

**Investment Management:
Areas of Regulatory Concern and Risk Assessment Methods**



IOICU-IOSCO

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Part I: Introduction

Rationale

The IOSCO Technical Committee through its Standing Committee on Investment Management (TCSC-5) has carried out a range of work on the standards that collective investment scheme (CIS) operators should be subject to and the supervisory arrangements that should be in place in member countries. This paper sets out this background and attempts to identify those areas, which may concern the regulator in fulfilling his objective of investor protection, whereby one CIS operator can be judged against another CIS operator. This paper is designed to help develop a common view of the risks that CIS operators may pose or face relevant to the achievement of regulatory objectives and of the relative importance of those risks. To further this common view the paper can be used as a starting point for exploration of differences and similarities in the regulatory approaches to certain risk areas. That should aid understanding and co-operation between regulators, which has become increasingly necessary as a result of the globalization of fund management.

The paper also provides an insight into the methods used by regulators of CIS operators to assess the risks that the activities of CIS operators pose to the objectives of securities regulation and the methods used by regulators to determine their inspection priorities and other activities in relation to CIS operators.

Background

CIS operators are increasingly operating on a global basis and the Internet is encouraging that development. All national regulators experience limitations on resources and hence are under pressure to prioritize the use of their scarce resources. Prioritization has become a matter of risk identification not only in specific firms but also across the industry as a whole.

The industry is now global and therefore regulators are becoming more international in their outlook and are also placing more reliance on each other. International co-operation will be improved if regulators form a common view on the risks inherent in the CIS business. That common view should lead to more efficient and effective communication between regulators and also to a more consistent regulatory response to issues arising.

The Technical Committee has published the following key documents: Principles for the Regulation of Collective Investment Schemes (1994), Discussion Paper on International Cooperation in relation to Cross-Border Activity of Collective Investment Schemes (1996), Principles for the Supervision of Collective Investment Schemes (1997), and Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for decision making for CIS Operators (2000). There has also been detailed work on Pricing, Risk Disclosure, and Conflicts of Interest and Delegated Functions. These papers contain valuable material concerning the jurisdictions of the Technical Committee members and their regulatory approach and highlight that the issues surrounding investor protection and the approaches to the regulation of CIS operators are very similar in different jurisdictions.

Focus

Investor protection and market confidence are the common objectives of the Standing Committee and the regulators represented on it. This paper attempts to identify those areas, which may concern the regulator in fulfilling its objective of investor protection, whereby one CIS operator can be judged against another CIS operator. This should facilitate a common understanding between regulators as to why one CIS operator is viewed by its regulator as more risky than another. This should help in communicating particular concerns about industry participants between regulators as well as providing a focus for the particular issue of concern. It should also assist an individual regulator in prioritizing resources and determining the focus of his work. A listing of risk areas and risk assessment factors assists the regulator's staff in applying a consistent approach in the risk assessment of firms. Risk areas and risk assessment factors are set out in part II of this paper.

It is important to make clear that this paper covers risk assessment from a regulatory point of view, not from a CIS operator point of view. That work was primarily dealt with by the IOSCO Technical Committee report of May 1998 "Risk Management and Control Guidance for Securities Firms and their Supervisors" where many of the issues faced by securities firms can be translated to CIS operators.

Those jurisdictions that use risk assessment most extensively do so because it is considered an important part of determining the allocation of their own resources. The use of risk assessment techniques therefore varies depending upon the extent of resources devoted to inspection visits by the regulator's own staff, compared with the reliance placed on external auditors.

Part II: Areas of regulatory concern and risk assessment factors

The areas of regulatory concern can be broken down into two overall types:

- Areas of inherent business risk: the risk arising from the type and nature of the business being undertaken; and
- Areas of control risk: the risk of management's control systems not identifying and rectifying deficiencies.

Under each overall risk type area a number of factors can be identified that should be taken into account when assessing the risk in that area. Many of the risk assessment factors described below overlap with or impact on other risk areas. For the purposes of this paper they are identified against the primary relevant risk area.

The risk assessment factors that can be used to identify inherent business risk areas are:

- Investor and product type factors, for example:
 - the nature of customer type;
 - the financial sophistication of consumer type;
 - the complexity of the investment products offered.

Explanatory note: Examining the customer base of a CIS operator is relevant as retail investors may require enhanced protection or more detailed regulation compared to institutional investors. Products that are targeted at and only available to institutional investors generally require less intensive regulation than those targeted at retail investors. The nature of the CIS products offered by the operator needs to be seen in the context of the operator's customer base and, hence, whether this poses a risk issue to the regulator. The complexity of the product gives rise to two concerns: whether the investor understands the nature of the product; and whether the operator can properly manage the complex investment. It is also important that the promotional material of the products offered by the operator reflects the complexity of the product. If not, this could lead to future misselling claims.

- Business strategy factors, for example:
 - frequency of changes in products;
 - introduction of new products;
 - distribution strategy (self-marketing or third party);
 - mergers, acquisitions and growth strategy;
 - clarity of strategy and likelihood of achievement;
 - other business activities by the CIS operator or related companies.

Explanatory note: The regulator needs to understand the strategy of the firms under its supervision. Significant changes in business strategy or management structure inevitably place stress on the operator and its staff, at least in the short term. Experience has shown that often a major event at a firm such as a major acquisition has a detrimental effect on the business (and hence investors may suffer). Equally this can happen with the rapid introduction of new and complex products. Significant changes in product type require the

sales force, asset managers and compliance staff to develop an understanding of the new product. So the regulatory questions would be: how realistic are management's ambitions; has the operator the capability e.g. systems and controls to introduce new products over a short period of time?

- Financial viability factors, for example:
 - financial history of operator;
 - capital levels and composition;
 - earnings stream relative to industry benchmarks.

Explanatory note: Although insolvency is not a common problem in fund management it cannot be in the interests of investors (or regulators) to have this occur. Some operators may voluntarily reimburse a CIS in the case of an operational error or maintain holdings in the fund in order to maintain an orderly market and stability in net asset values. It is important that the regulator is satisfied that the firm is sufficiently capitalized to cope with issues such as operational risk as well as having a sound business base to continue as a financially viable operation.

The risk assessment factors that can be used to identify control risk areas are:

- Management culture and effectiveness factors, for example:
 - quality of management;
 - integrity of management;
 - reputation of management.

Explanatory note: The assessment of the quality and integrity of the management of a CIS operator plays an important role in regulatory risk assessment. The regulator must assess the intentions of management and its ability, and willingness, to identify and manage risks and act in the best interest of the CIS investors. Their ability to do so depends largely on the quality of management, for example their effectiveness, their expertise and the business culture they establish. The willingness of management to identify and manage risks and act in the best interest of investors depends largely on their integrity and their approach to management responsibilities and business ethics. Inevitably, the regulator must use considerable subjective judgment in this area. Over the years the regulator may have built up a working knowledge of the quality, integrity and reputation which will influence that judgment. The regulator must also take into account external information concerning regulatory, financial, criminal and other antecedents of management.

- Organizational factors, for example:
 - corporate structure;
 - potential conflicts of interests;
 - segregation of duties;
 - delegation of functions;
 - outsourcing of functions;
 - financial and human resources.

Explanatory note: The corporate structure and the organizational set-up will inform the regulator as to the ability of the CIS operator to tackle risks. A regulatory concern is whether the operator has identified potential conflicts of interest and has put in place structures and procedures to monitor and supervise these conflicts. If the operator has delegated or outsourced certain activities, the regulator is interested in how the operator oversees such delegation or outsourcing and if the operator contains sufficient expertise to carry out this supervision effectively. This also entails assessment of the quality, reputation and reliability of the third party involved. Also it is important to determine whether the firm has adequate financial and human resource for its activities.

- Factors related to operational processes and procedures, for example:
 - administrative systems and procedures;
 - internal control procedures;
 - audit trail;
 - nature and complexity of fee arrangements;
 - investment decision procedures;
 - management information systems;
 - compliance history and procedures.

Explanatory note: Administrative systems and internal control procedures of the operator must incorporate such safeguards that the assets and liabilities of the CIS and the changes therein can be accounted for truly and fairly. It is important for a regulator to assess whether important processes, such as the NAV-calculation process, the subscription and redemption process and the investment process are well organized and well documented. The investment process is also of interest to the regulator with respect to adherence to the stated investment policy and compliance to legal or internal requirements. Deviant or complex fee arrangements may give rise to extra regulatory attention. Moreover, the way fees are calculated and paid may lead to aberrant practices, such as churning, which are to the detriment of the investor. The relation between the scale of operations and the extensiveness of the management information systems gives the regulator a clue to how management tries to control operations.

- Mandatory third party factors, for example:
 - reputation and quality of custodian;
 - reputation and quality of auditor.

Explanatory note: In most jurisdictions involvement of independent third parties is mandatory, for instance for safekeeping of assets and auditing reports. These parties must be of good reputation and quality, so that the regulator can depend on their prudence and judgment.

- Marketing practice factors, for example:
 - aggressiveness of advertising and selling practices;
 - use of past performance claims;
 - use of intermediaries;
 - nature and complexity of sale commissions;
 - complaints by investors.

Explanatory note: In this area the regulator is attempting to ascertain how aggressive the operator is in its marketing and dealings with investors. Misleading performance claims, high sales commissions for independent intermediaries or a high level of complaints from investors could suggest a "business at whatever the cost" approach by an operator.

- Regulatory history factors, for example:
 - regulatory actions;
 - follow-up on regulatory actions and inspection observations.

Explanatory note: As mentioned earlier the regulator will build up a working knowledge of the operator. Although the past is not always a good guide to the future the regulator's past experience of a CIS operator can provide useful clues as to the operator's determination to take its compliance responsibilities seriously or not. The regulator may keep a history not only of regulatory actions enforced and the follow-up on those sanctions, but also of the results of on-site inspections.

Most jurisdictions use an operator-based approach to assessment of the risk areas mentioned above. The risk type of products offered is taken into account while assessing the operator. The particular issues raised if an operator is part of a group are also taken into account in the assessment.

Although all areas of regulatory concern identified above must be considered while assessing the relative risk of an operator, Management culture and effectiveness, Organizational factors, Operational processes and procedures and Marketing practices are seen as some of the more important areas of regulatory concern.

Most jurisdictions evaluate the risk assessment factors qualitatively and in some cases, depending on the factor, quantitatively. The views of different regulators on the nature of the connection between the factors and the particular areas of concern are roughly the same. For example more complex investment products, lack of internal controls and compliance or an aggressive style of advertising pose a higher risk to the objectives of the regulator.

Part III Characteristics of methods for resource allocation

A questionnaire on risk assessment methodology was sent to all TCSC-5 members and the main findings are stated below.

- Nearly all jurisdictions use some kind of assessment of risk areas;
- Some jurisdictions use a modeling technique which scales and weighs different risk factors to create an overall risk indicator;
- Most jurisdictions do not currently use a modeling technique, but do employ a risk assessment in their supervision;
- A few jurisdictions do not employ explicit risk assessments of CIS operators, because of the limited size of their market, or because supervision of CIS operators is part of the supervision of financial conglomerates as a whole, or because funds are rated by an authorized rating agency.

Risk area assessment is mostly used to focus supervision and prioritize (on-site) activity. The frequency of updates differs from continuously to once every five years, but predominantly the assessment is updated annually.

Some jurisdictions argue that the individual analysis of each risk factor is considered to be more important than obtaining an individual overall risk indicator because of the difficulty in synthesizing and homogenizing the different risk factors considered in a model, and weighting them to provide an overall risk indicator.

Whether or not a model is used, some internal guidelines for harmonization of the evaluation are necessary, especially in the case of qualitative factors. But the regulator's subjective opinion based on years of experience must not be underestimated.

Regulatory risk assessment models

Regulatory risk assessment models attempt to view the relative riskiness of one CIS operator to another in the context of the regulator's mission of investor protection. They do not therefore attempt to detail market risks (i.e. the exposure of investment portfolios to more volatile markets) or operational risks (i.e. the use of sophisticated IT systems) but do take some account of these factors.

Models can contain a mixture of qualitative and quantitative factors. Wherever possible hard, quantitative risk identification factors should be utilized but ultimately the regulator's experience and knowledge is a vital component. A critical area of judgment is the assessment of management of a CIS operator. There are many demonstrable factors that provide evidence of sound management and the model should attempt to identify these.

Models should be dynamic, altering in reaction to changes in the underlying market and individual operators within it. Regulators may find when introducing or developing risk models that they do not possess all the information the model may suggest they require. The model might therefore need to operate, at least at first, on incomplete information and the introduction of a model might stimulate work on the information needs of the regulator.

Models can follow a simple scoring mechanism for each of the identified risk factors with the individual being totaled. A regulatory response, including a visit cycle, can be produced from the scores.

The purpose of the risk assessment models in those countries where it is used tends to be limited to the allocation of resources and the focus of inspection visits. The ratings therefore tend to be relatively crude, merely rating each factor as high, medium or low for each operator. The emphasis is on the relative risk assessment – the rating of one operator relative to another operator.

Risk models need to be:

- simple and easy to understand
- simple to maintain and adapt over time
- sufficiently comprehensive, drawing on a wide range of information
- easily accessible by the regulator's staff

and take account of the regulator's experience and knowledge. Training in the model is important to provide a consistent output from the regulator's staff.

Issues arise on the confidentiality or otherwise of the overall rating. For example, in the UK, IMRO did not reveal the relative risk ratings to firms. However, the general publication of the effect of the rating on visit frequency meant that an operator could estimate its own risk rating. IMRO's successor regulator in the UK, the FSA, is developing a common risk assessment model for all financial services businesses in the UK. The FSA envisages communicating to the operator the outcome of the FSA's risk assessment.

The risk assessment process used by many regulators provides an important resource allocation method for inspection visits. In addition, other supervisory tools are used either to identify appropriate operators to visit or to identify issues to focus work on during an inspection visit or as an alternative to inspection visits.

Inspection visits and other activities

As noted above, the use of inspection visits varies depending upon the extent of reliance placed on inspection visits compared with other tools of supervision, for example reports from external auditors.

Where regulators relied on inspection visits, these comprised a variety of types of inspection visits:¹

- (1) *Regular, periodic, ordinary or routine inspection visits* either with the frequency of visits the same for all CIS operators or with the frequency dependent upon the risk assessment process which is the subject of this paper. Depending upon the nature of the risk assessment process undertaken by the regulator, the work carried out on the

¹ IOSCO members in describing their types of inspection visits used different terms to describe visits, but the visits appeared to fall within the following categories.

inspection visit may vary dependent upon the risks identified in the risk assessment process.

- (2) *Cause, emergency or special inspection visits*, where the regulator has a particular reason to visit an operator; for example, the operator's auditor has reported a matter to the regulator which requires further investigation. These visits might arise as a result of a matter identified by one of the supervision tools set out below.
- (3) *Theme or sweep inspection visits* where the regulator focuses on a particular issue which it is considered may occur across a number of different CIS operators, for example soft commission arrangements or controls on pricing arrangements.

Many regulators rely extensively on annual returns prepared by CIS operators and reports prepared by external auditors on these returns. Reviews of publicly available information and of complaints can also help focus work.

In some jurisdictions movements in the net asset value are reported on a very regular basis and analyzed by special software vis-à-vis a pre-determined or expected movement for that type of fund. Strange patterns in the net asset value trigger the regulator to make enquiries. This could lead to a special inspection visit.

Part IV: Conclusion and Future Work

Many regulators have found that undertaking some form of risk assessment, either as part of scheduled inspection visits, or in order to prioritize which firms to inspect and what aspects to inspect in detail, is a useful regulatory tool. This paper is designed to provide a description of the categories of risk that might be considered in any risk assessment relevant to CIS operators. These categories will evolve over time, as risk assessments become more detailed or change to focus on the areas of greatest perceived risk.

The Technical Committee has continued its work in the area of risk assessment, by focusing on some particular risk categories and giving more thought to two key questions:

- (1) How does the regulator in practice assess or measure that particular risk category? and
- (2) What tools are available or steps may be taken by the regulator to address that category of risk?

The Technical Committee intends to publish further more detailed papers in the future on the following risk categories:

- management culture and effectiveness;
- operational processes and procedures; and
- marketing practices.