The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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FSOC 2020 Annual Report to Congress - Recommendations of Interest to the Regulated Fund Industry

[32968]

December 8, 2020 TO: ICI Members
Investment Company Directors
ICI Global Members
LIBOR Transition Working Group SUBJECTS: Alternative Investments
Bank Regulation
Closed-End Funds
COVID-19
Exchange-Traded Funds (ETFs)
Financial Stability
Fixed Income Securities
Investment Advisers
Money Market Funds
Municipal Securities
Trading and Markets RE: FSOC 2020 Annual Report to Congress - Recommendations of Interest to the Regulated Fund Industry

On December 3, with unanimous approval from all voting members, the US Financial Stability Oversight Council (FSOC or Council) issued its 2020 annual report to Congress.[1] As required by Section 112 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the FSOC report addresses significant financial market and regulatory developments, provides an assessment of those developments on the stability of the financial system, and identifies potential emerging threats to US financial stability. Section 112 further requires the report to make recommendations to enhance the integrity, efficiency, competitiveness, and stability of US financial markets, to promote market discipline, and to maintain investor confidence. This memorandum briefly describes the contents of the FSOC report and highlights the recommendations that may be of particular interest to members.[2]

Content of the FSOC Report

Chapter one of the report begins with a letter of support for the report from the FSOC members and proceeds substantively as follows:

- Chapter two, the executive summary of the report, briefly discusses the financial stress from the COVID-19 pandemic and the policy actions taken to minimize the pandemic's effects. It observes that although these actions have been effective at improving market conditions, risks to US financial stability remain elevated compared to last year. The report further states that the global outlook for economic recovery is uncertain, depending on the severity and the duration of the ongoing pandemic.

- Chapter three of the report provides a lengthy update on financial developments with respect to: household finance; nonfinancial business finance; government finance (including a call out box discussing Treasury market liquidity at the onset of the pandemic); financial markets (including a call-out box discussing stress in short-term funding markets); financial institutions; financial market structure, operational changes and financial innovation; and global economic and financial developments. The chapter includes discussion of registered funds—money market funds, mutual funds and exchange-traded funds—including their experiences during the market turmoil in March.[3]
- Chapter four of the report details regulatory developments and FSOC activity since the 2019 annual report.
- Chapter five, entitled *Potential Emerging Threats, Vulnerabilities and Council Recommendations*, presents a general discussion of identified vulnerabilities in the context of the COVID-19 stress, highlights key actions taken to mitigate risks, and makes recommendations for addressing the risks. Even with the transition to a Biden Administration, these recommendations provide some insight into potential areas of focus for the Council going forward. Chapter five also identifies global economic and financial developments that pose risks to the US financial system, including levels of indebtedness in some EU countries and emerging market economies, the prospect of a no-deal Brexit, and the size of China's economy and its centrality to global supply chains.

Recommendations of Particular Interest to Members

Investment Funds

The report states FSOC has identified "identified a potential vulnerability relating to redemption risk in certain open-end funds" and that "[t]he level of this risk is a function of, among other things, the liquidity of the underlying assets, the effectiveness of the fund's management of its liquidity, and the potential for an investor to enjoy a first-mover advantage." While acknowledging action by the Securities and Exchange Commission to address this potential vulnerability—notably, its adoption of the liquidity risk management rule—the report indicates that the events of March "demonstrate the need for additional analysis to assess broader market structure dynamics that may have contributed to the stress, including whether investors redeeming shares from bond funds may have affected the extent of selling pressure in the bond market differently than if those investors had held and sold bonds directly."

The report notes that the Council "has also previously highlighted the use of leverage by investment funds." It acknowledges the use of leverage for hedging purposes but indicates that leverage "introduces counterparty risk, and in a period of stress, if leveraged investment funds are forced to sell assets on a significant scale, it could exacerbate asset price movements." The report includes a call-out box discussing that hedge funds "may have also contributed" to Treasury market volatility this past spring.

The report expresses support for initiatives by the SEC and other agencies to address risks in investment funds, as well as data collection and analytical work aimed at the identification of potential emerging risks. It observes that the SEC has established additional reporting requirements for investment funds, with the result being that “there is now significantly more data available to regulators to monitor and analyze developments concerning fund liquidity, leverage, and risk-taking.” The report recommends that “the SEC and other relevant regulators consider whether there are additional steps that should be taken to address these vulnerabilities.”

Short-Term Wholesale Funding Markets

The report states that developments in these markets “can have implications for financial stability, as well as for the implementation of monetary policy.” It observes that “stresses on prime and tax-exempt MMFs revealed continued structural vulnerabilities that led to increased redemptions and, in turn, contributed to and increased the stress in short-term funding markets” and comments on vulnerabilities in the repo markets.

FSOC’s recommendation in this area is stated as follows:

“Recent market stresses, including the financial fallout from the pandemic, have confirmed that there remain potentially significant structural vulnerabilities in short-term funding markets. Market participants that rely predominantly on short-term debt are vulnerable to funding risks. For banks and other depository institutions, this risk is mitigated by deposit insurance and liquidity backstops, such as the Federal Reserve’s discount window. However, non-depository institutions are also important participants in these markets. Leveraged nonbank participants that depend on short-term funding also can pose a challenge to financial stability. If their short-term funding is not rolled over, these entities can be forced to deleverage, and that can create an adverse feedback loop of asset sales and margin calls.

The Council recommends that regulators review these structural vulnerabilities, including the vulnerability of large-scale redemptions in prime and tax-exempt MMFs (as well as other short-term funds with similar characteristics, such as short-term collective investment funds), and any role that leveraged nonbank entities may have played in the repo market, and, if warranted, take appropriate regulatory measures to mitigate these vulnerabilities.”

Nonfinancial Business: Corporate Credit

The report states that “[t]he potential risk to financial stability from nonfinancial business borrowing depends on the ability of businesses to service their obligations, the ability of the financial sector to absorb losses from defaults and downgrades, and the continued willingness of market participants to provide intermediation during times of stress.” It calls on regulators and market participants “to continue to monitor and analyze the exposures, loss-absorbing capacity, and incentives of different types of stakeholders. This includes the direct and indirect exposures of holders of U.S. nonfinancial corporate credit, the effects of potential liquidity risks in certain mutual funds, the effects of evolving loan covenant and documentation requirements, and the potential effects of mark-to-market losses and credit rating downgrades, among other considerations. Regulators and market participants should also continue to assess ways in which leveraged nonfinancial corporate borrowers and elevated asset prices may amplify stresses in the broader market in the event of a rapid repricing of risk or a slowdown in economic activity.”

Alternative Reference Rates

The report discusses the global push to transition away from using LIBOR in anticipation of its planned cessation. The Council cautions that “the failure of market participants to adequately analyze their exposure to LIBOR and transition ahead of LIBOR’s anticipated cessation or degradation could expose market participants to significant legal, operational, and economic risks that could adversely impact U.S. financial markets.”

FSOC recommends that market participants analyze their exposure to USD LIBOR, assess the impact of LIBOR’s cessation or degradation on existing contracts, and remediate risk from existing contracts that do not have robust fallback arrangements to transition the contract to an alternate rate. The report also urges market participants to assess the impact of LIBOR transition on “every business and function” and in “services provided by third parties.” The Council recommends that member regulators use their supervisory authority to “understand the status of regulated entities’ transition from LIBOR, including their legacy LIBOR exposure and plans to address that exposure.”

Financial Market Structure

The report observes that “[t]he extreme volatility in financial markets early in the pandemic further emphasized the importance of ensuring that appropriate market structures are in place so that financial markets can function effectively during stress events.” It notes that FSOC and its member agencies “are closely monitoring how changes in market structure have affected the robustness and efficiency of capital markets and the stability of the financial system.” Among the changes discussed in the report are interlinkages among dollar funding markets, developments that are putting pressure on dealer intermediation, and the significant role of non-traditional market participants (*e.g.*, principal trading firms). The “temporary solution” to these changes, notes the report, has been to “provide more balance sheet space to [bank holding companies] in the form of relief on capital and liquidity regulation so that affiliates of the BHCs are better positioned to intermediate investors’ demands for liquidity” together with increases in the Federal Reserve’s balance sheet “to absorb selling pressures on Treasury and MBS to a significant degree.”

The report states that “[i]n light of these developments, there should be active collaboration among regulators across jurisdictions to ensure coordination of efforts. The Council recommends that member agencies conduct an interagency operational review of market structure issues that may contribute to market volatility in key markets, including short-term funding, Treasuries, MBS, and corporate bond markets, and study the interlinkages between them. Market participants should also regularly assess how market developments affect the risk profile of their institutions. The Council recommends that financial regulators continue to monitor and evaluate ongoing changes that might have adverse effects on markets, including on market integrity and liquidity.”

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endnotes

[1] Financial Stability Oversight Council, 2020 Annual Report, *available* here.

[2] In addition to the recommendations summarized below, the report makes recommendations in the following areas: nonbank mortgage origination and servicing; commercial real estate; large bank holding companies; central counterparties; cybersecurity; data gaps and challenges; and financial innovation (*e.g.*, digital assets).

[3] *See* Report at 99-106.