Mitigating systemic risks in the asset management sector

Investment funds are regulated in the EU at the product level for funds sold to retail investors (UCITS directive) and at the management company level for funds sold to professional investors (AIFMD). These regulations cover many potential risks (such as leverage, liquidity and operational risks). Assessments of the risks posed by the "shadow banking" sector, however, showed that existing fund regulations do not directly address some systemic risks which may be amplified by factors such as the interconnectedness of funds within the financial system and their exposure to run risks. The risks identified concern in particular Money Market Funds (MMF) and funds using securities financing transactions such as securities lending and repos[1].

MMFs have been the main focus of regulatory projects so far in the EU and the US. Requirements have been proposed notably for mitigating the specific risks posed by Constant NAV MMFs (CNAV), which according to regulators are liable to develop a false sense of risk-free asset and to create potential run risks and first-mover advantages[2].

Securities financing transactions (SFT) i.e. securities lending and repurchase agreements (repo), and rehypothecation, used in particular by investment funds, have also been covered by a recent proposal of the EU Commission to regulate their reporting and transparency, because of their possible role in raising interconnectedness within the financial system. This proposal aims to provide the information necessary to facilitate the monitoring of SFT by supervisors, develop appropriate policy tools and remove the uncertainty about the extent to which financial instruments have been rehypothecated. It introduces requirements to report transactions to a central database and to improve transparency towards investors regarding such transactions[3].

Broader assessments of the systemic nature of asset management activities and entities have been conducted by international (FSB and IOSCO) and US regulators (Office of Financial Research (OFR) of the US Treasury) in the context of the work on the identification of non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs)[4].

These reports attempt to identify the channels whereby investment funds may transmit risks across the financial system. Connections within the financial system created for example by counterparty or credit exposures and the disruptions to financial markets potentially caused by large liquidations of assets by a fund are the main channels pointed out. The OFR report also stresses the growing connections asset managers have among themselves e.g. through funds of funds.

In terms of scope, the FSB consultation clarifies the fact that systemic implications should primarily be assessed at the fund level, where exposures to the financial system are created[5], but asks whether the focus should be extended to families of funds with similar strategies or to asset managers together with the funds they manage[6]. The OFR focuses more on asset management activities as the starting point for assessing vulnerabilities.

The factors that could potentially, make investment funds risky have also been analyzed by the FSB and the US OFR. Size is considered as a factor of risk by the OFR. The OFR questions the potential impact the failure of a major asset management entity may have on the financial system. The FSB proposes to use size as an initial filter (the threshold for investment funds would be set at $ 100 billion in net assets under management)[7] to identify the funds on which to focus further analysis. Further potential risk indicators or filters put forward by these reports include interconnectedness, leverage and complexity, a potential lack of substitutability of certain funds[8], the cross-border dimension and redemption risks which may lead to first mover advantages. The OFR suggests that "reaching for yield" and herding behaviours are additional risk factors that need to be considered. Another issue the OFR report stresses concerns the gaps in the data on asset management activities that impede effective macro-prudential analysis and the oversight of asset management firms and activities: data gaps regarding in particular "separate accounts" managed on behalf of large institutional investors, as well as securities lending and repo transactions.

In the EU work on the recovery and resolution (R&R) of non-banks has focused so far mainly on financial market infrastructures and insurance companies. The EU Parliament Econ Committee recently acknowledged in a report on the recovery and resolution framework for non bank institutions (October 2013) that the size

[1] The FSB identifies in the policy framework for "strengthening oversight and regulation of shadow banking entities" published in August 2013 several types of collective investment vehicles other than MMFs exposed to shadow banking risk factors (e.g. maturity / liquidity transformation and liquidity) and run risks including credit investment funds, ETFs, credit hedge funds and private equity funds. Different policy toolkits are proposed including tools to manage redemption pressures, tools to manage liquidity risks, limits on leverage, restrictions on the maturity of portfolio assets.

[2] A proposal for regulating MMFs was made by the EU Commission in September 2013 with a vote scheduled at the EU Parliament initially in April 2014 (now postponed). It notably includes the introduction of a 3% buffer (cash reserves) for Constant NAV funds (CNAV) which aim to maintain an unchanging value. In parallel, discussions are ongoing in the US regarding proposals made by the SEC to address structural features of MMFs (which differ to a certain extent from EU ones).

[3] Regarding rehypothecation the proposal is made to set minimum conditions to be met by the parties involved, including written agreement and prior consent

[4] The FSB published for consultation in January 2014 assessment methodologies for identifying NBNI G-SIFIs. A process of identification of non-bank SIFIs has also been launched in the US steered by the Financial Stability Oversight Council (FSOC). A report was released for consultation in September 2013 by the US Treasury's Office of Financial Research (OFR) detailing the possible vulnerabilities that the asset management industry could create in the financial system.

[5] Other reasons include the fact that the assets of a fund are separated and distinct from those of the asset manager and that data is available on an individual fund basis

[6] The FSB suggests that the focus of the assessments could be broadened to families of funds following a similar investment strategy, asset managers on a stand-alone entity basis and the asset management entity, given that the investment strategy and the risk management practices are determined at that level.

[7] In the case of hedge funds an alternative threshold is proposed to be set at a value between $ 400 – 600 billion in gross notional exposure.

[8] The FSB report indicates that funds are generally highly substitutable (except some highly specialized ones) and that funds close on a regular basis with negligible or no market impact. There may be some concern however with highly leveraged hedge funds, according to the FSB for which one can imagine a scenario in which an orderly wind-down or transfer of assets to a new manager is more difficult.

and business model of asset managers "do not typically present systemic risk" and that significant safeguards already exist in the EU notably with asset custody rules[9]. The Committee's report states that more work needs to be done on an international basis in this area based upon improved data collection and analysis and calls on the Commission to further assess the systemic risks associated with asset managers[10]. Additional assessments are justified, the report stresses, by growth of "much larger" asset management firms, many of whom are "exploring new business opportunities that could fundamentally change their business models and over time increase their systemic importance"[11]. An effective securities law regime is also pointed out as a way by which many of the issues involved in case of failure of a large cross-border asset manager could be mitigated.

A significant number of commentators, including think tanks, academics and policy makers, as well as industry participants have raised points of contention with the analysis of the possible link between asset management and systemic risk put forward in these regulatory initiatives and assessments that will need to be taken into account in their future steps.

These commentators and asset managers firstly refute that systemic risk resides at the management company level, arguing that asset managers primarily act as agents. Unlike banks they are not direct participants in the financial markets, they do not act as lenders or counterparties and do not invest on their own account. Market and counterparty risks are borne by the investors in the fund and investment decisions are made at fund level. Asset managers, as a company are therefore mainly exposed to operational risks, according to them, explaining why their balance sheets are considerably smaller than those of banks and insurance companies. Where the risks mentioned above may materialize is at the fund level. This requires product level regulations, which may be completed by rules covering specific activities or practices (e.g. securities lending, repo, collateral...) and addressing issues such as legal ownership of assets or investor protection.

In addition, they emphasize that risks are not correlated with the size of the assets under management, since larger asset managers tend to manage a more diverse range of funds (as their client base tends to be broad with different client segments seeking different investment solutions) and to have a more developed risk management function.

Secondly, industry players stress that many of the risks mentioned particularly in the OFR report, are already addressed in the EU by existing fund and derivative frameworks: UCITS and the AIFMD which together cover all funds distributed in the EU (including in particular restrictions to the assets in which funds may invest, leverage limitations, diversification rules, liquidity requirements) and EMIR covering derivatives exposures, due to be completed by legislative proposals regarding MMFs and the transparency of securities financing transactions.

Moreover, some additional issues identified during the financial crisis are being addressed by EU regulators. This is the case for example of Exchange Traded Funds (ETFs) for which specific guidelines were proposed by ESMA in 2012[12]. ETFs are indeed usually structured as UCITS in the EU, but raise interconnectedness issues with the banking sector which are not directly covered by the UCITS directive. The difficulty of tracking asset ownership in the case of re-use and the interconnectedness such practices create are another concern of regulators for which the transparency rules recently proposed for SFT could be an answer[13].

Suggestions have also been made that the consistency of regulatory reporting across jurisdictions could be improved in the EU (e.g. reporting on private / alternative fund, swap data, securities financing).

Finally, these commentators and industry players generally believe that specific plans for recovery and resolution are unnecessary in the case of asset managers. As assets are held in trust by a custodian (depository) and segregated (unlike a bank where the depositor has a contractual claim against the bank), investors are assured to get their assets back in case of failure of the asset manager. These rules will be further tightened in the EU with the implementation of the UCITS V and AIFM directives. If an asset manager goes bankrupt the management of the fund where assets are invested can be moved to another management company demonstrating substitutability at the entity level, industry players claim.

[9] In particular client assets are segregated and held with custodians and can therefore be transferred to another asset manager

[10] The EU Commission is asked to take into account the scope of the activity of asset managers in this assessment and to use a comprehensive set of indicators such as size, business model, geographical scope, risk profile, creditworthiness and whether or not they trade on their own account and are subject to requirements regarding the segregation of the assets of their clients.

[11] e.g. funds engaging more in the financing of EU enterprises and long term projects which may result in increased credit risk transfer to the asset management sector and counterparty risk – Source report of the Econ Commission of the EU Parliament on the recovery and resolution of non-banks

[12] ESMA guidelines on ETFs and other UCITS (July 2012) include measures for improving the safety of ETFs such as: clear labeling of products, disclosure of holdings and financial exposures, standards for diversifying counterparties and quality of collateral, disclosure of fees and costs. These guidelines also require UCITS engaging in efficient portfolio management techniques (EPM) such as securities lending, repo to inform investors clearly about these activities and the related risks. All revenues generated by these activities net of operating costs should be returned to the UCITS. When a UCITS enters into securities lending arrangements it should be able to recall at any time securities lent or to terminate the agreement. UCITS receiving collateral to mitigate counterparty risk from OTC derivatives transactions or EPM techniques should ensure that it complies with qualitative criteria and diversification rules.

[13] There is also a project to address this issue in the context of a securities law legislation covering a broader scope of instruments.