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FSB Follow-Up Consultation Proposes Methodologies for Identifying Investment Funds and Asset Managers as Global SIFIs

[28797]

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TO: BOARD OF GOVERNORS No. 2-15
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MONEY MARKET FUNDS ADVISORY COMMITTEE No. 9-15
SEC RULES MEMBERS No. 15-15 RE: FSB FOLLOW-UP CONSULTATION PROPOSES METHODOLOGIES FOR IDENTIFYING INVESTMENT FUNDS AND ASSET MANAGERS AS GLOBAL SIFIs

As anticipated, the Financial Stability Board ("FSB") has published a second consultative document ("second consultation") entitled "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (referred to as "NBNI G-SIFIs"). [1] The second consultation follows up on a January 2014 FSB consultation ("first consultation"), which proposed 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). [2] The second consultation proposes a revised methodology for investment funds and a new methodology for asset managers. [3]

Each methodology contemplates the application of a materiality threshold to determine the assessment pool. [4] The methodologies would assess the global systemic importance of entities selected for further analysis by looking at five "impact factors" (size, interconnectedness, complexity, substitutability, and cross jurisdictional activities), based on sector-specific indicators relating to each of the impact factors.

Comments on the second consultation are due by May 29, 2015. The summary below focuses primarily on the proposed assessment methodologies for investment funds and asset managers.

“Dual Approach”

The second consultation notes that after considering responses to the first consultation, the FSB and IOSCO decided to take a more inclusive approach that focuses on “the two categories of actors involved in the asset management industry: (i) investment funds and (ii) asset managers.” The dual approach consists of (1) a “refined” methodology for investment funds with an increased focus on leverage; and (2) a methodology focusing on activities that if conducted by a particular asset manager may have the potential to generate systemic risk and warrant consideration. The second consultation indicates that the “overarching objective” of the asset manager methodology is to identify—on the basis of their activities—those asset managers whose distress or disorderly failure could cause significant disruption to the global financial system and economic activity across jurisdictions. It emphasizes that the dual approach is not designed to focus on or to address potential financial stability risks that could be posed by asset management entities as a whole or activities that are commonly conducted across the asset management sector. Rather, the focus is on activities or risks “that are best addressed through a designation-based approach.”

Under the proposal, the two methodologies would be applied separately, meaning that funds could be identified as NBNI G-SIFIs even though their manager is not and, conversely, an asset manager could be designated as an NBNI G-SIFI even though funds it manages might not be. The second consultation notes, however, that each methodology takes into account links between investment funds and asset managers (e.g., the asset manager methodology takes into consideration the risks relating to managing investment funds).

Investment Funds Methodology

Transmission Mechanisms

The second consultation contends that despite regulatory protections, “the distress or forced liquidation of an investment fund that has extensive exposures and liabilities in the financial system or that provides a critical role in certain markets could have a destabilising impact on other market participants or counterparties in a cascading manner that could lead to broader financial system instability . . . .” The FSB discusses three transmission channels with respect to investment funds: [5]

Exposures/counterparty channel: This channel “describes the risks that investment funds may transmit to the global financial system when their distress or forced liquidation leads to losses at or other impairment to their counterparties, including banks or brokers that have extended them financing or have direct trading linkages to them.” The second consultation asserts that “losses on investments by a fund could, if exposures to such fund 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.” It discusses the use of leverage (both “balance-sheet leverage” and “synthetic leverage”) by investment funds and notes that many public funds currently have legal and regulatory limits on their ability to use leverage. It states that leverage constitutes a central component in the analysis of the counterparty channel, particularly for funds (e.g., private funds) that are not subject to any restrictions on their use of leverage.

Asset liquidation/market channel: This channel describes the impact of distress or liquidation of an investment fund on other market participants through asset sales that negatively impact market prices and, in turn, the market value of other participants’ financial positions. The second consultation states that this channel becomes more relevant when a market is experiencing stress or when a distressed or failing investment fund is a dominant investor in particular markets or asset classes. Included in the discussion is a reference to the possibility that open-end fund investors “could have an incentive to redeem before other investors to avoid sharing the costs associated with other investors’ redemptions, particularly for funds investing in less-liquid asset classes.” [6] According to the consultation, “[i]f an individual fund is very large and a significant investor in a particular market segment, its abrupt asset sales could cause distortions in that market’s liquidity and have negative effects to the extent that it could amplify distress to other market participants that hold these assets.”

The second consultation acknowledges that responses to the first consultation generally disagreed with the relevance of the asset liquidation/market channel for investment funds. It cites the need to further investigate the availability of certain liquidity management tools to mitigate potential systemic risk—“given that such tools are infrequently used.” It makes reference to “abundant academic research on capital markets contagion” that focuses on investment funds’ aggregate contribution to market movements. It explains that the FSB wishes to explore “particular situations where certain individual investment funds may play a significant role in a particular market segment and what impact that could have in the event of distress or forced liquidation, particularly during periods of market turbulence.”

Critical function or services/substitutability channel: The second consultation includes in its discussion of investment funds a third channel, which it says describes the impact of distress or liquidation of an investment fund that provides a function or service to the markets upon which market participants heavily rely. As an example, the consultation indicates that “an investment fund may provide a highly tailored investment strategy, or may serve as a significant source of liquidity to particular asset classes, such as certain types of derivatives contracts.” It acknowledges that in the first consultation, this transmission channel was not considered significant for investment funds because of the generally high level of substitutability, and that responses to the first consultation noted that the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies.

Materiality Thresholds

Based on the analysis of responses to the first consultation, which had proposed a “materiality threshold” of $100 billion [7] in net assets under management for investment funds, the second consultation includes leverage in the materiality threshold for investment funds. For “traditional investment funds,” the FSB is considering two options: [8]

- Option 1: $30 billion in net asset value (NAV) and balance sheet leverage of 3 times NAV, with a “size-only backstop” of $100 billion net assets under management (AUM).
- Option 2: $200 billion in gross assets under management (GAUM), “unless it can be demonstrated that the fund is not a dominant player in its markets (e.g. substitutability ratio [9] below 0.5% or fire sale ratio [10] below 5%).”

The second consultation explains that Option 1 maintains a size metric as a backstop “to capture large, potentially unlevered, open-end funds for more detailed assessment as to whether they may affect the global financial system through fire sales of their assets, especially when they are relatively large players in certain market segments.” Under Option 2, very large, unlevered funds may still be captured for detailed assessment but the threshold “tries to limit the focus [to] very large funds that may be dominant in the market segments in which they invest . . . by excluding those funds for which it can be demonstrated that their potential impact on the markets is negligible."

The indicators that would be applied in assessing the global systemic importance of investment funds are listed in the Appendix to this memo.

Asset Manager Methodology

The second consultation defines asset managers as "financial entities that generally manage client assets through individual accounts and/or investment funds." It discusses an asset manager's "core function" of managing assets as an agent on behalf of others in accordance with a specified investment mandate, or the investment strategy defined in the prospectus for the investment fund that it manages. The consultation mentions legal, regulatory, and contractual limits that may apply to an asset manager's discretion to invest assets, and notes that "in some cases (e.g. hedge funds), however, asset managers may invest along with their clients into funds they manage to seed money in new funds or to co-invest (or share risks and returns) as part of their contractual arrangements with their clients."

The second consultation highlights that asset managers may follow varied investment strategies involving various securities, products and instruments. It identifies certain "other activities" that asset managers may be involved in, including "securities lending agent services (including provision of indemnification to securities lenders), provision of risk management platforms or pricing services to clients, and consulting/advisory services that rely on the asset managers' breadth of asset expertise." It states that the FSB and IOSCO want to explore the types of other activities and extent to which investors, financial institutions, and corporations may rely on various other activities and which are difficult to readily substitute. It stresses the importance of considering the variety of business models of asset managers in connection with assessing potential systemic risks.

Transmission Mechanisms

The second consultation explains how the FSB believes the three transmission channels discussed above could come into play in the asset manager context.

Exposures/counterparty channel. The second consultation states that a failure of an asset manager could, if exposures to such asset manager are significant and have not been adequately managed, generate losses to the asset manager's counterparties and ultimately destabilize creditors who might be systemically important in their own right. If an asset manager acts not only as agent but also as a counterparty, then the asset manager's failure or distress could also be transmitted to other market participants through this channel. The consultation points to "the whole range of the asset manager's activities," noting for example that some asset managers may invest their equity as seed money in new funds and that others provide securities lending agent services that may include indemnification of securities lenders against any loss incurred if the borrower fails to return the borrowed securities.

Asset liquidation/market channel. The consultation acknowledges that owing to their agency role, "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions." It contends, however, that an asset manager's failure or distress "may still create or amplify potential market distress through its off-balance sheet activities (e.g. provision of indemnification and guarantees) or through its reputational/operational risks." It indicates that the assessment methodology may want to examine whether such risks "could cause, for example, substantial redemptions from any investment funds that it manages and substantial transfers of separately managed accounts that it advises in a way that could adversely affect the global financial system."

Critical function or services/substitutability channel. The second consultation indicates that the provision of advice or portfolio management service is generally substitutable because of considerable competition in the marketplace. It notes, however, that in the event of a stress or default of a manager, there could be delays or other obstacles in transferring its contracts to another asset manager and states that the FSB and IOSCO are interested in learning "whether there are any potential risks associated with such a transfer." The consultation also mentions that responses to the first consultation noted that certain characteristics of asset managers can make them highly substitutable. But it asserts that "in certain situations, an asset manager might engage in specific activities, for which it has developed a specific skill, and which would make the manager's business not easily transferable in the event of a default."

Materiality Thresholds

The consultation says that the FSB and IOSCO are considering two types of materiality thresholds for asset managers, either exclusively or in combination:

- Balance sheet total assets: the consultation indicates that asset managers are known to maintain low balance sheet assets because they manage clients' assets rather than their own. It states that a large balance sheet "could indicate the existence of potentially significant non-asset management activities" and that the threshold of $100 billion in balance sheet total assets may be considered. The consultation notes that different corporate structures and accounting methodologies may make it difficult to measure an asset manager's activities and that information about balance sheet total assets may not be as readily available as AUM (e.g., for non-publicly listed asset managers).
- AUM: the consultation states that asset managers with higher amounts of AUM "may have a greater potential systemic impact on the global markets in situations where the risks are transferred through the assets they manage." It proffers that a higher amount of AUM may be particularly relevant when considering specific transmission channels, such as market channels (e.g., reputational risks), but may not be the most effective threshold measure for other transmission channels. According to the consultation, a threshold of $1 trillion in AUM may be considered.

The indicators that would be applied in assessing the global systemic importance of asset managers are listed in the Appendix to this memo.

Scope of Assessment

Like the first consultation, the second consultation explains that the assessment methodologies "aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and wider economy, rather than the probability that a failure could occur." For this reason, it states that the methodologies should apply "at the highest level of the firm that is a financial entity and on a globally-consolidated basis." As was the case under the first consultation, 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.

Next Steps

The second consultation outlines the FSB's plans for next steps, which will be taken in the following three phases:

1. Following the second public consultation period, the FSB, in consultation with IOSCO, will further revise the methodologies with the expectation that they will be completed by the end of 2015.
2. Once the identification methodologies have been finalized and published, the FSB will begin work "to develop within the FSB SIFI policy framework the incremental policy measures needed to address the systemic and moral hazard risks posed by NBNI SIFIs." The FSB expects to work in cooperation with IOSCO and other standard-setting bodies where relevant.
3. Following the development of incremental policy measures, the FSB and IOSCO will establish an International Oversight Group to coordinate/oversee the actual assessment process in order to maintain international consistency in applying the NBNI G-SIFI methodologies, and begin the process for determining the list of NBNI G-SIFIs.

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Appendix
Proposed Assessment Methodologies for Assessing the Global Systemic Importance of Investment Funds and Asset Managers

Like the first consultation, the second 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 cross-jurisdictional activities. Below, for investment funds and then for asset managers, we briefly summarize the FSB's description (if any) of the relevance of each impact factor. Following each factor is a list of the particular "indicators" proposed by the FSB to inform the consideration of how such impact factor should be applied.

Investment Funds

Factor 1: Size

The consultation states that, as with the methodologies for assessing banks, insurers, finance companies, and market intermediaries, size is only one of five impact factors in the methodology. It adds that “[i]n theory, the larger the size of a fund, the greater its potential impact on counterparties (counterparty channel) and markets (market channel) and other market participants that may depend on it for critical functions (critical function/substitutability channel).”

- Net assets under management (AUM or NAV)
- For hedge funds and where available, gross notional exposure (GNE) as an alternative indicator

Factor 2: Interconnectedness

The consultation states that the following indicators are designed to capture interconnectedness with counterparties, including brokers and trading counterparties. It asserts that “the 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 . . . and to the broader financial system.”

- Balance sheet financial leverage
- Leverage ratio
- Ratio of GNE to NAV
- Ratio of collateral posted by the fund to NAV
- Counterparty credit exposure to the fund
- Intra-financial system liabilities to G-SIFIs
- Nature of the fund’s investors

Factor 3: Substitutability

The consultation states that substitutability “is intended to capture the extent to which a particular fund occupies a specific position in its market that may not be easily and rapidly replaced by other funds.” The indicators seek to capture “investment funds that are investing in markets where liquidity is low, trading activity is low, and substitutes are potentially scarce.”

- Daily trading volume of certain asset classes of the fund compared to the overall daily trading volume of the same market segment
- Fund holdings per certain asset classes compared to the overall daily trading volume of the same asset class
- NAV of the fund compared to the size of the underlying market

Factor 4: Complexity

The consultation indicates that the complexity indicators seek to measure the difficulty in liquidating or transitioning an investment fund to a new manager if it experiences severe distress or faces unexpected liquidation. It states that “[a]n investment fund that is complex could potentially compound financial distress in the system due to the difficulty in transitioning or winding up its positions or ensuring swift payments and dealing with eventual conflicts between creditors.”

- Non-centrally cleared derivatives trade volumes at the fund/Total trade volumes at the fund
- Ratio (%) of collateral posted by counterparties that has been re-used by the fund
- Proportion of fund’s portfolio using high frequency trading strategies
- Investment fund liquidity profile

- For leveraged funds, ratio of unencumbered cash to gross notional exposure
- Ratio of unencumbered cash to the NAV of the fund
- Amount of less liquid assets

Factor 5: Cross-jurisdictional activities (global activity)

The consultation says that the proposed indicators attempt to measure a fund's global activities and potential impact of its distress or forced liquidation on the global financial system. The concern is that a fund liquidation could create contagion that would transmit across borders via the market channel or counterparty channel. In addition, according to the consultation, "[t]he global nature of an investment fund's activities may also tend to complicate the resolution of the distressed investment fund due to legal disputes, potentially various law regimes at play or simply getting access to all interested parties." The "main aim" is to identify funds with "the broadest global footprint in terms of investments and commitments."

- Number of jurisdictions in which a fund invests
- Number of jurisdictions in which the fund is sold/listed
- Number of jurisdictions in which the fund has counterparties

Asset Managers

Factor 1: Size

- Net assets under management
- Balance sheet assets

Factor 2: Interconnectedness

The consultation states that the indicators are designed to capture interconnectedness of an asset manager with other market participants. It indicates that "[i]ndicators should provide for situations where asset managers themselves could be considered as interconnected with other market participants, for example due to the activities they might have besides asset management and potentially for their own proprietary purposes (and not for the account of the funds or [separately managed accounts] that they manage."

- Leverage ratio
- Guarantees and other off-balance sheet exposures

Factor 3: Substitutability

The consultation states that it is possible that an asset manager could provide services that market participants or its clients may not be able to easily obtain from other sources in the event of the manager's failure (e.g., if the asset manager was "a dominant pricing source for a particular type of asset or a prominent expert in a given market segment").

- Substitutability, measured by a percentage of the asset manager's revenues as compared to the total revenues attributable to the relevant business
- Market share, measured by a percentage of the asset manager's AUM in a particular strategy as compared to the total AUM invested in the same strategy for all managers

Factor 4: Complexity

- Impact of the organisational structure
- Difficulty in resolving a firm

Factor 5: Cross-jurisdictional activities (global activity)

- Number of jurisdictions in which an asset manager has a presence

endnotes

[1] The second consultation is available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf. The FSB has been conducting its NBNI G-SIFI work "in consultation and close coordination" with the International Organization of Securities Commissions ("IOSCO").

[2] The first consultation is available at http://www.financialstabilityboard.org/publications/r_140108.htm. ICI filed a detailed comment letter explaining why designation of regulated funds is unnecessary and would be harmful. The letter is available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

[3] The second consultation also includes "near-final" sector-specific methodologies for finance companies and market intermediaries. In addition, the second consultation lays out substantially the same complex process by which the FSB, IOSCO and national authorities would apply the methodologies in assessing the global systemic importance of NBNI financial entities as was included in the first consultation. See ICI Memorandum No. 27844, dated January 15, 2014. As an added step, the second consultation indicates that at the time the FSB publishes the final list of NBNI G-SIFIs, a summary of "Narrative Assessments" (which national authorities will develop, discussing all the indicators and transmission mechanisms resulting from failure or material distress, according to guidelines set by the FSB in consultation with IOSCO and other standard-setting bodies) also will be published.

[4] As was the case in the first consultation, national supervisory judgment could be used to add entities to the assessment pool "even when they fall below the materiality threshold but are considered potentially globally systemic."

[5] The first consultation focused only on the first two channels described below.

[6] The second consultation refers readers to the Financial Stability Oversight Council's December 2014 Notice Seeking Comment on Asset Management Products and Activities for details on this point.

[7] This and all other figures below are in US dollars.

[8] For private funds (e.g., hedge funds, private equity), the proposed materiality threshold would be $400 billion of gross notional exposure (GNE).

[9] "Substitutability ratio" is defined as "the fund's trading volume in relation to the daily trading volume of the underlying asset class (i.e. whether it is easily replaceable)."

[10] "Fire sale ratio" is defined as "the extent to which the total net AUM of the fund could be easily absorbed, in a stressed market scenario, by the daily trading volume of the

underlying asset class."