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AIFMD and Valuations: Ready for takeoff

Are alternative investment funds ready for the Directive's valuation framework?

When the European Commission introduced the Alternative Investment Fund Managers Directive (AIFMD), it drafted one of the most ambitious and complex regulatory reform agendas ever introduced into the asset management industry.

Amongst many reforms, the Directive provides a detailed valuation framework, including requirements for detailed valuation policy and procedures to be applied consistently across all alternative investment funds (AIFs) and requirements for competence and independence of personnel performing valuation functions. This requires close attention by Alternative Investment Fund Managers (AIFMs).

There are a number of challenges AIFMs face in order to satisfy the Directive on valuation. Here we focus on some of the more pressing areas that will impact AIFMs.

Independent valuation

AIFMs are required to ensure that the valuation function pertaining to the

investments they manage on behalf of investors is carried out impartially and with skill, care and diligence, either by an independent external valuer or by the AIFM itself.

The requirement for impartiality brings challenges for AIFMs. For instance, for AIFMs undertaking valuations internally, the Directive requires that those responsible for valuation be independent from portfolio management teams, yet have equivalent knowledge, experience and level in management hierarchy as those in portfolio management in order to appropriately challenge key valuation matters.

This relates to both those overseeing the valuation function and undertaking

valuation analyses. As such, "lending" staff from portfolio management to an internal valuation function will most likely be challenged by regulators. For many AIFMs, building an independent valuation function with the requisite knowledge of the underlying investments will be challenging. This will be increasingly challenging for AIFMs that do not readily have a larger pool of sufficiently experienced resources.

Regulators may also require that an external valuer verify the independence of the internal valuation function and an AIFM may wish to include such confirmations in its regulatory submissions.



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An AIFM could alternatively appoint an external valuer (which has no link to the portfolio management function of the AIFM or the AIF, and is not appointed by the portfolio managers) to undertake the valuation function. Whilst the appointment of an external valuer will not affect an AIFM's liability to an AIF, the external valuer will be liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks.

Valuation Policies and Procedures

For each AIF it manages, an AIFM must establish, maintain, implement and review Valuation Policies and Procedures (VP&Ps) that ensure sound, transparent, comprehensive and appropriately documented valuation processes. VP&Ps should include:

- The AIF's investment strategy and assets it may invest in;
- The valuation methodologies used for each asset type and the selection process for each methodology;
- Obligations, roles and responsibilities of all parties in the valuation process (including external valuers);
- Details of the competence and independence of those doing the valuations; and
- Escalation channels for resolving issues in asset values.

VP&Ps should be reviewed at least annually and, in any event, before an AIF engages in a new asset type. An AIF may not invest in a particular asset type before

a valuation methodology for that asset type has been included in the VP&Ps.

The AIFM's risk management function should review the VP&Ps and senior management should review and approve all VP&P changes.

AIFMs also need to implement sufficient governance to ensure that there is no disconnect between the documentation and implementation of the VP&Ps.

Use of valuation models

AIFMD requires that the main features of all valuation models be documented in the VP&Ps. Before being applied, a model must be validated by a competent and experienced person who has not been involved in building the model and be approved by senior AIFM management. Again, the regulator may require an independent audit on applied models.

This presents potential challenges for AIFMs, particularly when investing in more illiquid assets where bespoke and complex models are developed that evolve over time. As such, AIFMs will need to ensure there is sufficient governance around model validation, update procedures, version controls and documentation.

What questions should AIFMs be asking?

If you have not already done so, there are a number of valuation-related questions that AIFMs should be considering now:

- If performing valuations internally:
 - Do we have sufficient qualified individuals that are separate to

portfolio management in order to deliver impartial valuations?

- Do we have sufficient governance to support the delivery of objective valuations?
- If using an external valuer:
 - Have we performed the necessary diligence on external valuers to be satisfied of their competence?
 - Are there sufficient information transfer and governance processes in place to ensure an efficient process?
 - Have we ensured that the external valuer does not delegate any of the valuation work to a third party?
- Do we have sufficient governance structures around proprietary valuation models (particularly model validation, version control and model updates)?
- Do our VP&Ps contain sufficient detail and are we putting our VP&Ps into practice?

What should I do next?

AIFMs that have not already conducted an in-depth AIFM impact and readiness assessment should do so without delay. The timelines to compliance are increasingly short and by undertaking such an assessment, AIFMs can get a better sense of the implications and the scope of the work that needs to be done in order to not only comply with the Directive, but to maintain long-term profitability under these new rules.

Contact us



Doug McPhee
Global Head of Valuation Services
at KPMG in the UK and Member of the International
Valuation Standards Council's Professional Board

Doug is Global Head of Valuation Services at KPMG in the UK, Chartered Business Valuator and a member of the International Valuation Standards Professional Board. Visit the KPMG Global Valuation Institute for further information at www.kpmg.com/GVI



Matthew Warren
Director and AIFMD
subject matter expert for
Valuations at KPMG in the UK

Matthew is a Director at KPMG in the UK, specializing in commercial valuations. He is responsible for providing valuation advice to Investment Management clients and is the AIFMD Subject Matter Expert for valuation at KPMG in the UK.

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