JANUARY 2023

Managed Investment Schemes Sector Risk Assessment

Findings from the FMA's assessment of the sector risks and the underlying key risk factors for Managed Investment Schemes (MIS)

FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

Contents

Introduction

Managed funds, including KiwiSaver funds, are one of the main avenues for New Zealanders to meaningfully improve their long-term financial wellbeing. The sector has seen continued growth and, following this trend, fund managers[1] continue to develop new product offerings, target new market segments, and engage in merger and acquisition activities.

This presents additional risks and challenges for the sector and the Financial Markets Authority – Te Mana Tātai Hokohoko (FMA), alongside the risks inherent in the market. The performance of managed funds is dependent on how well the fund manager identifies and manages business and fund risks within a Managed Investment Scheme (MIS). Risk in this context refers to the likelihood and impact of harm to the best interests of investors, and to fund managers. A goal for fund managers is not to eliminate risk, but to manage risk in an effective way that serves and protects the best interests of investors.

This sector risk assessment (SRA) identifies some areas in the MIS sector we consider to be higher risk. It is predominantly based on the fund manager risk ratings assigned by their frontline supervisors (supervisors)[2].

Purpose

The data that informs this SRA establishes a broad perspective on the risks in the MIS sector. This view of sector risks will guide more targeted work on specific issues and managers. It will further highlight higher risk areas to help enhance supervisor monitoring and raise awareness with fund managers. We intend to collaborate with supervisors to ensure risks identified in this SRA are (or continue to be) managed effectively.

This is the first SRA on the MIS sector, and we expect that the insights drawn from it will inform future iterations. Our intention is to continue to build more data and intelligence on the MIS sector to promote our purpose of facilitating the development of fair, efficient, and transparent financial markets.

About fund managers

A fund manager of a MIS is responsible for:

- offering the managed investment products;
- issuing the managed investment products to investors;
- managing the scheme property and investments; and
- administering the scheme and performing their duties in accordance with the law, including acting with the care, diligence and skill of a prudent MIS Manager.

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[1] We use the term 'fund manager' here to mean 'licensed MIS manager of a managed fund' – to distinguish them from managers of 'other MIS', such as property and forestry schemes.
[2] 'Supervisors' are entities appointed to look after investor interests and supervise managed investment schemes, including KiwiSaver schemes.

Fund managers are licensed by the FMA against minimum standards. Where a licence is granted, the manager must adhere to the minimum standards they were assessed against, standard licence conditions, and all other relevant financial markets legislation, including Financial Markets Conduct Act 2013 (FMC Act) disclosure obligations. Fund managers are monitored by both the supervisors and the FMA.

About this SRA

In late 2021 we surveyed four supervisors on the 53 licensed fund managers they supervise. The scope of SRA includes all managed fund managers except:

- Superannuation and workplace savings schemes managers; and
- 'MIS-Other' (Forestry and Property funds) managers.

Of the 53 fund managers within the scope of the SRA, 15 are small fund managers[3] and three are mortgage fund managers.

We asked the supervisors to rate the risk level of each fund manager they supervise, across 22 different risk factors. We also asked the supervisors to assess the effectiveness of the mitigants[4] the fund managers use to manage risk, and to provide comments on the reasons for those ratings. The results of this assessment were aggregated by fund manager, risk category (business governance, investment risk, and operational risk), sub-sector and sector level, and then assessed by the FMA.

The risk factors covered in our survey are based on a sector risk assessment done by Corporate Trustees Association (CTA) in 2019/2020.

We wish to thank the supervisors for their time and effort in contributing to this assessment.

[3] In the SRA model, 'small manager' refers to MIS managers with funds under management (FUM) of less than NZD$250m, as at 29 October 2021.
[4] 'Mitigants' refer to the efforts and controls that the MIS entities take to reduce risk.

Findings

Summary

If no risk mitigations were in place, the overall risk of the MIS sector would be Medium-High. However, the mitigants and controls used by fund managers, including mitigations required by existing regulatory frameworks (such as the requirement to be licenced and supervised), effectively lower the overall risk to Medium-Low. This risk rating means that, for the MIS sector **overall**, the likelihood of harm occurring is "unlikely" and the consequence of the harm is "minor". There are some pockets of relatively higher risk within the sector, which are the main focus of this report.

- The top contributors to the overall sector risk are:
    - Responsiveness to changes in macro-economic factors (e.g. inflation, interest rates, exchange rates)
    - Product management (e.g. product disclosure documentation, marketing, and advertising)
    - New financial instrument management
    - Investment operations
    - Manager oversight of outsourced investment services
- Our assessment shows the importance of effective risk mitigation by fund managers in the MIS sector. It also highlights the importance of supervisors' continued efforts to monitor the sector and ensure that existing mitigants and controls remain adequate and effective.
- The effectiveness of mitigants that fund managers employ to manage the risks varies. Some managers' boards and governance structures provide stronger support than others at the 'top level' of the business to promote sound governance, compliance frameworks and control processes. Better practices were more common in large fund managers.
- Prior to mitigation, governance risk is higher than operational risk and investment risk at the sector level. However, the risk is effectively mitigated to a level marginally lower than operational risk and investment risk, especially by larger managers.
- Post mitigation, operational risk is higher than investment risk and governance risk at the sector level due to risks in product offering, investment operation, and outsourcing oversight.
- Some risk levels are correlated to the size of a manager:
    - The governance risk of small managers is typically higher than that of larger fund managers, driven by factors such as relatively weaker financial strength, less consistent reporting to the manager's board, limited capability and capacity of the board and/or senior management, and fewer independent directors.
    - Larger fund managers typically exhibit better financial strength, better managerial and board competency and capacity, and more effective risk management frameworks. However, their operational risk is relatively higher due to the size and complexity of the funds they manage.

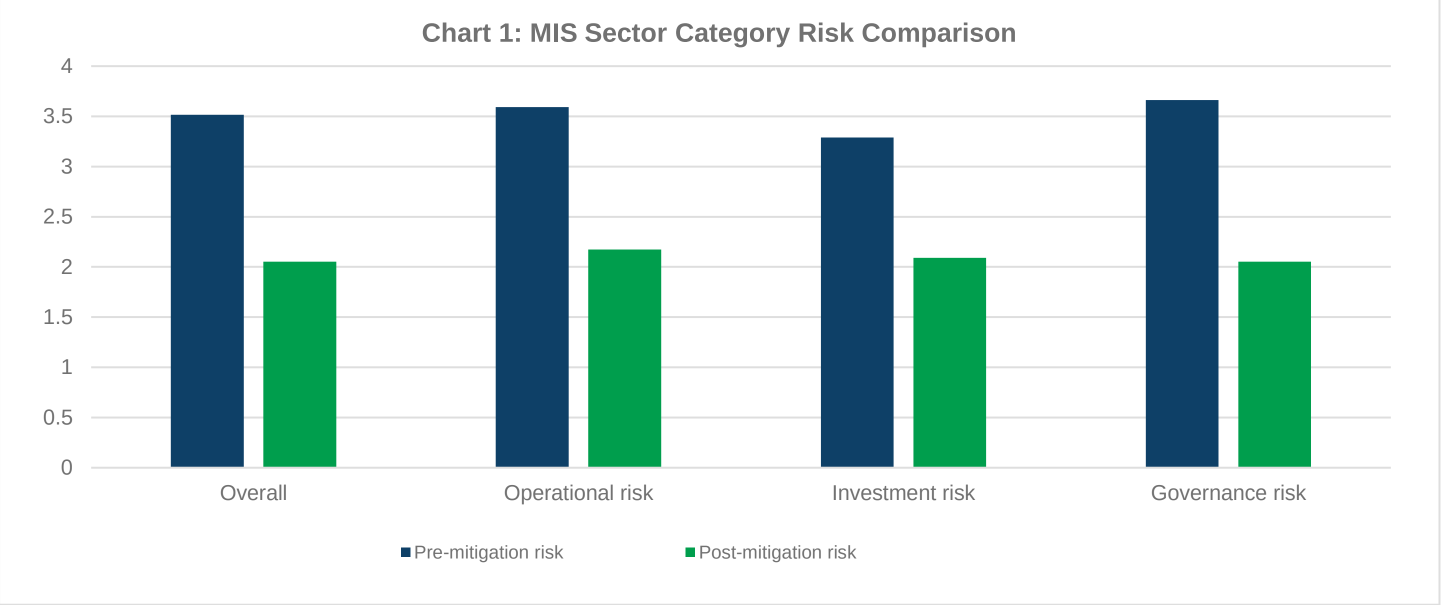
- Investment risk for mortgage fund managers is significantly higher than for other fund types. Even with mitigations, the risk is still at a Medium level. This higher risk arises mainly as a consequence of the illiquid products they invest in (property), exposure to the movements of interest rates and the regional economy, and more concentrated portfolio construction.

Category risk analysis

This SRA breaks down total risk into three categories: operational risk, governance risk, and investment risk.

Governance risk has been effectively mitigated by fund managers from the highest risk pre-mitigation to lowest risk post-mitigation. Operational risk is the highest risk post-mitigation. While a category's overall risk rating may be lower, individual risk factors within in the category could be higher risk.

The three risk categories are interrelated: governance risk may impact investment returns, and investment risk may create stresses within a fund manager that increase governance or operational risk.



Y-axis represents the risk scores from the scale of 1 to 5, with 1 the lowest risk level and 5 the highest risk level

Operational risk

> ***Operational risk*** *is risk embedded in the fund manager's business operations, processes, and systems. This includes functions such as investment valuations, trade implementations, fund accounting, investment compliance, product management, operation process management, and supervision of outsourced activities.*

Operational risk is relatively the highest post-mitigation risk of the three risk categories across the MIS sector overall.

The top contributors to operational risk are risks connected to product offerings, investment operations, and the oversight of outsourced investment providers.

Product offering risk (how products are offered to investors, e.g. market advertising and risk disclosure) is the highest risk from an operational perspective. This includes items such as deficiencies in product disclosure documentation, misleading advertising, and divergence between the investment strategy and actual fund marketing strategy.

Investment operation risks arise from issues such as unit pricing errors, inefficiency of trade settlements, and deficiencies in fund accounting and performance reporting. As many fund managers have outsourced investment operation functions, investment operation risk is correlated to the effectiveness of the manager's oversight of outsourced providers.

Governance risk

> ***Governance risk is*** *risk that affects the business management of the fund. It considers the control the company has over its operation and products, and the company's view and approach to compliance, staffing, reporting processes, and its governance framework.*

If mitigants were not in place, governance risk would be the highest risk for the sector overall. However, due to effective mitigations it had the lowest actual risk, Medium-Low.

The top contributors to higher governance risk are instances of:

- deficiencies in board oversight, including lack of independent directors, board capability and capacity limitations, and inefficiency in board reporting processes;
- deficiencies in senior management capacity and capability; and
- unwillingness to comply with statutory obligations or best practice.

Many fund managers do not have independent directors on their board. This is frequent across the sector, not only in small managers but also in certain larger managers.

For some managers, board and senior management *capacity* is a greater risk than *capability.* This lack of capacity is caused mainly by:

- small businesses lacking resources, resulting in the founder/senior management being stretched;
- fund managers entering into a growth phase while their staff capacity has not kept pace with the increased demands of greater size; and
- high staff turnover.

Risk from a fund manager's unwillingness to comply with statutory obligations or best practice relates to a firm's culture of compliance – the intention and implemented actions to comply with regulatory risk management requirements and to maintain good governance. Unwillingness to comply may be reflected in:

- the manager taking comparatively longer to identify and understand underlying compliance issues;

- the manager being comparatively slower to respond to supervisor requests; and
- operational and reporting documentation errors from time to time.

Investment risk

> ***Investment risk*** *is risk that may contribute to investment losses in the fund due to investment actions (or lack of actions) by fund managers. Investment risks include risks from the investment decision-making process, asset allocation, stock selection, currency hedging, and high risk financial instruments investing.*

Investment risk can be caused by an inappropriate investment strategy, poor strategy implementation, or inadequate investment risk management. The top risk factors that contribute to investment risk are:

- macro-economic impacts on investments;
- management of new financial instruments;
- manager decision-making; and
- fund concentration.

Macro-economic impact on investments was rated as the top contributor to investment risk. This is because the systematic risk of the investment makes up a large part of fund volatility. There is variability in fund manager skills and capabilities to predict and respond to macro-economic impacts on the funds they manage.

With the continuing growth in the managed funds sector, managers have been developing new product offerings in an effort to increase their market position, to take advantage of investment opportunities, and to differentiate their product offerings. Some fund managers have introduced novel financial product that present new risks. 'Novel' in this sense may refer to truly new products such as cryptocurrency, or to existing products that may be new to a particular manager. In either case, the need to have a good understanding of the product and its unique risks, as well as capability to knowledgeably invest in the product, add to the complexity of fund management.

Manager decision-making risk is higher where the investment decision-making lacks rigour or is highly dependent on a key person such as the managing director or founder. Risk is also increased by higher staff turnover, especially experienced staff or decision-makers – this has a material impact on investment decisions and maintaining strategy implementation, especially for active fund managers and small managers.

Fund concentration risk is the risk of the fund being concentrated in a single asset or class of assets, which might cause higher volatility during adverse market conditions.

Sub-sector risk analysis

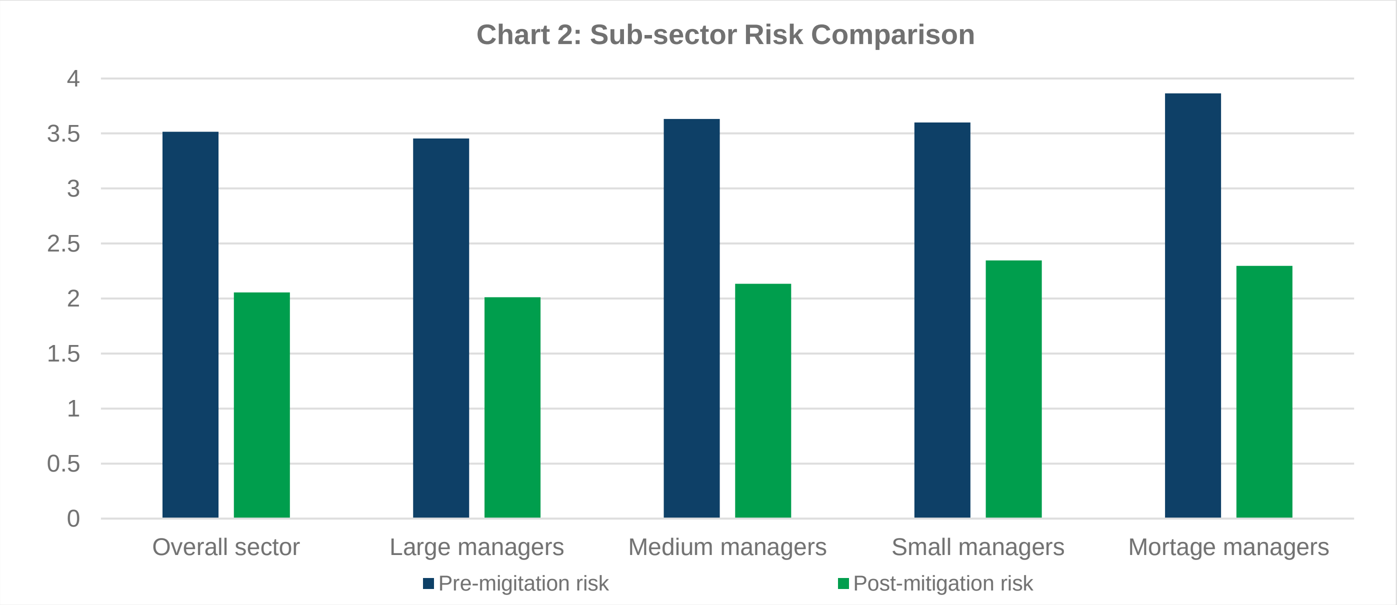
Some risks in the MIS sector are correlated to the size of the funds. For our assessment we divided the sector into four sub-sectors:

- Large fund managers – managers with FUM of more than $10 billion as of 29 October 2021;

- Medium fund managers – managers with FUM of between $250 million and $10 billion;
- Small fund managers – managers with FUM of less than $250 million;
- Mortgage funds.

Pre-mitigation risk on average is similar for most sub-sectors, but notably higher for managers of mortgage funds. Mitigants have significantly reduced risks of all types, but post-mitigation risks are significantly higher for small managers and managers of mortgage funds.

Our comments in this section highlight sub-sector post-mitigation risks that are materially higher than the risk level of the sector overall.



Y-axis represents the risk scores from the scale of 1 to 5, with 1 the lowest risk level and 5 the highest risk level

Large fund managers

In terms of FUM, 8 large fund managers make up over 60% of the market share within scope of the SRA.

Large managers' risk after mitigation is Medium-Low level, consistent with the sector overall. Large managers' risks are generally lower than the rest of the sector.

Operational risk is the highest risk for large managers. The top contributors to operational risk for large managers are:

- **Investment operation:** The investment operation processes for large managers are more complicated due to the size of the FUM, and the sophisticated fund structures. Most large managers have outsourced investment operations and, although the managers have robust outsourcing policies and procedures, and due diligence and review processes, outsourcing oversight is still a significant investment operation risk for large managers.
- **Product offering:** Large fund managers undertake more advertising of their funds compared to the rest of the sector. Some large fund managers have had issues with accuracy and clarity of public communications to investors such as product offering documentation and advertising.

Although large managers have lower risk overall, the potential impact of these risks materialising would be serious to investors and the wider economy, due to the size of the businesses and the scale of the managed assets they hold. This means large fund managers and their supervisors need to ensure their risk mitigations remain effective.

Medium fund managers

Medium managers' risk level is between that of large managers and small managers. Even so, certain medium-sized managers have some of the highest risks in the sector. This is largely due to systems, processes, and capability not keeping pace with the growth of the businesses. This is reflected in:

- deficiencies in product risk disclosure documentation, and misleading advertising;
- investment operational errors, especially during fund transition and new product launch periods;
- higher staff turnover, and capacity limitations of senior management constraining sustainable business growth;
- risks around the addition of innovative/novel financial products to funds or portfolios.

Small fund managers

Small managers' risks are more prevalent in areas that reflect their size, maturity, and capacity. Small fund managers have marginally higher risk compared to the sector overall, due to having higher-than-average governance risk. The top contributors to governance risk for small managers are:

- **Manager financial strength**: Small managers tend to have weaker financial strength than large managers for various reasons, such as lack of fund scale, lower levels of capitalisation, and lower cashflows and revenue streams.
- **Board efficiency**: This considers whether the structure of the board facilitates a diversified and open environment, as well as the board's capacity and capability, and the quality and efficiency of reporting to the board. Small managers may exhibit a lack of independent directors, domination by some board members, stretched board capacity, and insufficient board reporting processes due to their small size, and limited staff and professional resources.
- **Competency:** This refers to overall competency of the organisation, especially within the investment, compliance, and operations teams. Competency in this context refers to the adequacy of policies, processes and controls, rather than individual expertise or skill. Some small managers' competency was undermined by lack of established investment processes and capacity:
    - Small managers generally have limited investment decision-making resources such as in-house investment professionals. This leads to investment decision-making heavily relying on either key staff members or external investment consultants. While the external consultants may be high quality, the fund manager must have sufficient capacity and capability to oversee and challenge outsourced providers.
    - Changes in macro-economic conditions, especially market downturns, may impact small managers more heavily than large managers, as they have not achieved economies of scale, and their financial strength is weaker compared to the sector overall.

The overall impact to investors and the wider economy from a risk materialising in a small fund manager would be smaller compared a large fund manager. However, based on the risk ratings, the likelihood of a risk materialising is much higher in small fund managers, indicating a need for greater supervision or FMA scrutiny.

Mortgage funds

The overall risk for mortgage fund managers is higher than that of other sub-sectors. This is driven by higher investment risk, which is at a Medium level even after mitigation, while the average investment risk for the sector overall is Medium-Low. This indicates a need for mortgage fund managers to focus more on managing investment risk.

The top contributors to investment risk for mortgage funds are:

- liquidity (this is the top risk factor for mortgage fund managers across all risk categories)
- macro impacts on investments, such as interest rate volatility (as seen as present)
- fund concentration.

The investment risk for mortgage funds is highly correlated to their targeted property market. Liquidity risk arises as the underlying assets of mortgage loans and development loans are illiquid and it takes time to meet the redemptions requirements. Mortgage funds also have limited staff, senior management and board resources due to their smaller size relative to other fund managers.

Mortgage funds often have significant transactions with their related business partners. Although no mortgage fund manager has been found to have breached the conflict-of-interest rules, this still contributes to governance risk.

Key risk factors and mitigants

Our assessment identified key risk factors that have significant impacts on the sector overall, as well as the distinctive risk factors for specific types of fund managers. The following section describes those risk factors and some available good practices to mitigate risk.

Macro impacts on investments

Risk related to macro impacts on investments was not in the top 10 pre-mitigant risk factors identified, but it is the most prominent post-mitigant risk factor that impacts the overall risk level of all fund managers. This reflects that macro-economic factors have systematic impacts to investment performance. Macro-economic factors include:

- Interest rates, which affect the valuation of financial products, including equity and bonds. Changes in interest rates impact movement of asset prices.
- The economic cycle, which favours different asset types at various stages. This will impact the periodic performance of managed funds, especially if the fund is concentrated or heavily invested in a single sector or asset type.

- Other global market economic conditions, such as foreign exchange movements and country risks (including geo-political events, e.g. pandemics and wars), which will affect fund performance via currency and country exposures.

The management of macro economic impacts on investments are a core part of the role of fund managers and a key way that they add value. Although macro impacts on investments cannot be eliminated due to systematic risk components, some fund managers have been able to reduce the impact by engaging in good practice risk mitigations, including:[5]

- Diversifying investments into a variety of global markets, asset types, and currency exposures.
- Managing asset concentration by setting limits for single investment holdings and sector exposures.
- Enhancing risk management by improving due diligence processes, complying with the investment strategy and governance policies, and implementing cash redemption policies and liquidity risk management.
- Upskilling in-house investment management professionals and enhancing the investment process, to be able to respond promptly to changes in market conditions, or outsourcing investment decisions and operations to a reputable external professional investment management team.

Product offering risk

Product offering risk is one of the most significant risk factors among fund managers, both pre-mitigation and post-mitigation, and is an area that requires closer monitoring. Product offering risk relates to product management functions in general, including offer documentation, product and risk disclosures, oversight of distribution channels, reporting, and advertising.

The SRA identified risk associated with some fund managers seeking to serve a variety of investors' demands and improve their competitiveness by:

- Providing a variety of funds through different asset allocations or 'fund of funds' structures to suit the needs of different groups of investors.
- Introducing novel or high-risk financial products into their fund offerings, including funds with unique structures, or that invest in cryptocurrency, private equity, commodities, and venture capital.
- Expanding or creating different investment distribution channels, including online investment platforms, and using fund hosting businesses.

The FMA seeks to promote fair, transparent and resilient financial markets. Although we embrace innovation and the continuing development of the funds industry, we expect fund managers to be vigilant in managing the legislative compliance and risk disclosures of their product offerings, and to be especially mindful of product risk when developing new financial products.

The main risks identified in relation to product offerings are:

- Errors in offer disclosure documentation. Due to the complex nature of some fund structures and the practice of adding new funds to existing fund schemes, there are often errors in offer and disclosure documentation (e.g. errors in calculating fund returns).

[5] These mitigations are practical examples. They are neither comprehensive nor mandatory. This does not imply that single-sector funds, highly concentrated funds etc, are inappropriate, but they do carry greater risk for investors.

- Advertising and marketing products with unsubstantiated assumptions that could mislead investors.

Fund managers that have good governance and compliance practices have taken approaches such as the following to mitigate product offering risk:

- Formulating an effective and robust due diligence policy and review/sign-off process for offer and disclosure documentation.
- Ensuring disclosure documents are updated accurately and in a timely manner.
- Following the FMA's guidance Advertising offers of financial products guidance to ensure no misleading information is included in disclosure documentation or in distribution and redistribution channels.

Investment operations and outsourcing oversight risk

Investment operations and outsourcing oversight risk captures fund administration functions including trade execution and settlements, fund accounting, financial reporting, performance evaluation and investment compliance.

Many fund managers transfer investment operation functions from in-house to outsourced providers, to reduce operational costs and seek synergy of scaled specialties. However, when the investment operation function is outsourced, the fund manager still bears the responsibility for it. This means that effective oversight by fund managers of external investment providers should be an integral part of the manager's risk framework.

Effective investment operation and outsourcing oversight can include:

- A sound outsourcing service framework composed of a comprehensive due diligence policy, risk and compliance policy, service level agreement, and regular service monitoring reporting and meetings.
- Seeking external investment providers that can demonstrate the ability to build a robust operational system to suit the needs of the fund manager. Providers with a customer-centred mindset should have agile operational systems and resources to accommodate the manager's development needs.
- Effective communications between the fund manager and the outsourced providers. A stable and high-quality outsourcing outcome requires seamless connections between the fund manager and the outsourced providers that ideally are comparable to having the operation in-house. Effective communications are critical as:
    - errors in investment operations such as asset pricing, trade executions, and cash settlements can directly cause financial losses to fund investors, who may need to be compensated for any resulting losses; and
    - poor communication of changes, especially changes related to business strategies, operational models and fund transition processes, will generate higher risk in investment operations.

Manager decision-making risk

Manager decision-making risk refers to fund manager competency, key person risk within the investment team, quality of the investment decision-making process, and investment governance. One-third of fund managers have Medium or higher post-mitigation risk for manager decision-making, which is higher than the sector average across all risks (Medium-Low level).

Factors that significantly contribute to risks around manager decision-making are:

- High staff turnover, especially experienced professionals or decision makers. This has a material impact on investment selection and the manager's ability to maintain fund strategy implementation, especially for active fund managers and small managers.
- Investment decision-making being dependent primarily on the managing director or founder.
- Investment team members not having adequate training or support to perform investment analysis, possibly leading to deficient investment decisions.

Good practices managers can consider to reduce manager decision-making risk include:

- Having delegation processes and policies in place to mitigate key person risk.
- Making senior management investment and governance committees responsible for material decision-making, to ensure investment decisions:
    - are made by experienced professionals
    - adhere to the fund's strategy
    - comply with the manager's risk policy
    - are not dependant on one individual.
- Outsourcing investment decisions to an experienced investment firm when in-house resources lack capacity or capability. The fund manager will need to ensure due diligence, oversight and reporting processes, and effective communication channels are in place to monitor the performance of the outsource provider.
- Providing sufficient staff training and opportunities to upskill investment analysts and researchers to support informed decision-making.

Manager financial strength risk

Manager financial strength is not a current concern for the sector overall, but it is one of the highest-risk factors for some small managers, even after mitigations. A manager's financial strength relates to the long-term viability of the manager based on current and projected funds under management, revenues, cost structure, cashflows, debt, and dividend demands. It also considers the capital expenditures for human resources, IT infrastructure, and system improvements necessary for sustainable growth.

Indicators of weaker financial strength include:

- negative net tangible assets (NTA);
- low levels of equity and assets on the fund manager's balance sheet compared to liabilities;
- general concerns about the cashflows and slower growth in funds under management, with foreseeable revenue concerns;
- inability to support sufficient resources, e.g. experienced people and adequate systems, with current and projected revenues;
- the auditor report mentions going concern of the manager as a potential issue; or
- the manager's financial strength is dependent on individuals (like the founder) to provide financial guarantees, or on subordinated loans from shareholders.

A fund manager can improve their financial strength and resilience by, among other things, having:

- a strong focus and support from the board and senior management to safeguard a healthy financial position;
- a business model that supports the growth of assets under management and the corresponding revenue streams;
- healthy solvency ratios (e.g. debt-to-asset ratio and debt-to-equity ratio) to ensure long-term sustainable growth and reasonable profitability capability; and
- positive NTA.

Board oversight risk

Board oversight risk relates to the presence and proportion of independent directors on the fund manager's board. It also considers the effective control the independent directors can exercise, which is often related to the competence and composition of the board and the absence or presence of dominant executive directors.

Factors indicating risks in respect of board oversight include:

- executive directors or the founder dominate the board
- the board lacks a culture of fostering diverse opinions, inclusion and openness (which may lead to some board members dominating the board)
- no (or a minority of) independent directors or, independent directors lack relevant experience in the investment industry.

Weak board oversight may lead to poor decision-making due to:

- limited challenges from the fund manager's director(s)
- a lack of diversity, meaning the board may not be able to identify or consider different approaches to solving problems and acting in the best interests of investors
- a majority of executive directors, which dilutes the impact of independent directors and impinges on the effectiveness of the board overall.

Fund managers can mitigate board oversight risks by:

- adding independent directors to the board
- electing a board with a good mix of industry experts and executives experienced in organisational governance
- diversifying the board by demographics and specialist areas
- encouraging a board culture of openness and questioning
- providing board members with regular training on director duties and obligations, to ensure they carry out their duties diligently.

New financial instruments (and trend chasing) risk

New financial instruments (and trend chasing) refers to the risks arising from:

- Investing in emerging asset classes (such as cryptocurrencies) where the fund manager may not fully understand the risk and return profile or has not developed appropriate investment strategies.
- The fund manager expanding their investment universe to manage investments in asset classes that are new to them and outside of their existing knowledge base and capability. For example:
    - a traditional fund manager investing in private equity and venture capital
    - fund managers developing innovative financial products
    - fund managers developing or promoting new or innovative distribution channels or platforms.

One factor that contributes to this risk is that a MIS manager investing in new asset classes may not only lack skill or experience relating to that asset class, but also lack the experience and insight to *realise* that they are deficient – leading them to mis-ascribe poor investing results to macro-economic factors rather than to their lack of skill.

An additional risk factor is where the fund manager seeks to invest in an asset class to follow a fashionable investing trend, rather than following a carefully considered strategy to expand their capability. A fund manager that prioritises speed to chase a trend may be less likely to have adequately considered their capability and skill gaps.

The sector-wide proportion of managed funds invested in new financial instruments may not be substantial currently, but where this does occur it could result in increased risk for investors and create a need for supervisors and the FMA to enhance their regulatory oversight framework and collaboration. Fund managers and supervisors also need to be aware that some innovative products may fall into the remit of different regulatory bodies.

Fund managers seeking to introduce new financial instruments should:

- Go through a sound due diligence process and follow product management policy when directly investing in novel instruments, or via a 'fund of funds' structure, to ensure the new product risk is underpinned by sound investment logic (i.e. 'why invest'), and is measured, informed, controlled (e.g. holding or concentration limits) and monitored on behalf of investors.
- When directly holding a new class of financial asset, seek internal and external advice, or outsource (or partner with) professional investment expertise if there is a lack of capability to manage the new product internally.
- Ensure that disclosure documentation to retail investors is sufficient, clear and not misleading, so investors can make investment decisions based on reasonable and transparent information about the nature of the investment to suit their return/risk requirements.

Key emerging risk factors

As part of the SRA, the FMA and supervisors also jointly assessed emerging risks in the sector. The purpose was to consider risks for possible inclusion in future SRAs and monitoring. These risks were considered solely at the sector level. Overall, emerging risks are rated Medium-High pre-mitigation, and Medium-Low post-mitigation[6]. The predominant emerging risk factors are:

- Cybersecurity
- Business continuity planning (BCP)
- Climate-related disclosure and IFP disclosure (ESG disclosure).

Cybersecurity

Cybersecurity relates to the awareness, policies, processes, and technologies to protect the fund manager's business, critical systems, and sensitive information from cyber-attacks. In a digitised investment sector, cybersecurity issues have become a fundamental part of operational and governance risks.

Cybersecurity risk affects all parts of the business, from staff who may receive phishing emails to IT teams protecting core operations systems against cyber-attacks. If not sufficiently managed, these attacks could result in business disruptions, financial losses, and leaks of investor information.

We have published information sheets Developing cyber resilience for financial advice providers and Cyber Security and Operational Systems Resilience to assist fund managers and other market services licensees with enhancing the resilience of their cybersecurity and operational systems. General recommendations include:

- Creating a culture of awareness in the organisation and building capability through continuing cyber resilience training for staff at all levels.
- Using a recognised cybersecurity framework tailored to the organisation, to assist with the planning, management and prioritisation of cyber resilience.
- Having an established response procedure and recovery plan in place.
- Ensuring the board and senior management receive sufficient reporting on cyber risk and the tools in place to monitor it.

Business continuity planning (BCP)

A business continuity plan is a strategy for how an organisation will respond to any risks that could disrupt critical business functions, including natural disaster, a major cyber-attack, or other disruptions. All fund managers should ensure their BCP includes:

- BCP policies and procedures that clearly document:
  - situations when they apply, and the functions that require BCP coverage
  - a contact list, and clear responsibilities of each group of contacts
  - how to evacuate and to where
- regular BCP testing, including crisis communications and workplace recovery processes

[6] While there are some biases due to small samples, as some risk factors have only 1 or 2 supervisor ratings, the findings are still useful.

- evaluation of BCP test results, with a focus on identifying and remedying any deficiencies
- staff training, recovery site preparation and equipment maintenance.

Climate-related disclosure and IFP disclosure

With the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021 receiving Royal assent on 27 October 2021, all managers of registered investment schemes (other than restricted schemes) with greater than $1 billion in total assets under management will be required to release climate statements. The first statements are expected to be published around April 2024, for entities with a balance date of 31 December 2023.

We published our Climate related disclosures implementation approach in late 2021, which states that in the early stages, the regulatory stance will be focused on supporting the entities subject to the regime (climate reporting entities or CREs), and encouraging development of good practice as the sector builds capability. It is likely enforcement action will only be taken where there has been serious misconduct, such as failure to produce a climate statement, or where a climate statement is false or misleading.

In regard to IFPs (integrated financial products, i.e. products that look beyond financial returns and integrate non-financial factors), there is a risk that some managers fail to adequately disclose to investors the features, characteristics and limitations of managed funds that purport to be “green”, “ethical”, “sustainable”, etc. We have published a Disclosure framework for integrated financial products and Integrated financial products: Review of managed fund documentation, where we recommended that managers:

- improve the level of detail and clarity of information about their IFP approach, and make it available in a consolidated, easy-to-read source
- explain the scope of any exclusion policies through explicit thresholds and/or clear narratives
- seek to reduce ambiguity in their decision-making by disclosing how they will apply judgement to unforeseen circumstances that connect with their IFP policies
- adequately explain the financial performance implications (positive or negative) of integrating non-financial factors into investment decisions
- describe for investors any consequences of their IFP fund not achieving its non-financial outcomes or objectives.