The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 35687

April 24, 2024

FSB Publishes Consultation on NBFI Liquidity Preparedness

[35687]

April 24, 2024

TO: ICI Members
ICI Global Members
Derivatives Markets Advisory Committee
Equity Markets Advisory Committee SUBJECTS: Derivatives
Financial Stability
International/Global
Trading and Markets RE: FSB Publishes Consultation on NBFI Liquidity Preparedness

On 17 April, the Financial Stability Board (FSB) published a consultation on liquidity preparedness for margin and collateral calls.[1] Comments are due 18 June 2024. This memorandum provides an overview of the Consultation.

Background

In September 2022, an ad hoc group established by the Basel Committee on Banking Supervision (BCBS), the Bank for International Settlements' Committee on Payment and Market Infrastructures (CPMI), and the International Organization of Securities Commissions (IOSCO) published a Review of margining practices (Phase 1 Margin Report).[2] Part of the FSB's non-bank financial intermediation (NBFI) work program, the Phase 1 Margin Report presented analysis of margin calls during the volatility of March 2020 in centrally and non-centrally cleared derivatives and securities markets and identified several areas for further policy work (often referred to as Phase 2) including:

1. increasing transparency in centrally cleared markets;
2. enhancing the liquidity preparedness of market participants as well as liquidity disclosures;
3. identifying data gaps in regulatory reporting;
4. streamlining variation margin (VM) in centrally and non-centrally cleared markets;
5. evaluating the responsiveness of centrally cleared initial margin (IM) models to market stresses with a focus on impacts and implications for CCP resources and the wider financial system; and
6. evaluating the responsiveness of non-centrally cleared IM models to market stresses.

The Consultation presents the results of some of this Phase 2 work. Other Phase 2 work includes the recent consultations from BCBS, CPMI, and IOSCO on cleared initial margin,[3] cleared variation margin,[4] and initial and variation margin in non-centrally cleared markets.[5] ICI submitted comments on each of those other Phase 2 consultations.[6] The FSB liaised with BCBS, CPMI, and IOSCO on the measures in the Consultation, which are intended to complement the other Phase 2 work that was recently published.

In addition to the FSB's work focused on enhancing the liquidity preparedness of market participants, the FSB is seeking to address regulatory data gaps so that authorities can improve monitoring of NBFI liquidity preparedness and intermediaries' provision of liquidity to clients.

The Consultation

The Consultation presents eight cross-sectoral policy recommendations that are addressed to non-bank financial participants, in centrally and non-centrally cleared derivatives and securities markets. The FSB identifies a diverse group of NBFI participants within the scope of the Consultation, including regulated funds, insurance companies, pension funds, hedge funds, other investment funds and family offices, and non-financial entities such as commodities traders. Commercial banks and financial market infrastructures (including central counterparties) are excluded.

The policy recommendations in the Consultation address liquidity risk management and governance, stress testing and scenario design, and collateral management practices. They are intended to address liquidity risks that occur as margin and collateral calls spike, including in extreme but plausible conditions.

The FSB describes margin as a "key amplifier" of liquidity imbalances that transmit liquidity shocks through the financial system and to the real economy. The transmission mechanism can also include interconnectedness and leverage.

FSB Analysis

The FSB's analysis identified weakness in some NBFI participants' liquidity risk management and governance, which the FSB concludes are key causes of inadequate preparedness. The FSB's analysis is not described in detail, but included case study analysis, industry stakeholder outreach, and surveys.

The case study examined March 2020, the failure of Archegos, 2022 commodities volatility, and liability-driven investment (LDI) funds issues in September 2022. The FSB identified a number of lessons to be learned from the incidents:

- March 2020. The events of March 2020 show that hedge fund unwinding and institutional investors' liquidation of money market funds (MMFs) and other assets evidence a need for additional measures to strengthen the ability of MMFs to respond to future liquidity stress.
- Archegos. The Archegos failure demonstrates that prime brokers inadequately manage counterparty credit risk. Additional disclosures of positions are need so that lenders and counterparties can appropriately price risk. There are also deficiencies in oversight and supervision.
- 2022 Commodities Volatility. The volatility in 2022 demonstrates that there are regulatory data gaps for commodities traders and utility firms.
- LDI. This incident demonstrated lack of robust stress testing, which resulted in insufficient liquidity resources. Inadequate governance structures can magnify other problems.

The FSB surveyed pension funds, insurance companies, and investment firms, and in some jurisdictions, commodity traders and family offices, finding a wide range of regulations and lack thereof across segments of NBFI. Annex 2 to the Consultation provides an overview of relevant regulations, including the review of the directives for the undertaking for collective investment in transferable securities (UCITS) and alternative investment fund managers (AIFMs) in the European Union, the FSB's work on open-ended funds, the United States Securities and Exchange Commission's liquidity risk management regulations, and the Japanese Financial Securities Authority's stress testing rules for investment funds.

The Recommendations

The FSB recognises that market participants may establish robust liquidity risk frameworks under established rules and regulations. Since the recommendations in the Consultation are intended to apply across sectors, they are intended to build on and complement existing rules. In addition, Annex 3 provides illustrative guidance of policies that would be consistent with each recommendation.

The Consultation proposes recommendations to address:

1. Liquidity risk management practices and governance, including liquidity risk assessments, liquidity risk appetites and contingency funding plans, and review of liquidity risk management frameworks;
2. Liquidity stress testing and scenario design, including sources of liquidity strains, resilience levels, and use of results; and
3. Collateral management practices, including operational practices, diversity and liquidity of assets, collateral arrangements, and interactions with counterparties and third-party service providers.

While the recommendations are at a high-level, the supporting text identifies details that the FSB recommends be incorporated into participants' practices. For example, the Consultation recommends that when designing liquidity stress tests, entities incorporate considerations of the actions of their counterparties and other market participants experiencing liquidity stress that could adversely impact the entity. This includes considering the impacts of the actions of other parties that may sell or liquidate similar assets.

The Consultation also recommends that entities conduct a liquidation cost analysis for the proportion of the portfolio expected to be hedged, liquidated, or unwound in a relevant stress scenario. In cases where entities would anticipate liquidating the most liquid assets in a portfolio, rather than a pro-rata cross section, the Consultation particularly recommends consideration of the resulting liquidity profile of the post-liquidation portfolio. These analyses should also consider whether the entity "participate[s] in crowded strategies or concentrated market segments and are therefore prone to liquidating the same assets at the same time as other market participants."[7] The FSB recommends that entities estimate incremental market impact and liquidation costs in such cases.

The FSB proposes that the recommendations be applied proportionately to the liquidity risks, especially during times of broad market stress, by which the FSB proposes that liquidity risk management practices be appropriate for the entity's business model, investment strategy, and role in the financial system. This is to be determined based on an entity's size, organisational structure, international footprint, complexity of activities, and activity in the derivatives and securities markets in which the entity operates. Other considerations include liquidity risk profile, leverage, and funding mismatches.

Following the finalisation of the recommendations, the FSB acknowledges that relevant international standard setters may need to assess standards and guidance for consistency and revise if appropriate to address any gaps. The FSB expects a similar exercise to be conducted by financial authorities. The FSB and other international standard setters are intending to monitor the progress in implementing these recommendations.

Kirsten Robbins
Associate Chief Counsel, ICI Global

Notes

[1] FSB, Liquidity Preparedness for Margin and Collateral Calls: Consultation report (17 April 2024)

[2] BCBS-CPMI-IOSCO, Review of margining practices (29 September 2022).

[3] BCBS-CPMI-IOSCO, Consultative report: Transparency and responsiveness of initial margin in centrally cleared markets - review and policy proposals (16 January 2024).

[4] BCBS-CPMI-IOSCO, Streamlining VM processes and IM responsiveness of margin models in non-centrally cleared markets (17 January 2024)

[5] CPMI-IOSCO, Streamlining variation margin in centrally cleared markets - examples of effective practices (14 February 2024)

[6] Our responses to the cleared initial margin, cleared variation margin, and non-centrally cleared initial and variation margin are available through the embedded links.

[7] Consultation a 17.