The Systemic Risk Council

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

SUBMITTED VIA ELECTRONIC MAIL

October 15, 2016

Re: *Consultative Document: Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (June 22, 2016)

Dear Sir or Madam:

This letter sets out the comments of the Systemic Risk Council[1] on the Financial Stability Board's Consultative Document on the financial stability implications of asset management industry structures and practices.[2]

Since work on reforming the international financial system began in 2009 at the direction of the G-20 Leaders, the international community has been reviewing the potential risks to financial stability from various manifestations of non-bank finance. This work has focused largely on shadow banking, insurance, and asset management. In its latest Consultative Document, the FSB makes 14 recommendations under four headings: liquidity mismatch, leverage within funds, operational risk and challenges in transferring investment mandates or client accounts, and securities lending activities of asset managers and funds.

This comment letter comprises an introductory section on how asset management structures and practices might bear on the two types of social costs that stability policy can be concerned with. In the main body of the letter, we offer broad comments on each of the FSB's four groups of issues, and recommend some more concrete measures on liquidity and leverage for inclusion in the FSB's final set of policy recommendations. We then offer an observation on issues that should be covered in the FSB's planned future work on pension funds. The letter concludes with a summary of our recommendations.

[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The Council is funded by the CFA Institute, a global association of more than 125,000 investment professionals who put investors' interests first and set the standard for professional excellence in finance. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the CFA Institute. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.

[2] Financial Stability Board, *Consultative Document: Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (June 22, 2016).

POTENTIAL RISKS TO STABILITY FROM ASSET MANAGEMENT

Any analysis of risks to financial stability needs to distinguish between two broad kinds of social cost:

- the cost of parts of the financial system collapsing, leading to impaired or suspended supply of the core services of payments, credit, risk capital, and risk transfer (or insurance); and

- the cost of misallocated resources and debt overhangs resulting from underpricing of risk that is material or prolonged.

Broadly, the first arises from the bust that follows some booms or distress amongst firms, funds, and other intermediaries. The second arises from general or sector-specific booms irrespective of whether they end in a catastrophic bust or, instead, peter out in a non-catastrophic deflation of the bubble.

As a general matter, we think that the FSB, and policymakers more generally, should make clear which type of social cost a particular public policy measure is intended to remedy or mitigate. Although it is not completely clear, we infer that the FSB's recommendations to its member regulators on asset management are directed to the first type of social cost, which is essentially about the resilience of the financial system as a whole. We agree with this prioritization, but as indicated below we recommend that the FSB should do more work on whether any measures are warranted to address the cost of non-catastrophic booms that distort markets and the allocation of resources.

In assessing whether part of the financial system poses a threat to stability in either sense, the starting point should, in general, be an examination of the structures, dynamics, and pathologies of functions and services. The Council accordingly welcomes the way in which the FSB is stepping back to conduct that kind of analysis of asset management, leaving until a later stage the question of whether any intermediaries are so significant that their distress or behavior could have outsized social costs.[3]

Plainly, the structures and practices of asset management incorporate or are affected by each of the key frictions that are familiar in other parts of the financial system and which drive the social costs policymakers care about:

- fire sales of assets in the face of distress, which can drive down asset values, impairing the solvency of other intermediaries and the underpinnings of macroeconomic activity;

- opaque and complex interlinkages that impede efficient pricing of risk and, separately, propagate distress around the system; and

- for some kinds of fund or vehicle, bankruptcy and the suspension of services that it entails.

As stressed below, the Council believes that the FSB has rightly put redemption risk and

[3] *See* Letter from Sheila Bair, Chair, Systemic Risk Council to the Financial Stability Oversight Council (Mar. 25, 2015).

leverage at the center of its picture of how those frictions play out in asset management. We do think, however, that there is a possible gap in the FSB's analysis—particularly with the respect to the second type of social cost identified above.

A Possible Area for Further Work: Unlevered Funds with No Redemption Risk

There is one area not covered in the FSB's paper, which we think warrants exploration if the FSB means to address the social costs of non-catastrophic booms and, more generally, of herding amongst asset managers.

Unlevered funds that do not offer an opportunity to redeem frequently are essentially simple investors of risk capital. But that does not preclude material social costs of the second kind identified arising from herding behavior among such funds. Some research suggests that while they neither face the risk of runs nor the need to make fire sales to preserve their solvency, the asset managers of such funds nonetheless can have an incentive to buy/sell assets whose value is rising/falling in order to avoid falling short of absolute or relative return targets.[4] During an upswing, the escalation of purchases can push up asset values beyond what is warranted by fundamentals, causing a misallocation of resources to sectors that are booming relative to others or a widespread over accumulation of debt if general credit conditions become unduly easy. During a downswing, the cascade of disposals depresses asset values, reducing aggregate wealth and raising the cost of capital, which amounts to an adverse macroeconomic shock (or aggravates the transmission of a prior shock). In either case, social welfare is impaired.

At the least, these distortions to asset prices lead to a misallocation of resources in the economy, including excessive accumulation of debt by households and firms. In the downswing, the herding behavior of such unlevered funds might also damage the solvency of levered funds, indirectly leading to the first kind of social cost.

We think it would be prudent for the FSB to clarify whether it is seeking to address risks that might arise from asset-management industry practices and norms in the unlevered, non-liquid sector. As part of this, it would be important to assess whether such funds, taken together with pension funds, and perhaps insurance funds, are big enough to affect overall market stability.

THE CONSULTATIVE DOCUMENT'S FOUR CATEGORIES

As noted above, the Council is offering comments on each of the four categories of risk identified in the FSB's Consultative Document.

Liquidity Mismatch

The core of the FSB's proposed package is a set of recommendations for greater transparency around funds' liquidity (or redemption) risks. The Council agrees that the FSB's recommendations are generally sensible. But they could be sufficient only if the reduction of information asymmetries would correspondingly reduce the social costs of runs. Obviously

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[4] *See* Michael Feroli, Anil K. Kashyap, Kermit L. Schoenholtz & Hyun Song Shin, *Market Tantrums and Monetary Policy*, University of Chicago, Booth Research Paper No. 101/14-09 (Feb. 1, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2409092; Jimmy Shek, Ilhyock Shim & Hyun Song Shin, *Investor redemptions and fund manager sales of emerging market bonds: How are they related?* BIS Working Paper No. 509 (Aug. 2015), *available at* http://www.bis.org/publ/work509.pdf.

information on liquidity mismatches cannot arrest runs once they are underway, so the question is whether they can deter runs from starting. That depends upon the facts revealed. If a particular fund is revealed to be invested only in illiquid assets, then greater transparency on its own would do nothing to deter a run in states of the world in which those illiquid assets were considered by the market to be impaired.

Perhaps for those reasons, some jurisdictions are planning to introduce constraints on liquidity risks in open-end funds, including liquid-asset requirements and so-called "swing pricing," which places some of the costs of liquidation on those investors who choose to redeem.

In our view, the big question missing from the Consultative Document is whether open-end funds invested in illiquid and opaque assets should be subject to a regulatory requirement to hold a minimum level of liquid assets, as recently proposed by the U.S. Securities and Exchange Commission.[5]

We believe that the FSB should adopt such a policy, possibly combined with "swing pricing" since the two policies may be partial substitutes. Doing so would directly mitigate the potential social costs arising from forms of non-bank finance that are exposed to run risk, and would avoid the hazard of a regulatory regime oriented around form rather than substance.

Leverage within Funds

As with liquidity risk, the core of the FSB's approach to leverage in managed funds is to require greater disclosure. We expect this to lead to a debate about whether derivative- or synthetic-leverage should be disclosed on a net or gross basis. The Council believes it should be disclosed on both bases, in order to place counterparties and others in a position to evaluate the significance of their reliance on the integrity of netting mechanisms.

More broadly, for the reasons given above on liquidity policy, the Council is very doubtful that disclosure can cure the threats to stability from leverage given the substantial wedge between the private and social costs of financial distress. Transparency alone does not cause intermediaries to internalize the broader spillovers from their actions and risk-taking.

For that reason, the Council believes that a more targeted policy is warranted. Many asset management vehicles are levered but do not offer frequent redemption opportunities and so are not exposed to redemption-run risk. Nevertheless, leverage on its own can be sufficient to drive a fire sale of assets when a vehicle's solvency is in jeopardy. If on a sufficient scale in funds invested in illiquid or opaque assets, this can generate social costs by amplifying the decline in asset prices.

Leverage combined with frequent redemption rights is more hazardous—privately for the investors in the vehicle and, more important, for society. A fund that is not (initially) verging on insolvency can be driven to fire-sale disposals if faced with escalating redemptions.

Given those well-established pathologies of levered finance, the Council recommends that the FSB should consider the following policy responses:

[5] *See* Letter from Sir Paul Tucker, Chair & Sheila Bair, Chair Emeritus, Systemic Risk Council to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission (Jan. 13, 2016).

- A fund with little or no redemption risk invested in illiquid, opaque assets could be subject to a leverage limit. Such limits should become tighter with a fund's (gross) size given the greater prospective impact on market values of large funds making fire sales.

- A leveraged open-end fund invested in illiquid assets could be prevented from offering on-demand redemption rights. Rather, such funds could be required to have a minimum notice period for redemption and be subject to "swing pricing." A possible alternative would be a higher liquid assets requirement combined with swing pricing.

For both leverage-driven and liquidity mismatch risks, the Council supports the FSB's recommendation that regulators introduce stress testing across the asset-management industry. The details of any such initiative would need to take account of the different types or degrees of risk created by different fund structures and asset portfolios.

Operational Risk

The Council supports the broad thrust of the FSB's approach to the question of whether parts of the financial system are so dependent on services from asset management firms that the system would be disrupted if a service provider failed or suddenly became dormant (for example, due to a cyber-attack). In particular, we agree that it must be possible for assets to be transferred smoothly and swiftly to other managers.

In pursuing the proposed approach, policymakers must pin down whether, in each of the FSB member country jurisdictions, any asset managers dominate the provision of any critical service to the extent that ready substitutes do not exist. The interest of financial stability authorities in this area overlaps with that of the competition authorities, but the financial stability interest is distinct since the relevant social cost concerns the withdrawal of services rather than the terms on which they are provided.

Securities Lending Activities

The FSB's Consultative Document identifies how some asset managers indemnify the risks associated with securities lending undertaken by funds they manage. This is very important.

Any fund or vehicle holding high-quality liquid assets can produce what, in economic substance, amounts to a banking business by lending-out their assets on demand for cash collateral and investing the cash in illiquid assets (whether outright or on repo). As the events at AIG underlined in 2008, such activities are exposed to run risk because the business becomes one of borrowing short while lending long. And as society discovered during the 2008 phase of the crisis, the costs of runs of this type can affect markets generally and the economy as a whole.

The simplest manifestation of that risk, without asset-manager indemnities, is being addressed by the FSB in its work on shadow banking. As the FSB observes in its Consultative Document, there is an extra twist where the securities lending activities of a fund is indemnified by its asset manager. Where that structure is employed, the risks to financial stability run in both directions:

- problems in the fund (*e.g.*, a default by securities-lending counterparties) might impair the financial viability of the asset manager after it has honored its indemnity; and

- independent problems in the asset manager might cause the managed fund's investors or counterparties to run if they had been relying not on the franchise value of the fund itself but on the underpinning provided by the asset manager's indemnity of some of its risks.

The Council believes that any applicable capital adequacy regulatory regime for asset managers must address such indemnities. Further, we recommend that the existence and notional value of any such indemnities be disclosed by asset managers so that (private) risks can be appropriately priced.

SPECIAL CHALLENGES POSED BY PENSION FUNDS

The Council notes that the FSB plans, on the basis of the analysis set out in an annex to the Consultative Document, to do further work on pension funds in the context of deliberating whether any non-bank, non-insurance financial intermediaries should be designated as "systemically significant." We offer one observation on this planned work.

One central question about pension funds is whether their investment practices are being distorted by high nominal return targets, benchmarks and guarantees; and, if so, another is whether that is distorting relative asset prices or contributing to excessive risk-taking in the leveraged fund industry.

In considering those questions, policymakers might plausibly identify concerns even if the collapse of the financial system is not threatened. For example, if some or many pension funds have made promises that will be impossible to fulfill unless robust productivity growth resumes over the coming decades, it is possible that the burden of the obligations incurred by corporate and municipal sponsors will affect their nearer term spending and investment.

Consistent with our urging policymakers to make clear the types of social costs they are seeking to address, the Council encourages the FSB to state whether it is or will be exploring those possible pension fund-related issues.

SUMMARY OF THE COUNCIL'S RECOMMENDATIONS TO THE FSB

In summary, the Council makes the following recommendations to the FSB on the four categories of risk to stability identified in the Consultative Document:

1. *Minimum Levels of Liquid Assets*. Open-end funds invested in illiquid and opaque assets to hold a minimum level of liquid assets, the calibration of the requirement depending in part on whether "swing pricing" applies.

2. *Notice Periods for Redemption*. Open-end funds invested in illiquid assets to be subject to a notice period for redemption, again taking account of any "swing pricing."

3. *Leverage Limits*. Irrespective of whether they offer daily liquidity, funds invested in illiquid assets to be subject to leverage limits that become stricter as a fund gets larger, with calibration depending on whether a liquid-assets requirement applies.

4. *Stress Testing*. Stress testing to be at the level of individual funds and, where relevant, system wide.

5. *Equity Requirements for Indemnities*. Common equity to be held against indemnities provided by asset managers to funds they manage or to third parties.

6. *Disclosure of Asset-Manager Indemnities*. Individual asset managers to disclose their aggregate contingent liabilities.

In addition, the Council makes the following supplementary recommendations for the FSB's continuing work in this area:

1. *Identify Social Costs Being Prioritized*. The FSB should make clear which type of social cost its various measures are meant to address.

2. *Consider Unlevered Funds That Do Not Offer Frequent Redemption Opportunities*. The FSB should consider whether asset management practices can entail material social costs even when funds are unlevered and do not offer frequent redemption rights.

3. *Understand the Special Challenges Posed by Pension Funds*. The FSB's continuing work on pension funds should cover whether social costs could flow from the guarantee of minimum nominal returns provided by some corporate and other plan sponsors.

In closing, we underline the Council's support for the FSB's work on potential risks to financial stability from asset management structures and practices. It is important that any such risks are identified, understood and, where material, mitigated in a proportionate way before vulnerabilities are demonstrated by renewed crisis. We hope that our recommendations help the FSB and its member authorities in that work.

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

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