MEMO# 34369

November 17, 2022

FSB Reports on Expected Work Relating to Funds and Other Non-Bank Entities

[34369]

November 17, 2022

TO: ICI Members
Investment Company Directors
ICI Global Members SUBJECTS: Exchange-Traded Funds (ETFs)
Financial Stability
Fixed Income Securities
International/Global
Investment Advisers
Money Market Funds RE: FSB Reports on Expected Work Relating to Funds and Other Non-Bank Entities

On November 10, the Financial Stability Board (FSB) issued a progress report on work to enhance the resilience of non-bank financial intermediation (NBFI). The FSB's NBFI work program, first published as part of its Holistic Review of the March Market Turmoil in November 2020, spans the following areas:

- Resilience of money market funds (MMFs) and short-term funding markets
- Liquidity risk and its management in open-ended funds (OEFs)
- Margining practices
- Liquidity, structure and resilience of core bond markets
- Non-bank leverage
- Developing a systemic risk perspective in NBFI
- Developing policies to address systemic risks in NBFI

The progress report contains two tables that, taken together, provide a high-level overview of the FSB's work: Table 1 on page 3 summarizes planned deliverables and expected timing; and Table 2 on page 4 outlines deliverables already completed.

This memorandum provides high-level context and takeaways from the progress report, focusing on aspects of the report relating to MMFs and OEFs.

Overview

The report identifies the following circumstances as prompting the FSB's focus on enhancing NBFI resilience: the March 2020 market turmoil and measures by central banks to restore market functioning; a changed macroeconomic environment, characterized by reduced growth and higher inflation, and implications for the ability of central banks to intervene in stressed markets in the future; the failure of Archegos Capital Management; and strains in commodities and bond markets.

The main focus of the FSB's work over the past year was to "assess and address vulnerabilities in specific NBFI areas that may have contributed to the build-up of liquidity imbalances and their amplification in times of stress." The FSB is concerned that "[i]f liquidity imbalances become sufficiently large and pervasive, they may give rise to financial instability."

The FSB has identified activities and types of entities that it believes are "key amplifiers" of liquidity stress. The report observes that "some elements of [the NBFI] ecosystem are particularly susceptible to large swings in demand during stress that are not matched by a sufficient increase in the supply of liquidity at the system-wide level, resulting in the propagation of shocks across markets."

- With regard to liquidity demand, the report identifies the following as key amplifiers: (i) activities that give rise to liquidity mismatches, "particularly prevalent in some types of non-bank entities, such as certain MMFs and OEFs;" (ii) unexpectedly large margin calls for derivatives and securities trades; (iii) global use of the US dollar as a borrowing and investment currency; and (iv) leverage, especially when not visible to market participants or authorities.
- With regard to liquidity supply, the report states that key amplifiers "include factors that reduce the ability of bank and non-bank liquidity providers to absorb large spikes in liquidity demand, as well as other impediments stemming from the structure of core wholesale funding markets, which is characterized by limited standardization, low levels of automated trading and turnover, and heavy reliance on dealer intermediation."

The policy proposals described in the report are "largely repurposing existing policy tools" from the "extensive micro-prudential and investor protection toolkit already available." The report states that the FSB "will assess in due course whether repurposing such tools is sufficient to address systemic risk in NBFI, including the need to develop additional tools for use by authorities."

Enhancing MMF resilience

The report states that FSB member jurisdictions are examining MMF vulnerabilities and that several, including the US Securities and Exchange Commission, have published policy proposals. It notes the following planned deliverables:

- End-2023: FSB (working with the International Organization of Securities Commissions or "IOSCO") to conduct a stock-take of policy measures adopted by FSB member jurisdictions
- End-2026: FSB (working with IOSCO) to assess the effectiveness of these reforms in addressing risks to financial stability
- End-2023: FSB and IOSCO to carry out work to enhance functioning and resilience of short-term funding markets
- TBD: IOSCO to revisit its Policy Recommendations for MMFs in light of the framework and policy toolkit in the FSB report

Liquidity risk and its management in OEFs

The report states that while the FSB's 2017 recommendations to mitigate OEF vulnerabilities from liquidity mismatch remain broadly appropriate, the FSB's assessment suggests that greater clarity and specificity on intended policy outcomes would make the recommendations more effective from a financial stability standpoint. The report observes that there appears to have been "no measurable reduction in the degree of structural liquidity mismatch" and that "[t]here remains room for greater uptake of [liquidity management tools], in particular anti-dilution tools that are intended to pass on the cost of liquidity to redeeming shareholders in both normal and stressed market conditions." The report cites to "variance in the scope, frequency and content of periodic reporting" as a reason for authorities' continued challenges in monitoring liquidity mismatch and evaluating the availability, use and effectiveness of liquidity management tools (LMTs).

The report outlines the following planned deliverables:

- 2023: FSB (in consultation with IOSCO) to revise the FSB's 2017 recommendations. There would be a consultation mid-year and a final report by late in the year. The report states that "this work would aim to: provide greater clarity on the redemption terms that OEFs could offer to investors based on the liquidity of their asset holdings; promote greater inclusion of anti-dilution LMTs (such as swing pricing and anti-dilution levies) aimed at passing on explicit and implicit costs of redemptions (including any significant market impact of asset sales) to redeeming investors in OEF constitutional documents; and encourage greater use, and greater consistency in the use, of these tools in normal and stressed market conditions, including to avoid any threshold effects."
- TBD: Following the work above, IOSCO to operationalize the revised FSB recommendations through amendments to IOSCO's 2018 recommendations and good practices
- 2023: IOSCO (in consultation with the FSB) to develop detailed guidance on LMTs to complement the revised FSB recommendations. There would be a consultation mid-year and a final report by late in the year. The report states that "this would include identifying the factors that managers should consider in employing anti-dilution LMTs to impose the explicit and implicit costs of redemptions on redeeming investors in both normal and stressed market conditions.
- 2023-24: FSB (in consultation with IOSCO) to launch a pilot program to enhance the availability of OEF-related data for financial stability monitoring. This work would seek to close identified data gaps relating to OEF liquidity mismatch, the use of LMTs, and attendant financial stability risks.
- Late 2023/early 2024: FSB and IOSCO to facilitate sharing of experiences among authorities on the design and use of fund- and system-level stress tests to support OEF liquidity risk management and inform vulnerabilities assessments and policy development. The report states that most jurisdictions surveyed by the FSB 'have conducted some form of system-wide stress testing to capture the effects of collective selling by funds and other investors on the resilience of financial markets and the financial system more generally."

Rachel H. Graham
Associate General Counsel & Corporate Secretary