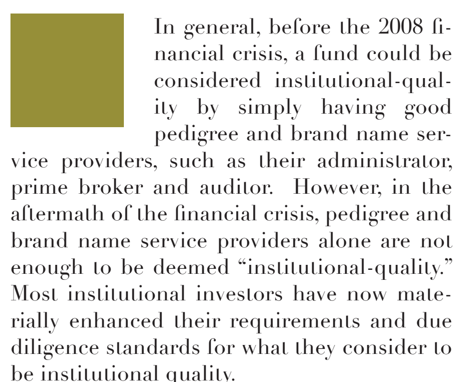
Post 2008: Why the Confusion About "Institutional-Quality"?

When fund managers discuss the topic of raising or retaining assets or investors share their requirements for investing, there is no prerequisite that comes up more often than whether a fund is deemed to be "institutional-quality." "Given that there is universal agreement among fund managers and service providers alike that in order for a fund to grow, prosper and attract institutional investors a fund must meet the institutional quality litmus test, then why is it that what it means to be institutional quality is so misunderstood? And, why is there such a large disparity in the definition of what it takes to be institutional quality?"



In general, before the 2008 financial crisis, a fund could be considered institutional-quality by simply having good pedigree and brand name service providers, such as their administrator, prime broker and auditor. However, in the aftermath of the financial crisis, pedigree and brand name service providers alone are not enough to be deemed "institutional-quality." Most institutional investors have now materially enhanced their requirements and due diligence standards for what they consider to be institutional quality.

From our experience, institutional investors and allocators have started to focus greater attention on ascertaining whether or not a fund has sound, sustainable and repeatable risk and investment management. As part of this focus, they expect to see well-functioning operations and back office departments that have the appropriate systems and processes to support both the business aspects of the fund manager as well as the investment management operations of the fund manager. Specifically, institutional investors are now putting the onus on funds to prove that they have effective processes, controls and governance. For example, in the most recent release of Alternative Investment Management Association's ("AIMA's") newly updated Due Diligence Questionnaire, funds are required to demonstrate the "effectiveness of the investment manager's controls and processes for managing and controlling market, liquidity and operational risk." If a fund cannot demonstrate the "effectiveness" of their risk management, your chances of receiving a check from investors becomes very low.

For the purposes of this piece, I will focus largely on demystifying what it means to be institutional quality with regards to risk management in the post 2008 environment.

Impact from Regulations on the "New" Institutional Quality

The "new" definition for institutional quality has been significantly shaped by the spate of new regulations and reporting requirements passed in the aftermath of the financial crisis. For example, regulatory reporting requirements for alternative investment funds such as Form PF, CPO/PQR and Annex IV, have had a tremendous impact on the breadth and depth of transparency many funds now feel obliged to report to provide institutional quality risk transparency. Furthermore, regulations, such as AIFMD, have raised the bar for what qualifies as institutional quality risk management. For example, to be in compliance with AIFMD, funds must be able to demonstrate that their risk management function is truly substantive and goes beyond window dressing risk measurement. Specifically, the Directive requires that the fund manager have an independent and permanent risk management function. In addition, the fund manager must have in place well functioning processes, controls and governance for risk measurement, risk monitoring and risk management. They are required to have comprehensive and documented risk management policies that governs the firm and, should there be any mate-

rial changes to their risk management policy or risk measurement and management processes, the manager is then required to notify the national regulator. Lastly, and significantly, under the AIFMD Directive, funds are required to have an independent and periodic review of the risk management function.

Key Elements for Institutional Quality Risk Management

Today, in order to pass institutional quality muster with both investors and regulators requires a fund to have in place a sound risk management framework that includes some of the following key elements with regards to infrastructure, processes, controls and governance for risk management:

- ***Risk Management Governance:*** as part of good governance, a fund manager should have a formal Risk Management Committee that is responsible for setting risk management policies and procedures and overseeing the regular reporting of investment risks and escalation of issues, should there be a breach in risk management policies.

- ***Risk Management Processes and Controls:*** it is expected that a fund manager have comprehensive and documented risk management policies and procedures for governing its funds. In addition, the fund manager should have in place risk limit guidelines that are appropriate to the underlying risk factors in the portfolio and that are being measured and monitored.

- ***Risk Measurement, Monitoring and Reporting/Transparency:*** given that most funds must now report a number of key risk statistics to both regulators and investors on a periodic basis, fund managers would be wise to ensure that the risk information that they convey externally is an accurate portrayal of their risk profile. Otherwise, funds have significant regulatory and legal risk if their risk profile is not accurate and/or consistent with the representations in fund disclosure such as PPMs or marketing documents. Funds should not confuse simple statistics that are "slices and dices" of long, short, gross and net exposure that they obtain from portfolio management systems or OMS software as being risk metrics or sufficient for regulatory, investor or internal risk monitoring and reporting.

- ***Risk Management Infrastructure:*** a fund manager must have qualified and experienced in-house risk management staff or, alternatively, have external risk management assistance from qualified experts to fully execute the risk management function. The risk team must have the means to measure, monitor and manage all major investment risks such as market, credit and liquidity risk.

Why be Institutional Quality for Risk Management?

The climate for attracting and retaining assets continues to be extremely competitive and arguably more difficult than ever before because investors have many funds to choose from and have become more informed and better able to due diligence managers. These new institutional quality requirements might at first blush seem onerous to fund managers. However, in the long run, being institutional-quality will help funds have better "shelf attractiveness" and longevity. Ultimately, it will further legitimize the alternative asset managers and the asset class as a whole. Therefore, we strongly believe and recommend that it is clearly in every fund manager's best interest to fully meet, if not exceed, the "new institutional quality standards," especially with regards to risk management if they hope to attract and retain capital from institutional investors in the new post 2008 environment.

About the Author:

Samuel K. Won is the Founder and Managing Director of Global Risk Management Advisors, Inc., the leading independent risk management advisory and implementation firm that provides institutional-quality risk management services to asset managers and institutional investors. He has over 25 years of experience in risk analysis and reporting, risk infrastructure implementation, risk strategy, capital markets, trading and portfolio management at major global financial institutions, asset management firms and the government. He has advised major hedge funds, private equity funds, other asset managers, institutional investors and regulatory agencies, such as the SEC, CFTC, the Federal Reserve Bank, the OCC, FHLB and the FCA, on major risk management, trading and capital markets issues and policies.