Private asset management

Evolving regulatory expectations

08 July 2024

Asset managers with a significant private assets capability can expect greater regulatory scrutiny from supervisors in the short term.

As described in the introductory article for this series, the significant growth of the industry and political efforts to pivot investment into private assets such as UK infrastructure mean that policy measures and supervisory action look set to deliver greater regulatory oversight of the sector. This article summarises the latest developments and sets out proactive actions for private asset fund managers.

The regulatory direction of travel for private asset managers

For several years, securities regulators and central banks have been concerned about the growing role of the non-bank sector, including asset managers and their funds. Property fund suspensions in 2016, subsequent issues with specific funds, and market events in March 2020 triggered a series of reviews by the Financial Stability Board (FSB) and IOSCO.

These reviews resulted in new policy recommendations for money market funds (MMFs) and revised recommendations and new guidelines for open-ended funds. National supervisors have also made their own policy adjustments and completed supervisory reviews. In the UK, the authorities have proposed enhancements to swing pricing and liquidity bucketing, invited views on the future of the MMF regime, and reviewed fund managers' liquidity management practices.

However, reviews to date have largely focused on what the FCA would call “mainstream” asset management — for example, funds that invest in public equities, fixed income or emerging market securities. In comparison, relatively little attention has been paid to the activities of private asset fund managers. This has changed, given the significant growth of the private asset fund industry, the high interest rate environment, and regulators' concerns about the potential interconnection with private markets and the real economy.

Securities regulators' initiatives

For the first time, in its 2023 work programme IOSCO identified private assets as a priority area of focus. Subsequently it published the findings of its thematic review, and good practices for market participants in the context of leveraged loans and collateralised loan obligations.

IOSCO noted the "inherent opacity" of private markets and focused on potential conflicts of interest and valuation challenges — in particular around stale valuations, a lack of standardised valuation principles for investments that lack an observable market, and potential vulnerabilities. In a March 2024 update to its work programme, IOSCO stated that it would conduct further work on private finance over the remainder of the year, including work on valuation issues and conflicts of interest.

In addition, IOSCO confirmed that over 2024 it will review its 2013 principles for the valuation of funds in order to determine whether updates or further guidance is needed. This will take account of the findings of the work described above — resulting in an interim report to the IOSCO board in Q1 2025.

Meanwhile at national and regional level, some regulators have already introduced new requirements for private fund managers.

For example, the EU has established a new framework for loan-origination funds and expanded existing reporting requirements as part of its review of AIFMD and the UCITS Directive — see more on the reforms here.

The UK will progress its review of UK AIFMD over the remainder of 2024 and 2025 — this is expected to be narrower in scope than the EU AIFMD II package. It remains to be seen how the incoming Labour government will progress its wider policy agenda for financial services, including any tax adjustments that might be made (e.g. on carried interest payments to fund managers).

The FCA's priorities for private asset fund managers

In parallel with increasing opportunities for fund managers and investors (e.g. through creating and adjusting the LTAF regime), the FCA most recently set out its supervisory priorities for the UK asset management and alternatives industry in March 2024 — see a summary here.

The letter provided an update on previous communications from the FCA. As expected, it confirmed that the FCA is launching a review of valuation practices for private assets, which is now underway. It is examining the following areas specifically:

- Personal accountabilities for valuation practices;
- Governance of valuation committees;
- Valuation MI reported to the board; and
- The board's oversight of valuation practices.

> "While values are ultimately crystallised on exit, there is the potential for inflated values to support borrowing, avoid covenant breaches, and support fund performance and therefore fundraising. Where liquidity is provided to investors this can also result in unfair redemption prices."
>
> **Ashley Alder, Chair, FCA**
>
> Speech — "Our ambitious agenda for UK asset management" — May 2024

Importantly, the FCA`s work builds on its previous review of fund managers' approaches to “hard to value” assets, including private assets, and the FCA's 2023 liquidity management review (see a summary here). As part of the liquidity review, the FCA noted that “internal challenge to valuations was seldom evident”.

Fund managers should already have performed a review of their own arrangements against these findings and documented the outcome and any enhancements made.

Financial stability considerations

As well as increased attention from securities regulators, central banks and organisations with a financial stability remit are closely monitoring the private equity sector.

In its latest Financial Policy Report, the Bank of England's Financial Policy Committee (FPC) set out an overview of potential risks relating to leverage and challenges arising from the higher interest rate environment. In particular, the FPC is concerned that the vulnerabilities in the private equity sector could generate losses for banks and institutional investors, as well as impacting wider, interconnected markets such as leveraged loans and private credit.

As a next step, the FPC will consider the outcomes of the FCA's valuation review described above, and the PRA's work on banks' risk management practices.

> “Vulnerabilities in the PE sector include multiple layers of leverage and strong interconnections with riskier credit markets, where underwriting practices weakened through the low rates era. In addition, valuation and risk management practices vary and are opaque.”
>
> **Financial Stability Report — June 2024**
>
> Bank of England

The European Systemic Risk Board has also reviewed financial stability risks relating to private finance. It found that some vulnerabilities are mitigated by the closed-ended structure of private equity funds, which reduces liquidity mismatch. However, it concluded that there are potential vulnerabilities that would benefit from closer monitoring, and that transparency around private finance should be enhanced.

Proactive actions for private fund managers

Given this ongoing regulatory attention and as a matter of good practice, private asset fund managers should take proactive steps to continue to tighten up existing practices, complying with the underlying rules for AIFMs in FUND 3.9, as well as taking account of wider rules and the supervisory reviews noted above.

Fund managers should focus on the following areas as part of a front to back review of their valuation framework:

- **Governance**: Whether undertaken internally or externally, a proper and independent valuation of the fund's assets should be performed. Assisted by decision-useful MI, the valuation committee should provide robust, effective challenge to portfolio managers (particularly where they input into valuation models), alongside effective challenge from the second line of defence. Roles, responsibilities and accountability for the valuation process should be clearly defined, and firms should review the composition of their valuation committees and whether the chair is independent. Good practice also involves rotating the appointment of external valuers.
- **Policies and procedures**: Documentation should be coherently organised, regularly updated, and should ensure that valuation methodologies are applied consistently and fairly. Where relevant, firms may find it helpful to ensure that procedures align valuation methodologies with IOSCO's valuation principles (that are now under review) and industry guidelines such as IPEV[1].
- **Conflicts of interest**: Firms should consider where conflicts can arise and how they are managed fairly — this includes at the different stages of the fund lifecycle and between different stakeholders. Conflicts should be avoided, managed or disclosed — examples can include conflicts between investments in the same underlying company (e.g. both equity and credit-related investments), conflicts between investors, and conflicts arising from a fund's fee structure. Remuneration policies and other measures should contribute to mitigating conflicts.
- **Valuation model risk management**: Notably, private assets span a wide variety of different investments. Where firms have a different valuation model across these different asset classes, then governance arrangements to manage the model valuation process should be consistent and robust.
- **Skills and expertise**: The FCA expects firms to have relevant valuation expertise in the first and second lines of defence to ensure that valuation is performed with appropriate due skill, care and diligence. Wider expertise that goes beyond traditional financial services expertise can provide additional assurance — for example with identifying potential reputational risks in portfolio companies.
- **Valuation frequency**: Firms should consider and document the appropriateness of valuation frequency in the context of a fund's underlying assets and its redemption frequency.
- **Due diligence**: Where firms appoint an external valuer, they should perform and document appropriate due diligence.

Contacts

Firms' valuation arrangements will be tested soon by the FCA. If you need assistance with tightening up your existing practices and aligning these with regulators' expectations, or wider aspects of regulatory compliance — such as with the AIFMD II package — please get in touch.