

FOCUS ON

FUND ADMINISTRATION

Georges B. Archibald of JPMorgan explains how shifting market, regulatory and investor landscapes have led to a re-shaping of the administrator's role



Georges B. Archibald

is head strategist at JPMorgan Worldwide Securities Services. As head strategist for the alternatives fund administration business, Georges spends his time on regulatory issues, best of breed solutions and general operations. His prior experience includes work with Goldman Sachs, UBS and Alliance Bernstein.

The alternatives industry continues to evolve, placing broader reporting and related analytic requirements on fund managers. And in this new environment, fund managers are increasingly turning to fund administrators to support their growing needs.

Today, fund administrators sit at the nexus of portfolio information, acting as the hub for counterparty information and multiple product set consolidation. This is partly a result of the natural evolution of the industry and partly due to the 2008 financial crisis, which compelled managers and other market participants to carefully plan and monitor their counterparty exposures.

In this new model – driven by clients and regulators, as well as internal portfolio and risk management teams – the fund administrator's role has significantly evolved from traditional month-end NAV offerings to now including middle- and front-office functionality, ranging from reconciliations to performance and risk analytics.

As a result, managers selecting fund administration partners have expanded their criteria to include a deeper set of due diligence inquiries. While in the past the manager's operational staff was the primary arbiter in the selection process, today fund administrators must meet with approval from multiple stakeholders, including operational staff, front-office personnel such as portfolio and risk managers, and investors.

A RECENT HISTORY OF MARKET FORCES AND REGULATORY CHANGE

In the wake of the 2008 financial crisis, many hedge fund and other alternatives managers realised the twin perils of counterparty credit exposure and retaining

one prime broker as the sole linchpin for their portfolio holdings. Most quickly increased the mechanisms by which they offset counterparty exposure¹.

Concurrently, hedge fund investors also became acutely aware of counterparty risk and re-examined their due diligence processes, incorporating enhancements as necessary. These factors significantly facilitated the promotion of fund administrators into their new role of portfolio aggregator.

In addition to managing counterparty exposure issues, investors typically became less comfortable with solely self-administered funds. Specifically, as fund managers institutionalised their models to appeal to pension funds and other fiduciaries in the marketplace, they looked to fund administrators to supplement their processes, including three-way reconciliations between prime brokers, internal systems and administrators, and other middle-office reconciliations.

The advent of Dodd-Frank and other global regulation (such as the Alternative Investment Fund Managers Directive) has meant increased regulatory scrutiny of hedge fund managers for, among other things, registration as applicable. As a direct result, they and their partners now view fund administration as a necessary component of managing third-party money. Here, fund administrators can be very helpful in terms of their ability to aggregate holding information across portfolios as well as supporting fund managers in regulatory reporting requirements.

WHAT THIS MEANS FOR FUND MANAGERS TODAY

A significant outcome of these changes is increased industry activity and product development in the fund administration space. Fund administration has taken a much more central role in alternatives fund management. As a result, we are seeing industry progression in the form of product evolution, consolidation and deal activity.

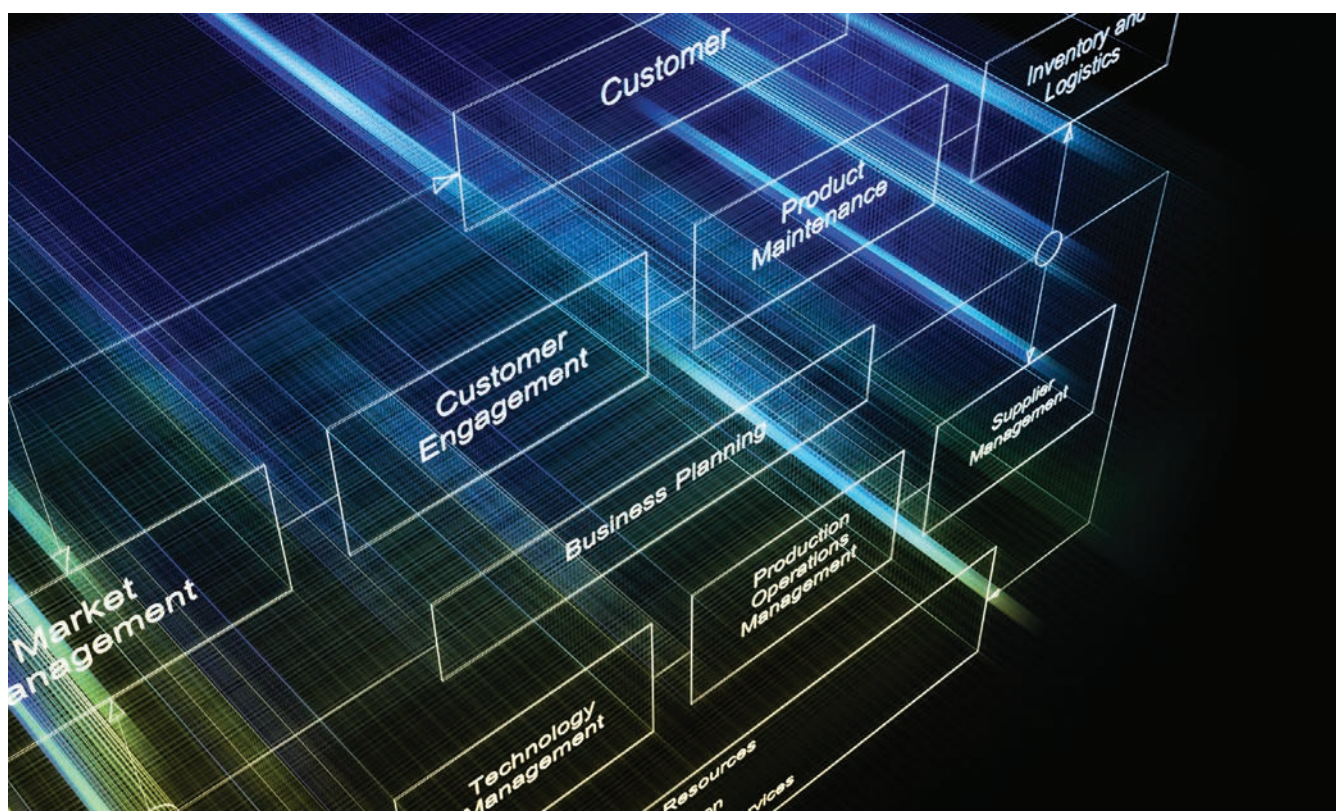
Product evolution includes managers utilising administrators to provide scale for business growth. Moreover, consolidation and deal activity continues as a result of the changing market demand, with a continued focus by managers on top tier administrator providers. In addition, as large fund managers consider their expense bases and further examine their business models, they are increasingly looking to fund administrators for middle-office support and other NAV reporting functionality.

With respect to middle office functions², fund managers are focused on the scalability of their businesses and their expense structures more generally. As middle-office administration functionality develops and matures, managers see multiple reasons for changing their business models to include this component across their respective value chains. Most are happy to note that a key byproduct of this development is their ability to track and audit middle-office processes in a controlled environment.

Historically, many large fund managers managed NAV reporting in-house. As the investor and regulatory landscape shifted, many managers began to include an NAV checking component in administering their onshore funds; this is in contrast to previous standard practice, where often no NAV check was performed. Today, three-way reconciliations between prime bro-

“FUND ADMINISTRATION HAS TAKEN A MORE CENTRAL ROLE IN ALTERNATIVES FUND MANAGEMENT. AS A RESULT, WE ARE SEEING INDUSTRY PROGRESSION IN THE FORM OF PRODUCT EVOLUTION, CONSOLIDATION AND DEAL ACTIVITY”

GEORGES B. ARCHIBALD



kers, internal systems and fund administrators is becoming the norm – with increasing responsibility typically transferred to the fund administrator as the relationship evolves, because this new model clearly works.

BETTER RISK MANAGEMENT PROCESSES

Because fund administrators are newly positioned at the apex of information, they are in an excellent position to help fund managers ‘slice and dice’ portfolio information – and better manage risk. This is key for fund managers, who are looking to employ a broader, more evolved approach to risk management.

First, working with a fund administrator reduces the level of both perceived and real operational risk. Perceived operational risk is mitigated by the imprima-tur benefits of having a reputable third-party validating a portfolio’s value. The measure of mitigation success would be the stickiness of capital, the associated touch point volume in terms of capital servicing (fielding of investor inquiries) and finally the ability to attract new capital. Real operational risk would be mitigated by, among others, a provider with vetted operational controls and processes.

Second, in terms of portfolio risk, fund administrators can help in a number of areas, including: VAR and other standardised risk calculation methodologies; sensitivity and scenario testing; exposures on a multiplicity of bases (including use of Greeks); sources of return (alpha and beta, for example) and notional exposures.

The ultimate benefit of all of this to the fund manager is the simplicity of design and the sourcing of information from one centralised provider. The benefits ultimately inure from managers to investors in terms of confidence around the veracity of methodology versus

an in-house proprietary process and confidence in the accuracy of that data set. To put it simply, both managers and investors stand to gain in terms of efficiency and focus when it comes to leveraging fund administrators in the risk mitigation process.

Third, enhanced risk mitigation clearly spills over into the middle office, where risk numbers are factored into new compliance and regulatory reporting requirements (new Form PF in the US, for example).

Finally, with respect to performance, investors are keeping a keen eye on fund returns in the overall composition of their respective portfolios. This transparency trend can be seen in something as obvious as managed account structures, but has also made its way into portfolio information required by investors, and now regulators, on traditional single manager accounts. Again, the fund administrator is well-positioned at the hub of portfolios to help provide this information.

CONCLUSION

The role of the fund administrator has evolved from its back office origins. Industry developments across market dislocations, market regulation and investor demand have put fund administration at the nexus of helping fund managers satisfy their ever-growing middle and front office needs. ■

¹ Counterparty credit exposure mitigation tools include, among others, fully paid-for custody accounts, as well as counterparty diversity and exposure analysis.

² Some key middle-office functions include management of the trade lifecycle; cash and collateral management including derivatives; corporate action processing; compliance and regulatory reporting.