



# BNY MELLON AND AIFMD RESEARCH

## AIFMD: INDUSTRY READINESS: RISK AND COMPLIANCE

JANUARY 2014

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## AIFMD RESEARCH

We are now half way through the authorisation period for the Alternative Investment Fund Managers Directive (AIFMD). By 22 July this year, fund managers wishing to market alternative investment fund managers inside the EU will be required to have obtained regulatory authorisation. This is only one of a number of important regulatory measures for the alternative fund management sector and fund managers will be aware of its importance.

In December 2013, BNY Mellon conducted the second in a series of surveys amongst alternative fund managers to take stock of the industry's preparedness to implement the AIFMD. A total of 52 respondents from institutions with an accumulated total of over \$4 trillion assets under management participated in the survey. In addition to gauging the industry's progress in complying, the survey specifically focuses in some detail on the industry's approach to the myriad risk management and compliance monitoring requirements relating to AIFMD: we look at how the industry is addressing the AIFMD's data and monitoring requirements, what the key challenges are, the cost of compliance, how risk management solutions are developing, and how far down the line the industry is in preparing for authorisation.

## EXECUTIVE SUMMARY

There is evidence that AIFMs are delaying their application process. While 26% of our July 2013 survey participants expected to have submitted applications to their regulator by the end of 2013, according to respondents, only 12% had by mid-December with a further 7% expecting to by year-end. A full 81% of participating fund managers have yet to submit applications. Taking into account the amount of time taken for in-house functions, external administrators and depositaries to fully prepare, and the time needed by regulators to review applications, in our view there is a risk that many fund managers will miss the July deadline. On this point, many AIFMs have yet to make a final decision on how they will approach many of the critical elements needed to be compliant by the July deadline.

For instance, 37% are unclear about how they will address the additional requirements for regulatory reporting. 45% of survey participants are not yet close to completing their risk management processes, 45% are still assessing whether to pass on additional compliance costs required to their fund managers, and 26% of respondents are not yet decided on whether they will be hiring additional staff. Close to a third have yet to advance beyond conceptual stages in their risk and compliance monitoring solutions with only months to go until full compliance is required.

5% of AIFs are expected to be closed, merged or re-sold, suggesting a reduction in the choice of fund managers available to investors. However, this is significantly lower than the 39% of respondents in our July 2013 survey who expected to close some fund managers, move them out of the EU or merge fund managers.

Encouragingly for investors, there is a shift in attitude towards passing on AIFMD-related costs to the fund managers, therefore increasing the Total Expense Ratio (TER). Whereas in our previous survey 88% of respondents expected the cost of fund managers to increase, only 26% of respondents in this survey expect to pass on some costs to the fund and 29% don't expect to pass on any costs. No respondents expected to pass on all additional costs to investors. A significant number (45%) have yet to decide.

In terms of implementing new AIFMD risk and compliance capabilities, the industry appears to be making more progress. The majority (55%) have implemented, or are close to implementing, a risk management framework while even more (68%) have completed, or are near completing, their compliance framework.

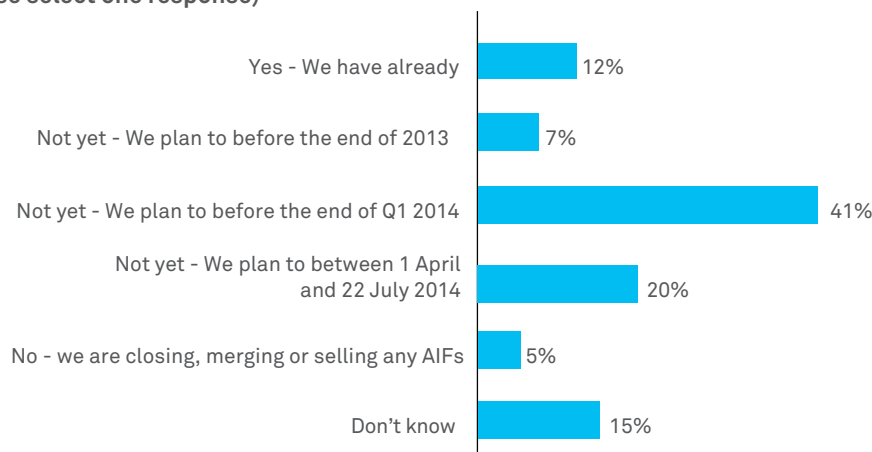
Almost all respondents (93%) see the increasing costs to support risk and compliance data as being challenging. 46% of respondents see the cost of additional technology increasing as a consequence of compliance with 36% of AIFMs in this survey expecting to incur additional cost for external service providers. Once more, 43% of respondents are still assessing where additional costs will lie.

## GENERAL PREPAREDNESS FOR RISK AND COMPLIANCE OBLIGATIONS

### HAVE YOU SUBMITTED YOUR APPLICATION TO YOUR LOCAL REGULATOR UNDER AIFMD?

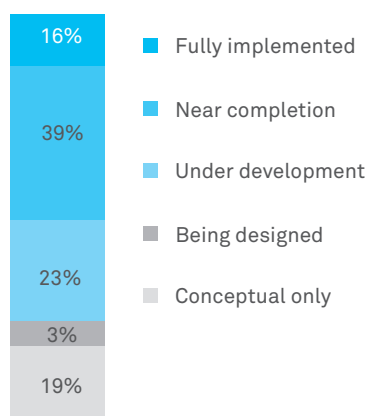
In our last survey of July 2013, 26% of participants expected to have submitted their applications to their local regulator during 2013. By the middle of December 2013, the actual percentage of fund managers that had submitted their applications was only 12%, with a further 7% expecting to by year-end. This has had the effect of increasing the number of fund managers that expect to submit applications in Q1 and Q2 2014, as the majority of the industry delays its implementation whilst the deadline for full compliance to the directive looms large. This suggests there will be a bottleneck of applications in Q1/Q2, potentially putting administrators, depositaries, other third parties and the regulators under pressure to complete the necessary work and to process applications in time for the July deadline.

**Graph 1 Q. Have you submitted your application from your local regulator under the AIFMD?**  
(Please select one response)



### IMPLEMENTATION OF RISK MANAGEMENT

**Graph 2 Q. How complete is your implementation of the RISK MANAGEMENT requirements?**  
(Please select one response)



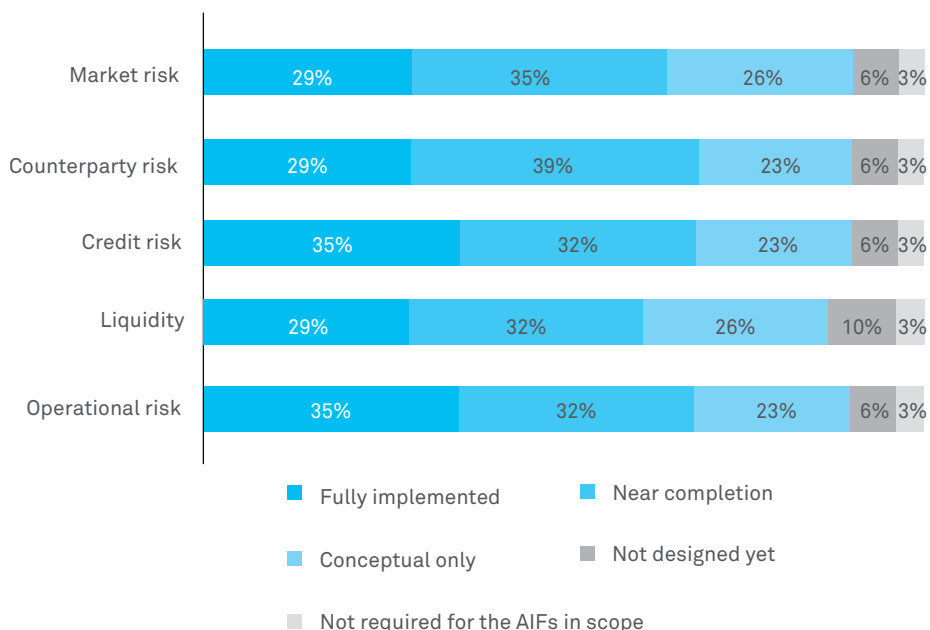
As an essential tool for a firm’s ongoing business and regulatory obligations, risk management and the solutions to effectively achieve this are critical. The firm with a flexible risk management system will find implementation for the purpose of AIFMD less onerous, particularly if an existing risk management package can be leveraged.

More than half of firms have taken account of the urgency to have such solutions in place as they approach the authorisation deadline for AIFMD. Therefore, risk management requirements have either been fully implemented (16%) or implementation is near completion (39%) in firms, making them eligible for full compliance with AIFMD.

Of the remaining 45% of respondents, 26% are either in the process of development or ‘being designed’. The 19% of respondents whose risk management systems are only at the conceptual stage have a short time to ready themselves for implementation, given the July 22 deadline and the time required by regulators to process applications.

A breakdown of the five key areas of risk requirements and their relative state of preparedness is below. While the majority of respondents are at or near completion for most areas of risk management, close to a third are yet to have moved beyond the conceptual stages in any of the five key areas required for full compliance.

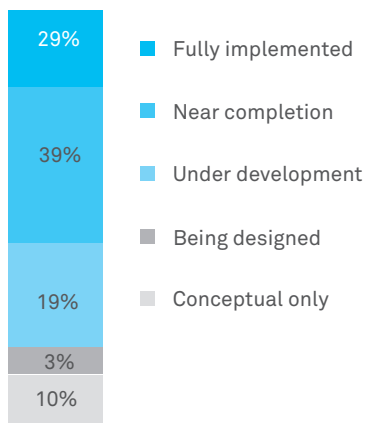
**Graph 3 Q. How complete is your solution for these RISK MANAGEMENT requirements? (Please select one column response for each row)**



### IMPLEMENTATION OF COMPLIANCE MONITORING

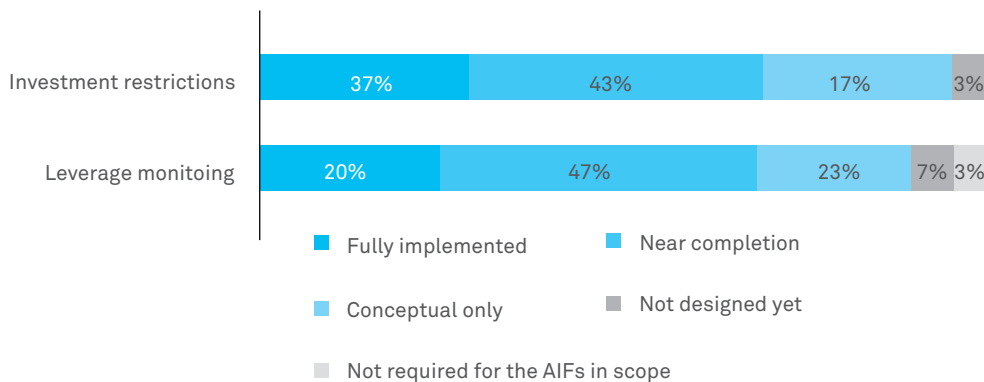
Implementation of the compliance requirements is at a similarly advanced stage with 39% of respondents nearly completed and 29% completed. More concerning from an implementation point of view is that 19% of respondents cited their compliance tools as 'being designed', suggesting some lag to implementation, while a further 10% are 'conceptual only'.

**Graph 4 Q. How complete is your implementation of these compliance requirements?**  
(Please select one response)



Below is a breakdown of the level of completeness of participants' compliance solutions. Again, this highlights how, while the majority are at or close to completing compliance monitoring solutions, 20% and 30% of respondents have yet to advance beyond conceptual stages in their investment restrictions and leverage monitoring systems at this stage.

**Graph 5 Q. How complete is your solution for these COMPLIANCE requirements?**  
(Please select one column response for each row)



## COST OF PREPARING FOR RISK AND COMPLIANCE OBLIGATIONS

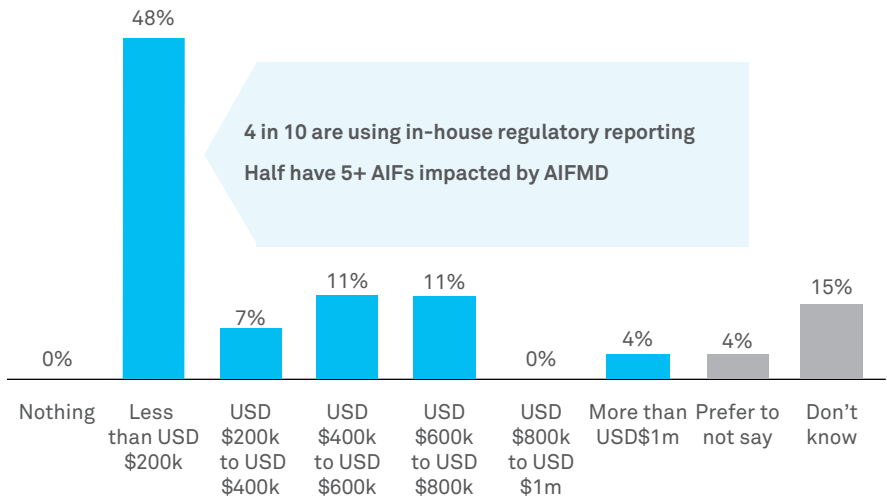
### COSTS INCURRED AS A RESULT OF AIFMD

The industry has had time to make an assessment of the total cost of gaining authorisation and implementing the AIFMD. The mean expected total cost of implementation is \$300,000, in line with the \$305,000 mean from the first survey we conducted in July 2013.

The range of projections of costs is broad, but fewer than half the respondents (48%) believe the cost will be less than \$200,000. In the previous survey, only 43% of respondents estimated the cost would be less than \$200,000. The most recent figure suggests that over the course of the last six months, fund managers have concluded the cost of implementing the AIFMD to be less onerous than feared.

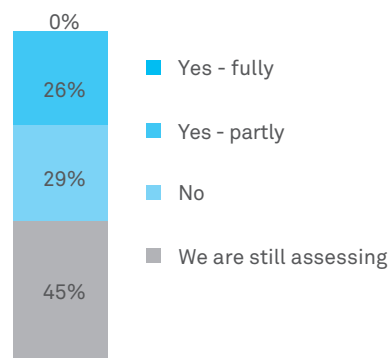
An accumulated total of over \$20 billion assets under management covered by AIFMD. Mean total costs (Those selecting an amount): \$300,000

**Graph 6 Q. Approximately what total costs are you expecting to incur as a result of AIFMD? (Please select one response)**



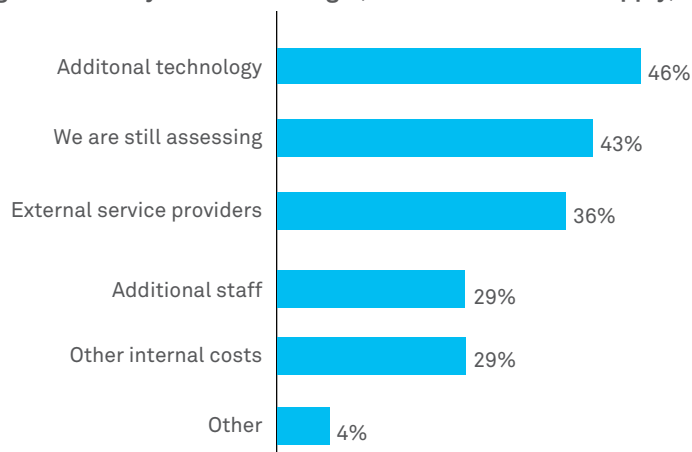
Fund managers are biding their time deciding how to allocate the cost of AIFMD compliance with some 45% still assessing whether the costs should be borne by the firm or by the fund, therefore potentially impacting the total expense ratio (TER) incurred by the investor. Of those who have made their decision, a little under a half will be passing on some of the increased costs to the fund resulting in higher costs for investors. Interestingly, none of those surveyed expect to pass on all additional costs to the funds.

**Graph 7 Q. Are you likely to pass on cost increases onto the fund, impacting the TER (Total Expense Ratio) of the fund? (Please select one response)**



Respondents were asked about where they expect additional costs to be borne as a consequence of complying with AIFMD. The results can be seen below. Reflecting the findings elsewhere in this survey, a surprisingly high number of participants are still assessing how their costs will be impacted.

**Graph 8 Q. Will complying with the risk and compliance requirements increase your on-going costs for any of the following? (Please select all that apply)**



## CHALLENGES

### RISK AND COMPLIANCE CHALLENGE

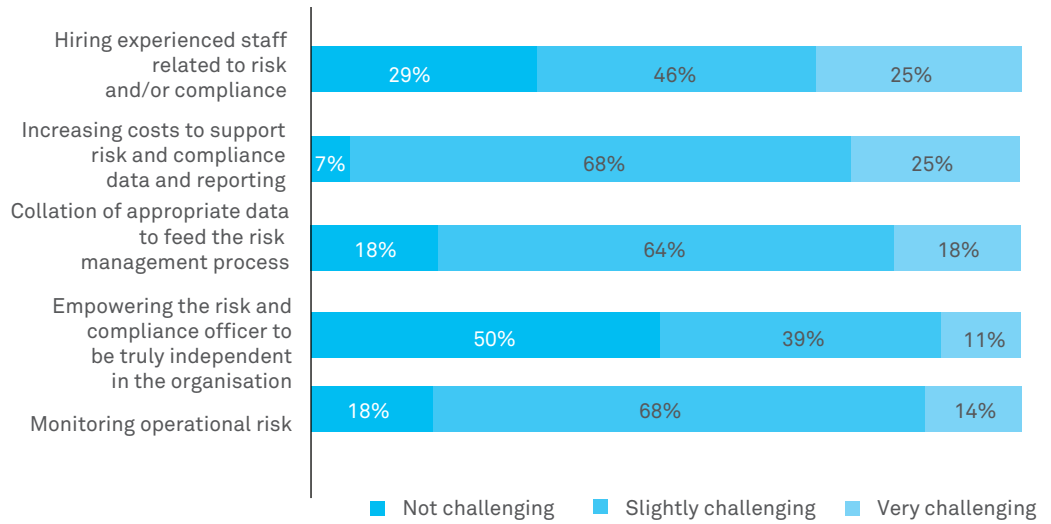
The increasing cost of supporting risk and compliance data and firms reporting of it is regarded as a challenge by the great majority of respondents given the additional requirements. No fewer than 93% of respondents, the largest aggregate total of any group in the survey, see this as 'very challenging' or 'slightly challenging' when considering the AIFMD's risk and compliance requirements.

Monitoring operational risk presents risk managers with overall challenges as it is a broad and less defined risk category. This is expressed by respondents, many of whom (68%) see slight challenges in the Operational Risk monitoring category.

25% of respondents believe that hiring experienced staff related to risk and /or compliance is very challenging while collating the appropriate data to feed the risk management process is seen as 'very challenging' or 'slightly challenging' by 82% of participants.

Respondents are less concerned about ensuring the independence of the risk and compliance officer, with 50% saying that they do not find it challenging.

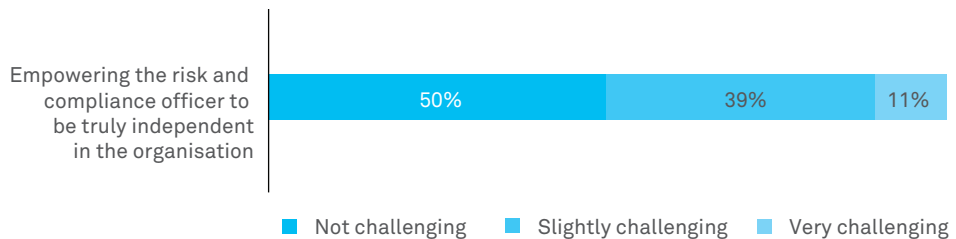
**Graph 9 Q. Which of the following do you consider are challenging in delivering the risk and compliance monitoring requirements under AIFMD? (Please select one column response for each row)**



## INDEPENDENCE

AIFMD clearly stipulates that a permanent and independent risk management role is established. As we saw in the previous chart, 50% of participants do not see the empowerment of the risk and compliance officers to be truly independent as a challenge. There is however a reliance upon front office data to support these processes with 47% of participants leveraging information from the portfolio managers.

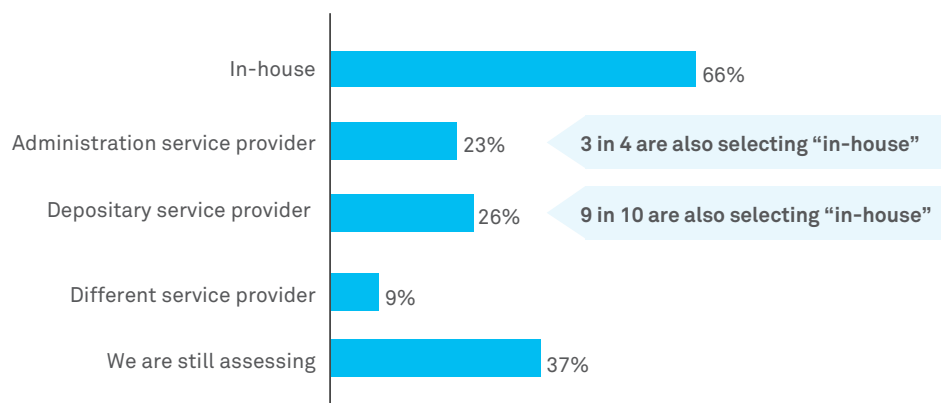
**Graph 10 Q. Which of the following do you consider are challenging in delivering the risk and compliance requirements under AIFMD? (Please select one column response for each row)**



At the same time, respondents have a clear preference for handling their regulatory reporting in-house. Some two thirds of respondents indicated this option. 37% of respondents said they were still assessing their approach to regulatory reporting. They will be aware that this decision has cost considerations and fund managers will be assessing relative costs of using Administration, Depositary or a different service provider to perform the regulatory reporting role. Fund managers may also be aware that in-house departments hold considerable data and monitoring systems and this can be leveraged for the purpose of AIFMD compliance.



**Graph 11 Q. How are you addressing the additional requirements for Regulatory reporting?  
(Please select all that apply)**



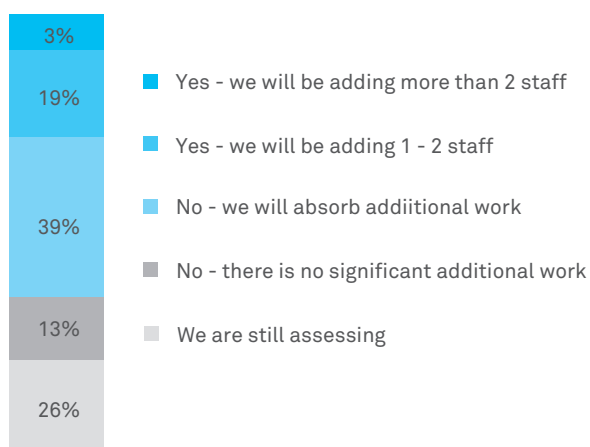
### UNDERSTANDING AIFMD IN ORGANISATIONS

More than a third of fund managers (39%) have decided that they are adequately equipped to handle the administrative requirements of AIFMD with their existing staff. Existing resources will absorb the pressure of the additional regulatory reporting requirements in areas like market risk, counterparty risk, credit risk, liquidity and operational risk. This suggests that they are seeking to minimise the cost burden of compliance, while at the same time believing that the in-house department is equipped to fulfil reporting obligations with related data and systems.

Some firms (13%) indicate considerable confidence in their ability to manage the process of compliance with no expectation of significant additional work under AIFMD. This indicates that existing compliance systems already cover the data firms will be required to gather and provide under the AIFMD. One may infer that such firms have no intention to hire additional staff.

However, fewer than 20% of firms plan to recruit one or two staff to cover AIFMD compliance. Those firms may have decided to address additional requirements for regulatory reporting in-house, rather than use an external administration service provider.

**Graph 12 Q. Do you expect to have to add additional resources to meet with requirements of the AIFMD? (Please select one response)**

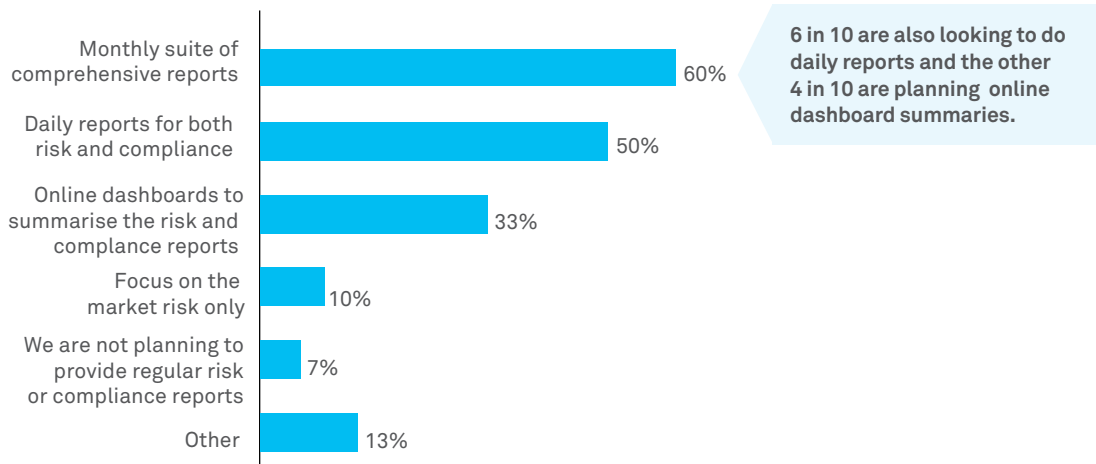


## SOLUTIONS

### REPORTING FREQUENCY

The importance of monitoring risk and compliance under AIFMD is understood by the great majority of respondents, with 83% looking to either report daily or provide an online dashboard to summarise the risk and compliance reports.

**Graph 13 Q. Are you planning any of the following for monitoring risk and compliance under AIFMD? (Please select all that apply)**



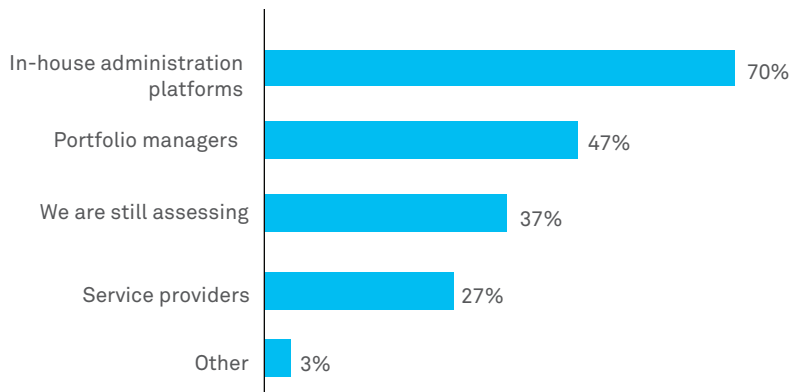
### SOURCES TO SUPPORT AIFMD

One of the key areas for compliance reporting is the regular provision of high quality, objective and independent data.

Once more, we can see here that a significant number of participants (37%) are still assessing the sources of data they expect to use for compliance reporting purposes.

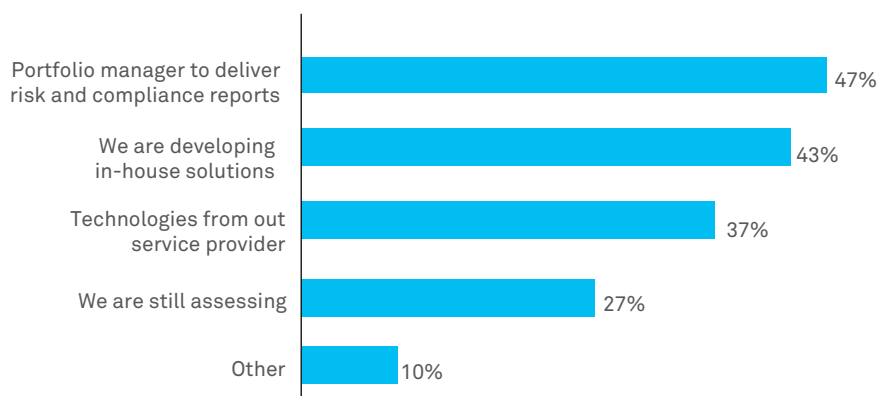
70% of respondents see in-house administration platforms as the most effective data source for compliance reporting. Portfolio managers are a key source of data (47%) and Service providers will be called upon to provide data sources by 27% of participants.

**Graph 14 Q. What sources of data are you using to support the AIFMD risk and compliance reporting requirements? (Please select all that apply)**



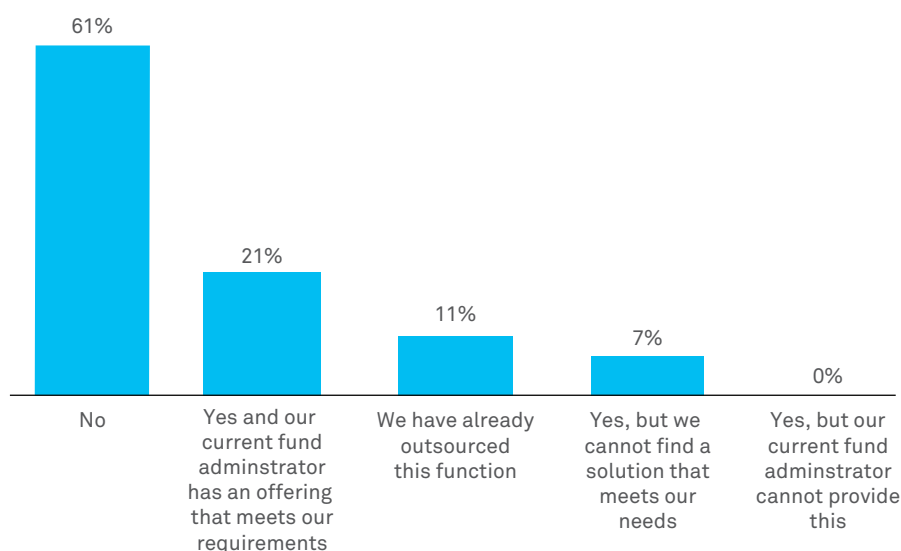
While fund managers are seeking to manage their way through the AIFMD requirements as much as possible on their own, there is some suggestion that finding necessary risk metrics and compliance monitoring is a challenge for in-house teams. The evidence for this is that 37% of respondents are using a service provider to provide technologies required to monitor compliance and keep the firm updated.

**Graph 15 Q. What tools and technologies are you using to deliver AIFMD risk metrics and compliance monitoring? (Please select all that apply)**



39% of respondents are to some extent outsourcing their risk reporting and compliance reporting requirements to a third party provider.

**Graph 16 Q. Have you considered outsourcing your risk reporting and compliance reporting requirements? (Please select one response)**



## RESEARCH METHODOLOGY

This research was conducted using a mixed research methodology of online research and telephone interviews from 10th to 29th December 2013.

A total of 52 Alternative Investment Fund Managers participated in the research from Europe, Asia, the US and Latin America from companies who operate or are considering operating an alternative fund that would be covered under the AIFMD. Respondents of this survey have an accumulated total of over USD 4 trillion of total assets and over USD 20 billion of assets covered by the AIFMD. Just over one third operate more than five AIFMs.

For more information on the research methodology:  
[market-research@fticonsulting.com](mailto:market-research@fticonsulting.com).

Please note that the standard convention for rounding has been applied and consequently some totals do not add up to 100%.

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