NON-BANK FINANCE RISKS

1. The current regulatory framework and on-going work at the international and EU levels

1.1. On-going regulatory work at the international and EU levels

An official noted that the FSB released in January 2017 policy recommendations to address structural vulnerabilities from asset management activities, complementing the IOSCO recommendations on money market funds (MMFs), which have now been rolled out in the main jurisdictions. The FSB observed at the time that asset management is not an area that is unregulated, but that two particular areas – liquidity risk management and leverage within funds - could be a matter for concern. IOSCO was requested to provide more detail for the implementation of the measures proposed by the FSB and subsequently published additional recommendations in 2018 in relation to liquidity risk management. Work on leverage is still underway and due to be finalised by the end of 2019.

With this process there has been a significant increase in awareness and understanding around potential systemic risks both on the industry and policy-maker sides and further guidance has also been provided domestically, particularly regarding liquidity risk. A number of industry participants have stepped up their internal risk management processes. This dialogue has been very healthy, and the ESRB has also made five recommendations to further strengthen the European framework. These include, among others, the improvement of data collection, as well as the availability of liquidity tools to investment managers.

Another official mentioned that IOSCO recommendations to improve liquidity management practices focus more particularly on open-ended investment funds. In the EU, the ESRB recommendations issued in 2018 to address systemic risks related to liquidity mismatches and the use of leverage in investment funds are now in the hands of ESMA and the European Commission.

An industry representative had one concern regarding the current actions of IOSCO on leverage. There is a legitimate objective of IOSCO to facilitate the calculation and monitoring of leverage at a global level. However, the EU is the most advanced region in terms of calculating leverage, due to UCITS and AIFMD requirements and it is important that IOSCO recommendations should be consistent with the calculation methods for leverage currently used in AIFMD reporting. Otherwise, that would generate additional burden without any added value.

In addition, regarding future regulatory actions, the EU should not go beyond what is already being defined at the global level, the industry speaker felt. The FSB has started to assess the measures adopted post-crisis, and the EU should avoid launching any new initiatives at least in terms of Level 1 legislation before this assessment is completed. Finally, updating the guidelines issued in 2010 by CESR, the predecessor of ESMA, on risk measurement in funds would be useful, since there have been changes in the market since then such as the further development of credit and exotic derivatives.

1.2. Framework and toolkits implemented in the EU and impacts in terms of risk mitigation

An industry representative emphasized that current EU fund regulations work well in terms of risk mitigation, as demonstrated by assessments published by ESMA in its latest quarterly report on 'Trends, Risks and Vulnerabilities' (February 2019). ESMA has done a specific assessment at EU-level of alternative investment funds (AIFs) and found no sign of significant liquidity mismatches. On leverage, the maximum gross leverage is around 1.3, or 130%, for the whole scope of AIFs, excluding hedge funds, bearing in mind that this is a gross and not a net (potentially lower) measure of leverage. Additionally, the ESMA statistics show that the maximum gross leverage is stable since 2016. Regarding borrowing, AIFs ultimately have a borrowing that is less than 10% of the NAV, which is interesting as UCITS are capped at 10%. In terms of evolution of liquidity and leverage risks, as it stands today the data shows they are stable in Europe and still relatively low. Additionally, there has been no failure of funds in Europe or no systemic issues related to funds in the recent years, despite market events such as the euro crisis and the Brexit referendum.

Going forward it is expected that the on-going monitoring of the activities of funds from a systemic risk perspective will improve, the industry speaker considered, since this is a requirement of AIFMD. More generally the mitigation of systemic risk is a key objective of AIFMD and there is a requirement to ensure cooperation on this between ESMA, the ESRB and the national competent authorities (NCAs).

A speaker explained that in France, legislative changes have been made to ensure that a comprehensive fund framework is in place. At a regulatory level, different liquidity management tools have been introduced including notice periods and swing pricing, which complement the ability already contained in EU legislation to suspend redemptions. The law was also changed to introduce temporary suspension of redemptions, in the form of redemption gates. Changes in the French law also took into account the impact of gates at the underlying fund level for unit linked products sold by insurers.

The French securities regulator, the AMF, has also improved the monitoring of risks. A first study was published on the French AIF market aiming to improve the understanding of market-wide trends. The AIF market in France includes around 5000 non-UCITS funds representing €700 billion assets under management. The 'others' category accounts for €385 billion comprising many very basic traditional equity, bond and diversified funds that are largely "UCITS like" funds that have opted not to be authorised as UCITS, generally because they do not intend to use the EU passporting system. The size of the highly leveraged hedge fund segment is very limited (0.6% of AIFs). The French market has exposures mainly in euros and the figures are quite consistent with those put out by ESMA.

On liquidity, the AMF found that the percentage of liquidity of AIF funds managed by French asset managers is consistent with the strategy defined by the managers. According to the AIFMD reporting, managers expect that for open ended funds, a large proportion of assets can generally be liquidated within one day. For those funds, daily liquidity is reported at 50%, and reaches 80% for assets that can be liquidated within a week. With private equity funds, which generally are closed-ended, there is only 5% that can be liquidated within a day. For real estate funds, it is 15%. Secondly, the liquidity declared largely covers the liquidity that it is estimated would need to be given back to investors. This means that in normal times managers should be able to meet redemptions, although of course further monitoring is needed.

On leverage, the data is also consistent with the fund strategies. Real estate funds report 150-200% leverage ratios. Money market funds and equity funds report low leverage ratios around 100-120%. For the 'other' AIF category, leverage appears at 130-150%. Supervisory actions are taken in connection with the manager on a case-by-case basis, when erratic or inconsistent leverage is identified.

Following an observation by an official that France has more liquidity management tools available than most other EU member states, as shown by an ESRB report, an industry representative suggested that it would be beneficial if other EU member states would implement these tools also.

2. Emerging risks in the non-bank finance sector and issues raised by leveraged loan funds

An industry representative stressed that when scanning for emerging risks it is important to distinguish between systemic and market risks. Systemic risk relates to severe market disruptions that have serious negative consequences for the real economy. By contrast, market risk is present in markets at all times and reflects normal price adjustments. Much of the conversation about emerging risks conflates the two. In addition, it is important to bear in mind that the vast majority of funds are vanilla funds without leverage. In the case of the speaker's institution – a major asset manager - alternative funds, including hedge funds, private equity, real estate, infrastructure funds etc. do not reach 2% of the total.

In terms of emerging risks, the only one which comes to mind is leveraged loan or bank loan funds. It is a small asset class, of around $1 trillion in the US, but it is growing fast. The majority by far of these loans are in the US. This is an asset class with a longer settlement period, typically two weeks or longer, rather than a couple of days. Only some of these funds have liquidity risk. 60% of the funds are CLOs or closed-ended funds that have no liquidity risk. Another 20% are separate account funds dedicated to a given institutional client: these have no liquidity risk as the investor has control over the assets and the ability to redeem as desired. Around 20% are open-ended funds or ETFs, which do have some liquidity risk. A leveraged loan open-ended fund will need a more robust liquidity management than a vanilla bond fund to manage this increased risk, whereas ETFs with in-kind redemptions mitigate such risks. Another aspect is that the EU business and regulatory models do not support the establishment of open-ended AIFs with portfolios of bank loans, preferring closed-ended structures, unlike the US where both exist. Concerning ETFs, the list of firms that offer them even in the USA is fairly small.

When assessing the risks posed by these funds in the US, the lesson is the importance of having robust liquidity management and managing appropriately the percentage of truly illiquid assets they contain. A solution could also be for regulators to reduce the settlement period through regulation, although the industry representative noted that during the market stress at the end of last year and start of this year, industry participants worked together to reduce the settlement period from around 15 days to 8 days on average.

An official emphasized that the growth of corporate leverage financed by non-banks is a relatively new issue at the international level and that there are hardly any tools to address the related issues. The existing policy tools are predominantly administered through banks, including borrower-based tools, but there are no prudential tools to address specifically risk related to corporate debt funding by non-bank lenders. Some EU countries have expanded the set of borrower-based tools and impose loan-to-value ratios (LTVs)[1] on households to all providers of mortgage credit. However, there is nothing like that for corporate borrowing. In the US there is a borrower-based tool, the intra-agency guidance on leveraged lending issued by US regulators, which describes expectations for the sound risk management of leveraged lending activities. However, this only applies to institutions supervised by the Fed.

Another official noted that an evaluation has begun in the EU of the need for borrower-based measures at a corporate level. There may be a situation where corporates are insufficiently capitalised, and are living thinly on the basis of leverage, either from banks or issuance of securities. The problem is that if the economy is going down, these companies will not have a strong enough capital base and this may have disastrous consequences.

3. Respective roles of micro- and macroprudential polices in tackling systemic risks

3.1. The possible need for enhancing macroprudential approaches in the non-bank finance sector

An official noted that growth in non-bank finance has been observed, which is very welcome. Complementing a traditionally very bank-based European system with non-bank finance has proven helpful in various countries recently. At the same time, there has been a need to pursue very accommodative monetary policies by Central Banks, despite the risks this creates, underscoring the need to expand the toolkit to counteract a build-up of vulnerabilities in this context. Progress has been made in the mitigation of systemic risks but most countries do not have a developed set of tools in the macroprudential area. There is variation, but the toolkit in most countries in this area is far from complete according to the annual survey performed by the IMF.

Another official did not see an opposition between micro and macroprudential policies. It is important to define an approach where these tools can interact together. A third official agreed that progress has been made in the assessment of risks associated with non-bank finance and views have converged in the last few years. Initially there was concern that risk might be shifting out of the banking sector into less regulated areas without the tools or understanding to properly address these risks but these issues have since been clarified to a great extent.

3.2. Combining micro and macro-prudential approaches in the asset management sector

In the asset management sector the responsibility is first and foremost with the asset manager, a speaker recalled. They know the circumstances in which risks appear, have the information, and therefore are the best placed to act in case of stress. The problem is if the stress is market-wide. There are then questions around what tools are needed, the roles of various stakeholders in the market, and the dialogue needed between micro and macroprudential authorities. The thinking on this is still underway and progress should be possible thanks to the better understanding of these issues that has developed in the market and the greater availability of data and tools. Macroprudential authorities are assessing the risks associated with the development of non-bank financing and the tools available to address them. This is the case in France in the HCSF[2]. Stress tests have been conducted at the national level in France to assess the impacts on the non-bank sector of potential shocks e.g. a commercial real estate shock, and issues potentially raised by interconnections with the banking and insurance sectors.

It was argued that much can be done at the so-called microprudential level, which can meet the goal of what macroprudential is supposed to achieve. The AMF for example has ensured that managers are equipped with the necessary tools for the first level of defence in terms of liquidity management. A number of tools are also available at the

authority level. Soft interventions are possible and guidance can be issued. Stronger actions can also be taken, such as gating or the suspension of redemptions for a single fund or a group of funds. Also, the EU fund framework allows leverage to be capped, which can be done where active monitoring shows a build-up of leverage in a given country or market segment. This is one of the ESRB recommendations, and work is ongoing on implementation. Care is needed however about potential market effects of intervention in a volatile and unstable market, which might have unintended consequences.

An industry representative stated that potential risks in non-bank finance are best managed through market-wide data-gathering and monitoring of trends in activities and products, combined with a targeted supervisory focus where risks have been identified. Whilst market surveillance might be called macroprudential, any actual intervention should be micro-prudential - i.e. at the fund level - to be effective. It also needs to be proportionate, given the diversity of funds, and to preserve investor confidence and a continued investment in funds, given their importance for the development of capital markets in the EU. Ensuring that supervisors and fund boards have available the full range of ex-ante and ex-post tools will be most effective in addressing systemic risks.

The IOSCO work on leverage is a perfect expression of the combination of micro and macroprudential approaches, as stage one of the recommended process is a market-wide assessment of leverage levels across all funds with different criteria, followed in stage two by a deep-dive into funds that appear to have high leverage. Leverage, though, is not a perfect expression of risk, and hence stage two should look at VAR, for example stress testing the real mark-to-market potential losses, and having a framework for counterparty risks, or looking at how much liquid assets individual funds have to meet margin calls. That detailed information would help securities regulators to focus on particular fund issues and have fruitful conversations with fund boards about for example, whether the fund board should reduce leverage or suspend redemptions. This illustrates that market-wide data and then focused action is what is required.

One example of a potential macroprudential tool that would be very harmful would be mandatory cash buffers, kept high in good times and drawn down in bad times. This could negatively impact the long-term investment performance for the end investor. Currently, investment fund investors are a mix of retail, high net worth and smaller institutional investors. If the investment performance is reduced by a high mandatory cash buffer, the more sophisticated investors can consider alternative vehicles, but retail investors have fewer alternatives and if they stay invested, receive lower investment returns, which may impact retirement revenue and, ultimately, the fiscal situation in a number of States.

3.3. Data gap issues

An official noted that despite a great deal of progress, significant data gaps remain overall. On leverage, UCITS have a leverage cap, but there is some concern with synthetic leverage on which there is not much data in most jurisdictions. Another official agreed that there are still some gaps, but many improvements have been made with the recent reforms. Supervisors now need to pull all the data together and make it meaningful.

An industry representative emphasized that supervisors are provided with vast amounts of data; both the standard data submitted periodically for each jurisdiction, and also additional data corresponding to occasional requests from supervisors. For example, some countries asked for enhanced liquidity reporting, which shows that they are looking at not just the market level, but fund by fund. With Brexit, daily information on bond funds is also being provided in certain countries. The issue is improving the quality of the data and the processes for providing it. Whilst much has been done, in the future hopefully there will be some form of automated standardised reporting. Asset managers also need better data. Having transparency through omnibus accounts has been proposed, not for individual clients of a bank or a distributor, but to have visibility of the composition of different client types. Each client type behaves slightly differently, and that would help asset managers to make better decisions.

An official noted enormous progress on data. Requests for data on specific areas or where there are issues can now be answered by the ESRB in a few hours. In terms of managing big data, they are completely ahead of the curve.

An industry representative added that progress is also visible on the derivatives side, but at a fund level it is more challenging due to the number of different providers of different sets of data. A qualitative assessment is required to understand the data, as the same data can be used in different ways, with reporting through the securities regulator. There will never be instantaneous fund-level reporting.

An industry representative noted that in the context of liquidity stress testing, there is a need for information from intermediaries on the investors who invest in funds. If funds are not self-distributed, then it is up to the intermediaries to provide the information and asset managers cannot be held responsible if appropriate data is not provided. Another point is that the easiest way of addressing data gaps is to give the supervisors and regulators the raw data at a portfolio level, in order to avoid duplicate calculations, since investment managers already perform their own calculations that may be different from what supervisors want. In some countries, inventories of funds are already being given.

1. Loan-to-value (LTV) ratio is an assessment of lending risk that financial institutions and other lenders examine before approving a mortgage. Typically, assessments with high LTV ratios are higher risk and, therefore, if the mortgage is approved, the loan costs the borrower more. Additionally, a loan with a high LTV ratio may require the borrower to purchase mortgage insurance to offset the risk to the lender.

2. The "Haut Conseil de Stabilité Financière" (HCSF) is the macroprudential authority in France. It is chaired by the Minister of Finance, and brings together the Governor of the Banque de France, the chairman of the ACPR, the prudential regulator, the AMF, the authority of accounting standards and three highly-qualified external economists.