Grant Thornton

#GTBharat
SHAPING A VIBRANT INDIA

Impact of new risk management framework of mutual funds

Contents

Need for revised framework

During inspections carried out in the past, SEBI noticed various irregularities such as:

- Non-compliance of the guidelines with respect to the parking of short-term deposits of scheduled commercial banks by mutual funds
- Investments in the scheme not in lines with the objectives of the scheme as disclosed in SID
- Rationale of investments not documented for all investment transactions, including inter-scheme transfers
- Instances of close ended schemes investing in assets having maturity beyond the scheme maturity, and premature liquidation of such assets may result in a loss to the scheme

Furthermore, there have been significant developments in the mutual fund industry and in the financial markets, viz. investment in newer asset classes, which have led to innovation in products, distribution landscape, technological evolution, investor penetration and awareness, increase in risk elements, etc., driving the need to review the existing risk management framework.

Accordingly, the Mutual Funds Advisory Committee (MFAC) reviewed the erstwhile risk management framework basis the inputs received from various industry players, such as the Association of Mutual Funds of India (AMFI), and their recommendations were incorporated in the new risk management framework (RMF) issued by the regulator in September 2021, replacing decades old guidelines issued in September 2002. The new rules came into effect from April 2022.

Laying down a detailed framework, SEBI has segregated certain elements of RMF into ‘mandatory elements’ that should be implemented by the asset management companies (AMCs) and ‘recommendatory elements’ that address other leading industry practices that can be considered for implementation.

Characteristics of RMF

The RMF should be structured, efficient and reviewed in a timely manner. It should be integrated with the mutual fund processes, both on an operational as well as strategic level. The RMF should be customised to both AMCs and the scheme's risk profile. The RMF has to be dynamic/flexible in nature to incorporate new/emerging risks, at the same time eliminating redundant risks.

Objective of the revised framework

The risk management framework should assist the management and board of directors of both the AMC and trustee in early identification of the key risks, measure the risks, and take action for its proactive management to ensure that the risks are within the tolerance limits defined in the RMF. It also helps the management and board of directors of both the AMC and trustee in clearly defining the roles and responsibilities of the board of AMC and trustees, management, CXOs, Chief Risk Officer (CRO) and the internal auditors.

To achieve this objective, the revised RMF shall provide a set of principles or standards, which inter alia comprise the policies, procedures, risk management functions and roles and responsibilities of the management, the board of the AMC and the board of trustees.

Self-assessment of existing risk management framework

AMCs need to perform a self-assessment of their existing RMF and practices and submit the roadmap to the board of the AMC and trustee for implementation of the revised RMF framework.

Annual review of compliance of RMF

The report of compliance, along with findings, should be shared with the board of the AMC and trustee. The trustee may forward the findings to SEBI as a part of the half yearly trustee report.

Four components of RMF

(key mandatory changes mentioned)

Governance and organisation 01

- An independent risk management function should be formed by the AMC as a second line of defence.
- Risk management will be an independent function of the AMCs. For each risk area, such as investment, compliance, operations and cyber security, the AMC will have to appoint a dedicated CXO-level risk officer.
- The CRO will be responsible for the overall risk management of the mutual fund operation, with clear demarcation of its roles and responsibilities from CXOs.
- Separate risk management committees should be created at both the AMC and the trustee level, and an annual review of the RMF should be done at both the AMC and the scheme level.
- The AMC should maintain a risk metric for each mutual fund scheme. The risk metric should incorporate each key risk type, such as investment risk, liquidity risk, credit risk, etc.
- There should be a Delegation of Power (DoP) framework covering daily risk management, daily risk reporting and corrective actions at various levels of management.
- The risk management policy should clearly mention the roles and responsibilities assigned to CXOs, and the same needs to be updated on the website.

Position/designation	Role and responsibilities* (illustrative)
Board of AMC and trustees	• Review and approve the RMF policy and the risk appetite framework of the AMC and each of its schemes • Define specific responsibility of the management, including the CEO • Reporting of material risk related observations to SEBI on a periodic basis
Management	• Oversee the risk management process and keep the board and trustees informed about new and emerging risks • Prepare a quarterly report on risks and share it with the board and trustees • Include risk management in the performance appraisal of the CEO and senior officials
CEO	• Take responsibility for all risks at both the AMC and the scheme level • Review risk management functions every month • Define risk appetite framework for schemes, the AMC and risk metric for the CIO, CXOs and fund managers • Report to the board and trustees in case of any risk issue and approve the corrective action
CRO	• Implement the risk management framework • Review specific responsibility of the management, including the CEO, CIO, CXOs and fund managers • Put in place a mechanism for risk reporting, at least on a quarterly basis, to the board of AMC, trustees and risk management committees (RMCs) • Independent assessment of reporting of risk to various committees and the CEO
CIO and fund managers	• Daily management of risk and reporting important aspects on market risk, liquidity risk, credit risk, etc. • Define responsibilities of fund managers and adhere to SEBI guidelines with respect to the RMF • Calculate the overall risk by taking into account the risk-o-meter and events of default
CXOs	• Ensure adherence to risk management rules in respective risk type • Maintain risk level as per the risk metric • Take immediate corrective action after approval from the CEO and report risk reports to the CRO

* Above mentioned roles & responsibilities are only the key ones reproduced here. For a detailed/comprehensive list, please refer the SEBI Circular SEBI/HO/IMD/IMD-1 DOF2/P/CIR/2021/630 dated September 27, 2021

Identification of risks 02

- AMCs shall identify, on an ongoing basis, the specific risks to be covered within the RMF, based on the nature, scale and complexity of their business, the risk profiles and strategies of the funds they manage, and the impact of different risks on their mutual funds business.
- SEBI has released a set of questions, which AMCs can use to identify risks. They include:
  - What are the different types of risks faced by the mutual fund?
  - What is the probability of each of the identified risks happening?
  - What is the likely impact of key risk events, in terms of financial loss, reputation loss, impact on investors/ unit holders and regulatory action?
  - What are the emerging or new risks?

Measurement and management of risks 03

- AMCs should have an approved internal policy for the measurement of organisation-wide risks, such as operational risk, technology risk, legal risk, talent risk, outsourcing risk, etc. Having identified and documented the applicable risks, the risk management function should develop process/tools to measure and manage those risks. For this purpose, the following needs should be considered for each risk category:
  - Ascertaining the measurement criteria for each risk category (qualitative and quantitative criteria)
  - Documentation of measurement tools for each risk category, i.e., risk and control self-assessment (RCSA), stress testing, scenario analysis, etc.
  - Determination of the required frequency of monitoring
  - Developing a process for escalation
  - Determination and documentation of remedial or mitigating actions
- The AMCs shall have an established structure and responsibility across these three lines of defence:
  - Business operations
  - Oversight functions, such as risk management and compliance
  - Internal audit
- Internal audit and oversight function, such as risk management and compliance, shall ensure that there is a dedicated internal auditor of the RMF of the AMC that audits at the scheme level as well. The internal auditor should audit compliance with the internal policies of the AMC on risk management, as well as the applicable rules and regulations mandated by SEBI on risk management.
- For the processes being audited by the internal auditor, a non-compliance rate shall be computed based on the sampling out of the total number of processes being audited. The non-compliance level shall be converted to an overall internal audit score represented in the form of a number, providing a quantitative representation of the internal audit report (this number shall be generated considering all key risk types). Furthermore, this number shall be compared in subsequent internal audits to analyse the improvement in minimising the non-compliance level at the AMC. Therefore, this number may be represented in the form of a ‘rectification index’ in the internal audit report.

An illustrative calculation of overall Internal audit score:

For the processes audited by the internal auditor, a non-compliance rate may be arrived at by identifying the number of issues noted or controls failed in all the processes of the AMC and mutual fund operations. Magnitude scores may be assigned to the audit issues based on their risk categorisation.

A simple average of non-compliance in all the processes shall reflect an overall internal audit score.

Alternatively, a weighted average method may be adopted to arrive at the overall internal audit score, wherein various processes may be classified into categories based on key functions, such as front, middle and back-office operations, as well as support functions. Magnitude weights may be assigned to such categories. The weighted average internal audit score shall be arrived at by applying these weights to the compliance rate of each process.

The comparison of subsequent internal audit reports for overall internal audit score shall be represented as a rectification index to measure the improvement in the non-compliance level at the AMC.

The above-mentioned calculation methods are illustrated below for reference:

Mutual funds operations

Assumptions:
Audit areas and figures used are illustrative and for demonstration purpose only
Audit issues identified are assumed to be low risk and weighted 1

Option 1 – Simple Average Method

		FY 21-22				FY 22-23				
Sr no	Audit Area	Controls Reviewed	Issues Noted	Risk (H - 3, M -2, L -1)	Non-Compliance Rate	Controls Reviewed	Issues Noted	Risk (H - 3, M -2, L -1)	Non-Compliance Rate	Rectification Index
1	Investments	55	3	1	5%	55	2	1	4%	33%
2	Middle Office Group	20	1	1	5%	20	1	1	5%	0%
3	Customer Service	40	1	1	3%	45	1	1	2%	11%
4	Marketing and Advertisement	25	4	1	16%	25	3	1	12%	25%
5	Investor Education and Distributor Development	25	6	1	16%	29	3	1	10%	35%
6	Compliance	20	3	1	15%	23	3	1	13%	13%
7	Fund Accounting & Custodian	110	2	1	2%	110	1	1	1%	50%
8	Unit Administration	120	3	1	3%	117	2	1	2%	32%
9	Sales & Distribution and Business Development	30	2	1	7%	27	1	1	4%	44%
10	Reconciliations	10	3	1	30%	11	3	1	27%	9%
11	Product Development	15	1	1	7%	16	1	1	6%	6%
	Total	**470**	**29**		**6%**	**478**	**21**		**4%**	

	FY 21-22	FY 22-23
Overall Internal Audit Score	**94%**	**96%**
Rectification Index		**2%**

Mutual funds operations

Option 2 – Weighted Average Method

Step 1: Classifying the processes into 3 categories, viz., Front End Operations (Weights assigned - 3), Back End Operations (Weight assigned - 2), and Support Functions (Weight assigned - 1) Audit areas and figures used are illustrative and for demonstration purpose only
Step 2: Assigning weights according to the categories (3, 2, 1)
Step 3: Arriving at weighted average internal audit score

FY 21-22								
Step 1	**Step 2**	**Step 3**	**Step 1**	**Step 2**	**Step 3**	**Step 1**	**Step 2**	**Step 3**
Classifying the processes into 3 categories	Assigning weights according to the categories	Arriving at Weighted Average Internal Audit Score	Classifying the processes into 3 categories	Assigning weights according to the categories	Arriving Weighted Average Intern Audit Score	Classifying the processes into 3 categories	Assigning weights according to the categories	Arriving Weighted Average Intern Audit Score
Front End Operations	Weights	Weighted Score	Back End Operations	Weights	Weighted Score	Support Functions	Weights	Weighted Score
Investments	3	2.94	Middle Office Group	2	1.90	Compliance	1	0.85
Fund Accounting & Custodian	3	2.95	Customer Service	2	1.95			
Reconciliations	3	2.10	Investor Education and Distributor Development	2	1.52			
			Unit Administration	2	1.95			
			Sales & Distribution and Business Development	2	1.87			
			Product Development	2	1.87			
Total	9	7.99		12	11.05		1	0.85

Total Weighted Score	19.89
Total Score	22.00
Overall Internal Audit Score (A)	**90%**

	FY 22-23
Overall Internal Audit Score (B) - Assumed	**94%**
Rectification Index (B-A)	**4%**

Reporting of risks and related information 04

- There needs to be a structured bottom-up reporting process for facilitating a meaningful and independent analysis by the risk management function
- The findings of the risk management function should be conveyed at least monthly to the management and quarterly to the board of the AMC and the trustees
- The risk management function should promptly report to the management/risk management team/AMC board where any significantly emerging risk issues are not adequately addressed

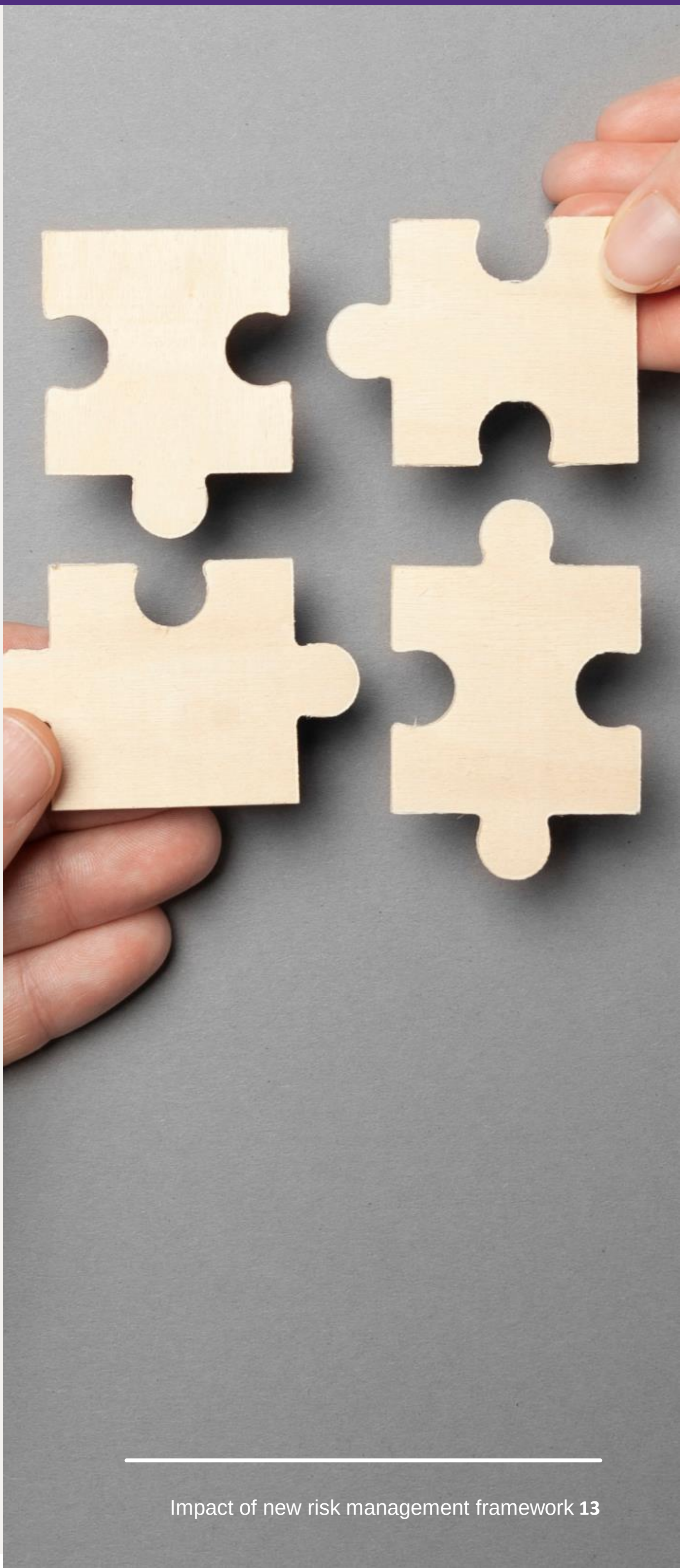
Managing key risks

Select guidelines provided by SEBI for management of the key risks are as tabulated below:

Type of risk	Key mandatory guidelines
Investment risk	• Have an investment policy for each asset class • Pre-defined policies for inter-scheme transfers (ISTs), investment valuation and broker empanelment policy, stock or sectoral exposure • Review and take corrective actions in case of passive breaches • Analyse trends such as redemption, investor concentration and distributor concentration
Credit risk	• Introduce credit risk management policy, evaluate ratings received from multiple rating agencies and carry out an internal risk assessment • Generate early warning signals of issuers' credit profiles • Carry out stress testing by applying shocks based on downgrade and negative outlook
Liquidity risk	• Introduce separate framework at the scheme level. For the debt and money market, liquidity has been tested based on maturity of papers, such as 0-30 days and 30-60 days • Carry out back testing and stress testing to check redemption pressure • Manage mismatch in the asset and liability of underlying securities
Governance risk	• Introduce an approved policy for managing governance risk • Assess track record and history of issuers • Monitor conflict of interest of the board and key personnel
Operational risk	• Implement operational risk policy to check governance structure and introduce new product approval process • Introduce dealing room policy • Define roles and responsibilities for time stamping, KYC review, credit identification, tracking high value transactions, etc. • Identify frauds and put in place a monitoring mechanism to address such scenarios
Compliance risk	• Put in place a system where the compliance officer directly receives complaints. The officer will have to review complaints with an objective to catch early warning signs for fraud • Among other key requirement of AMCs to reduce compliance risk are: timely filing of regulatory reports, review of marketing material, ensuring that the investment declaration is in line with disclosure, introducing a mechanism to check possible insider trading, and prevent and detect trading violation
Technology, information security and cyber risk	• Integrate reputation management in business planning • Establish a crisis management policy to minimise the risk of negative publicity in an event of any incident or conduct of an employee • Monitor social media grievances • Establish code of ethics and business conduct • Consumer behaviour must be considered to design a product
Outsourcing risk	• AMCs have to appoint a dedicated person to oversee outsourcing activities • Introduce an outsourcing policy, which will have the description of activities that can be and cannot be outsourced • Monitor and control outsourcing activities • Ensure that all outsourcing activities are accurate and timely
Financial risk	• Introduce accounting policies for finance and mutual fund accounting • Regular testing of internal controls over financial reporting of mutual fund schemes
Legal and tax risk	• Introduce documented process with defined responsibilities for calculation and deposit of taxes applicable to mutual funds • Appoint a person for execution and registration of legal agreement and documents
Talent risk	• Introduce a succession plan for identified key positions • Ensure that AMCs cannot be deprived of the services of any key managerial person • Screen employees, including background checks, particularly for key positions

Conclusion

The new RMF will help the AMC industry in accelerating the monitoring of risks, focusing on identification and mitigation of potential and emerging risks, and protecting the reputation of the AMCs. In addition, it will ensure stringent risk reporting requirements to the management, the board of the AMC and trustees, along with enhanced disclosure norms issued by the regulator on a time-to-time basis, which will increase transparency and gain customer confidence.



It will also help investors in making a conscious decision while investing, as they will have more transparent information in the form of risk appetite through scheme information documents, marketing materials, and website updated with the risk management framework adopted by the AMC. It will establish that the AMC is investing after thorough risk assessment of investment, credit and liquidity risks, thereby minimising the size and probability of losses.

The rigorous assessment of various new schemes launched in line with emerging financial market risks, reporting and strict monitoring by the regulators will boost the confidence in investors to channelise their savings into a mutual fund investment option.

Grant Thornton Bharat contributors

Vivek Ramji Iyer
Partner and National Leader
Financial Services - Risk
E: vivek.iyer@in.gt.com

Vernon Dcosta
Partner
Financial Services - Risk
E: vernon.dcosta@in.gt.com

Dharmesh Jadav
Director
Financial Services - Risk
E: dharmesh.jadav@in.gt.com

Sneha Goenka
Manager
Financial Services - Risk
E: sneha.goenka@in.gt.com

Scan the QR code to view our office addresses