Analysis

Investment funds have grown significantly in Finland – do their operations involve stability risks?

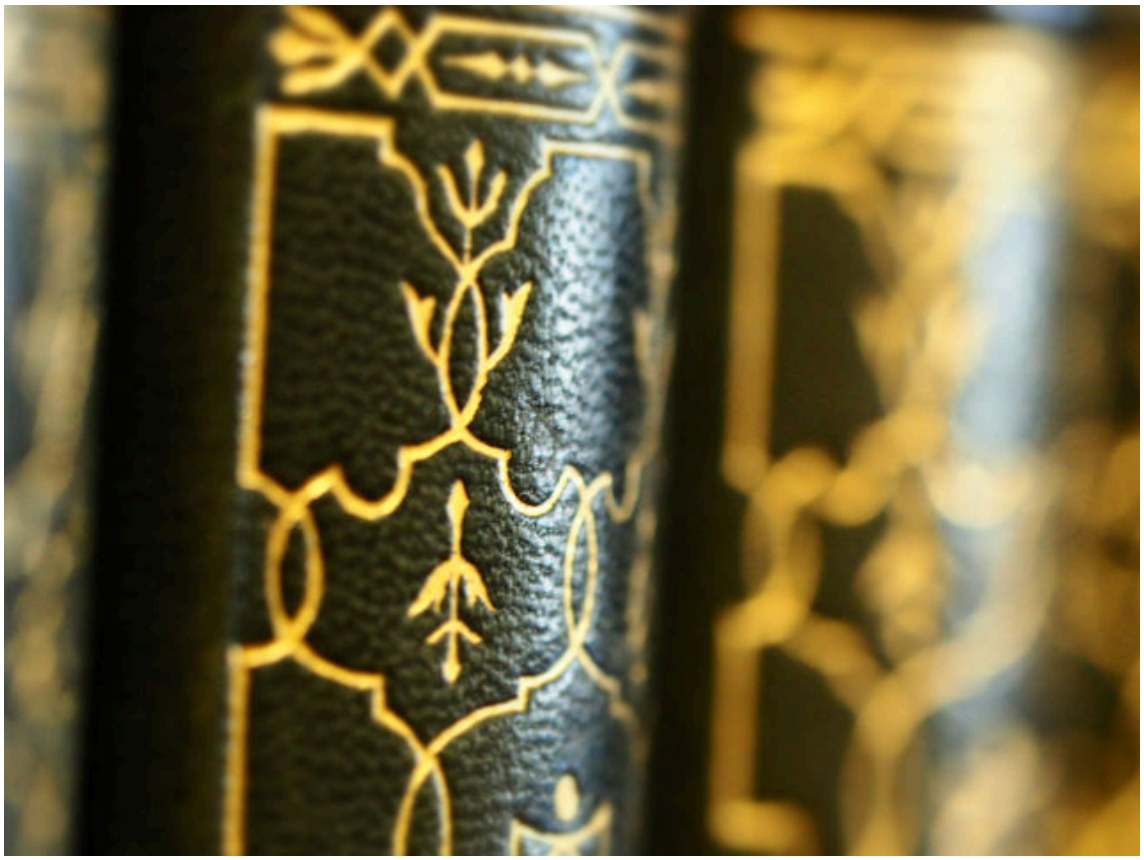
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Investment funds have emerged as significant financial intermediaries in Finland since the turn of the millennium. In this role, they supplement traditional deposit banking. However, from the perspective of financial stability, investment funds may also involve risks reminiscent of banking. One such key risk is if assets invested in funds are converted into significantly less liquid (less cash-convertible) form. Why can such liquidity transformation in a worst-case scenario pose a risk to financial stability, and how extensively is it performed among Finnish investment funds?

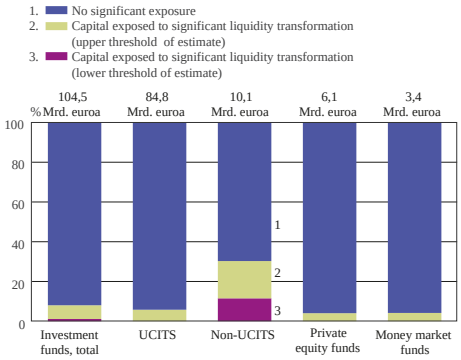


Investment funds registered in Finland[1] have posted significant growth in size since the beginning of the new millennium. While still at the beginning of the millennium the value of assets held by these funds totalled EUR 10.3 billion, this had increased about tenfold, to EUR 104.5 billion, by the end of 2015.

Meanwhile, investment funds have emerged as significant financial intermediaries alongside with traditional deposit banking (Chart 1).

Chart 1.

In relative terms, non-UCITS were the undertakings most strongly engaged in significant liquidity transformation in Finland at the end of 2015



Sources: Calculations by the author, Bank of Finland statistics and FIN-FSA's AIFMD data collection.

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Money changes form in investment funds

One of the key economic functions of investment funds, like banks, is to intermediate finance. The funds collect money from the 'surplus sector' (investment funds in the form of fund shares, and deposit banks in the form of deposits) and channel such money as investments to those who have a shortage of funds, i.e. the 'deficit sector'.

From the perspective of financial stability, a key risk may arise from the fact that assets could become more difficult to convert into cash, i.e. less liquid, in connection with financial intermediation.[2]

Within investment funds, this liquidity transformation can take different forms. A fund may, for example, promise that the fund shares offered by it are redeemable at two days' notice but simultaneously invest part of the received assets in financial instruments for which conversion into cash takes longer.

Liquidity transformation becomes a problem especially when investors, for whatever reason, want to simultaneously withdraw large amounts of their assets from an investment fund. In such a case, the liquid assets of the fund will not necessarily suffice to cover all demands for redemption within the fund's promised redemption period. This may arouse suspicion among the investors and further stimulate demands for redemption. Increasing redemption demands put pressure on the investment fund to sell its illiquid holdings at discount prices, which in turn weakens the possibility for remaining investors to get their money redeemed on reasonable terms.

Possible runs on investment funds and related dumping at fire-sale prices may depress not only the prices of the investments themselves but also the prices of linked assets, thereby destabilising the markets.

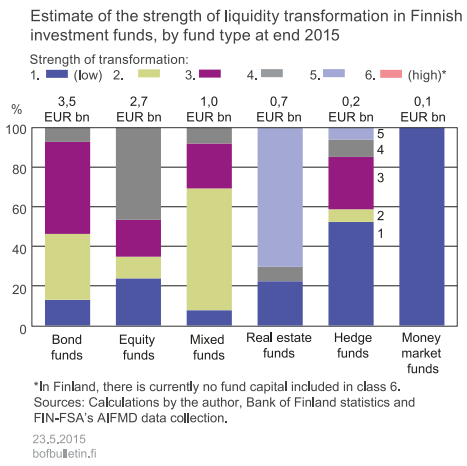
This phenomenon is significant – and difficult to assess – because it is linked to financial stability via two channels. On one hand, overall adverse financial market developments may weaken the liquidity of funds' investment assets; on the other hand, the dumping of illiquid assets could serve to reinforce unfavourable trends.

Liquidity transformation in Finnish investment funds

We examine below the extent of liquidity transformation in Finnish investment funds, based on an evaluation method making use of fund-level data.[3] The method, which is described in the appendix to this article, is to an extent sensitive to the assumptions of the analysis, which is why the results presented must be regarded as merely indicative.

The results give a description of assets exposed to significant liquidity transformation in investment funds under normal market conditions.

Chart 2.



On the basis of the results, a maximum of about 8% (EUR 8.4 billion) of fund capital in Finnish investment funds is exposed to significant liquidity transformation. Accordingly, 92% of fund capital would appear to be excluded from at least significant liquidity transformation (Chart 2).

Viewed by fund category, non-UCITS funds carry the highest degree of exposure in relative terms. In these funds, depending on the evaluation method, 12–30% of fund capital is exposed to

significant liquidity transformation. Non-UCITS funds also constitute the most heterogeneous group in respect of their redemption and investment rules.

UCITS investment funds, i.e. funds according to the European Union UCITS Directive and regulated by the Finnish Mutual Funds Act, are in absolute terms subject to the largest exposure, EUR 4.9 billion.[4] In these, the exposure is heightened, on one hand, by the large size of the fund category and, on the other hand, by the channelling of some investments into assets estimated as being relatively illiquid, such as fund shares. However, evaluations of their liquidity are surrounded by uncertainty.

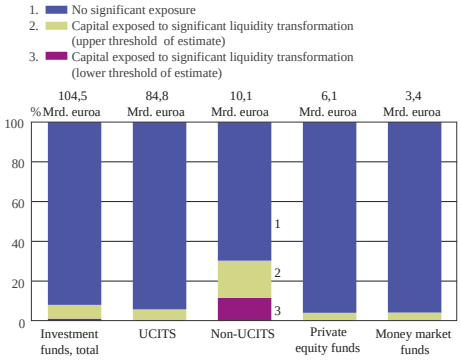
The results point to the lowest degree of liquidity transformation in money market funds and private equity funds. While redemption periods in money market funds are short and investment instruments highly liquid, redemption periods in private equity funds are typically long so as to match with their holdings of illiquid investment assets. Consequently, in the case of both of these fund categories, there is no significant liquidity mismatch between investment assets and fund-share liabilities.

Even so, the extent of liquidity transformation alone does not provide a sufficient indicator for the risks involved in this process.

If the capital exposed to liquidity transformation is further divided into six classes[5] reflecting the strength of transformation, differences can be identified between fund categories (Chart 3) and between types of fund investments (Chart 4).

Chart 3.

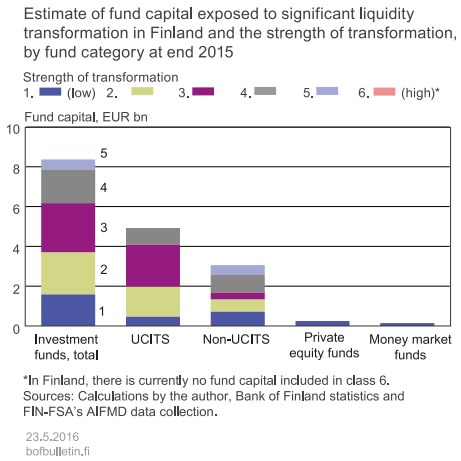
In relative terms, non-UCITS were the undertakings most strongly engaged in significant liquidity transformation in Finland at the end of 2015



Sources: Calculations by the author, Bank of Finland statistics and FIN-FSA's AIFMD data collection.

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Chart 4.



According to the results, relatively strong liquidity transformation appears to be present mostly in real estate funds, even though the exposure in absolute terms is rather limited. In equity funds, the strength of exposure is boosted mainly by investments in unlisted shares.

Overall, the above outcomes do not point to pronounced and, relative to fund capital, particularly large risk concentrations related to liquidity transformation in Finnish investment funds at the end of 2015. However, given the strong links of the phenomenon with general market developments, close monitoring is warranted going forward.

In assessing the results, it is also worthwhile bearing in mind that they are based in part on the author's own estimates and in part on fund managers' estimates provided in a survey. These estimates may change, especially in situations of market distress.

Notes

1. In this article,investment funds refer to funds included in sectors S.123 (money market funds) and S.124 (other undertakings for collective investment in transferable securities, UCITS) in the European System of Accounts. This includes all funds governed by the Finnish Mutual Funds Act and alternative investment funds, special investment funds (i.e. non-UCITS) and private equity funds. ↑
2. Liquidity means the convertibility into cash of a financial claim or other asset. ↑
3. The information comprises fund-level data serving as the basis for the Bank of Finland's investment fund statistics on fund assets and liabilities and data reported by alternative investment funds, included in the Financial Supervisory Authority's (FIN-FSA) AIFMD data collection, on the redeemability of their fund shares and the convertibility into cash of their assets (fund manager's estimate). The data refer to the end of 2015. ↑

4. UCITS = Undertakings for Collective Investment in Transferable Securities. ↑
5. Here, the strength of liquidity transformation means the notional difference between the days needed for redemption of fund shares and for conversion into cash of investment assets. The categories of strength and the method used for their definitions are explained in the technical appendix. ↑

Keywords

financial stability, investment funds, shadow banking