The Future of Asset Management:
New Systemic Standards and Their Strategic Impact

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Abstract

In this report, Federal Financial Analytics, Inc. (FedFin) assesses the prospects for U.S. asset-management systemic regulation now that the FSOC has backed away from firm-specific SIFI designation and instead turned to a review of activities and practices in which asset managers, regardless of charter, engage. This approach – activity-and-practice, not firm, designation – reflects the approach FedFin managing partner Karen Petrou advocated before the Federal Reserve last spring[1], not to mention the formidable political and policy objections both non-bank asset managers and the SEC have raised to designation.

This paper is an overview of the specific actions under immediate consideration with regard both to regulating asset managers and/or their funds and ensuring orderly resolution under stress at a firm, fund, central counterparty (CCP), or in connection with the Federal Reserve's reverse repurchase-agreement program (RRP). Given the confluence of systemic and resolution concerns, we also address the extent to which the Federal Reserve may become a "market-maker of last resort" for asset managers.

We conclude that the FSOC is moving quickly to ready activity-and-practice designations for specific types of funds. The most immediate rules will cover leveraged funds, and the SEC has already begun preliminary analyses here that suggest it will not prove the obstacle to FSOC recommendations it was to money market funds. We expect limited capital standards for asset managers focused on sponsored-fund investments – a proposal we expect the SEC to adopt – and far more controversial consideration of sponsor capitalization backing leveraged, concentrated, or similar fund offerings. FSOC will also push the FDIC to advance orderly-liquidation procedures for systemic asset managers upon conclusion of pending global ones. We do not expect near-term Federal Reserve action on a new asset-management resolution facility, but rather continued consideration of the extent to which current authority permits intervention and the potential implications of the RRP for both asset managers and systemic liquidity risk. However, specific capital or liquidity standards may be imposed on non-banks that make extensive use of the RRP as the program is opened for unlimited business in coming months.

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[1] Karen Shaw Petrou, *The Not-So Normal New: The Assault on Bank Franchise Value and Its Policy Impact* (May 8, 2014), *available at* http://www.fedfin.com/images/stories/client_reports/The%20Not-So%20Normal%20New%20-%20May%202014.pdf.

The New Asset-Management Regulatory and Resolution Framework

The key excerpt from the FSOC statement deciding for now not to designate individual asset managers reads as follows:

> *During the meeting, the Council discussed its ongoing assessment of potential industry-wide and firm-specific risks to U.S. financial stability arising from the asset management industry and its activities. The Council directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry.*[2]

The FSOC has, however, power only to propose activity-or-practice designation and requisite regulatory standards, not to demand that primary regulators institute them. In the event a primary regulator like the SEC resists FSOC recommendations, as was the case with the money-market fund (MMF) rule[3], the FRB and bank regulators will likely proceed on their own both to impose activity designations and curtail transactions with non-compliant companies, moving most quickly to address fears about over-reliance on short-term funding in the repurchase-agreement arena. Continued designation of large firms that meet FSOC-designation criteria[4] will, we expect, also proceed on a parallel path, especially with regard to large broker-dealers outside the scope of the Federal Reserve's rules for large broker-dealer subsidiaries of foreign banking organizations.[5]

Activity-and-Practice Designation

FSOC stepped into a whirlwind when the Office of Financial Research (OFR) released a study suggesting that asset managers pose systemic risk[6]. The industry – encouraged by its ability to prevent SIFI designation and tough rules for big MMF sponsors – mobilized an effective political and policy campaign criticizing the OFR report on many grounds, most importantly that asset managers are not banks and take little risk because invested funds are those of customers, not the asset manager.

FSOC and the FRB are concerned that, while most asset managers are investor agents, this is not always the case. They also fear that, even in pure agency arrangements, reputational risk

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[2] FSOC, *Council Meeting readout* (Jul. 31, 2014), *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf.

[3] SEC, *Money Market Fund Reform; Amendments to Form PF,* 79 Fed. Reg. 47736 (Aug. 14, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-08-14/pdf/2014-17747.pdf (see FedFin Client Report **MMF13**).

[4] FSOC, *Final Rule on Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies,* 77 Fed. Reg. 21647 (Apr. 11, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-04-05/pdf/2013-07688.pdf (see FedFin FSM Report **SYSTEMIC60**).

[5] FRB, *Final Rule on Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations,* 79 Fed. Reg. 17240 (Mar. 27, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf (see FedFin FSM Report **FBO3**).

[6] OFR, *Asset Management and Financial Stability* (Sep. 30, 2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf (see FedFin FSM Report **SYSTEMIC69**).

may prompt fund managers to support fund valuations at potential cost to their resilience and/or in a manner that creates systemic risk akin to that which occurred when the Reserve Primary Fund could not honor redemptions in 2008 and had to be supported by a Treasury rescue facility now barred under the Dodd-Frank Act[7].

However, we understand that FSOC and the FRB also recognize one of the industry's arguments: manager or fund-specific legislation that does not affect all like-kind offerings could simply exacerbate regulatory arbitrage and lead investors to pick higher-yielding funds offered by smaller managers or those in nations that do not subscribe to systemic regulation for this sector. The decision likely by the Financial Stability Board (FSB) ahead of the Group of Twenty meeting in November should address this concern at least in part – the FSB is expected to move away from the firm-specific designation proposed late last year[8] and instead adopt a more fund-specific approach that focuses both on specific activities and the overall resolvability concerns also discussed below.

FSOC activity/practice designation will consider:

Regulatory Arbitrage: Asset managers both as agents and principals have, in recent years, significantly expanded activities that reduce the presence of, or in some cases replace banks, broker-dealers, and other prudentially-regulated financial institutions. Both the FRB and some at the SEC (e.g., Commissioner Kara Stein) are actively considering broker-dealer capital standards, with these effectively already put in place for the largest foreign banking organizations doing business in the U.S.[9] Another major concern related to regulatory arbitrage is the extent to which asset managers effectively make loans by gathering investor funds for instruments comprised of loans the sponsored fund provides from these investor allotments. Because funds comprised of loan and similar credit risks do not bear any regulatory capital, borrower costs may be significantly reduced in concert with greater credit availability than banks (especially those in the EU) are able to provide. These non-bank funding channels pose the type of maturity transformation the FSB has cited in its work on shadow banking,[10] although there are currently no pending initiatives to address it. U.S. regulators do not oppose credit-focused investment vehicles *per se*, but fear their regulatory-arbitrage effect and inability to sustain financial intermediation in stress situations.

Asset-Management Capital: While asset management is otherwise largely an agency activity, many firms also provide seed capital to start funds and co-invest in those they sponsor to show

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (Jul. 21, 2010), §§ 1101-1109 (see FedFin FSM Report **RESCUE65**).
[8] FSB, *Proposed Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/press/pr_140108.htm (see FedFin FSM Report **SYSTEMIC70**).
[9] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, *op. cit*.
[10] FSB Chair Mark Carney, *Letter to G20 Ministers and Governors on financial reforms - Update on Progress* (Apr. 4, 2014), *available at* http://www.financialstabilityboard.org/publications/r_131114.pdf (see FedFin Client Report **SUMMIT21**).

investors that they too have "skin in the game." In the wake of the Volcker Rule,[11] asset-management fund sponsorship has gained new competitive advantages because large banks have had to shutter many of the vehicles previously offered in the hedge- and private equity-fund arena. This has created opportunities for asset management that increase the amount of their capital at risk. Asset managers may also establish their own credit or liquidity facilities to support their funds, viewing these as off-balance sheet exposures that may not be disclosed and are generally exempt from prudential regulation. FSOC may consider requiring asset-management companies to hold capital and liquidity against some or all of these exposures and/or require them to rely on regulated providers of credit and liquidity facilities.

Leverage: We expect FSOC to assess which funds or asset-management strategies are premised on significant leverage to identify practices that could lead to sudden redemptions not covered by fund resources or, should the asset manager defend the fund for reputational risk reasons, pose broader market risk. Of particular concern are the alternative funds already subject to SEC scrutiny because of large holdings of complex or leveraged instruments. Responses could include limitations on holdings of illiquid assets within such funds and/or dedicated capital backstops to be held by the manager. A key question here is whether fund leverage would be judged by gross notional exposures or by the commitment approach, as it is in the EU.

Separate Accounts: A key OFR concern, asset managers have countered that each investor is responsible for its holdings in these accounts. However, FSOC may side with OFR and note that commingled separate accounts might not be quickly disentangled under stress, especially if assets among them have been rehypothecated within the commingled account or outside it. Operational requirements mandating account segregation and similar risk-management practices will be considered.

"**Herding**:" Commingled funds, either comprised of separate ones or structured at the outset as such, may be subject to herding – that is, holding correlated investments not dictated by investor-stipulated allocations. Rapid investor redemptions in commingled funds of this sort can create fire-sale risk, as well as broader asset-price bubbles that then destabilize markets more generally. Redemption standards that prevent first-mover advantage or bar use of fund practices some deem herding "accelerants" will be considered, although both the FRB and some at the SEC have significant reservations about extending the MMF gates-and-fees provisions. Broader prudential standards for commingled funds (e.g., stress-testing, restrictions on fund-pricing methodologies, fund governance, and disclosures) are also under review.

Family-of-Fund Standards: The FSB suggested it would designate fund families, not funds, in its pending designation standards for entities that are neither banks nor insurers[12]. The thinking here is that asset managers are exposed to non-agency risk in such cases due to correlated strategies across these funds, possible commingling, and other concerns. The industry counters that risk is in fact diversified if the fund family offers different options. FSOC may decide that

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[11] FDIC, FRB, OCC, SEC, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds,* 79 Fed. Reg. 5536 (Jan. 31, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf (see FedFin Client Report **PROPTRADE18**).

[12] Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, *op. cit.*

funds that do not diversify, or are of considerable size, nevertheless pose risk and thus lay out diversification and other similar rules, including prohibitions on cross-subsidies within the family.

ETFs: Exchange-traded funds are an occasional concern on Capitol Hill but a longstanding one for regulators[13]. ETFs will thus be actively reviewed with an eye towards activity-and-practice regulation for these funds now that the MMF framework is settled (if not satisfactorily from FSOC's perspective). The issues that will be addressed are limits to exchange-traded instruments in ETFs, standards for reference-index selection, new disclosure and reporting standards, diversification of ETF market-maker operations from single to multiple firms, and new risk management, collateralization, and similar prudential standards.

Resolution

Three key resolution concerns affect the asset-management industry:

- resolvability of the asset manager within a broader SIFI and/or as a free-standing entity;
- protocols for central counterparties under stress that ensure their resolution without downstreaming so much risk to clearing members that they succumb in tandem with the CCP. This is of particular concern if the clearing member is an asset manager not subject to sufficient capital or liquidity requirements to handle this new risk; and
- changes to financial markets as the Federal Reserve's reverse-repo program ramps up, possibly to hundreds of billions of dollars in transactions between the central bank and MMFs.

Asset-manager resolution is under review by the FSB.[14] It has undertaken this in concert with a broader review of resolution for any company that holds other people's assets – firms that include not only asset managers, but also broker-dealers and custodians. Custodial banks are governed by insured-depository resolution in the U.S. and similar schemes in other nations, but the nature of their business is only now being directly addressed by the resolution plans large custodial banks are being required to file in the U.S.[15] Work remains to be done on these documents[16], but these resolution plans are nonetheless far more advanced than those for broker-dealers and asset managers.

Resolution for asset managers not affiliated with an insured depository institution or controlled by a bank holding company remains wholly unaddressed in the U.S. Upon completion of the

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[13] IOSCO, *Principles for the Regulation of Exchange Traded Funds* (Jun. 2013), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD414.pdf (see FedFin Client Reports in the **ETF** series).
[14] FSB, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (Aug. 12, 2013), *available at* http://www.financialstabilityboard.org/publications/r_130812a.pdf (see FedFin FSM Report **RESOLVE20**).
[15] FDIC, FRB, *Resolution Plans Required,* 76 Fed. Reg. 67323 (Nov. 1, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf (see FedFin FSM Report **LIVINGWILL7**).
[16] FDIC, FRB, *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers* (Aug. 5, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm (see FedFin Client Report **LIVINGWILL9**).

FSB consultation, FSOC is likely to turn to U.S. implementation of both the resolution and regulatory issues laid out in the global protocols, working with primary regulators or, if necessary, seeking to direct them to finish addressing this systemic-risk concern. It is at best unclear how the single-point-of-entry resolution protocol proposed for banks[17] would work for asset managers, with FSOC likely to rely heavily on FSB's approach in the absence of ready alternatives. Significant business-model changes would thus ensue in concert with activity-or-practice standards designed to limit the externalities likely to result if asset managers and/or their funds face severe solvency or liquidity threat.

CCP resolution is a critical question for the financial system as a whole, and also one directly germane to asset managers given their major role in instruments that are now moving from the over-the-counter market to CCPs and similar central clearing facilities. One approach under discussion for CCP resolution focuses on their recovery through access to investor-margin accounts. This would permit return of margin to investors, but trades would still be significantly disrupted in the absence of a substitute CCP for the affected asset class. However, in the event a national authority pursues a recovery approach to CCP stress (as opposed to liquidation), asset managers could be significantly exposed. This could occur as end-users demand access to funds that would otherwise be dissipated due to significant uncertainty about or actual deployment of margin accounts for the CCP's use. These redemption fears sparked by CCP stress could provide the type of fire sale for which many of the fund-specific rules are intended, but perhaps be of such magnitude that even tougher rules would not withstand CCP margin calls.

Finally, concern is growing that the RRP could create resolution challenges beyond those known to be problematic for asset managers and CCPs. OFR in fact addressed this in a major working paper earlier this year,[18] concluding that MMFs will disintermediate dealer banks in this program due to their exemption from leverage and liquidity regulation. Indeed, MMFs have already been major counterparties for the RRP even though the program remains largely a pilot. Federal Reserve officials have recently speculated that the RRP could equal $200-300 billion when it is fully ramped up to ensure an orderly exit from the central banks' quantitative easing, exacerbating the disintermediation worry if the FRB concurs with OFR's fears about limited dealer-bank capacity.

The Board may thus add proxy capital and liquidity requirements for MMFs, making these a condition for RRP access. This will not, however, satisfy stress-scenario concerns, forcing the Board also to assess the extent to which its current emergency-liquidity powers are sufficient to support its counterparty MMFs in the RRP. Even if the Board believes its so-called 13(3) powers remain adequate, it will also need to decide if it will make this clear in concert with ramping up the RRP to limit the risk of firesale runs or if it should leave this backstop implicit to avoid any reoccurrence of moral hazard or public criticism that a new class of large financial institutions

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[17] FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy,* 79 Fed. Reg. 5536 (Dec. 18, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-30057.pdf (see FedFin FSM Report **RESOLVE23**).

[18] Pozar, Zoltan, (2014) "*Shadow Banking: the Money View"* Working Paper, OFR, *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFRwp2014-04_Pozsar_ShadowBankingTheMoneyView.PDF (see FedFin Client Reports **OFR** and **SHADOW8**).

has become too big to fail.

Conclusion

This paper is an overview of issues under U.S. consideration with regard to asset managers from both the activity-or-practice regulatory perspective and the manner in which asset managers or their funds would need to be resolved in the event of a firm-specific problem, CCP defaults, or problems in the RRP. It does not recommend policy actions, lay out FedFin's views on appropriate actions, or recommend business and advocacy strategies for asset managers and other large financial-services firms.

We believe it critical first to lay out issues that have profound bearing on U.S. competiveness, regulatory arbitrage, and systemic risk. This overview shows clearly the far-reaching impact of many measures being considered now for rapid U.S. action due to growing worries about this sector and the failed initial effort to address them with firm-specific designation. Future FedFin public and proprietary work will consider both the policy and strategic implications of individual proposals and resolution protocols.