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ASSET MANAGEMENT AND INVESTORS COUNCIL

ICMA AMIC response – Consultative Document (2nd): Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Introductory Comments

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus and both buy-side and sell-side representation. AMIC welcomes the opportunity to respond to the second FSB/IOSCO consultation on the assessment methodologies for identifying non-bank non-insurer Global Systematically Important Financial Institutions ('NBNI G-SIFIs')

We appreciate the progress made since the first consultation and commend the FSB/IOSCO for their determination to incorporate the experience and views of the industry in the assessment methodology. We strongly believe that the final framework will greatly benefit from a close engagement with market practitioners and from a thorough understanding of how the asset management industry and financial markets work. We are committed to supporting the competent authorities in their endeavour to enhance existing regulatory rules and supervisory practices – both of which have already been significantly strengthened and expanded in the NBNI space in recent years, especially for investment funds (see, for example, the AIFMD).

To this end we are concerned about the poor quality of the data and other factual evidence underpinning the assessment methodology as currently drafted. We strongly suggest to rectify this and encourage the FSB and IOSCO to work with the industry to generate a more detailed and current body of empirical evidence to explain which potential risks are posed by NBNI's to financial stability and to lend support to the authorities' desire to designate a group of globally important SIFIs. In this context we would welcome a consideration of the broader market ecosystem and in particular a greater focus on the activities that cause risk rather than the entities that cause risk. There should also be greater consideration on recently introduced or revised legislation and the regulatory tools which are now available to manage and contain risk, such as the UCITS and AIFMD legislation in the EU.

Although we support the proposal by the FSB and IOSCO to exclude from the scope of NBNI entities those entities which are already included in G-SIB or G-SII designation, we maintain that more generally the designation of asset management companies in addition to individual investment funds as a distinct NBNI category is obsolete as it creates unnecessary redundancy and duplication. If an asset management company suffers financial stress or defaults, its (separately managed) investment funds should, by definition, remain unaffected. Any outflows due to possible business continuity concerns by clients should be manageable as the funds' operations are most likely transferred to a new entity or an acquirer on a timely basis. Furthermore, it is extremely unlikely that an asset management company itself suffers financial distress or defaults given the nature of their business model and very few, if any, would be large enough to undertake proprietary activities of sufficient scale to be of systemic importance.

Furthermore, we feel that the consultation's assumption of three distinct transmission channels for systemic risk does not apply to investment funds. We cannot imagine a scenario under which the 'critical function or services/substitutability channel' would ever be triggered by the distress or wind-down of an investment fund and potentially impair the financial system's stability. With respect to the asset liquidation/market channel we find it hard to see how the liquidation of an investment fund's assets could pose a risk to financial stability unless there is an underlying problem with the affected assets or asset class themselves in which case the issue at hand would not be the management or regulation of the respective fund(s).

We also continue to question the need and relevance of cross-jurisdictional activities as a factor determining the systemic risk of NBNI G-SIFIs. Cross-jurisdictional activities should be considered a mitigating factor for systemic risk purposes. Also, cross-jurisdictional activities are too commonplace in the industry to be a useful differentiator and even purely domestic operators can become systemically important if other criteria are met.

Last but not least, FSB/IOSCO's second consultation has not answered a significant omission from the first consultation: details about the consequences of being designated an NBNI G-SIFI. This is cause for concern among market participants due to the significant legal uncertainty for the future.

Q2-1. In your view, is the exclusion of (i) public financial institutions, (ii) sovereign wealth funds or (iii) pension funds from the definition of NBNI financial entities appropriate? If so, please explain the rationale.

AMIC is concerned that the *a priori* exclusion of public financial institutions, sovereign wealth funds and pension funds could lead to an insufficient consideration of where decisions are made with regard to asset allocation. The recent IMF financial stability chapter on the risk of vanilla mutual funds overestimates the decision making ability of delegated portfolio managers as compared to the rest of market participants. These entities are part of a broader market ecosystem which necessitates the focus to be at the product and activity level if the goal is to address risks that may pose financial stability concerns. The exclusion of certain relevant entities from the scope of the consultation exacerbates the problems arising from the imposition of a framework originally designed for the banking industry on the investment fund industry which is acting often much more in an agent role (on behalf of its clients) rather than as a principal (as banks do).

However, we agree that for the purposes of systemic risk designation public financial institutions, sovereign wealth funds and pension funds do exhibit some differences to traditional or private investment funds due to either public guarantees or the "sticky" nature of their liabilities which we have described further in our response to Question 2-2 below.

Q2-2. Please explain any potential systemic risks associated with failure or financial distress of (i) public financial institutions, (ii) sovereign wealth funds or (iii) pension funds that, in your view, warrant their inclusion in the definition of NBNI financial entities so that NBNI G-SIFI methodologies would apply.

Any liabilities of public financial institutions and sovereign wealth funds are typically covered by national taxpayers of the respective countries. It is therefore hard to imagine them suffering financial distress causing systemic damage through either transmission channel unless the country in question is unable or unwilling to support their public sector institutions or sovereign wealth funds. Pension funds have "sticky" liabilities (i.e. beneficiaries cannot withdraw their money and move to another provider), which limit the systemic damage a failure or even default of a pension funds could have.

Q2-3. Please explain any other NBNI financial entity types that should be excluded from the definition of NBNI financial entities so that NBNI G-SIFI methodologies would not apply and their rationale.

As we stated in our response to the first consultation, we do not think that asset management companies should be included in the definition of NBNI financial entities in the absence of a compelling rationale for their separate and distinct inclusion alongside investment funds (please see our response to question 7-1 below).

Q6-1 Please explain any potential systemic risks associated with the financial distress or disorderly liquidation of an investment fund at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel? Are there elements that have not been adequately captured? Please explain for each of the relevant channels separately.

We believe that the exposures/counterparty channel properly and comprehensively captures any potential systemic risks posed by the financial distress or disorderly liquidation of an investment fund at global level.

By comparison, the asset liquidation/market channel is of much lesser, if any, relevance as a transmission mechanism for global systemic risks arising from the failure of an investment fund, given the weakness of respective empirical evidence (see also our responses to Questions 6-2 and 6-3). Furthermore, there appears no empirical evidence at all for the critical function/substitutability channel to be of any relevance as a distinct transmission channel for global systemic risks.

On the contrary, as noted by an EDHEC study on the 2006 implosion of the Amaranth fund, a key player at the time in natural gas markets, other counterparties stepped in quickly to assume Amaranth's positions which stabilised the natural gas markets. There is no reason to assume that future failures of investment funds with strong positions in specific asset classes would not result in the same reaction, i.e. other investment funds quickly filling the gap left by the failing fund, provided the asset class in question is considered as viable and attractive. FSB and IOSCO should provide more empirical evidence to justify the relevance of this risk distribution channel if it is to be kept as a distinct category.

Q6-2. For the asset liquidation/market channel, to what extent is the potential for risk transmission heightened with respect to an individual fund that is a dominant player (e.g. its asset holdings or trading activities are significant relative to the market segment) in less liquid markets?

As stated above we are unconvinced that the asset liquidation/market channel represents a valid risk transmission mechanism in its own right. Firstly, most investment funds have a number of measures available to them to cope with unusually high outflows (i.e. investors redemptions), such as swing pricing or liquidity fees or gates. In this context we note our concern that the IMF in its recent financial stability chapter on the asset management industry and financial stability has taken insufficient account of an investment fund's ability to control and/or accommodate (fund-specific, i.e. non-market related) increases in outflows or other factors requiring involuntary asset liquidations. We believe that FSB and IOSCO has unfairly disregarded the tools already available in this regard to investment funds.

However, even if an investment fund is forced to reduce its market exposure and/or liquidate its assets, there should be no shortage of other investors emerging as willing buyers even if the liquidating fund was a dominant player, provided the assets and asset classes in question are considered as intrinsically valuable and attractively or fairly priced. If this does not apply there would, by definition, be very little risk of a systemic contagion as the 'failure' of the fund would most likely be or be seen as an isolated event caused by the deteriorating value of its main assets. From a global risk perspective this would be a non-event in a world with many different financial asset classes whose values are fluctuating regularly and where investment funds associated with specific asset classes are emerging, growing, shrinking and closing in anticipation and response of such relative value trends as a matter of course.

If, as stated in the above question, a market is 'less liquid', the respective assets will be subject to an normal illiquidity price discount (i.e. wider bid-offer spreads), which will naturally dampen the (price and sentiment) reaction to, and systemic risk implications of, a failure of an investment fund specialised on this asset class, as investors in the fund would have a greater tolerance for risk to materialise. FSB and IOSCO should trust investors to understand the nature of the assets they and their investment funds invest in.

By definition, the 'liquidation' of assets in a 'less liquid' market is almost a contradiction in terms, even under normal trading conditions. This applies especially if the 'liquidator' is a dominant holder of these assets and therefore represents most of the market. Although we find such a scenario difficult to envisage (we would like more evidence from FSB and IOSCO of dominant investment funds in specific asset classes), if such a scenario was to materialise, investors and markets will most likely understand the specifics and limited information value of any related price action and correctly attribute any sharp falls in the 'price' of these assets to their illiquid nature and the absence of sufficiently large off-takers, which should make the risk of other markets suffering similar price falls 'in sympathy' extremely small.

In our review of publicly available data, the proposed materiality thresholds do not capture any funds that would exhibit these characteristics. Even in the event that an individual fund constituted a dominant player, we do not believe this would support the need for a SIFI designation given that such a fund would still be inherently substitutable with an asset owner managing their assets directly.

Q6-3. Under what conditions might the asset liquidation/market channel apply to an individual fund in ways that are distinct from industry-wide behaviours in contributing to broader market contagion?

We find it hard to imagine such conditions as it is difficult to see how a single fund liquidating its assets could trigger a sequence of events which culminates in a systemic crisis. Funds are constantly accumulating and liquidating assets. If funds exit from the market because their strategy underperformed this is most unlikely to cause any broader ripple effects. Any other reasons for liquidation are also likely to be highly idiosyncratic and thus not going to affect the decisions of other funds and investors.

In considering the impact of investment funds need to liquidate assets, while leverage in and of itself does not equate to systemically significant levels of risk, the term structure of leverage can be an indicator of the asset liquidation risk presented by a leveraged fund.

Furthermore, where investors, such as banks or insurers, are themselves prudentially regulated, such investors are already required to hold capital against losses in assets in investment funds, which reduce the systemic risk from investment losses.

Q6-4. Is the proposed threshold defined for private funds appropriately calibrated? If not, please explain the possible alternative level (e.g. USD 200 billion of GNE) that could be adopted with clear rationale for adoption and quantitative data to back-up such proposed level?

We do not agree with the proposal to capture private funds under a different materiality threshold than that applied to traditional investment funds. Systemic risk is not limited to one type of fund or another; therefore materiality thresholds should not be different for the various types of funds.

GNE may be a useful, even if imperfect, proxy for a fund's overall exposure to the financial system (and vice versa), but it is a poor gauge of the potential risk a fund might present to the financial system as it ignores the extent to which this exposure was created through leverage and it also ignores the benefits of any hedging etc. There is no evidence to suggest that GNE has any meaningful correlation with the risk of an investment fund. Given these shortcomings we are concerned that GNE could be used as a de-facto 'short-cut' measure for risk parameters, such as liquidity risk, counterparty risk, etc. If GNE were to become included in the methodology for identifying NBNI G-SIFIs it would be essential to bear the concept's limitations in mind and to only employ it as a (crude) size measure whilst using other tools to determine an entity's riskiness.

We believe there is a better way to measure leverage for a materiality threshold. We note that in 2013, European regulators implemented the Alternative Investment Fund Managers Directive (AIFMD) which introduced a dedicated measure of leverage, the "commitment approach", outlined in Article 8 of the Commission Delegated Regulation (EU) No 231/2013. This approach considers both borrowings and (net) derivative exposure when measuring leverage, thereby providing the ability to gauge structural leverage and actual borrowings. Given this advantage we believe that the commitment approach should be considered by FSB and IOSCO for the purpose of defining a meaningful materiality threshold for NBNI G-SIFIs.

We suggest FSB and IOSCO consider a two-pronged filter which includes a) a leverage calculation, for example the sum total of net risk from derivatives and direct investments, gross financial borrowings and leverage from the reinvestment of collateral exceeding <u>three times NAV</u> (defined as total assets less gross financial borrowings) and b) a secondary filter capturing size, which, although imperfect, could be expressed in gross AUM. We will not suggest a specific figure for the secondary size filter as any such suggestion would be highly arbitrary at this stage given the lack of relevant data and analyses. We suggest that the competent authorities undertake more dedicated analysis of the issue of critical size thresholds in the investment fund industry in support of a specific minimum figure.

The benefit of this dual approach is that it would avoid capturing (1) very small funds with large leverage, which can be a source of risk, but not systemic risk, or (2) very large funds with very little leverage, which are not a source of systemic risk. Incorporating the recently developed 'commitment approach' in European legislation for the calculation of leverage would also be a good example of harmonisation of regulatory tools, thus avoiding inconsistency and wasteful duplicity of both industry and regulatory efforts.

Q6-5. In your view, which option for the proposed threshold applied to traditional investment funds is the most appropriate initial filter to capture the relevant funds for detailed assessment and why? Also, are they appropriately calibrated? Please provide evidence (data or studies) to support your argument. If you prefer Option 2, please provide a practical definition of a dominant market player that can be applied in a consistent manner.

We do not support either of the options proposed for traditional investment funds. As we explain above in Question 6-4, we believe that private and traditional funds should be subject to the same materiality threshold criteria. As AUM or NAV are too narrow as measures for overall size, we propose three times NAV leverage as the materiality threshold for all investment funds, including traditional investment funds, combined with a size threshold expressed in AUM.

However, such a dual threshold should only be used for materiality purposes. We emphasise that we remain unconvinced that G-SIFI designation of investment funds is an appropriate measure to address actual risks in the investment fund industry and instead recommend that the FSB and IOSCO pursue a broader product and activities based approach.

Q6-6. In addition to the two options for traditional investment funds, the FSB and IOSCO also considered a simplified version of Option 2 using GAUM (e.g. USD 200 billion) with no dominant player filters. Please provide your views if any on this as a potential threshold with the rationale (especially compared to the proposed two options above).

As explained above, if FSB and IOSCO will pursue this designation route, we consider a three times NAV leverage threshold, combined with a size threshold expressed in AUM, as the least bad way to capture both private and traditional funds for materiality purposes. Size should only be relevant for systemic risk purposes in the presence of other factors, like leverage and complexity.

Q6-7. Please explain any proposed revised indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning.

Our comments in this response reflect our understanding, as set out in Section 3 of the consultation paper, that there is a two-stage process for designating systemically important investment funds. The first comprises the application of the materiality threshold as outlined in Section 6.3 of the consultation paper to create a 'short-list' of NBNI G-SIFI candidates. The second stage addresses the assessment of the riskiness of candidates on the 'short list', using, for example, the indicators of systemic risk outlined in section 6.4. The second phase strictly follows the first phase. In other words, only funds meeting the materiality threshold will be assessed under the risk indicators. We urge the FSB and IOSCO not to give regulators the discretion, as proposed in section 3.2 of the consultation document, to start demanding data relating to the risk indicators for investment funds that have not passed the materiality threshold test. And more widely we consider that the relevant thresholds (if adopted despite our disagreement in principle with this exercise) should apply everywhere without possibility for local regulators to overturn them or enhance them – in order to give potentially designated market operators worldwide legal certainty.

Generally we believe that the number of risk indicators outlined in this section is too large and many of them are redundant and too vague and discretionary and of little practical use. The FSB and IOSCO are urged to reduce and simplify the number and type of risk indicators in the consultation paper.

With regard to size, we do not believe there is a link between risk and size, so there is no need to have further systemic risk indicators related to size as size is already captured as a materiality threshold.

Most importantly, the indicators listed under 6.4.2 "interconnectedness" should be re-labelled as "risk", as that is substantially what these indicators are in fact addressing. The most important risk indicator is financial leverage. We would suggest the following calculation of leverage as a risk indicator for an investment fund (as opposed to the materiality threshold, for which a calculation like the AIFMD commitment method could be more appropriate):

Total on-balance sheet financial borrowings plus net contingent liabilities divided by NAV (NAV=Total Balance Sheet Assets (at market value) minus gross financial borrowings)

The indicators for complexity listed under section 6.4.4 are also relevant for systemic risk purposes. Analyses of previous non-bank non-insurance credit events show that both leverage and complexity are significant as risk drivers. Previous events show that these measures could be applicable to highly levered funds that obtain leverage through highly bespoke and uncleared derivatives positions. Given the move to greater standardisation of derivatives and the ongoing move to central clearing, this indicator will become less and less applicable over time.

Overall though we believe there is a considerable degree of redundancy in the list of indicators and we suggest the FSB and IOSCO should remove the indicators for substitutability and for cross-jurisdictional activities. We remain unconvinced by substitutability as an indicator of risk. As we explained above in our response to Question 6-1, we think there is insufficient evidence that a trading strategy or service provided by a failing fund could not be replaced by others if its key strategy or service is deemed viable and profitable. Also, we strongly believe that cross-jurisdictional activity, while potentially complicating proceedings if an investment fund fails, should be considered as a mitigant for systemic risk purposes as it provides a fund with diversification benefits, both in terms of counterparties and investors. Furthermore, even purely domestic funds can be sufficiently large to pose systemic risks in case of them failing or falling into distress.

Q6-8. What alternative indicators should be added and why would they be more appropriate? For example, do you see any benefits in adding price-based indicators? If so, please explain the rationale for inclusion and possible definitions of such indicators.

We do not see the need for alternatives. As stated above, FSB and IOSCO should pare down their current list to just risk (particularly leverage) and complexity. Such indicators should at the very least be applicable to the risks that could be presented by investment funds.

Q6-9. What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

Regulators are in a strong position to collect any data they deem relevant from regulated entities under their jurisdiction. ICMA member firms cooperate well with their respective regulators and respond to data requests from regulators in a timely and comprehensive manner. Hence we do not anticipate major obstacles for regulators seeking relevant financial information as far as entities within their jurisdiction are concerned. We encourage the FSB and IOSCO to ensure a level playing field for all NBNIs with respect to regulatory reporting requirements and to any (additional) constraints imposed on entities seen as systemically important. Also the FSB and IOSCO should ensure that there is no duplication in reporting etc requirements imposed on NBNIs whose operations span across borders and are therefore overseen by more than one regulator.

Q6-10. For "size", should GNE be adjusted? If so, please explain how GNE should be adjusted and the practicality of such adjustment (e.g. data availability).

GNE is a very crude size measure (and completely inadequate as a measure of riskiness as all open exposures are aggregated rather than the net exposures to market risk). Although the "total footprint" measure of GNE is not without merit for understanding the systemic relevance of an investment fund, the sum total of net market exposures in relation to an investment fund's net assets (NAV for investment funds), for example as outlined in the AIFMD commitment approach, would be a better indicator of riskiness. We assume that all NBNIs are able to provide such data on a regular and timely basis as it most likely generated by their risk management systems anyway.

Q6-11. For "interconnectedness", should financial leverage measured separately from synthetic leverage?

We do not agree that financial leverage should be treated separately from synthetic leverage, and we try capturing both in our leverage calculation formula in our response to Question 6-7 above. There should not be any differentiation between leverage which is created on-balance sheet through i.e. borrowings and leverage created off-balance sheet through i.e. contingent liabilities from underwriting swaps or options. We believe that the AIFMD commitment leverage approach should be the starting point for measuring leverage.

Q7-1. Please describe any activities or services conducted by asset managers other than described above. In particular, please explain any other activities that, in your view, should be included in the scope.

As stated earlier we do not see a strong rationale to designate asset managers as a distinct NBNI category alongside investment funds, as this would result in an unnecessary duplication of systemic entities – given that investment funds are typically operated by asset managers and as such far more systemically important than asset management firms themselves. We also note that some asset management companies may already be captured as part of G-SIB or G-SII designation of their parent groups.

We accept that asset management companies do undertake some operational activities, such as securities lending operations or fund seed financing, using their own limited balance sheets that create a small footprint in financial markets. Furthermore, asset management companies may run the risk of reputational damage, which could lead to redemptions from investment funds managed by the company. However, in both these cases we do not believe that the risk involved is systemic in nature, owing to typically small asset management company balance sheets and systemically insignificant proprietary activities undertaken, and the high degree of substitutability in case of reputational damage.

AUM or fund NAVs would not be suitable as a size indicator for asset management companies since assets held on behalf of clients are typically managed separately from the assets owned by the asset management firm itself (with the main exception of any seed monies placed in funds which are also open to client investments).

If the FSB and IOSCO are concerned about particular activities that asset managers might undertake on a proprietary basis that might pose systemic risk, the FSB and IOSCO should conduct an activity-based analysis to determine whether further regulation of these activities is needed. Targeting specific entities will only cause the activity to shift from one entity to another and will not reduce any risks associated with these activities.