



**Financial Services
Commission**

Information page

Alternative Investment Fund Managers Directive Operating conditions – Risk management

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Financial Services Commission
PO Box 940, Suite 3, Ground Floor,
Atlantic Suites, Europort Avenue,
Gibraltar

Any advice or interpretation covered in this information page represents the views of the FSC as to its expectations of how the requirements of the AIFMD are to be complied with and/or how it fails to be applied. This however is not intended as a definitive interpretation of the AIFMD which is ultimately a matter for the courts to determine. The FSC does not provide, or purport to offer, legal advice.



1. Introduction

- 1.1 In this information page, reference is made to the Alternative Investment Fund Managers Directive 2011/61/EU (“AIFMD”) and to the supplementing Level 2 Delegated Regulation (“Level 2”).
- 1.2 The AIFMD requires Alternative Investment Fund Managers (“AIFMs”) to operate in accordance with conditions set out in the AIFMD and Level 2. The purpose of this information page is to provide AIFMs with clear information, based on the information on the AIFMD and Level 2, on what requirements and conditions they must comply with in relation to risk management.
- 1.3 Risk management is an important aspect of AIFMs’ activities as AIFMs are unlikely to be authorised to provide portfolio management without also providing risk management or vice versa.

2. Risk management

Article 15 of the AIFMD

- 2.1 AIFMs must functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management.
- 2.2 The FSC will review the functional and hierarchical separation of AIFMs in accordance with the principle of proportionality, on the understanding that an AIFM must, in any event, be able to demonstrate:
 - (a) that specific safeguards against conflicts of interest allow for the independent performance of risk management activities, and
 - (b) that the risk management process satisfies the requirements of this section 2 and is consistently effective.
- 2.3 AIFMs must implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed; and an AIFM must review its risk management systems with appropriate frequency at least once a year and adapt them whenever necessary.
- 2.4 AIFMs must at least:
 - (a) implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;
 - (b) ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF’s portfolio can be properly identified, measured, managed and monitored on an on-going basis, including through the use of appropriate stress testing procedures;
 - (c) ensure that the risk profile of the AIF shall correspond to the size, portfolio structure and investment strategies and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

- 2.5 AIFMs must set a maximum level of leverage which they may employ on behalf of each AIF they manage as well as the extent of the right to reuse collateral or guarantee that could be granted under the leveraging arrangement, taking into account, inter alia:
- (a) the type of the AIF;
 - (b) the investment strategy of the AIF;
 - (c) the sources of leverage of the AIF;
 - (d) any other inter-linkage or relevant relationships with other financial services institutions, which could pose systemic risk;
 - (e) the need to limit the exposure to any single counterparty;
 - (f) the extent to which the leverage is collateralised;
 - (g) the asset-liability ratio;
 - (h) the scale, nature and extent of the activity of the AIFM on the markets concerned.

3. Risk management systems - definition

Article 38 of Level 2

- 3.1 For the purposes of this information page, 'risk management systems' shall be understood as systems comprised of relevant elements of the organisational structure of the AIFM, with a central role for a permanent risk management function, policies and procedures related to the management of risk relevant to each AIF's investment strategy, and arrangements, processes and techniques related to risk measurement and management employed by the AIFM in relation to each AIF it manages.

4. Permanent risk management function

Article 39 of Level 2

- 4.1 An AIFM shall establish and maintain a permanent risk management function that shall:
- (a) implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an on-going basis all risks relevant to each AIF's investment strategy to which each AIF is or may be exposed;
 - (b) ensure that the risk profile of the AIF disclosed to investors in accordance with Article 23(4)(c) of the AIFMD (on disclosure to investors) is consistent with the risk limits that have been set in accordance with section 9 below;
 - (c) monitor compliance with the risk limits set in accordance with section 9 below and notify the AIFM's governing body and, where it exists, the AIFM's supervisory function in a timely manner when it considers the AIF's risk profile inconsistent with these limits or sees a material risk that the risk profile will become inconsistent with these limits;
 - (d) provide the following regular updates to the governing body of the AIFM and where it exists the AIFM's supervisory function at a frequency

which is in accordance with the nature, scale and complexity of the AIF or the AIFM's activities:

- (i) the consistency between and compliance with the risk limits set in accordance with section 9 below and the risk profile of the AIF as disclosed to investors in accordance with Article 23(4)(c) of the AIFMD;
 - (ii) the adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have been or will be taken in the event of any actual or anticipated deficiencies;
- (e) provide regular updates to the senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches of any risk limits set in accordance with section 9 below, so as to ensure that prompt and appropriate action can be taken.
- 4.2 The risk management function shall have the necessary authority and access to all relevant information necessary to fulfil the tasks set out in section 4.1. They should also have regular contact with the senior management and the governing body of the AIFM in order to provide them with updates so that they can take prompt remedial action where needed.
- 4.3 In summary, this function should have a primary role in shaping the risk policy of the AIF, risk monitoring and risk measuring in order to ensure that the risk level complies on an on-going basis with the AIF's risk profile.

5. Risk management policy

Article 40 of Level 2

- 5.1 An AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIFs it manages are or may be exposed.
- 5.2 The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages.
- 5.3 The AIFM shall address at least the following elements in the risk management policy:
- (a) the techniques, tools and arrangements that enable it to comply with section 10 below:
 - (b) the techniques, tools and arrangements that enable liquidity risk of the AIF to be assessed and monitored under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests in accordance with Article 48 of Level 2¹ (please refer to the FSC information page on "AIFMD – Operating conditions – Liquidity management" for further information);

¹ For further information, please refer to the FSC information page on "AIFMD – Operating conditions – Liquidity management".

- (c) the allocation of responsibilities within the AIFM pertaining to risk management;
 - (d) the limits set in accordance with section 9 below and a justification of how these are aligned with the risk profile of the AIF disclosed to investors in accordance with Article 23(4)(c) of the AIFMD²;
 - (e) the terms, contents, frequency and addressees of reporting by the permanent risk management function referred to in section 4 above.
- 5.4 The risk management policy shall include a description of the safeguards referred to in section 8 below, in particular:
- (a) the nature of the potential conflicts of interest;
 - (b) the remedial measures put in place;
 - (c) the reasons why these measures should be reasonably expected to result in independent performance of the risk management function;
 - (d) how the AIFM expects to ensure that the safeguards are consistently effective.
- 5.5 The risk management policy referred to in section 5.1 shall be appropriate to the nature, scale and complexity of the business of the AIFM and of the AIF it manages.
- 5.6 The risk management policy forms another pillar of the risk management system. The policy should be appropriately documented and should explain, in particular, measures and procedures employed to measure and manage risks, the safeguards for independent performance of the risk management function, the techniques used to manage risks and the details of the allocation of responsibilities within the AIFM for risk management and operating procedures.

6. Assessment, monitoring and review of the risk management systems

Article 41 of Level 2

- 6.1 AIFMs shall assess, monitor and periodically, at least once a year, review:
- (a) the adequacy and effectiveness of the risk management policy and of the arrangements, processes and techniques referred to in section 10 below;
 - (b) the degree of compliance by the AIFM with the risk management policy and with the arrangements, processes and techniques referred to in section 10 below;
 - (c) the adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process;
 - (d) the performance of the risk management function;
 - (e) the adequacy and effectiveness of measures aiming to ensure the functional and hierarchical separation of the risk management function in accordance with section 7 below.

² For further information, please refer to the FSC information page on “AIFMD – Transparency requirements – Disclosure to investors”.

The frequency of the periodic review referred to in the first subparagraph shall be decided by the senior management in accordance with the principle of proportionality given the nature, scale and complexity of the AIFM's business and the AIF it manages.

- 6.2 In addition to the periodic review referred to in section 6.1, the risk management systems shall be reviewed where:
- (a) material changes are made to the risk management policies and procedures and to the arrangements, processes and techniques referred to in section 10 below;
 - (b) internal or external events indicate that an additional review is required;
 - (c) material changes are made to the investment strategy and objectives of an AIF that the AIFM manages.
- 6.3 The AIFM shall update the risk management systems on the basis of the outcome of the review referred to in sections 6.1 and 6.2.
- 6.4 The AIFM shall notify the FSC of any material changes to the risk management policy and of the arrangements, processes and techniques referred to in section 10 below.

7. Functional and hierarchical separation of the risk management function

Article 42 of Level 2

- 7.1 The risk management function shall be considered as functionally and hierarchically separated from the operating units, including the portfolio management function, only where all the following conditions are satisfied:
- (a) persons engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM;
 - (b) persons engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function;
 - (c) persons engaged in the performance of the risk management function are compensated in accordance with the achievement of the objectives linked to that function, independently of the performance of the operating units, including the portfolio management function;
 - (d) the remuneration of senior officers in the risk management function is directly overseen by the remuneration committee, where such a committee has been established.

Those in the risk management function should not carry out any conflicting tasks or be supervised by someone who is in charge of conflicting functions.

- 7.2 The functional and hierarchical separation of the risk management function in accordance with section 7.1 shall be ensured throughout the whole hierarchical structure of the AIFM, up to its governing body. It shall be reviewed by the governing body and, where it exists, the supervisory function of the AIFM.

- 7.3 The FSC will review the way in which the AIFM has applied sections 7.1 and 7.2 on the basis of the criteria laid down in section 2.2 above.

8. Safeguards against conflicts of interest

Article 43 of Level 2

- 8.1 The safeguards against conflicts of interest referred to in sections 2.1 and 2.2 above shall ensure, at least, that:
- (a) decisions taken by the risk management function are based on reliable data, which are subject to an appropriate degree of control by the risk management function;
 - (b) the remuneration of those engaged in the performance of the risk management function reflects the achievement of the objectives linked to the risk management function, independently of the performance of the business areas in which they are engaged;
 - (c) the risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently;
 - (d) the risk management function is represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function;
 - (e) any conflicting duties are properly segregated.
- 8.2 Where proportionate, taking into account the nature, scale and complexity of the AIFM the safeguards referred to in section 8.1 shall also ensure that:
- (a) the performance of the risk management function is reviewed regularly by the internal audit function, or, if the latter has not been established, by an external party appointed by the governing body³;
 - (b) where a risk committee has been established, it is appropriately resourced and its non-independent members do not have undue influence over the performance of the risk management function.
- 8.3 The governing body of the AIFM and, where it exists, the supervisory function shall establish the safeguards against conflicts of interest laid down in sections 8.1 and 8.2 above, regularly review their effectiveness and take timely remedial action to address any deficiencies.

9. Risk limits

Article 44 of Level 2

- 9.1 An AIFM shall establish and implement quantitative or qualitative risk limits, or both for each AIF it manages, taking into account all relevant risks. Where only qualitative limits are set, the AIFM must be able to justify this approach to the FSC.

³ For further information on the compliance and internal audit functions of AIFMs, please refer to the FSC information page on "AIFMD – Organisational requirements – General".

- 9.2 The qualitative and quantitative risk limits for each AIF shall, at least, cover the following risks:
- (a) market risks;
 - (b) credit risks;
 - (c) liquidity risks;
 - (d) counterparty risks;
 - (e) operational risks.
- 9.3 When setting risk limits, the AIFM shall take into account the strategies and assets employed in respect of each AIF it manages as well as the national rules applicable to each of those AIFs. Those risk limits shall be aligned with the risk profile of the AIF as disclosed to investors in accordance with Article 23(4)(c) of the AIFMD (on disclosure to investors) and approved by the governing body.
- 9.4 The risks incurred by each AIF cannot be managed effectively if the risk limits have not been set in advance by AIFMs.

10. Risk measurement and management

Article 45 of Level 2

- 10.1 AIFMs shall adopt adequate and effective arrangements, processes and techniques in order to:
- (a) identify, measure, manage and monitor at any time the risks to which the AIFs under their management are or might be exposed;
 - (b) ensure compliance with the limits set in accordance with section 9 above.
- 10.2 The arrangements, processes and techniques referred to in section 10.1 shall be proportionate to the nature, scale and complexity of the business of the AIFM and of each AIF it manages and shall be consistent with the AIF's risk profile as disclosed to investors in accordance with Article 23(4)(c) of the AIFMD (on disclosure to investors).
- 10.3 For the purposes of section 10.1, the AIFM shall take the following actions for each AIF it manages:
- (a) put in place such risk measurement arrangements, processes and techniques as are necessary to ensure that the risks of positions taken and their contribution to the overall risk profile are accurately measured on the basis of sound and reliable data and that the risk measurement arrangements, processes and techniques are adequately documented;
 - (b) conduct periodic back-tests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates;
 - (c) conduct periodic appropriate stress tests and scenario analyses to address risks arising from potential changes in market conditions that might adversely impact the AIF;
 - (d) ensure that the current level of risk complies with the risk limits set in accordance with section 9 above;



- (e) establish, implement and maintain adequate procedures that, in the event of actual or anticipated breaches of the risk limits of the AIF, result in timely remedial actions in the best interest of investors;
- (f) ensure that there are appropriate liquidity management systems and procedures for each AIF in line with the requirements laid down in Article 46 of Level 2⁴.

11. Application of implementing measures

Any measures adopted by the European Union Commission under Article 15(5) of the AIFMD will also be applicable.

⁴ For further information, please refer to the FSC information page on “AIFMD – Operating conditions – Liquidity management”.