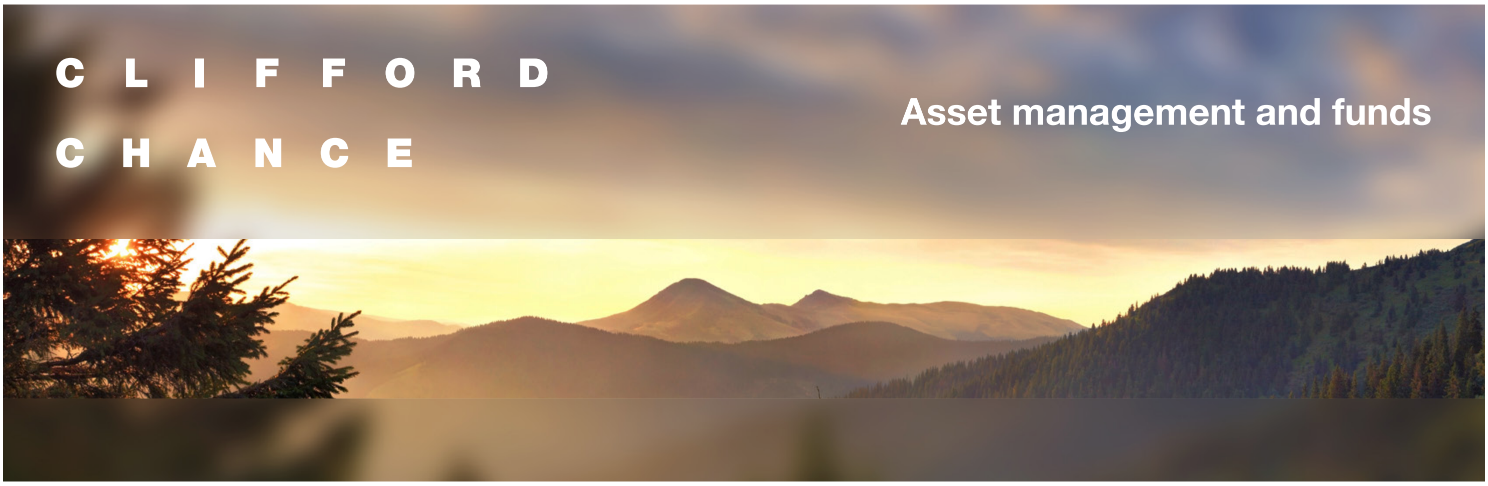


ADDRESSING STRUCTURAL VULNERABILITIES FROM ASSET MANAGEMENT ACTIVITIES

The Financial Stability Board (FSB) has issued final policy recommendations to address the perceived risk to financial stability arising from 'structural vulnerabilities' associated with asset management activities. The policy recommendations are deemed necessary because, despite the reforms that have been introduced since the financial crisis, residual risks remain and the size and expected growth in the asset management sector means that regulators may need further tools at their disposal. The policy recommendations are intended to provide a 'general framework' to assist national regulators develop such tools if necessary, through data collection, risk monitoring and 'other appropriate policy actions'.

Structural vulnerabilities

The policy recommendations address four 'structural vulnerabilities', areas where the FSB conclude that risks to financial stability may arise, due to the structure of different types of fund and/or the services offered by asset managers. They reach this conclusion notwithstanding the fact that open-ended funds have been 'generally resilient' in stressed market conditions (with the exception of money market funds which are being dealt with separately by regulators e.g. the proposed EU Regulation on Money Market Funds) and that the characteristics of the asset management sector, such as the asset manager acting in a fiduciary capacity as agent for its client for example, 'offers some important stabilising features to the global financial system'. This is because they remain concerned about the risk to financial stability, particularly the degree of leverage and liquidity issues, and the size of the asset management sector and the growing importance of funds as a source of non-bank finance, have lead them to the conclusion that further measures may be needed.

The four vulnerable areas identified by the FSB are:

- liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units
- leverage within investment funds
- operational risk and challenges at asset managers in stressed conditions and
- securities lending activities of asset managers and funds.

Of these, liquidity mismatch and leverage are considered key issues and all but two of the policy recommendations relate to these.

Key facts

- 14 policy recommendations to address potential risks to financial stability from the asset management sector
- Risks caused by 'vulnerabilities' inherent in the sector due to the way funds are structured or because of certain asset manager activity
- Liquidity mismatch, leverage, operational risk in stressed conditions and certain securities lending activities, notably agent-lender indemnifications are the main areas of vulnerability
- Residual risk deemed present notwithstanding recent regulatory measures and more stringent market practices post financial crisis
- The growing size and importance of the asset management sector means that regulators may need tools in the future to maintain stability in this market
- The policy recommendations need to be incorporated into national or regional regulatory regimes in order to take effect
- IOSCO is expected to finish its work on the liquidity recommendations by the end of 2017 and on leverage measures before the end of 2018.

Scope

The policy recommendations focus on the asset management *sector* rather than on *individual* firms. Risks posed by individual asset managers will be analysed as part of the FSB-IOSCO work on Non-Bank Non-Insurer G-SIFIs (NBNI G-SIFIs), which has been suspended pending finalisation of the policy recommendations. Thus, once resumed and in the case of asset manager G-SIFIs, the focus will be on entity-based sources of systemic risk that cannot be effectively addressed by market-wide policies.

Pension funds and sovereign wealth funds are not intended to be covered by the principles, the FSB noting that the risks from such entities would also be better assessed as part of the FSB-IOSCO work on NBNI G-SIFIs. However, the FSB note that risks to financial stability can arise from these entities and these are discussed in Annex 2 of the principles.

Each FSB policy recommendation focuses on a particular part of the asset management sector. Those dealing with liquidity mismatch focus on open-ended funds (excluding MMFs), although it is noted that liquidity transformation risk may also be present in ETFs, so the recommendations may require 'tailoring' to address the characteristics of ETFs. This is discussed further in Annex 3 to the principles. Recommendations on leverage are meant to apply to all funds, operational risk to all asset managers and those for securities lending are meant to apply to asset managers' agent lender activities, in particular where they provide indemnities to clients.

The policy recommendations

As well as outlining what the FSB see as the four key areas of vulnerability that may lead to systemic risk in the future, the policy recommendations also discuss any mitigating factors. They go on to outline areas where the FSB sees residual risks, notwithstanding the mitigating factors, and the policy recommendations intended to reduce these. Table 1 below provides a summary.

National implementation

As the FSB is a policy setting body, to take effect the policy recommendations will need to be incorporated into national or regional regulatory regimes, and as is their normal practice, the FSB will regularly review progress in implementing the recommendations. Some of the recommendations are already in place or are being reviewed, e.g. in the EU through AIFMD regulatory reporting, and in Hong Kong through enhancements to the SFC Fund Manager Code of Conduct. This is a point acknowledged by the FSB who felt that, nonetheless, more could be done to eliminate gaps and promote consistency across jurisdictions. ESMA has already indicated that one of its priorities for 2017 will be to assess the opportunities for conducting stress tests of investment funds on a pan-EU basis and the potential methodologies to be used in such an exercise.

Some recommendations be introduced through IOSCO. IOSCO is expected to finish its work on the liquidity recommendations by the end of 2017 and on leverage measures before the end of 2018.

Table 1: Asset Management: summary of the key vulnerabilities, mitigants, residual risks and policy recommendations

Liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units

Potential structural vulnerability

A mismatch between daily redemptions and the liquidity of the underlying investments. Risk may have increased in recent years as funds hold less liquid assets in search of higher returns. Risk may be amplified as open-ended funds are playing a bigger role in financial intermediation.

Existing mitigants

Regulatory requirements e.g. limits on investment in illiquid assets and/or funds' internal rules e.g. side pockets. Most mitigants are aimed at protecting investors rather than at protecting financial stability.

Residual risks

Existing mitigants may not be sufficient to protect financial stability in stressed market conditions:

- existing regulatory information and public disclosures may be insufficient to allow regulators to assess the degree of liquidity transformation and its potential systemic implications
- liquidity risk management practices may not be appropriately calibrated to address potential risks
- discretionary liquidity management tools may be insufficient in stressed market conditions

Policy recommendations on Liquidity

Lack of information and transparency

Recommendation 1: Authorities should collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective. They should review existing reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.

Recommendation 2: Authorities should review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-ended funds to investors regarding fund liquidity risk, proportionate to the liquidity risks funds may pose from a financial stability perspective. Authorities should enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Gaps in liquidity risk management tools both at the design phase and on an ongoing basis.

Recommendation 3: In order to reduce the likelihood of material liquidity mismatches arising from an open-ended fund's structure, authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behaviour during normal and stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Recommendation 4: Where appropriate, authorities should widen the availability of liquidity risk management tools to open-ended funds, and reduce barriers to the use of those tools to increase the likelihood that redemptions are met even under stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Recommendation 5: Authorities should make liquidity risk management tools available to open-ended funds to reduce first-mover advantage, where it may exist. Such tools may include swing pricing, redemption fees and other anti-dilution methods. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Recommendation 6: Authorities should require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management to mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be done. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Adequacy of liquidity risk management tools to deal with exceptional circumstances

Recommendation 7: Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of exceptional liquidity risk management tools, and the processes should be made transparent to investors and the relevant authorities. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Recommendation 8: While asset managers have the primary responsibility to exercise exceptional liquidity risk management tools regarding the open-ended funds they manage, authorities should provide guidance on their use in stressed conditions. Where jurisdictions consider it appropriate, authorities should provide direction in extraordinary circumstances regarding open-ended funds' use of such liquidity risk management tools taking into account the costs and benefits of such action from a financial stability perspective. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Additional market liquidity considerations

Recommendation 9: Where relevant, authorities should give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other investors on the resilience of financial markets and the financial system more generally.

Leverage within investment funds

Potential structural vulnerability

Balance sheet leverage and use of derivatives may create/amplify systemic risks as it increases the risk of a fund encountering financial distress which then spreads through the financial system due to interconnectedness and 'fire-sales' of assets. Leverage within funds may also contribute to pro-cyclicality in downturns in the business cycle.

Existing mitigants

Funds and their bank counterparties use a variety of internal risk management techniques to control the risks associated with borrowing and derivatives, such as daily mark-to-market, netting and collateralisation. There are also regulatory measures in place e.g. limits on balance sheet leverage although these vary across types of funds and jurisdictions. Other regulatory measures should mitigate risk by preventing the build-up of leverage e.g. margin on uncleared derivatives and the FSB regulatory framework on haircuts for non-centrally cleared securities financing transactions. The Basel III framework, in particular the capital requirements for banks' investment in the equity of funds, should also help reduce risks from interconnectedness between banks and funds.

Residual risks

Despite the existing mitigants, the FSB believe that there are residual risks because the measures focus on other issues rather than on reducing the risk to financial stability. Supervisory intervention powers mostly focus on individual firms rather than on the ability for supervisors to intervene when leverage builds up across all or a segment of funds. Particular weaknesses include a lack of consistent and accessible data on leverage and wide variation in leverage limits across jurisdictions.

Policy recommendations on leverage

Recommendation 10: IOSCO should identify and/or develop consistent measures of leverage in funds to facilitate more meaningful monitoring of leverage for financial stability purposes, and help enable direct comparisons across funds and at a global level. IOSCO should also consider identifying and/or developing more risk-based measure(s) to complement the initial measures with a view to enhance authorities' understanding and monitoring of risks that leverage in funds may create. In both cases, IOSCO should give consideration to appropriate netting and hedging assumptions and where relevant build on existing measures.

Recommendation 11: Authorities should collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which may pose significant leverage-related risks to the financial system, and take action when appropriate.

Recommendation 12: IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions based on the consistent measures it develops.

Operational risk and challenges at asset managers in stressed conditions

Potential structural vulnerability

Asset managers face a variety of operational risks e.g. cyber attacks, although these are common across the financial services sector. The FSB focus on operational risks in stressed conditions, in particular transferring investment mandates or client accounts.

Existing mitigants

There are a number of regulatory measures and market practices which address operational risk e.g. regulatory requirements for appropriate risk management practices, requirements to have an external custodian and business continuity plans. However, it is noted that these vary substantially across jurisdictions.

Residual risks

Despite there being no serious operational incidents during stressed market conditions, and there being an number of regulatory measures and market practices in place to mitigate operational risk, the FSB conclude that there are residual risks e.g. there may be 'gaps' because the mitigant may not be addressing financial stability risk or variations across jurisdictions. There may also be insufficient information for regulators to assess operational risk and business continuity plans may not deal with the transfer of client accounts in stressed conditions.

Policy recommendations on operational risk

Recommendation 13: Authorities should have requirements or guidance for asset managers to have comprehensive and robust risk management frameworks and practices, especially with regards to business continuity plans and transition plans, for example, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions. Such risk management frameworks and practices should be commensurate with the level of risks that the asset managers' activities may pose to the financial system.

Securities lending activities of asset managers and funds
Potential structural vulnerability Securities lending activities, including by funds, can potentially cause risks to financial stability, as outlined in the FSB's previous work in this area. These include: maturity/liquidity transformation and leverage associated with cash collateral reinvestment, procyclicality, risk of 'fire-sales' and inadequate collateral valuation practices. Another potential vulnerability concerns agent-lender indemnifications. Although relatively few asset managers provide these, the FSB notes that the scale of the exposures 'can be as large as that of some global systemically important banks (G-SIBs)'.
Existing mitigants Securities financing transactions have been one of the key areas of focus for the FSB. Existing policy measures once implemented, should address risks from these products in a consistent manner. Internal risk management practices such as stringent counterparty selection processes, credit risk managements and collateral management are embedded across the sector.
Residual risks The FSB believe that there are residual risks associated with client indemnifications, namely a lack of accurate data, and the risk of regulatory arbitrage because of the capital treatment for indemnification under the Basel framework in relation to financial entities.
Policy recommendations on agent lender indemnifications **Recommendation 14**: Authorities should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

CONTACTS

Owen Lysak
Senior Associate
London
T: +44 20 7006 2904
E: owen.lysak @
cliffordchance.com

Will Winterton
Senior Associate
London
T: +44 20 7006 4386
E: will.winterton@
cliffordchance.com

INSIGHTS FOR ASSET MANAGERS CALL SERIES

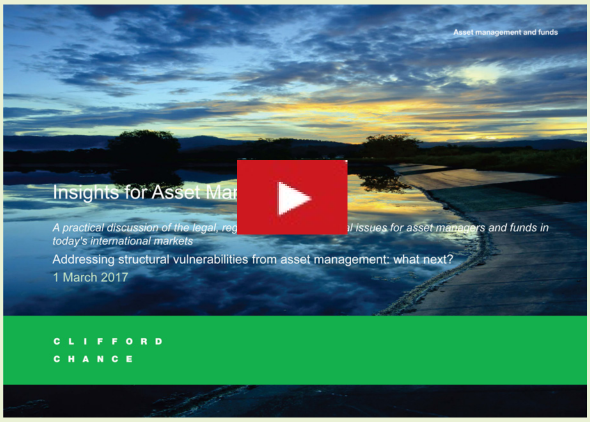
ADDRESSING STRUCTURAL VULNERABILITIES FROM ASSET MANAGEMENT – WHAT NEXT?

The Financial Stability Board has issued final policy recommendations to address the perceived risk to financial stability arising from 'structural vulnerabilities' associated with asset management activities.

On 1 March, a Clifford Chance panel discussed the recommendations and considered what might be in store for asset managers if the recommendations are incorporated into national regulatory regimes.

Please click below to view the online recording of the session. Recordings are only available to registered users of the Financial Markets Toolkit. If you are not yet registered, please email fmtoolkit@cliffordchance.com.

To subcribe to the Insights for Asset Managers call series mailing list, please email lon.insightforassetmanagers@cliffordchance.com



C L I F F O R D

C H A N C E

J201702070050238