

Capital Markets - Estonia

Stricter Rules for Risk Management of Investment Funds

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The call for tighter financial regulation can be heard everywhere - Estonia is no exception. The Financial Supervision Authority (FSA) recently issued an advisory guideline to investment funds specifying the requirements for internal rules regarding risk management. The guideline, entitled "Requirements for the Management of Risks Related to the Investment of the Assets of a Fund", will enter into force on February 15 2010.

The main objectives of the guideline are to clarify the requirements of risk management procedures and to direct asset management companies to implement more sound risk management measures. Before the guideline, the legal framework provided only a general obligation to stipulate appropriate risk management procedures. Although FSA guidelines are documents of an advisory nature, they explain legal norms and reflect the FSA's accepted market practices.

Sound risk management systems require organizational requirements and specific safeguards and checks in order to ensure that all material risks are adequately managed. Therefore, the guideline provides an illustrative list of risks related to investing (eg, market, financial, legal and operational risks). This can be considered as a framework for risk management procedures and is a helpful tool for asset management companies.

The complexity of risk management procedures depends on the scale and nature of the asset management company's activities. More detailed risk management procedures are expected to be applied in case the fund is focused on financial instruments which are traded outside the regulated market (eg, convertible and unsecured bonds, derivatives and securitized instruments). Furthermore, asset management companies are obliged to employ third parties to assess risks adequately in case the company's professional knowledge is insufficient to assess relevant risks, and to adopt necessary, proportionate and sufficient risk management measures.

As an important part of risk management, the guideline also provides rules for liquidity management. The management company must apply a liquidity management procedure and establish measures to ensure compliance between the investments and obligations. The investment fund must be capable of performing its obligations to redeem its units on time. To assess liquidity risks, management companies must carry out regular stress tests with different scenarios and hypotheses concerning trading assets on the fund's balance sheets and market conditions.

It is believed that many investment funds suffered significant losses during the recent market turbulence, not only because of the unexpected general fall in asset prices, but also because of poor risk management. The comprehensive approach to risk management and high standards for risk management set forth in the guideline should lead to more sound risk management and reduce funds' vulnerability.

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