

**MEMO# 30531**

January 23, 2017

# **FSB Issues Final Policy Recommendations to Address "Structural Vulnerabilities" from Asset Management Activities**

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TO: ICI Members  
Investment Company Directors  
ICI Global Members SUBJECTS: Compliance  
Derivatives  
International/Global  
Operations  
Portfolio Oversight  
Risk Oversight

Systemic Risk RE: FSB Issues Final Policy Recommendations to Address "Structural Vulnerabilities" from Asset Management Activities

As we previously informed members, the Financial Stability Board issued a consultative document in June 2016 setting forth proposed policy recommendations regarding "structural vulnerabilities" in asset management activities ("Initial Consultation").<sup>[1]</sup> ICI submitted a detailed comment letter responding to the Initial Consultation in September 2016.<sup>[2]</sup> Recently, the FSB issued a document containing its final policy recommendations ("Final Recommendations Document").<sup>[3]</sup> In total, there are 14 policy recommendations, nine of which relate to "liquidity mismatch" and three of which relate to leverage.<sup>[4]</sup> As the FSB had proposed, the International Organization of Securities Commissions ("IOSCO") and national capital markets regulators will have responsibility for operationalizing the final recommendations.

Certain aspects of the Final Recommendations Document and how it compares to the Initial Consultation are described further below, first with general observations and then focusing in on specific recommendations. A copy of Annex 1 to the Final Recommendations Document, which lists all of the final policy recommendations, is attached.

## **General Observations**

The Final Recommendations Document retains the same structure as the Initial Consultation. It begins with an overview of recent trends in the asset management sector. It

then focuses on four areas: (1) liquidity mismatch between fund investments and redemption terms and conditions for fund units; (2) leverage within investment funds; (3) operational risks and challenges in transferring investment mandates in a stressed condition; and (4) securities lending activities of asset managers and funds.<sup>[5]</sup> For each area, the Final Recommendations Document (like the Initial Consultation) describes the purported vulnerability, analyzes existing mitigants, and sets forth policy recommendations to address “residual risks.”

ICI’s comment letter expressed few objections to the proposed policy recommendations, but took issue with the justifications underlying some of the recommendations, especially those related to “liquidity mismatch.” In the Final Recommendations Document, the FSB left virtually unchanged its narrative about the potential for open-end funds to experience destabilizing redemptions—a narrative that ICI’s comment letter called into question with an analysis of experience in the high-yield bond market and high-yield bond funds from November 2015 to February 2016. The FSB cited ICI’s analysis as evidence that *historically*, stock and bond funds have not created global financial stability concerns in recent stress periods, but stated that it is important to address vulnerabilities “before they manifest themselves as realized threats to financial stability.”

In addition, the FSB reiterated its intent to return to its prior work on methodologies to identify global systemically important financial institutions (G-SIFIs) outside of the banking and insurance sectors, although the timing is uncertain. As in the Initial Consultation, the FSB stated that, in the case of asset management, the focus “will be on any residual entity-based source of systemic risk from distress or disorderly failure that cannot be effectively addressed by market-wide activities-based policies.”

## **Final Policy Recommendations**

### **Liquidity mismatch**

- Of the nine proposed recommendations, most are unchanged. ICI’s comment letter was most critical of Recommendation 9 (consideration of system-wide stress testing), raising concerns about the speculative nature of such testing and how authorities could use the results to shape policy. The final recommendation is largely the same as the proposed recommendation, although the accompanying discussion does acknowledge that such testing is still in the “exploratory stage” and that “it is expected that macro-prudential authorities and securities regulators would coordinate among themselves as appropriate.”

### **Leverage within funds**

- The FSB has made some slight changes to Recommendation 10 (regarding measuring leverage in funds) that appear to give IOSCO more flexibility to determine “consistent” measures of leverage that would facilitate more meaningful monitoring of leverage. Consistent with ICI’s comments, the recommendation does not call for IOSCO to develop a “simple” measure, which we cautioned could invite a simplistic, highly inappropriate tool for regulatory monitoring. The FSB envisions that IOSCO would collect national/regional aggregated data based on the measures it develops (see Recommendation 12).

## Operational risk

- The Initial Consultation focused on “operational risks and challenges in transferring investment mandates or client accounts.” In the Final Recommendations Document, the FSB has broadened the discussion to cover operational risk more generally.
- Consistent with ICI comments, Recommendation 13 (requirements/guidance for comprehensive risk management frameworks and practices) now applies to asset managers of all sizes, not just those that are “large, complex and/or provide critical services.” In addition, it now states that “such risk management frameworks and practices should be commensurate with the level of risks that the asset managers’ activities may pose to the financial system.”
- The discussion of existing mitigants gives more prominence to regulatory requirements that asset managers have appropriate risk management processes and risk limits and maintain business continuity plans. It gives less prominence to the fact that some jurisdictions require certain asset managers to hold capital or indemnity insurance to cover operational risk. The FSB also deleted language suggesting that “[f]urther assessment is needed to understand whether [capital/indemnity insurance] requirements are common across jurisdictions or calibrated to sufficiently cover potential losses from operational issues arising in stressed market conditions.”
- The FSB now describes the potential for operational risks and challenges as dependent upon the “nature and scope of the activities” of an asset manager rather than the manager’s “scale or complexity.”
- The FSB has qualified its discussion of the likelihood of systemic implications developing from operational difficulties. ICI’s comment letter objected to the fact that the FSB had based its proposed recommendation concerning operational risk on unsupported claims about financial stability risks.

## Securities lending

- Recommendation 14 (monitoring of indemnifications) and the accompanying discussion are largely unchanged.
- The FSB added the following language: “While this recommendation addresses the existing practice of a limited number of asset managers who act as asset lenders and provide indemnification to their clients, it may be appropriate for authorities to take a consistent approach in other areas, if any, where asset managers take on similar financial risk as principals that, if risk materialised, could adversely affect financial stability.”

Rachel H. Graham  
Associate General Counsel

Frances M. Stadler  
Associate General Counsel & Corporate Secretary

## [Attachment](#)

### endnotes

[1] For a summary of the Initial Consultation, please see ICI Memorandum No. 30003 (June 23, 2016), available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo30003>.

[2] ICI's comment letter is available at [https://www.ici.org/pdf/16\\_ici\\_fsb\\_ltr.pdf](https://www.ici.org/pdf/16_ici_fsb_ltr.pdf). For a summary of ICI comment letter, please see ICI Memorandum No. 30283 (Sept. 29, 2016), available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo30283>.

[3] See FSB, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (12 January 2016), available at <http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf>.

[4] According to the FSB, "issues associated with liquidity mismatch and leverage are considered key vulnerabilities."

[5] As in the Initial Consultation, the Final Recommendations Document notes at the outset that money market funds are excluded from its scope, in light of "regulatory reforms that have been implemented (or are in the process of being implemented) in many jurisdictions to address financial stability issues that arose during the 2007-09 global financial crisis."

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