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Briefing note

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Identifying investment fund G-SIFIs: FSB-IOSCO consult on non-bank, non-insurer global systemically important financial institutions

On 8 January 2014, the Financial Stability Board (FSB) and the International Organisation of Securities Commissions (IOSCO) issued a consultative document (Consultation) on proposed methodologies to identify systemically important non-bank non-insurer financial institutions (NBNIs). This is the latest step towards implementation of the FSB SIFI Framework, which requires, at the outset, identification of entities which are systemically important at a global level. Similar methodologies have already been issued for banks (G-SIBS) and insurance companies (G-SIIs). In addition to proposing a general, high-level framework and operational approach, which would apply across the board to all NBNIs, the Consultation proposes specific methodologies for indentifying NBNI G-SIFIs in three key sectors – finance companies, market intermediaries (securities broker-dealers) and investment funds. The Consultation does not propose that any specific entity be designated as a NBNI G-SIFI, or describe any policy that might apply to them – this is to follow at a later date. The Consultation closes on 7 April 2014.

Key issues

- Systemic risks posed by NBNIs
- A high-level framework for identifying NBNIs
- Implementation approach - to be adopted across all NBNIs
- Specific methodologies for finance companies, intermediaries (securities broker-dealers) and investment funds
- A 'guiding methodology' for 'all other' NBNIs

Investment funds as G-SIFIs

In addition to a high-level framework which would apply to all NBNIs, specific methodologies have been proposed for three sectors – finance companies, market intermediaries (securities broker-dealers) and investment funds – chosen because of their relatively large size in the non-bank financial sector and also because previous failures in these sectors had an impact on the global financial system. These sectors also feature in the FSB Policy Framework on Shadow Banking Entities and the author of the proposed methodologies is the FSB Workstream (WS3) on

Other Shadow Banking Entities, in conjunction with IOSCO.

This briefing focuses on the proposed methodology for assessing whether investment funds are G-SIFIs, which includes the issues outlined below.

Scope

The scope of the proposed methodology for investment funds is broad. It covers 'collective investment schemes' (CIS), including open or closed ended funds, regardless of whether their units are traded on a regulated or organised market. Separately Managed Accounts (SMAs) are specifically mentioned; they are not included, as they are not CIS, but because they represent a large segment of the asset management industry their inclusion is still under review. Hedge funds are within scope. It is noted that, as what constitutes a hedge fund may vary from one jurisdiction to another, national authorities will have to clarify which type of NBNI financial institution will fall within the definition of a hedge fund in their jurisdiction.

Systemic risk posed by funds

In the context of systemic risk posed by investment funds, the Consultation notes the different risk profiles of investment funds compared with other market participants, notably banks. For example, that fund investors take on investment risks based on full disclosure and are knowingly exposed to potential losses and that, in fact, funds may act as 'shock absorbers', as investors absorb the losses incurred by a fund, thereby mitigating the effect on the broader financial system. Further, asset managers may employ techniques (e.g. the imposition of liquidity management tools such as redemptions gates, side pockets, temporary suspensions etc.) that may dampen the global systemic impact of an investment fund failure. That said, the Consultation notes two main ways – described as 'systemic risk transmission channels' – in which investment funds may nonetheless pose systemic risks:

- The Exposures/Counterparty channel: when distress or failure of an investment fund results in losses to their counterparties. It is noted that such risks may occur, for example, if counterparties have extended financing to a fund or if trades are directly with the fund. Losses on investments by a fund 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: when an investment fund is in distress or fails this may have an indirect impact on other market participants e.g. 'fire sales', when 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 potential for forced liquidations and market distortions may be amplified by the use of leverage by funds, particularly in the event of a 'run' on their financing, such as through redemptions or increased margin calls.

"…It is significant that the Consultation recognises that the risk profiles of funds are very different to those of banks and that funds act as 'shock absorbers' to the broader financial system. This should not be overlooked and begs the question whether investment funds are of real systemic concern…"

Investment funds within scope

- Mutual Funds
- Money Market Funds
- ETFs
- Hedge Funds
- Private Equity Funds
- Venture Capital Funds

Indicators for assessing systemic importance

The Consultation describes the criteria or 'indicators' to be used to assess the systemic importance of all types of investment funds, taking into account the specificities of the asset management industry described above. These are summarised in Figure 1 below.

Fund v fund managers – the rationale for the proposed focus on funds

The focus of the proposed methodology is at the fund level because:

- Economic exposures are created at the fund level as they stem from the underlying asset portfolio held by the fund

- A fund is typically organised as a corporation or business trust under national law and, as such, is a separate legal entity from its manager
- The assets of a fund are separate and distinct from those of the asset manager and as a result, the assets of a fund are not available to claims by general creditors of the asset manager

It may also be more practical to focus on the fund because certain data (such as data collected in the US through the SEC/CFTC Form PF/PQF and in the EU under the Alternative Investment Fund Managers Directive (AIFMD) transparency reporting requirements) is or will be available to supervisors at the fund level.

Figure 1: FSB – IOSCO proposed Indicators for assessing the systemic importance of investment funds

Categories for Determining Systemic Importance	**Investment Funds**
	Materiality Criteria: $100 billion in net AUM for individual investment funds. Hedge funds have an alternative threshold at a value between $400-$600 billion in GNE.
	Individual Indicators
Size	1. Net assets under management (AUM or NAV) for the fund, 2. For hedge funds, gross notional exposure (GNE) as an alternative indicator
Interconnectedness	1. Leverage ratio, 2. Counterparty exposure ratio, 3. Intra-financial system liabilities
Substitutability	1. Turnover of the fund related to a specific asset/daily volume traded regarding the same asset, 2. Total fund turnover vs. total turnover of funds in the same category/classification, 3. Investment strategies (or asset classes) with less than 10 market players globally
Complexity	1. OTC derivatives trade volumes at the fund/Total trade volumes at the fund, 2. Ratio (%) of collateral posted by counterparties that has been re-hypothecated by the fund, 3. Ratio (%) of NAV managed using high frequency trading strategies, 4. Weighted-average portfolio liquidity (in days)/Weighted average investor liquidity (in days), 5. Ratio of unencumbered cash to gross notional exposure (or gross AUM)
Cross-jurisdictional presence	1. Number of jurisdictions in which a fund invests, 2. Number of jurisdictions in which the fund is sold/listed, 3. Counterparties established in different jurisdictions

The US angle

The FSB-IOSCO consultation comes in the wake of the US Treasury's Office of Financial Research report on asset management and financial stability which was issued in September 2013. The report - which has drawn widespread comment from regulators, academics and the asset management industry - indicates that the activities of larger asset managers may pose risks to the broader marketplace and qualify them as systemically important financial institutions.

A possible alternative focus for the methodology

The methodology for investment funds could be potentially broadened to include:

- Family of funds – managed by the same asset manager
- Asset managers on a stand-alone entity basis
- Asset managers and their funds

Another approach mentioned in the Consultation is to consider possible financial stability risks that could arise out of certain *asset management-related activities*. Under this approach, the methodologies would consider how particular activities or groups of activities might pose systemic risks. However, this Consultation takes an entity-based approach, designed to achieve consistency with other G-SIFI methodologies for banks and insurance companies, focusing on certain core impact factors of investment funds for financial stability.

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