TheNED

Risk supervision

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The growing need for effective risk supervision

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The NED invited RiskSystem to contribute this White Paper on risk supervision. As mentioned in recent issues risk is becoming an ever more important part of the fund supervision process, including for non-exec directors. As a result The NED will be publishing many articles on risk supervision and management this year.

From SMIC to ManCo

Ireland in particular has had a long and fruitful relationship with the Self-Manged Investment Company model (SMIC[1]).

Indeed SMICs have reigned supreme in Ireland since the dawn of UCITS. The reasons for the success of this model are many – cost and simplicity were to the forefront. Managers could domicile a fund in Ireland relatively quickly, establish a board of directors and outsource to experienced, expert service providers such as administrators and custodians.

Occasionally a specialist governance company was engaged to provide compliance and governance assistance but this was not a regulatory requirement. Rather it was a way of supporting a manager who may have lacked the expertise to navigate the UCITS regulatory jungle.

The ManCo Model

So why on the face of it does this model that has worked so well seem potentially set to disappear? It is clear from AIFMD (there are several references to funds being potentially deemed letter-box entities) that regulators wish to see more substance behind funds.

If all services are outsourced per the SMIC model is there really any significant substance in place? It would appear that one driver behind Luxembourg instigating the conducting officer role was the increasing pressure from Swiss investors to see some actual substance behind the funds domiciled there[2].

> In many cases ManCos do not have the ability to produce their own risk metrics in house

It would seem the Irish Central Bank is similarly motivated to do likewise as evidenced by the introduction of CP86 with its focus on compliance, governance and supervisibility. The CBI sees the role of the Designated Person (DP) as the "day-to-day" link between the board (largely non-executive in most cases) and the Investment Manager. A criticism of the DP role is that it can in fact blur the distinction between executive and non-executive roles – in particular where non-execs take on DP roles.

However "beefing" up SMICs would appear to just load the fund up with costs and so the Management Company (ManCo[3] model is gaining traction. Costs can be shared across several funds and the ManCo can provide real and significant substance by providing legal, compliance and risk management services in-house.

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[1] Known in Luxembourg as "Sociétés d'Investissements Autogérées", also known as "SIAGs"

[2] See Luxembourg CSSF circular 12-546 (the 'substance circular') which clarified the organisational and substance requirements for Luxembourg based UCITS ManCos.

[3] In this paper no differentiation is made between AIFM ManCos and ManCo platforms.

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However evidence from The NED indicates that managers are trying to have their cake and eat it. ManCos are in some cases being established that are effectively SMICs in disguise in that there is in reality no actual (or at least very little) substance. They are trying to combine the advantages of the ManCo model with its low cost plug & play approach with the zero infrastructure (and hence zero-cost) of the SMIC. If you can set up a ManCo with just a couple of people, on-board ten funds at even half the cost of a traditional SMIC then this generates a nice revenue stream. At least for as long as you can get away with it.

However as The NED reports the regulators may be closing the door on this:

"Regulators like the CBI in Ireland and the CSSF in Luxembourg are taking a much closer interest in risk supervision since AIFMD came on the scene. As reported in this month's News The NED has heard that the CSSF has written warning letters to Luxembourg based ManCo platforms on this topic. One may well be closing as a result."

So the regulators are pushing for real substance and (finally) cracking down on "Manco-lite" models. So what piece of the Manco model is missing? Again the The Ned may have found the answer:

"Ireland's CP 86 stipulates that boards have to have a designated risk director. The risk director has to be independent of the investment manager and portfolio management function. Irish legislation says that boards can't rely on the risk figures from the investment manager."

What many ManCos have been doing is providing "risk-oversight" or "risk-lite". In effect they are merely taking the Investment Managers risk reports, reviewing and perhaps asking a question or two, but effectively signing off on the reports. In many cases they do not have the ability to produce their own risk metrics in house and therefore cannot drill down to see where risk is changing or evolving. If you cannot properly interrogate and evaluate the risk metrics provided by a manger (or ideally calculate

the metrics independently) how can you really understand the true risks of the fund?

The key drivers to the risk oversight model are cost and expertise. True risk professionals that fully understand the many types of instruments and strategies that modern day investment manager's trade are rare enough. And in general experienced risk managers do not come cheap. So how can a ManCo with two or three people and charging a very low fee satisfy the regulatory authorities that they are truly identifying, measuring, monitoring and managing all risks at all times (or as the regulators also like to say "on an ongoing basis). The reality is they can't – certainly not at a very low price.

What has the Luxembourg authorities so exercised appears to be the lack of substance as the ManCos there engage in a race to the bottom in terms of fees. Thus they feel obliged to take action and the net result likely will be the smaller ManCos, and those ManCos that cannot provide all the required services, will close up shop.

Those ManCos that have a comprehensive service will thrive as more and more formerly self-managed funds throw themselves at the feet of the fully comprehensive ManCo solution - thus ultimately (and ironically) driving down overall costs at the ManCo level. At a seminar hosted by The NED in London it was suggested, somewhat provocatively, that the number of ManCos (currently increasing in number) in Luxembourg would

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actually begin to shrink. This could be right in the short term but ultimately we will end up where there are a proliferation of ManCos and almost no self-managed funds (as that is what the regulators appear to want).

Another key driver (apart from the regulators) is that many service providers will not take on small funds – and in fact would like to reduce the large tail of smaller current funds. The 90/10 rule is in effect where the administrators make most of their money from a small number of large funds – the reality is there is not a lot more work involved administering a billion dollar long/short fund with 100 positions than there is managing a ten million dollar fund with only a few less positions.

With a basis point charging fee the maths are compelling. So what does the smaller manager do? The obvious and only solution is to go to a platform or ManCo and for a fixed fee seek cover under the regulatory umbrella. Ultimately there will be a small number of very large ManCos that have the economies of scale to undertake the governance, compliance and risk management effectively and cost efficiently.

Effective Risk Management

Focussing on one aspect of the ManCo functions – namely the risk management function – how would this function be structured in a properly functioning ManCo? The Central Bank of Ireland in a timely note titled "Thematic Review of Risk Function"[4] sent to the Chair of Investment Firms, Fund Service providers and Stockbrokers in December 2016 gave some indication of its expectations:

"Undoubtedly, identifying risks and the process in place to manage and mitigate those risks is essential for all firms. Critical to this is the risk function, which is the responsibility of the management of the entity in the first instance and ultimately with the Board of Directors.

The CBI found "notable inconsistencies and deficiencies in firms approach to identification of risks"

However, creating a culture of risk awareness amongst staff at all levels within a firm will serve to strengthen the risk framework. It is the Central Bank's expectation that boards' continuously examine their current risk frameworks in order to strengthen the resilience and cultural awareness of risk management within firms."

The CBI found "notable inconsistencies and deficiencies in firms approach to identification of risks, documenting risks, quantifying risks, mitigating risks and communicating these risks within the firm". Furthermore the CBI goes on to say "a key finding from the onsite inspections is that many of the good practices identified in the firms' documentation are not always evident in the operations of the business. Firms are reminded that policies and procedures are only of use to the firm if they are implemented at all levels."

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[4] *http://www.centralbank.ie/regulation/industry-sectors/fund-service-provider/administrators/Documents/Industry%20Letter%20-%20Thematic%20Review%20of%20Risk%20Function%205%20December%202016.pdf*

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At a minimum regulators clearly expect not only that policies and processes are documented but they are actually implemented in full. A Risk Management Process (RMP) needs to be produced but also needs to be a "live" roadmap covering the various risks a fund may be exposed to, limits (both hard and soft), action to be taken to remediate breaches or action to be taken when amber limits are reached, and finally escalation processes in terms of reporting to those ultimately charged with the funds supervision (usually the Board).

The following is a non-exhaustive list of questions the board, investors (or indeed regulators) should ask regarding the risk management function:

- Does the Board have a risk management policy in place?
- Is it appropriate to have a risk sub-committee?
- Does the Risk Director (RD)/ Designated Person have relevant market experience?
- Does the RD/DP have access to timely and relevant risk information?
- Does the board have a risk profile for each fund detailing all relevant risks and accompanying risk appetite and risk capacity for each relevant risk?
- Is the fund's risk function independent of the fund portfolio management function?
- Is there an escalation process in place to manage limit breaches that includes the RD/DP in extremis?
- Is there a regular review of the effectiveness of the Board and RD/DP oversight of the risk management process?

The only real question the Board should ask of the Risk Management Function is if it is fit for purpose. That is, can it independently monitor, in a timely fashion, all of the relevant risks to which the fund is exposed and can it act appropriately in extreme conditions? This can be broken down to the following:

- Do the personnel performing the risk function have the appropriate level of experience and expertise?

Can boards independently monitor all of the relevant risks to which the fund is exposed and can it act appropriately in extreme conditions?

- Is the risk function reliant on one person or is there a team in place?
- Has the risk manager manged risk in a crisis situation (stressed markets)?
- Does the risk function have the necessary independent tools to undertake the totality of the risk management function?
- Does the risk management function have a direct reporting line to the RD/DP?
- Is there a written policy detailing situations where the risk management function has the authority to alter the risk of the fund?
- Is the senior risk manager on the Board or attend all Board meetings?
- How is the risk manager(s) remunerated and does their remuneration depend on the performance of the fund(s)?

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- From which source does the risk manager receive position data (Portfolio Managers / PBs / Administrator)?
- From which source does the risk manager receive time series and indicative data?

In conclusion, it appears there is an inexorable move away from the SMIC model to a more substance-oriented operational model. This will require ManCos to beef up their operational capabilities across the board from risk and investment management monitoring, to internal audit and compliance.

This will require hiring employees with relevant backgrounds and experience - for example expertise and knowledge of different asset classes, instruments and strategies in the case of risk personnel. It is also worth noting that international agreement such as BEPS[5] will also require greater substance on the ground for entities wishing to avail themselves of tax treaty benefits.

A key component of any successful ManCo will be an effective risk management function. This is not intended as a replacement for the investment managers risk function but rather should be seen as complementary providing clarity, transparency and independence on behalf of investors.

[5] Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations. http://www.oecd.org/ctp/beps/

RiskSystem *provides comprehensive and innovative financial risk management and data services to the global funds industry via a proprietary cloud based platform. The company was formed in 2013 and services approximately 40 funds across Europe and North America. The company's prime focus is on providing its clients with risk information and undertaking regulatory reporting in a timely fashion. www.risksystem.com*

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