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REVISITING THE METHODOLOGY FOR SELECTING DOMESTICALLY- RELEVANT INVESTMENT FUNDS

BOX 5: REVISITING THE METHODOLOGY FOR SELECTING DOMESTICALLY-RELEVANT INVESTMENT FUNDS¹

The growth of the investment fund industry merits macroprudential oversight given its potential impact on financial stability as flows into funds, coupled with the fund managers' actions, can potentially amplify vulnerabilities in the financial system. Malta has established itself as a cost-effective fund domicile giving fund managers direct access to the EU internal market. Similar to other fund-oriented jurisdictions, this results in a distinct characteristic where funds domiciled in one country do not necessarily exhibit links with the domestic economy. Such characteristics make it necessary for the Bank to distinguish between those investment funds which are domestically relevant and others that are not. In this manner, it can monitor relevant developments in this sector and identify any potential risks to financial stability.

Under the previously adopted methodology, domestically-relevant investment funds were selected on the basis of whether the investment fund's resident shareholder units exceed 50% of the overall NAV of the fund. This methodology limits the classification to a single factor, emphasising residency rather than domestic relevance. Starting from this edition of the *Financial Stability Report*, the methodology for the categorisation of such funds was updated to better capture other factors reflecting the domestic relevance of investment funds. This box highlights the changes in the current methodology and presents the identified list of funds on which the assessment of domestic relevance within the *Report* is based.

Revised methodology

The new methodology is based on the following three indicators, which aim to capture a better understanding of the links with the domestic economy.

Indicator 1: The proportion of resident shareholder units (NAV) in the fund, excluding the holdings of other resident investment funds²

Indicator 2: The proportion of resident assets held by the investment fund

Indicator 3: Whether the investment fund is managed by an entity that has ties with the domestic economy.

Indicator 1: The proportion of resident shareholder units (NAV)

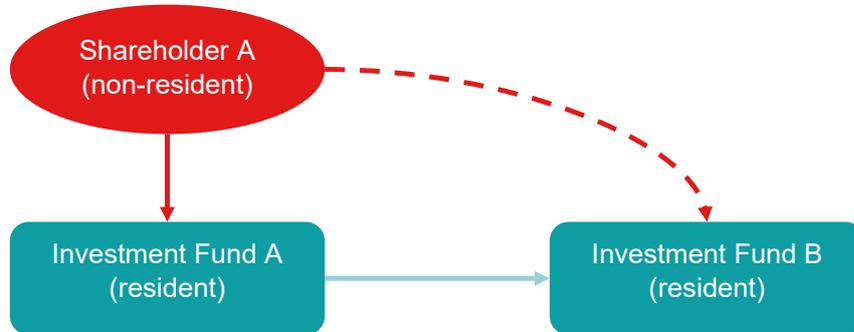
The first indicator captures the share of the resident NAV out of the total NAV for each investment fund, building on the indicator which was used so far. The main difference is that the part of the resident investment fund's NAV which is held by other resident investment funds is excluded from the overall investment fund's resident NAV.

Excluding the NAV units held by other resident investment funds is relevant since information on the ultimate investor is not available, and the investor could well be a non-resident. By way of an example, a non-resident shareholder A holds investments in the resident Investment Fund A. In turn, this resident Investment Fund A invests in the resident Investment Fund B. Should the holdings of the resident Investment Fund A into the resident Investment Fund B be considered, Investment Fund B would be considered as domestically relevant even though its ultimate investor, shareholder A, is a non-resident (see Figure 1).

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² Other resident investment funds include those funds classified as non-MMFs.

Figure 1
NON-RESIDENT SHAREHOLDER INVESTING IN RESIDENT INVESTMENT FUND



The proportion of resident shareholder units (NAV) is calculated using the formula:³

$$\frac{\text{IF's NAV (RoM)} - \text{IF's NAV [Other IFs (RoM)]}}{\text{IF's Total NAV}} \times 100$$

Indicator 2: The proportion of resident assets held by the investment fund

The second indicator captures the share of assets invested domestically. The assets are composed of two broad sets: those holdings recorded as Security-by-Security Assets (SbSA), which are the ones identified by an ISIN code; and those which are without (non-SbSA).⁴ The proportion of assets held by residents of Malta is calculated using the formula:

$$\frac{\text{MT Non SbSA Holdings} + \text{MT SbSA Holdings}}{\text{Total Assets}} \times 100$$

Indicator 3: Managed by a domestically-relevant entity

The aim of this indicator is to highlight which funds are managed by entities that are considered to have a marked domestic footprint in the Maltese financial sector. The domestic relevance of a management company can be gleaned by the share of the aggregate resident NAV of the investment funds managed by a given management company in the total managed funds. In this step, similar to indicator 1, the share of resident NAV held by other resident investment funds is also excluded. Investment funds which are self-managed or managed by foreign entities are excluded. The indicator is calculated as follows:⁵

$$\frac{\text{MT entity } i \text{ NAV (RoM)} - \text{NAV [Other IFs (RoM)]}}{\text{MT entities NAV (RoM)} - \text{NAV [Other IFs (RoM)]}}$$

Based on the above calculation, five management companies accounted for almost 99% of the overall resident NAV (excluding other investment funds NAV) for funds managed by resident companies. These five management companies are considered to be domestically relevant as identified by indicator 3. Domestic relevance is further confirmed by the fact that for each of these entities the share of the resident NAV (excluding other IFs NAV) out of the total NAV of the management company is above 50%.

³ RoM refers to residents of Malta.

⁴ An International Securities Identification Number (ISIN) is a code that uniquely identifies a specific securities issue.

⁵ See footnote 3.

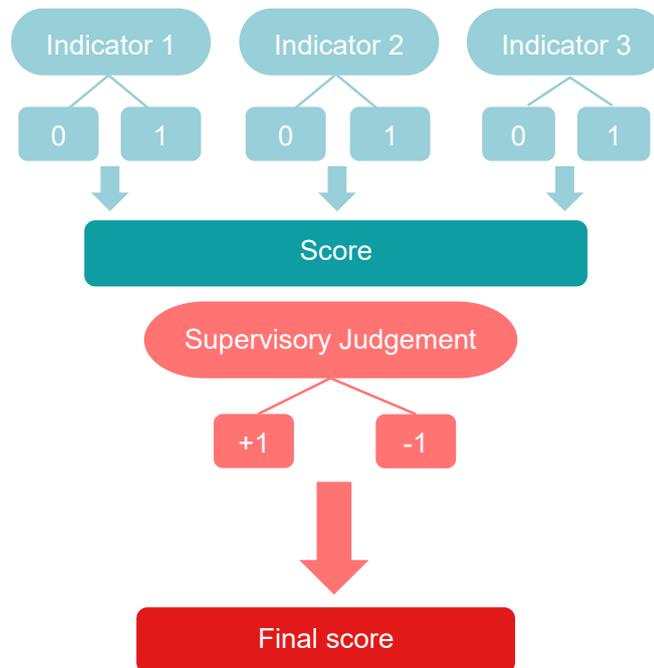
Scoring system and supervisory judgement

The new methodology is built on a scoring system, which assigns a score of either 1 or 0 to each of the three indicators used and aggregates them to arrive at a mechanical score. The score of 1 for indicators 1 and 2 is assigned if the indicator's value is higher than 50%, with a 0 assigned if the indicator's value is lower than or equal to 50%. For indicator 3, investment funds – managed by a domestic entity which has a domestic relevance within the local economy – are assigned a score of 1, while the remaining investment funds are assigned a score of 0. This scoring mechanism is, in some instances, augmented by tapping into supervisory judgement in collaboration with the MFSA to better assess the relevance of the investment funds for the stability of the domestic financial system. This judgement will be updated on an annual basis aiming to arrive at a harmonised list of domestically-relevant investment funds.

The supervisory judgement can add or deduct one notch to the score based on the indicators, thus enabling funds with a score of 1 to become domestically relevant, or those with a score of 2 to be considered as not domestically relevant. Investment funds with a score of 0 are automatically excluded from the list of domestically-relevant funds, while those with a score of 3 are outright considered as domestically relevant. There are several factors that may affect the supervisory judgement, including information about the Ultimate Beneficial Owner's (UBO) links with the domestic economy. Should the latter be considered not domestically relevant, the score is adjusted one notch down. In contrast, if the UBO and other domestic ties are not captured in the scoring system, a score of 1 is awarded.

The investment fund is classified as domestically relevant if the final score, post supervisory judgement, is either 2 or 3 (see Figure 2). The list of domestically-relevant investment funds will be updated on an annual basis.

Figure 2
NEW METHODOLOGY: SCORING SYSTEM AND SUPERVISORY JUDGEMENT



Results

Based on the new scoring mechanism, 36 investment funds were classified as domestically relevant in December 2020, compared to 67 funds as captured in the *Interim Financial Stability Report 2020* (see Table 1). The resulting reduction in the number of institutions falling within scope is attributable to a more granular approach under the revised methodology. The primary driver for this reduction relates to the exclusion of those funds that under the old methodology would have been classified as resident institutions, but in reality are owned by other resident funds as explained by indicator 1.

At the same time, those funds which are captured by indicator 1, and are thus considered to be resident in the previous methodology, but which do not meet at least one of the requirements set under indicator 2 or 3, are excluded. These include those investment funds which – despite exhibiting a share of resident NAV of 50% or above – do not invest more than 50% of their portfolio in resident assets or are not managed by a local investment company. Ultimately, the inclusion of supervisory judgement also contributed to some of the funds not being considered as domestically relevant any longer. The classification based on the new methodology allows a clearer picture of those funds exhibiting material links with the domestic economy. These 36 investment funds form the sample on which the assessment of domestically-relevant funds is carried out in this edition of the *Financial Stability Report*.

Table 1
DOMESTICALLY-RELEVANT MANAGEMENT COMPANIES AND INVESTMENT FUNDS

BOV ASSET MANAGEMENT LIMITED	REAPS ASSET MANAGEMENT LIMITED
BOV Balanced Portfolio Fund	APS Diversified Bond Fund
BOV Conservative Portfolio Fund	APS Income Fund
BOV Growth Portfolio Fund	APS Regular Income Ethical Fund
Global Balanced Multi-Manager Fund	HSBC GLOBAL ASSET MANAGEMENT (MALTA) LIMITED
Vilhena Broad Opportunities Fund	Equity Growth Fund
Vilhena Euro Income Fund	International Bond Fund
Vilhena Euro Liquidity Fund	Malta Bond Fund
Vilhena European Multi Manager Fund	Malta Government Bond Fund
Vilhena Far East Opportunities	Maltese Assets Fund
Vilhena Global Themed Fund	JESMOND MIZZI FINANCIAL ADVISORS LIMITED
Vilhena High Yield Fund	Merill Global Equity Income Fund
Vilhena Malta Bond Fund	Merill High Income Fund
Vilhena Malta Fund	Merill Total Return Income Fund
Vilhena Malta Government Bond Fund	Self-managed
Vilhena Maltese Equity Focus Fund	Amalgamated Growth and Income Fund
Vilhena Maltese Opportunities Fund	
Vilhena Sterling Income Fund	
CALAMATTA CUSCHIERI INVESTMENT MANAGEMENT LIMITED	
Emerging Market Bond Fund	
Euro High Income Bond Fund	
Global Balanced Income Fund	
Global High Income Bond Fund	
Global Opportunities Fund	
Malta Balanced Income Fund	
Malta Government Bond Fund	