there is now a realisation that risk management systems need to go beyond market risk; a "one-size-fits-all" approach to systems doesn't work. One risk consultant said: "Now managers are becoming much more aware that you need to have a risk management service that is driven by strategic requirements." Another consultant believes that few managers know how to create a risk profile. "It's very easy for them to say 'I need the tool' because the tool is all about programming and implementation, but in terms of building a proper management framework, I can see that people are still reluctant What we need to do is try to make our clients move from only market risk to any type of risk; we need to try to help them expand the range of risks that they look at."

Consultancies and technology companies surveyed liked to emphasise the importance of systems integration in risk management. Levels of systems integration is one of the ways of judging the success of an organisation's risk management capability. Systems integration also help organisations keep on top of the increased specialisation that there has been within risk management since the market crisis.



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Separation of risk management from portfolio management

The survey sought to obtain views from respondents on the importance, or otherwise, of an entirely segregated approach to risk management from a more integrated one. Views on how segregated risk management should be were largely determined by the size of the fund management business.

One of the largest managers suggested that risk management is very integrated in the company's processes. "It doesn't get any more glorious than that; it's part of our process, it's part of our operations; if you take it away, our process would be completely broken; it's interchangeable: we look at VaR, concentration risk, we look at counterparty exposure, we look at market impact, what market trends are...It's all risk related."

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All respondents say that they have at least a degree of separation of risk management from portfolio management. But some are more separate than others.

Every manager interviewed has a CRO. But usually at smaller managers, those with AUMs below \$1 bn, that person will also be responsible for other functions in the organisation as well.

The smaller the manager the greater number of functions that he or she will be responsible for. At boutique managers the CRO is

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Separation of risk management from portfolio management

usually the compliance officer or the COO. In some situations all these roles are combined. The CRO at some boutiques might also be the finance director too.

The smaller managers surveyed tend to focus their attention market and portfolio risk issues. They take a less holistic view of risk management from the large managers.

Managers surveyed with more than one fund tend to share risk oversight functions, with the portfolio manager of one fund acting as the CRO on another fund.

The larger managers interviewed have segregated risk management functions with separate reporting lines for different teams. In these organisations reporting lines up to the board are separate. One larger asset manager, that is part of an investment bank, said that that his reporting line is not even into anyone else in their asset management division.

Smaller managers interviewed will obviously comply with the letter of the AIFMD law, in terms their risk reporting functionality, but not necessarily the spirit of the Directive. The results of this survey indicate that they do not have the resources to do that, especially given the time and money they have been required to devote to meeting the overall regulatory Tsunami. One of the largest boutique managers interviewed said the following: “AIFMD has raised our administration costs by approximately 50% in our funds but I do not expect any investor will ever be able to identify a single benefit they have derived from the expenditure they have been forced to undertake”.

Just one manager interviewed reported that it is putting more resources into risk management as a result of AIFMD, as well as segregating functions to a greater extent than they have done before. This is a manager with an overall AUM of approximately \$100 bn. It has just segregated its risk management function of its alternative funds in the last six months.

“I think that things can get very bad if risk managers are solely responsible for changing a portfolio’s composition. I think effectively the impact of the risk management team is its influence on fund managers, and avoid confrontations”

“AIFMD has raised our administration costs by approximately 50% in our funds but I do not expect any investor will ever be able to identify a single benefit they have derived from the expenditure they have been forced to undertake”

Separation of risk management from portfolio management

Managers, both large and small, said that if portfolio and risk managers are at loggerheads then the system is not working. Managers interviewed with both alternative and long only funds agreed that their risk teams work more closely with the portfolio managers of their hedge funds than their long only ones.

Integration vs separation, the views of boutiques:

Boutiques said that risk management is an integral part of portfolio construction. “No other approach works and so frankly is just cosmetic.”

Degree of separation of risk functions made by large managers is “unnecessarily bureaucratic” and done “mainly for appearance’s sake” to keep investors and regulators happy.

“I hope nobody changes the portfolio composition just because the risk manager thinks that the right composition is another one. Risk management must have a consultancy, rather than a decision-making role.”

Integration vs separation, the views of large managers:

“The caveat to independence is that we work very collaboratively with the risk takers”.

“The risk team sits on the floor with the portfolio managers but their numbers are created independently.”

“It is about understanding each other’s concerns we have a subtle influence” (on the portfolio managers).

“We might tweak portfolios but we don’t change them.”

All respondents say that they have at least a degree of separation of risk management from portfolio management. But some are more separate than others

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“The caveat to independence is that we work very collaboratively with the risk takers”

Risk expertise board issues and AIFMD

Probably the most concerning finding of the survey is how ill prepared many fund boards are for the AIFM Directive. No one interviewed thinks that there are enough people with risk management experience available to serve on the boards of hedge funds, particularly funds falling under the AIFM Directive. (Hedge funds are the problem: for other alternatives, such as private equity and real estate, this was not an issue.)

In addition to the managers that were interviewed survey respondents included the leading fund director firms in the European fund domiciles (both those in the EU and offshore) as well major service providers operating in these jurisdictions. Not one respondent, from any of these categories, believes that the majority of boards are up to speed with the risk requirements of AIFMD.

Fund boards have always had a risk oversight role but those that fall under AIFMD now bear additional responsibilities that are codified by the Directive. Written rules have taken the place of general principles. Some of the alternative fund managers that were interviewed did not appear to be aware of this. (Under AIFMD if portfolio management is delegated then risk supervision has to be done in the jurisdiction where the fund is domiciled.)

The concern is that if a fund collapses and its directors were not able to demonstrate that there was someone on the board that was sufficiently well-qualified to take on the fund's risk oversight function then law-suits from aggrieved investors could follow. Boards may well outsource their risk oversight function but they are still required to have some with risk experience on the board to interpret the figures and make informed decisions.

“It is very difficult indeed to find good people for risk management activities” – Director firm in Luxembourg

“Historically risk management has never been embedded in fund governance practices. It has traditionally focused on due diligence and operational functions” – Director firm in Dublin and Luxembourg

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Risk expertise board issues and AIFMD

Boards are also required to demonstrate independence from the fund's portfolio manager: they are required to use third party data sources to evaluate the risks that the fund is undertaking. Less than half of those surveyed said that this has been put in place.

Survey respondents were asked if they might subcontract some or all of their risk monitoring role under AIFMD to a third party. The majority said yes. One interviewee said this is already happening frequently in Dublin and Luxembourg.

Just one of the service providers interviewed said they are looking to further develop risk management services, independent from their back office administration function, to managers and boards.

It is worth emphasising that this is a problem that is largely confined to the hedge fund sector. Survey respondents from private equity and real estate fund backgrounds gave very different answers to these questions. Particularly interviewees from the Channel Islands, where many of these funds are domiciled, are less concerned about the risk management board stipulations of AIFMD. Respondents from Guernsey and Jersey said that board risk supervision skills are sufficient for private equity and real estate funds.

Just one of the service providers interviewed said they are looking to further develop risk management services, independent from their back office administration function, to managers and their boards. This service provider already offers middle office services and is well known on the quant side of the business. This firm said that offering analytical tools and other services for risk management in the hedge fund business is an obvious growth area for them.

“Historically risk management has never been embedded in fund governance practices. It has traditionally focused on due diligence and operational functions”

Operational & regulatory risk

Operational and regulatory risk are the areas of greatest concern for the majority of survey interviewees. Regulatory risk, in particular, is a growing problem.

The area of risk management that is discussed least is probably operational risk. The reason for that is almost certainly because it is the most difficult to quantify or to measure. Also what might be considered a potentially serious operational risk for one firm might be of little to no importance to someone else.

Nonetheless operational risk is becoming more embedded in risk calculations at the larger organisations interviewed. CROs that look at overall enterprise risk include components for operational and regulatory risk (along with market risk, liquidity risk, credit risk etc).

But the response from boutique managers interviewed was significantly different. One of the smaller managers interviewed said that “day to day” operational issues are of “little to no concern” to his firm. But fraud and bankruptcy questions are. Another boutique described its interest in operational risk as being “episodic.” However for the investment banks and large managers interviewed it is continuous.

Unlike in other areas of risk management there is little standardisation or text book solutions to these questions. Many interviewees acknowledged that more should be done to standardise and define operational and regulatory risk, at least within alternative investing. There is less certainty on what to do about operational and regulatory challenges. There are no metrics that are robust enough to measure operational risk, but there are a lot of qualitative tests. Also operational risk management cannot be outsourced or placed in a subsidiary office on the other side of the world (as some investment risk measurement functions currently are).

Survey respondents defined operational risk as everything that doesn't fall into any of the other risk category. It can include systems risk, cyber risk, fraud, settlement failure, compliance,

“There are no metrics that are robust enough to measure operational risk, but there are a lot of qualitative tests”



“It is important define what it is before trying to mitigate it”

Operational & regulatory risk

counterparty, collateral, cash, legal, tax, etc. A number of interviewees made the point that it is important define what it is before trying to mitigate it. Operational risk management is about trying to work out what could go wrong and how exposed a fund would be to the various sources of error.

Regulatory risk is easier to define but is perhaps more difficult to keep on top of as a result of the regulatory Tsunami. One interviewee was very concerned about the consequences of falling foul of reverse solicitation rules under AIFMD whilst another thinks that FATCA could be more of a problem than his firm had previously anticipated.

Some of the ways that survey respondents deal with operational risk:

- STP measurement (at the manager's organisation and with external service providers)
- Key Operational Indicator measurements (measuring complexity of the trade flow, settlement, technology efficiency etc).
- Staff turnover levels at key counter-parties
- Qualitative written operational risk reports for covering different areas
- External reports from risk consultants and third party fund administrators
- Levels of responsiveness

A number of the largest managers surveyed said that staying on top operational risk is mostly about reducing the amount of manual effort in various processes. These managers are trying to reduce levels of human interaction in operational processes to a minimum. "We tend to be focussed on what the levels of human interaction, right through from trade processing to calculation of the NAV, the value of new securities, reconciliation. So we

Operational risk is becoming more embedded in risk calculations at the larger organisations interviewed



Operational & regulatory risk

measure the levels of straight-through processing throughout our operation, both internally and externally with key service providers” said one of the larger managers interviewed.

A risk consultancy said that across the asset management industry his firm sees two broadly different approaches to operational risk management. One is a bottom up approach to identify any deficiencies (such as the manual elements in any process). But many managers find this expensive and time consuming because it requires specialist people for each different area (for example, specialist IT people for IT etc). Then there is the top down approach in which a manager looks at all the operational losses it has encountered.

One interviewee suggested that the industry should establish an operational risk exchange. This would allow managers to benefit from work done by others. It is likely to be of particular benefit to smaller managers. This respondent mentions an ORX-type exchange (ORX=Operational Riskdata eXchange Association; www.orx.org).



Conclusion

The results of this survey results leave more questions than answers. For example:

Should more be done to standardise operational procedures in alternative investing?

Would an operational risk information exchange be of help to the industry, especially to smaller managers?

Should there be more of a coordinated response to regulatory risk issues (both in Europe and worldwide)?

How can AIFMD fund boards get up to speed on risk and what can managers do to help?

Should risk managers be offshoring functions in today's more regulated and holistic risk environment? Should risk monitoring functions be done at or close to where the firm's risk management decisions are made?

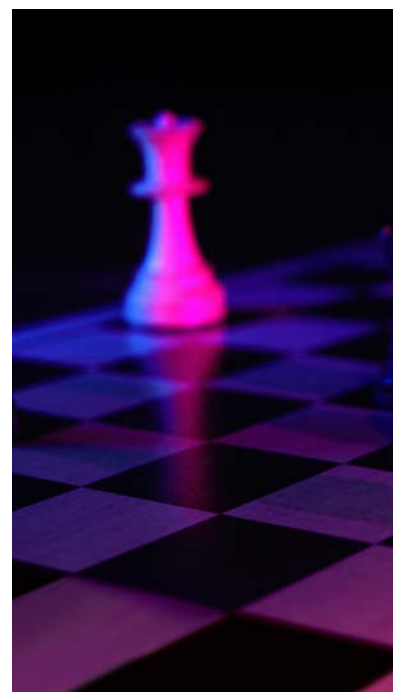
Should more be done to encourage the smaller managers, in particular, to take a more forward looking and holistic approach to risk management?

Should risk managers have veto powers?

Will there be a Weaving moment for AIFM fund boards? (The Weaving judgement in Cayman had a salutary effect on offshore fund boards. Will it require the collapse of an AIFMD regulated fund, one that was shown to be in breach of the risk requirements imposed on boards by the Directive, to make fund directors take their risk responsibilities seriously?)

These and various other questions that could be posed suggest the risk management in the European alternative investment industry is going through a period of profound change.

Risk management practices have come a long way since the



Conclusion

market crisis taking on board, as many of those surveyed have done, lessons learnt from the last decade. There will very likely be a great deal more innovation in risk management over the next few years. By the time of the tenth anniversary of the market crisis risk management will likely be almost unrecognisably better from where it was a decade before.

On other hand this survey has identified a number of areas of concern. The lack of preparation on risk management by many AIFMD fund boards is a particular problem. The level of multi-tasking of risk management with other unrelated functions by many boutiques is another.

But perhaps most worrying of all is that through its extensive reporting requirements AIFMD allows risk management respectability to be bestowed on a number of manager organisations that does not appear to be justified. It is not clear that investors understand this. ■





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