Financial Services Management

Global Asset-Management Systemic Regulation

Cite

Financial Stability Board (FSB), Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

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Impact Assessment

- FSB is pushing IOSCO hard on fund standards, laying standards in broad terms either for new rules or break-up of this aspect of the global framework.
- New leverage and/or risk-based standards for funds would dramatically change business models and reduce investor return. Integration of any such standards with those applicable to parent-company banks could prove complex and costly.
- Similar problems arise integrating the operational risk-based standards applied to bank-housed asset management and the new operational-risk mitigants recommended by FSB. Challenges also arise with regard to resolution planning for critical services and asset transfer.
- Custody banks could gain new business through global standards pressing for greater reliance on them to enhance asset transfers.
- Agent asset managers could come under new constraints, perhaps enhancing bank SFT competitiveness.

Overview

Although the FSB has decided to preserve its option to designate individual asset-management firms as systemically-important financial institutions (SIFIs), its final global framework for this sector instead addresses the activity-and-practice concerns that have dominated debate since the industry decisively defeated the FSB's initial attempt to lay out a designation framework.[1] The International Organization of Securities Commissions (IOSCO) is pressed hard by the FSB – dominated to a considerable degree by global regulators with a banking focus – to impose standards in an array of areas of primary concern often only to bank regulators through use of bank-regulatory tools. These include an array of liquidity-risk and stress-testing standards for open-end funds that could lead to numerous liquidity-risk management requirements as well as to imposition of the redemption limitations included in the SEC's rules for U.S. MMFs.[2] New leverage standards – also recommended by the FSB perhaps in concert with risk-based ones – could significantly reduce returns for some funds, including many hedge funds which are to be covered by these rules. The FSB's approach relies at least to some degree on the Basel leverage ratio (LR)[3] and thus could be particularly problematic for funds with large derivatives activities, even as banks gain some competitive parity with non-bank asset managers. Efforts to contain operational risk in this sector build out prior FSB work to enhance asset transfer but also focus on an array of other operational risks (e.g., cyber attacks) in ways that may be redundant to or conflict with standards already applicable to asset managers and/or their parent organizations (especially banks). Although the FSB initially appeared set to press for capital standards for asset-management indemnification and other on-balance sheet risk, the new standards do not directly do so. All of them depend on IOSCO action which, even though pressed hard by the FSB, remains uncertain, as does national-level implementation.

Impact

The FSB's final standards are based on an initial proposal[4] that was greeted favorably by the industry largely because it diverted work from SIFI designation. This is not to say that, as discussed below, several FSB proposals were noncontroversial, but rather to reflect that the global approach has become one aimed at identifying specific actions of larger companies that warrant governance instead of singling out specific firms for stringent regulation. IOSCO, a group subsumed beneath the FSB in the global framework, strongly opposes SIFI designation in this sector and the U.S. Financial Stability Oversight Council (FSOC) has also moved away from it in laying out systemic-risk concerns so far left largely unaddressed thereafter by U.S. regulators.[5]

The final statement generally follows the proposed one, although providing greater scope for nations to provide emergency liquidity to asset managers – an option not likely to be deployed in the U.S. unless the FRB is able to construct the market-maker-of-last-resort facility it has contemplated

1 See **SIFI4**, *Financial Services Management*, March 12, 2015.

2 See *Client Report* **MMF13**, July 23, 2014.

3 See **LEVERAGE9**, *Financial Services Management*, April 13, 2016

4 See **ASSETMANAGEMENT4**, *Financial Services Management*, June 30, 2016.

5 See **SYSTEMIC75**, *Financial Services Management*, January 5, 2015.

from time to time. The final statement also provides clearer confidentiality protection for certain liquidity reporting and the still-preliminary understanding of stress testing in this sector is made more clear (and thus the need for nations to act less urgent).

However, despite strong comments urging that this issue be deleted or differently addressed, the final FSB standards also address fund leverage, here covering all investment funds other than the pension and sovereign-wealth ones excluded from this report. Laying out a grim picture of the systemic risk that can result from fund leverage, the FSB as noted adopts what critics would call a bank-centric approach, calling for IOSCO to implement standards that govern this through capital restrictions, adding to the LR a risk-based framework designed to capture the specific problems unique to individual funds and business models. To the extent the IOSCO approach tracks FSB's recommendations and is based on the Basel leverage and/or risk-based capital standards, it would dramatically change the overall structure of investment funds and their investor returns. Advocates of these standards would counter here that, as with banks, long-term stability warrants short-term investor cost. However, prior FSB efforts along similar lines have been blocked by those who argue that fund risk is borne by investors who are well able to judge it for themselves. A compromise could be crafted through new disclosures and/or through more limited capital standards that address only the balance-sheet risk taken directly by the asset manager. Large banks already subject to leverage and risk-based capital rules could find themselves under an additional and possibly contradictory level of capital restrictions depending on the extent to which IOSCO's requirements track the banking rules and then are implemented by home and host authorities. However, in the absence of capital standards at least covering manager balance-sheet risk, banks in this sector will remain at a competitive disadvantage.

As in the proposal, the final standards also emphasize that its operational-risk rules should apply to all asset managers, an approach designed in part to press forward long-stalled global resolution protocols designed to ensure smooth and speedy asset transfer when one management company is troubled.[6] The final standards include a description of how operational risk in this sector could turn systemic, focusing in particular on the extent to which asset managers provide critical services to other financial institutions. The resolution plans U.S. GSIBs must file now must also address these risk nodes, especially those related to internal operational dependencies. Integration of these planning standards and resulting structural changes with any specific to asset management remains to be seen; so far, no home or host authority has implemented FSB's resolution protocols for asset managers.

6 See **RESOLVE29**, *Financial Services Management*, November 6, 2014.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

Similar challenges arise with other recommended operational-risk mitigants. These include expanding stress testing to consider operational risks and/or using capital in a manner similar to that now governing global banks and their asset-management activities.[7] Reflecting an array of systemic risk-fears, the FSB now also lays out concerns it believes should govern asset managers active in securities lending, finding that some large firms have balance-sheet exposure in this complex arena of scale comparable to that of GSIBs. Other activities could also create balance-sheet risk for which asset managers now are not generally regulated. However, despite strong statements about various types of potential systemic risk resulting from these exposures, the final FSB standard does not provide specific action recommendations akin to those described above. As a result, individual nations will likely take very different steps – if any – to address the FSB's fears. Where action is taken, banks active in securities lending would regain competitive ground lost due to the cost to them of capital required against indemnification.

What's Next

The FSB released these recommendations on January 12. Apparently dissatisfied with IOSCO work to date in this contentious arena, the FSB has instructed it to act quickly on an array of new global standards on a relatively short-turnaround basis. These are detailed below. Much of IOSCO's work is to be done by 2017, although whether this occurs in practice is uncertain given remaining controversies.

The FSB will defer SIFI designation in this sector until at least 2019 pending consideration of how its approach is adopted. The FSB postponed further action on its framework for designating non-banks/non-insurance companies as SIFIs[8] until its asset-management assessment was complete. With that now done, it is possible that the FSB will move back to designating other entities in this sector despite strong opposition by brokers to designation. A more likely near-term target is major finance companies or payment-product providers with significant cross-border operations, with the FSB also keeping a close eye on the sovereign wealth and pension funds it decided not to include in this asset-management statement. Action on any additional designations is at best uncertain given continued dissent on this overall approach and disagreements in home and host nations about implementing FSB edicts.

7 See Client Reports in the **OPRISK** series.

8 See **SYSTEMIC70**, *Financial Services Management*, January 28, 2014.

Analysis

The FSB's policy recommendations address:

A. Open-End Fund Liquidity Mis-Match

These recommendations cover all open-end funds but are likely to require refinements for ETFs laid out in an annex to this policy statement. Recommendations address:

- Transparency: Authorities should collect liquidity information proportionate to fund systemic risk, with information focused on factors including liquidity risk at the portfolio level and contingent funding and/or credit lines. Authorities are also to seek to make their own reporting consistent with that of other nations.
- Disclosure: Authorities should also review investor disclosures to ensure clarity and transparency with regard to liquidity risk (again here only from a systemic-risk – not investor protection – perspective). Disclosures should address matters such as fund valuations and exposure to sudden decline, as well as liquidity risk-management tools such as fees and gates. The statement also notes the risk of too much disclosure – e.g., predatory trading – with IOSCO as noted told to address this in its new rules by the end of 2017.
- Redemption: Policies should ensure that redemption rights are consistent with fund liquidity profiles under normal and stress conditions, with IOSCO again told to enhance its guidance. Strategies to achieve this goal are detailed, with authorities told to consider enforceable illiquid-asset limits and minimum liquidity standards (e.g., buffers, targets). IOSCO is also to review its liquidity-risk management standards by the end of this year. Regulators should additionally eliminate first-mover advantages (i.e., through swing pricing) and remove barriers to systemically-risky redemptions (e.g., gates, notices), and IOSCO should also review current standards.
- Stress testing: Authorities should either require or provide guidance on open-end fund stress testing, focusing on specific funds and resulting inter-fund risk from a systemic-risk perspective. Stress testing should be used by asset managers to recalibrate funds as needed and (where reported) by authorities as a guide to emerging risk; no specific interventions or penalties are recommended. In addition, authorities should consider stress testing funds on a collective basis to anticipate systemic risk despite the "exploratory" state at which such systemic-wide testing has advanced so far. IOSCO is told to review its existing guidance and consider enhancements to it.
- Transparency: Liquidity-risk management tools (e.g., redemption fees)

should be disclosed to investors and regulators. IOSCO is again told to improve its standards. Authorities should also provide guidance on the use of tools in stress conditions and be sure fund governance and operational capacity is sufficient to take stipulated actions. Spill-over effects should be considered as agencies review these plans.

B. Leverage

These recommendations apply across all covered asset-management funds (i.e., including hedge funds), not only to open-end funds.

As noted, IOSCO is told to consider new leverage constraints, using the bank leverage standards and addressing potential limitations of this approach to funds by adding a risk-based component. Work on these standards is due in 2018. FSB's principles for these standards include:

- There should be measures of synthetic leverage, with FSB laying out ways to do so.
- Netting and hedging assumptions require careful consideration, with FSB also laying out ways to do so.
- Position directionality should also be addressed.
- Model risk should be constrained.

The FSB also recommends that authorities gather extensive data on fund leverage, with IOSCO told to develop metrics for measuring fund leverage consistently on a global basis to spot emerging systemic risk. This should be done by the end of 2019.

C. Operational Risk

FSB recommendations here are that authorities should have standards or guidance governing asset-management operational risk, especially with regard to asset transfer. Work regulators should undertake to enhance their understanding of these risks as detailed. Consideration should be given to operational-risk capital standards, mandatory business-continuity plans, and numerous other risk mitigants described in the final standards.

D. Securities Finance

As noted, the FSB now also lays out where it finds that securities financing transactions (SFTs), most notably lending, pose systemic risk when conducted through asset managers. The most worrisome aspect of SFT is the extent to which some large asset managers act as agent lenders, providing the indemnifications captured for bank-regulatory purposes but not now widely governed in this sector. To address this, the FSB recommends that authorities should monitor agent asset-management lending and indemnification activities and, where signs of systemic risk emerge, ensure that the firm has capacity to cover losses. To gather these data, the FSB will consider adding SFT factors to its global data initiative, likely doing so in 2019 or thereafter. Authorities are also told to monitor this area for signs of regulatory arbitrage and, if these emerge, take actions not clearly laid out in the FSB document (which notes an array of often-conflicting factors regulators are to consider). Authorities are also told to consider other areas where asset-management companies take balance-sheet risk and consider actions if risks are evident.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com