Non-bank finance

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Developing a macroprudential framework for the non-bank sector

Since the global financial crisis, non-bank finance has become an increasingly important source of funding for the real economy. Total net finance raised by euro area non-financial corporations fell sharply over the past decade due to a reduction in bank lending. The non-bank financial sector has helped to fill this funding gap by providing both debt funding through the issuance of debt securities and equity funding through the issuance of shares. As the Capital Markets Union (CMU) progresses, the role of non-bank finance is expected to increase further.

From a financial stability perspective, this may be seen as a welcome diversification of funding sources as risks are transferred from the banking sector towards a broader set of investors. At the same time – unless the regulatory framework keeps pace with this development – it could lead to excessive credit growth, increasing private sector indebtedness, deterioration in credit quality, as well as risks and vulnerabilities building in the non-bank financial sector.

> *"Tools should deal with liquidity risk and those risks associated with leverage."*
>
> \- FRANCESCO MAZZAFERRO

The asset management industry is an important part of the non-bank financial system. Over the past decade, assets held in EU investment funds increased from around EUR 6 trillion to more than EUR 15 trillion, with growth spread across equity, bond and mixed funds. Vulnerabilities may arise from funds' engagement in risk transformation activities, such as maturity or liquidity transformation, while the use of excessive leverage can also be a source of risk.

Individual fund managers already have tools available that help them to manage some of the vulnerabilities in the asset management sector. For example, liquidity management tools such as swing pricing or fund suspensions can help fund

>>> managers to deal with the impact of large redemption requests during market stress. The use of such tools can help stabilise markets as first-mover advantages and the risk of fire sales are reduced. As previously noted in the European Systemic Risk Board's (ESRB) Recommendation on liquidity and leverage in investment funds, it is important for fund managers to be given a broad range of tools to better manage such risks.

Policymakers also need a comprehensive macroprudential toolkit to act in case existing risks migrate outside the banking sector or new risks emerge. This means widening the toolkit so that policymakers are able to effectively confront risks emerging beyond the banking sector. Additional tools should deal with liquidity risk and those risks associated with leverage among some types of investment funds.

International coordination is important when trying to address risks in the non-bank financial sector and the consultation on leverage published by the International Organization of Securities Commissions (IOSCO) is an important step. It includes the relevant concepts and building blocks for developing leverage metrics which would need to be applied consistently across jurisdictions. A globally consistent core set of measures would facilitate effective financial stability monitoring and would support supervisors' decision-making.

In order to design effective macroprudential tools, a better understanding of how risks may spread through the financial system is also crucial. Individual fund managers already conduct stress tests to help ensure their portfolios can withstand significant redemption shocks. However, the sophistication of these stress tests can vary and may focus on fund-specific risks rather than systemic risks. Macroprudential authorities therefore continue to work on system wide stress simulations. This is a complex undertaking due to the wide range of entities included in the non-bank sector, the range of market activities they engage in and their linkages to the banking sector and the real economy.

The continued development of such simulations should help to improve regulators' understanding of how shocks are transmitted through the system and inform the design of future macroprudential tools. To contribute to these efforts, regulation introduced since the global financial crisis such as the European Market Infrastructure Regulation (EMIR) and the Alternative Investment Fund Managers Directive (AIFMD) provide new data sources and are already generating new insights. ●

Natasha Cazenave

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Strengthening resilience in asset management: are we there yet?

Considerable effort has been made since the financial crisis to strengthen the financial system, particularly in the non-bank sector and, specifically, in asset management. As we head towards CMU 2.0, a stock-take is warranted. Two points stand out.

Firstly, the holistic monitoring of financial stability risks has improved significantly. Systemic risk objectives are now full part of market authorities' national (AMF in France), regional (ESMA in Europe) and international (IOSCO) statutory mandates and reach across financial sectors (e.g. at the French High Council for Financial Stability (HCSF), ESRB or FSB). Better understanding is being drawn from the analysis of EU regulatory data collection exercises, e.g. AIFMD and EMIR. Accordingly, risk assessments should not focus on isolated funds only but also on global market activities involving potential liquidity risk or leverage.

Funds may channel such risks but may also re-allocate and mitigate them. Thus, assessing market imbalances requires both granular views of individual exposures and market-wide dynamics. Merit can also be found in mapping interconnections (Benhami et al. (2018)) or stress testing market segments >>>

>>> that could be at risk (HCSF (2018) on commercial real estate). Besides, risk-based policies should avoid unwarranted effects – e.g. impact of pro-cyclicality (say excessive reliance on cash buffers), moral hazard induced by the anticipation of authorities' interventions, or failure to account for stabilizing/contrarian forces correcting market prices.

Secondly, policy reforms to enhance asset management resilience are being completed. As part of post-crisis G20 reforms, new regulations have firstly targeted MMFs and alternative investment funds' (AIFs). The EU framework is prominent in its ability to manage investment fund liquidity and leverage risks. UCITS' leverage is capped, that of AIFs expressly managed (e.g. by AIFMD article 25).

"Recognising the macro-prudential virtues of micro-prudential tools."

\- NATASHA CAZENAVE

As for liquidity, in addition to MMF and AIFMD's comprehensive rules, France's open-ended investment fund framework generalizes the availability of liquidity management tools (LMTs) such as managers' powers to suspend redemptions or implement gates and notice periods. Stress testing requirements are also common on all fund types.

Further guidance is still needed (e.g., IOSCO's recommendation on leverage measures and ESMA's work on UCITS' stress tests) and additional data welcome (e.g. MMFR, SFTR). However, awareness has significantly increased and it is now time to ensure proper implementation and risk assessment. Hence, looking forward, progress in managing financial stability risks in the asset management sector should rest primarily on the recognition of the macro-prudential virtues of micro-prudential tools. ●

Stéphane Janin

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Systemic risks and investment funds: where do we stand today in Europe?

Since the last global financial crisis, regulators have been concerned about the potential systemic risks involved in funds.

In 2009, the G20 decided to enhance the regulation of hedge funds. Therefore, Commissioner McCreevy launched what was called the Hedge Fund Directive which became the AIFMD.

The AIFMD was explicitly aimed at tackling the potential systemic risks involved in hedge fund management. Such an official objective of AIFMD was finally extended by European institutions to the management of all non-UCITS funds to reduce further systemic risk in the EU. Today, at global level, the EU legislation is the widest and most advanced for systemic risks involved in funds.

Indeed, since the adoption of AIFMD, in spite of many market turmoils – such as the Euro crisis and the Brexit referendum – the various safeties introduced in AIFMD allowed for avoiding any occurrence of systemic failure coming from EU-based funds.

What can be expected from the framework proposed by IOSCO for assessing leverage in investment funds?

IOSCO is currently trying to find the best way to assess at worldwide level the evolution of leverage in funds. IOSCO is aware this is a very challenging task, and wishes to avoid aggregating data which might not be meaningful if they relate to funds having various strategies and profiles.

We are highly concerned by two risks which might come from IOSCO: first, having to add any new leverage calculation method to the various ones we are already complying with through AIFMD and UCITS, which made their proof and which are sufficient to assess systemic risk; second, having to add any new leverage reportings to regulators to the ones we are also already complying with. Alternatively, a solution might be to communicate directly to supervisors the portfolios of funds themselves – as we already do for France and Luxembourg.

Are there differences or additional elements compared to existing practices in the EU?

"The EU legislation is the most advanced for systemic risks involved in funds."

\- STÉPHANE JANIN

IOSCO's proposals mention the methods applicable in the EU, among others. Let's see which methods will finally be kept by IOSCO. While the EU is the most advanced region for fund leverage calculation and monitoring, it would be a pity if European securities regulators were not able to make their voice heard.

Is leverage a major issue for EU-domiciled funds?

ESMA is monitoring the evolution of leverage in EU-domiciled funds, and publicly reports on it in its Quarterly Risk Dashboard.

Furthermore, national regulators receive from fund managers comprehensive reports required by AIFMD, and in addition some supervisors ask for receiving the fund portfolios themselves to make their own calculations.

Based on such information, facts did not show that currently leverage is a major issue for EU-domiciled funds – while of course it must be kept monitored. ●

Alexandra Richers

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Asset managers play an active role and take responsibility

The further growing significance of the asset management sector leads also to a higher responsibility for asset managers. Their active role within the economy as well as in society for retail and institutional investors becomes evident.

Being aware of this enormous responsibility, asset managers are keen on identifying and limiting risks. Their reputation - their most important asset - is at stake.

Thus, asset managers support early identification of potential risks and structural risk vulnerabilities. The implementation of sound investment processes is key.
The most discussed potential risks are leverage, liquidity risk and herding.

However, it is essential to highlight that the European legislator has already adopted very strict legal requirements in the asset management sector, in particular the UCITS Directive and the AIFMD, where strong legal requirements apply for asset managers with a focus on protection of the interests of investors in Europe. Strict standards are also set in the field of liquidity management and leverage limits as potential structural vulnerabilities of investment funds.

Additionally, many macro-prudential instruments that take into account the investor's profile and behaviour, explicitly considering prospective redemption rates as well as the liquidity profile of fund assets, are in place.

The existing EU fund framework is appropriate to ensure the continued success in the asset mangement sector and is supported by significant supervisory experience and expertise that fosters certainty for both asset managers and investors.

In terms of current efforts of supervisors to better assess the impact of leverage measures in funds on financial market stability at the macro level, we support the two-stage approach proposed by IOSCO, whereby only those funds which may pose risks to financial stability at the first stage due to their leverage use are subject to more detailed risk-based assessments.

This approach should build upon the comprehensive and advanced EU regulatory framework AIFMD and UCITS Directives. The main leverage metrics (the gross and commitment methods) should serve as a point of reference for developing a matrix of consistent measures at international level.

"The principles of proportionality and subsidiarity need to be maintained."

- ALEXANDRA RICHERS

It should also be examined to what extent smaller funds or funds with low leverage can be exempted from extensive reporting requirements. In general, we call for uniform reporting based on existing reports from the AIFM Directive, without adding overlapping reporting layers. A threatening jungle of different data standards and formats presents a huge burden for asset managers. The principles of proportionality and subsidiarity need to be maintained.

Asset managers are aware of their huge reponsibility for institutional and retail investors. Also, the supervisor should hold the administrative burden, that leads automatically to increasing costs, at an adequate level. ●

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