FedFin Client Report

Tuesday, April 19, 2016

U.S. Asset-Management Strategy: Stand Back for SEC, See about Hedge Funds

Client Report: **ASSETMANAGEMENT3**

Executive Summary

In this report, we build on our analysis of the Monday FSOC meeting (see Client Report **ASSETMANGEMENT2**) to evaluate the details of the FSOC work program now under way for hedge funds and the broader mutual-fund sector. As previously noted, nothing on FSOC's to-do list encompasses firm designation and we see nothing in the new activity-and-practice framework likely to come to meaningful fruition before the close of the Obama Administration other than various rules already or shortly to be under way at the SEC. This uncertain path to action in part results from the incomplete nature of the SEC's rules, but also is due to the many issues on which FSOC in its detailed report says it has yet to reach any firm conclusions (e.g., whether mutual funds pose systemic liquidity risk). In the FSOC's initial assessment of the sector (see FSM Report **SYSTEMIC75**), we noted not only the mutual-fund issues now being addressed by the SEC, but also considerable focus on inter-connectedness risks found at banks with large asset management and/or broker-dealer operations. Nothing in FSOC's latest work plan addresses this nor have the federal banking agencies taken this on as a discrete regulatory focus. However, the new living-will orders (see Client Report **LIVINGWILL12**) include numerous sanctions in this area likely to force considerable strategic realignment at affected U.S. GSIBs and FBOs. This report analyzes the FSOC report, noting not only the details of its work plan, but also key aspects of the analysis that underpin them. As Treasury Secretary Lew noted yesterday, these conclusions now form the basis of U.S. views to be reflected at global regulatory bodies, which are now in the process of acting on issues such as insurance systemic risk and asset-management resolution protocols addressed in the FSOC report.

Analysis

With regard to fund liquidity and leverage risk, key FSOC conclusions include:

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- Redemption and/or first-mover risk are difficult to assess with regard to prior or potential systemic impact. The larger the market-share funds hold in illiquid assets, the greater the likely risk, especially due to correlated selling by funds, insurance companies, and pension funds during stress scenarios.
- External borrowing sources at funds, as well as inter-fund borrowing, may also increase risk, but it is difficult for FSOC to draw conclusions beyond this point due to data limitations.
- ETFs do not appear to be subject to as much liquidity and redemption risk as other pooled funds, but basis risk is a growing concern.
- Collective investment funds (CIFs) at banks do not pose significant liquidity or leverage risk due to bank-regulatory and supervisory protocols (a point Comptroller Curry emphasized at the FSOC meeting). Non-depository trust companies could be problematic, but data on them are limited.
- Hedge funds may pose significant leverage risk, although certain rules create indirect limits on it. However, the extent to which hedge-fund leverage risk poses systemic risk is unknown and requires complex analysis and considerably more data. Data FSOC has to date show that leverage is concentrated at a small number of hedge funds, although these data may misrepresent risk across the spectrum of large funds.
- Counterparties are often unable to manage their hedge-fund exposures due to inadequate data and no single regulator can assess them.

Reflecting these conclusions, the Council adopted the following objectives:

- There must be robust liquidity-risk management (including for extreme events via stress testing) at mutual funds, especially those invested in less-liquid assets.
- Clear guidelines that set limits on illiquid-asset holdings for mutual funds should be established.
- There is a need for enhanced reporting and disclosure of mutual-fund liquidity profiles and management practices. Tools should be explored to allocate losses more fairly across mutual-fund investors, although no specific ones are named.
- Consideration should be given to additional public disclosure of external funding sources and events that trigger it.

The new working group on hedge funds will:

- assess leverage and resulting systemic risk;
- analyze current data and determine what else is needed; and
- consider the need for new and/or improved regulatory standards, although it appears that the group will look only at those that enhance data, not those that directly address leverage.

The group's report is due by the fourth quarter.

In addition to the conclusions above, FSOC also considered:

- asset-management operational risk, with a particular focus on correlation risk due to reliance on a few critical-service providers (including large custody banks). Reflecting this, FSOC is undertaking a study of critical-service providers to this sector and across the overall financial system. The study will also assess operational-risk mitigation (e.g., disaster planning) and what can be done to enhance it;
- securities-lending risk, especially with regard to cash collateral reinvestments and indemnification. Additional data on these matters will thus be sought; and
- resolvability and transition planning, where the near-term focus is on rules the SEC plans shortly to release.

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