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FSB Proposes Methodology for Identifying Investment Funds as Global Systemically Important Financial Institutions

[27844]

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TO: BOARD OF GOVERNORS No. 1-14
CLOSED-END INVESTMENT COMPANY MEMBERS No. 2-14
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 1-14
ICI GLOBAL MEMBERS No. 2-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 1-14
SEC RULES MEMBERS No. 3-14 RE: FSB PROPOSES METHODOLOGY FOR IDENTIFYING INVESTMENT FUNDS AS GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

In early January, the Financial Stability Board ("FSB") published a Consultative Document ("consultation") entitled "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (referred to as "NBNI G-SIFIs"). [1] The consultation proposes a high level framework for identifying NBNI G-SIFIs, as well as sector-specific indicators to be applied to investment funds, finance companies, and market intermediaries (securities broker-dealers). The consultation further proposes a process by which the FSB, the International Organization of Securities Commissions ("IOSCO") and national authorities will apply the methodology in assessing the global systemic importance of NBNI financial entities.

Comments on the consultation, which is briefly discussed below, are due by April 7, 2014. ICI and ICI Global intend to submit a joint comment letter to the FSB.

Background

In November 2011, members of the G20 tasked the FSB with developing methodologies to identify systemically important financial entities, whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. [2] Methodologies already have been adopted for the identification of global systemically important banks (G-SIBs) [3], of which there are currently 29, [4] and insurers (G-SIIs), of which there are currently

9. [5] According to the consultation, the FSB sought to make the proposed methodology for NBNI G-SIFIs "broadly consistent" with these existing methodologies, while still ensuring that it can capture a wide range of business models and risk profiles. IOSCO worked on the sector-specific indicators for investment funds and market intermediaries, while the FSB developed those for finance companies.

Transmission Mechanisms

The consultation begins with a brief discussion of the ways in which financial distress of an NBNI financial entity "is most likely to be transmitted to other financial firms and markets, and thereby pose a threat to global financial stability." In the investment fund context, the FSB focuses on two transmission channels:

Exposures/counterparty channel: The consultation describes this as the exposures of creditors, counterparties, investors, and other market participants to the NBNI financial entity. It suggests that risks may occur when an investment fund's distress or failure leads to counterparties (not including equity investors) incurring losses or other impairment, either because they have extended financing to a fund or "through direct trading linkages." The consultation states that an investment fund's losses could, "if exposures are significant and have not been adequately managed, generate heavy losses to counterparties and ultimately destabilise creditors who might be systemically important in their own right."

Asset liquidation/market channel: The consultation describes this as the liquidation of assets by the NBNI financial entity, which could trigger a decrease in asset prices and thereby could significantly disrupt trading or funding in key financial markets or cause significant losses or funding problems for other firms with similar holdings. It provides examples of the indirect impact an investment fund's distress or failure could have on other market participants. It indicates that "[i]in times of stress (when there might be an increase in correlations between asset classes), forced liquidation of positions by funds could cause temporary distortions in market liquidity and/or prices that cause indirect distress to other market participants." The consultation states that use of leverage by funds may amplify the potential for forced liquidations and market distortions, especially in the event of a "run" on their financing, such as redemptions or margin calls. As another example, it mentions the possibility of "the loss of investor confidence in one specific asset class as a result of the distress of one particular fund leading to 'runs' on other funds presenting similar features or conducting a similar strategy."

Proposed Methodology and Scope of Assessment

The consultation sets forth a high-level framework, consisting of five "impact factors," that would be applied to all types of NBNI financial entities. These impact factors are size, interconnectedness, substitutability, complexity and global activities (cross-jurisdictional activities). It also proposes sector-specific methodologies for assessing systemic importance with regard to investment funds, finance companies, and market intermediaries. These "indicators" are designed to inform the consideration of each impact factor.

For investment funds, the FSB, in consultation with IOSCO, has established a "materiality threshold" of $100 billion (US dollars) in net assets under management (and an additional threshold for hedge funds that is based on gross notional exposure). The appendix to this memorandum discusses in detail the five impact factors (including size) and the indicators that would be applied in assessing the global systemic importance of investment funds.

The consultation explains that the methodology "aim[s] to measure the impact that an NBNI financial entity's failure can have on the global financial system and wider economy, rather than the risk that a failure could occur." For this reason, it states that the methodology should apply "at the highest level of the firm that is a financial entity and on a globally-consolidated basis." For NBNI financial entities owned or controlled by banks and/or insurers, this means that:

> NBNI financial subsidiaries of banks/insurance groups would be excluded from the scope of NBNI G-SIFI assessment if (1) the parent bank/insurer has been assessed by the Basel Committee on Bank Supervision and the International Association of Insurance Supervisors on a consolidated basis and (2) such subsidiaries are captured in prudential consolidated regulation and supervision of the parent bank/insurer.
>
> Investment funds managed by an asset manager subsidiary/affiliate of a banking group or insurer group will still have to be assessed by NBNI G-SIFI methodologies because such funds usually are not consolidated with the parent bank's/insurer's financial statements.

Commentary on Investment Funds

The consultation indicates that the sector-specific methodology for investment funds is designed to cover "collective investment schemes" (CIS) including, for example, closed-end funds, mutual funds (including sub-categories such as money market funds and exchange-traded funds), and private funds (including hedge funds, [6] private equity funds, and venture capital funds). It states that more work is needed to assess any potential financial stability risks posed by separately managed accounts and that the treatment of such accounts in still under review.

The consultation highlights the "very different nature of funds' risk profiles when compared with those of other financial entities." It points out that unlike banks, which must set aside capital to protect depositors, "investment management is characterised by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio." It further observes that "funds contain a specific 'shock absorber' feature that differentiates them from banks . . . fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system." The consultation recognizes that the fund's manager acts as an agent, managing fund assets on behalf of investors according to the fund's investment objectives, strategy, and time horizon.

In addition, the consultation describes several "important aspects worth considering that may dampen the global systemic impact of a fund failure." These include various liquidity management tools, and the history of funds being launched and closing on a regular basis with negligible or no market impact. The consultation states that "the investment fund industry is highly competitive with numerous substitutes existing for most fund strategies (funds are highly substitutable)." It indicates that funds may close for a number of reasons and that the manager or fund board can choose among several options for disposing of the fund's assets. Noting that hedge funds may close for similar reasons, it expresses "some concern" that the orderly wind-down or transfer of assets to a new manager could be more difficult in the case of a highly leveraged hedge fund.

Focus on investment funds vs. asset managers. The consultation explains that the proposed methodology focuses on investment funds, rather than their managers, because (1) economic exposures are created at the fund level, (2) a fund is a separate legal entity from its manager, and (3) certain data (e.g., data collected through SEC/CFTC Form PF/PQF) is or will be available to supervisors "in a per entity format." It seeks comment, however, on whether the methodology should be broadened to consider the following additional possibilities:

> Groups of funds following the same or similar investment strategy that are managed by the same manager;
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> Asset managers on a stand-alone entity basis; or
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> Asset managers and their funds collectively.

The consultation notes that—while the entity-based approach taken is designed to achieve consistency with other G-SIFI methodologies—another possible approach would be to consider possible financial stability risks that could arise out of certain asset management-related activities. With this in mind, it seeks comment on whether the methodology should be designed to focus on whether particular activities or groups of activities pose systemic risks.

Proposed Process for Identifying NBNI G-SIFIs

The consultation proposes a complex process for assessing the global systemic importance of NBNI financial entities. It states that this assessment will require authorities "to rely more on supervisory judgment" than in the G-SIB and G-SII contexts because of difficulties in obtaining and sharing appropriate data/information. To ensure consistency in application of the methodology across jurisdictions and across NBNI financial sectors, the FSB believes it is "critical" to establish an appropriate international oversight mechanism. This and other key features of the proposed process are as follows:

Establishment of international oversight group (IOG). The IOG would initially be led by co-chairs nominated by the FSB and IOSCO and include representatives from the FSB and IOSCO member jurisdictions and from other relevant standard-setting bodies. It will coordinate/oversee the assessment process conducted by national authorities, and will report to the FSB Standing Committee on Supervisory and Regulatory Cooperation ("SRC") and to the IOSCO Board with respect to investment funds and market intermediaries.

IOG to compile "Stage 0" reference lists. These reference lists will identify the investment funds, market intermediaries and finance companies that meet or exceed the materiality thresholds proposed in the consultation. The lists will be shared among the IOG members on a confidential basis for further detailed assessment according to the NBNI G-SIFI methodologies. The consultation notes that "a buffer may be set below the materiality thresholds for collecting additional names so as to prevent potential arbitrage or capture errors that may occur around the thresholds."

Preliminary analysis. National authorities will construct "Stage 1" lists of the entities that they will assess under the NBNI G-SIFI methodology. A jurisdiction's list will include any "Stage 0" entity assigned to that jurisdiction by the IOG for assessment, as well as entities below the materiality thresholds that the national authority believes should be subject to assessment. These lists will be submitted to the IOG on a strictly confidential basis. National authorities will then collect data on the indicators applicable to the particular NBNI entities using all available sources, including information obtained directly from an entity if possible, and develop a “Narrative Assessment” discussing all of the indicators and the transmission mechanisms outlined in the consultation.

Consistency check by IOG. National authorities will provide the IOG with an initial Narrative Assessment and recommendation on which NBNI entities should be designated as NBNI G-SIFIs, on a strictly confidential basis. IOG will discuss these assessments and recommendations, with a focus on consistency of implementation across jurisdictions, and provide feedback to national authorities.

Preliminary determination. National authorities will consider IOG feedback and conduct any necessary follow-up analysis, then reach a preliminary determination as to the NBNI entities on the Stage 1 list. They will convey these determinations and final Narrative Assessments to the IOG, which will compile them for discussion and review by the SRC and the IOSCO Board. The SRC may conduct a “comparability analysis” to ensure that the potential NBNI G-SIFI designees are comparable with the G-SIBs and G-SIIs as necessary.

Final determination. The FSB and the national authorities “together will determine” the final list of NBNI G-SIFIs.

The consultation states that the above process will be repeated annually and an NBNI G-SIFI list will be issued every year (along with the G-SIB and G-SII lists).

Policy Measures Applicable to NBNI G-SIFIs

The consultation notes that, once the identification methodologies have been finalized and published, the FSB will begin work “to develop within the SIFI framework the incremental policy measures needed to address the systemic risks posed by NBNI SIFIs.” The FSB expects to work in cooperation with IOSCO and other standard-setting bodies where relevant. [7]

Appendix

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Appendix

Proposed Methodology for Assessing the Global Systemic Importance of Investment Funds

The consultation sets forth a high-level framework, consisting of five “impact factors,” that would be applied to all types of NBNI financial entities. These impact factors are size, interconnectedness, substitutability, complexity and global activities (cross-jurisdictional activities). Each of these impact factors is briefly described below. Following each factor are the particular “indicators” proposed by the FSB to inform the consideration of how such impact factor should be applied to investment funds.

Factor 1: Size

The consultation states that “[t]he importance of a single entity for the stability of the financial system generally increases with the scale of financial activity that the entity undertakes.”

Indicator 1-1: Net assets under management (AUM or NAV) for the fund. The Consultation states that “[i]n theory, the larger the size of a fund, the greater its potential impact on counterparties (counterparty channel) and markets (market channel).” It asserts that this is a key indicator for determining systemic importance and proposes that it be used to determine the pool of investment funds subject to the methodology. For investment funds, the FSB, in consultation with IOSCO, has established a “materiality threshold” of $100 billion (US dollars) in net AUM.

Indicator 1-2: For hedge funds, gross notional exposure (GNE) as an alternative indicator. The consultation notes that many hedge funds use leverage as an investment technique and that, because net AUM does not take leverage into account, gross AUM (as measured using the GNE method) [8] would be a better indicator of hedge fund size. Thus, hedge funds with either $100 billion (or more) in net AUM or a value set between $400- $600 billion (or more) in GNE would be subject to assessment.

The consultation further notes that “national supervisory judgment could also be used to add entities to the assessment pool even when they fall below the materiality threshold but are considered potentially globally systemic.”

Factor 2: Interconnectedness

According to the consultation, “[s]ystemic risk can arise through direct and indirect inter-linkages between entities within the financial system so that individual failure or distress can have repercussions throughout the financial system.”

Indicator 2-1: Leverage ratio. The consultation indicates that “[t]he greater a fund’s leverage, the greater its potential impact on counterparties that have provided finance (counterparty channel) and on markets in the event of a disorderly and rapid de-leverage (market channel). Leverage ratio would be measured by “Gross AUM of the fund/NAV of the fund” or, for hedge funds, by “GNE of the fund/NAV of the fund.”

Indicator 2-2: Counterparty exposure ratio. This indicator is defined as “total net counterparty exposure at the fund/Net AUM (NAV) at the fund.” Total net counterparty exposure at the fund is defined as “the total sum of all residual uncovered exposures that the fund positions represent for its counterparties, after considering valid netting agreements and collateral/margin posted by the fund to its counterparties.” The consultation explains that “[t]he more interconnected a fund, or the greater the counterparties’ credit exposures are to that fund, the greater that fund’s potential impact in case of default on counterparties (counterparty channel) and to the broader financial system.”

Indicator 2-3: Intra-financial system liabilities. This indicator is “total net counterparty exposure at the fund in value, primarily with G-SIBs and G-SIIs.” The consultation says that “[t]he larger the exposure of the fund to counterparties, especially with more systemically important financial entities, the greater the impact of its failure.”

Factor 3: Substitutability

The consultation asserts that "[t]he systemic importance of a single financial entity increases in cases where it is difficult for other entities in the system to provide the same or similar services in a particular business line or segment in the global market in the event of a failure.

Indicator 3-1: Turnover of the fund related to a specific asset/daily volume traded regarding the same asset. According to the consultation, this proposed indicator "attempts to measure a fund's substitutability by its turnover related to a specific asset, as measured by the fund's percentage of daily trading volume with respect to that asset."

Indicator 3-2: Total fund turnover vs. total turnover of funds in the same category/classification. The consultation contends that the higher this measure, "the higher the potential systemic risk of the fund."

Indicator 3-3: Investment strategies (or asset classes) with less than 10 market players globally. The consultation notes that "[a]lthough funds generally are highly substitutable products . . . there may be particular niche markets where a fund invests heavily, either cornering or occupying a significant portion of the market, and where like substitutes may not be available."

More generally, the consultation acknowledges that "the ultimate judgment [regarding a fund's substitutability] will likely have to depend on a case by case analysis by the national authorities of the fund's specific features."

Factor 4: Complexity

The consultation indicates that "[t]he systemic impact of a financial entity's distress or failure is expected to be positively related to its overall complexity, i.e. its business, structural and operational complexity. That is, in principle, the more complex a financial entity, the more difficult, costly and time-consuming it will be to resolve the failing institution."

Indicator 4-1: OTC derivatives trade volumes at the fund/Total trade volumes at the fund. The consultation states that "[f]unds that engage in a significant volume of OTC derivatives in comparison to their total trading activity potentially could be exposed to higher counterparty risk."

Indicator 4-2: Ratio (%) of collateral posted by counterparties that has been rehypothecated by the fund. The consultation contends that a high percentage "increases exposure risks for counterparties" because they "may not see their collateral returned if the fund does not honour its commitments."

Indicator 4-3: Ratio (%) of NAV managed using high frequency trading strategies. The consultation states that "[h]igh frequency trading strategies can introduce market risk" and that "the interaction between automated execution programs and algorithmic trading strategies can quickly erode liquidity and result in disorderly markets."

Indicator 4-4: Weighted average portfolio liquidity (in days)/Weighted average investor liquidity (in days). According to the consultation, the lower this ratio (of "the number of days it takes to liquidate a portfolio of investments" to "the number of days it takes for an investor to realise their investment"), the lower the potential risk of the fund. With a lower ratio, "the fund is less exposed to liquidity risk and mismatch with investors' liquidity demands." The consultation notes that the ratio varies depending on whether the historical data used are based on normal market conditions (which "will understate risk") or on stressed market conditions.

Indicator 4-5: Ratio of unencumbered cash to gross notional exposure (or gross AUM). The consultation states that the lower this ratio, "the higher the potential systemic risk of the fund as adverse market moves can cause the fund to run out of assets to satisfy margin calls or to post collateral."

The consultation observes that "[a] fund's complexity is particularly difficult to measure given the challenges of the availability and consistency of data, among other things." It states that the proposed indicators "have focused on areas where data may be available, although further study is necessary to fully consider the appropriateness and availability of the data."

Factor 5: Global Activities (cross-jurisdictional activities)

The consultation says that "[t]he global impact from a financial entity's distress or failure should vary in line with its share of cross-border assets and liabilities. The greater the global reach of a financial entity, the more widespread the spill-over effects from its failure."

Indicator 5-1: Number of jurisdictions in which a fund invests. According to the consultation, "[f]unds that invest globally may have a larger global impact than funds that invest in the securities of only a few jurisdictions."

Indicator 5-2: Number of jurisdictions in which the fund is sold/listed. Funds sold or listed in many jurisdictions "may have a larger global impact with respect to their operations" than those sold in one or a few jurisdictions.

Indicator 5-3: Counterparties established in different jurisdictions. The consultation notes that contract and bankruptcy laws can vary across jurisdictions. It states that "[t]he higher the number of jurisdictions faced by a fund through its trading counterparties, the potentially more complex the situation if the fund had to be liquidated."

The consultation explains that these measures could indicate that "a fund failure may create contagion that would transmit across borders via the market channel or counterparty channel." [9] It adds that determining an entity's global impact "is an essential aspect of the methodology since the overall objective is to identify globally systemic entities."

endnotes

[1] See FSB, Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (8 Jan. 2014), available at http://www.financialstabilityboard.org/publications/r_140108.htm.

[2] For a discussion of this mandate, see FSB, Policy Measures to Address Systemically Important Financial Institutions (4 Nov. 2011), available at http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

[3] See Basel Committee on Banking Supervision, Global systemically important banks:

assessment methodology and the additional loss absorbency requirement (Nov. 2011), available at http://www.bis.org/publ/bcbs207.pdf; BCBS, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement (July 2013), available at http://www.bis.org/publ/bcbs255.pdf.

[4] See FSB, 2013 update of group of global systemically important banks (11 Nov. 2013), available at https://www.financialstabilityboard.org/publications/r_131111.pdf.

[5] See FSB, Global systemically important insurers (G-SIIs) and the policy measures that will apply to them (18 July 2013), available at http://www.financialstabilityboard.org/publications/r_130718.pdf.

[6] The consultation states that national authorities should clarify which type of NBNI financial entities will fall under the definition of hedge funds for the purpose of identifying NBNI G-SIFIs in their jurisdiction. It lists the following "characteristics that in combination may indicate the presence of a hedge fund": (1) use of leverage; (2) performance fees based on unrealised gains; (3) complex strategies, which may include use of derivatives, short selling, high frequency trading and/or the search for absolute returns; and (4) tendency to invest in financial rather than physical assets.

[7] See generally FSB, Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF): Report of the Financial Stability Board to the G-20 (2 Sept. 2013), available at http://www.financialstabilityboard.org/publications/r_130902.pdf.

[8] The consultation explains that GNE is calculated as the absolute sum of all long and short positions, considering the notional value (delta adjusted when applicable) for derivatives. It indicates that this measure takes into account both financial leverage and synthetic leverage.

[9] The consultation indicates that these "vulnerabilities may appear in particular when looking at master/feeder structures, where investors in one or multiple feeder funds may suffer losses as a result of the master fund in a different jurisdiction."
