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Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Fidelity Worldwide Investment is pleased to be able to respond to this important consultation.

We fully support the FSB and IOSCO in seeking to identify further possible sources of systemic financial instability. We however have concerns that if the search is misdirected and reaches wrong conclusions there could be a series of unintended and damaging consequences.

We do feel that the FSB/IOSCO paper reflects a flawed and weak understanding of how authorised funds operate with too many unsubstantiated theories framing the methodolgy. There is a very heavy responsibility on the authorities to ensure that any actions they take are well based in understanding and fact.

Our reply relates solely to fund and asset management.

The main points we would wish to make are;-

Asset management is strongly interconnected with the banking system through a wide range of transactions.

Authorised funds cannot "fail" (apart, possibly through fraud.) The investment risk is accepted by the underlying investor. Funds do not act as principals.

The systemic effects of any chain of events will occur in the banking system, that is where regulators should be focussed

Size of an entity itself will not be a significant indicator of systemic causation. It is more likely that leverage, which almost always has a bank as a counterparty, is the key indicator of potential systemic failure. If a particular chain of transactions is seen as dangerous the size of the potential outcome would be indicative, but not the size of a fund on its own.

To the extent that leverage occurs through the use of derivatives the authorities should examine carefully the mitigation now in place globally to deal with unwanted risks.

We believe the FSB/IOSCO would do better to look closely at interconnected transactions rather than seek to designate entities.

FSB is right to rule out management companies themselves as sources of systemic failure. In 1995 Barings Bank failed over a weekend, it owned a substantial fund management business. The units of the UK funds resumed trading the following Tuesday.

It is difficult to make judgements about these issues without some idea of what the remediation tools would be for a designated institution. The debate about that is only just beginning.

Remediation has been discussed in the form of enhanced supervision. The authorities should examine carefully where that might lead. Supervisors supplanting their judgement for that of the managers chosen by investors could damage the provision of market-based finance at precisely the time that it is most needed.

Q1-1. In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

As noted before authorised funds cannot fail, they therefore do not bring danger to their counterparties through that channel.

Forced liquidation can be a transmission mechanism but on the whole the investors bear the risk. Liquidation of assets across a market where large volume have been purchased through leverage could generate a cascade effect , the damage would be to the lenders.

Lack of substitutability could cause market disruption but authorised funds are notable for their substitutability. As Andy Haldane (BOE) has noted

"The good news here is that, unlike in banking, history is not littered with examples of failing funds wreaking havoc in financial markets."It is worth highlighting that funds when active on OTC markets are protected by the new high level of regulatory scrutiny, variation margin, etc.

Q2-1. Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

As noted above we believe these factors should be organised in a clear hierarchy. Of these the most important will be leverage because of its direct connection with the banking system. Related to that will be interconnectedness. If size is relevant it will be size of outcome not the size of the entity.

We have commented on substitutability above.

By definition authorised funds are not complex so that criterion is irrelevant.

Global activities are unlikely to be relevant except to the extent that a fund disperses risk internationally.

In general we suggest the FSB focusses on connections with the banking system to identify systemic risks. The banking supervisors should be able to map the links from their end of the telescope.

Q2-2. Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector-specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

For the reasons set out above we think the focus on funds is misplaced. There may be sense in focussing on funds transactions, that will be more helpful than looking at funds themselves

Q3-1. Is the proposed scope of assessment outlined above appropriate for operationalizing the high-level framework for identifying NBNI G'SIFIs? Are there any practical difficulties associated with the proposed scope of assessment?

The major weakness of the FSB analysis is the concentration on failure or distress. This may occur in a market or a bank but is very rare in a fund, and there are a range of well-known legitimate ways to mitigate problems.

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

As already noted we do not believe size is a useful materiality indicator when considering funds. Size of outcome would be more useful but is less easily measured.

We would also note that using such a criterion will be defeated by funds ensuring that such a size is never reached, or funds will be split.

Q3-3. Are there any practical difficulties in applying the materiality thresholds?

See above **Q3-4. In your view, what is the appropriate threshold level, taking into account the range given above (USD 400-600 billion in GNE), for hedge funds? Please also provide reasons with data to back it up.**

No comment

Q3-5. Do you think that it would be beneficial to set additional thresholds based on "global activity"? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

We see global activity as a risk dispersant so believe it has little part to play as a materiality indicator.

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

The definition is fine but arguably insufficient even though the purpose to which it is being put is flawed.

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

As noted several times before the failure of an asset or fund management company is irrelevant to this work.

The understanding of funds as a transmission mechanism is also basically flawed.

This statement is partially true,"Exposures / Counterparty channel: Risks through this channel may occur when distress or failure of an investment fund leads to losses or other impairment incurred by banks, brokers and other counterparties (not including equity investors). This may occur if counterparties have extended financing to a fund or through direct trading linkages. <u>Losses on investments by a fund could, if exposures are significant and have not been adequately managed, generate heavy losses to counterparties and ultimately destabilise creditors who might be systemically important in their own right."</u>

But the sentence underlined is simply untrue and shows a limited understanding of fund management. Losses on investments are borne by investors. The only impact on counterparties would be via an operational failure,(failure to settle) or leverage where the loan/transaction was secured on the falling asset.

Second it should again be re-iterated that funds do not fail.

This further statement also misses the mark.

" Asset liquidation / Market channel: This channel describes the indirect impact of distress or a failure of an investment fund on other market participants. For example, individual funds may be significant investors and/or providers of liquidity in some asset classes. In times of stress (when there might be an increase in correlations between asset classes), forced liquidation of positions by funds could cause temporary distortions in market liquidity and/or prices that cause indirect distress to other market participants. The potential for forced liquidations and market distortions may be amplified by the use of leverage by funds, particularly in the event of a "run" on their financing such as through redemptions or increased margin calls. Another example would be the loss of investor confidence in one specific asset class as a result of the distress of one particular fund leading to "runs" on other funds presenting similar features or conducting a similar strategy."

This is merely a description of fund management which has a number of strategies to deal with the problems described. Again it is not failure, it is normal fund management . There is no evidence of runs on asset classes causing anything approaching systemic danger.

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

As described above we do not think focus on any of these entities is appropriate. It is the interactions of funds with banks which should be the focus Certainly the management company is irrelevant, Haldane says:

"Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank. Asset managers are, to a large extent, insolvency-remote."

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reasons why and how such a methodology should be designed.

This should be the heart of the FSB's investigative work. There are incomplete data sets available to help the analysis but there probably needs to be further quantitative work carried out to aid further analysis. FSB and IOSCO have already identified work-streams: securitisation, MMFs, shadow banking etc, all this analysis should be considered in this debate. The authorities must forswear designation of any funds until their analysis has been completed and published**.**

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

The indicators of leverage and interconnectedness are appropriate for measuring the potential impact of interactions with banks which could be systemically damaging.

Q6-6. For "cross-jurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

We find it difficult to imagine how cross-jurisdictional use of service providers could create systemic risk.

Q6-7. Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

We do not believe size is an appropriate indicator.

Q6-8. Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator3-3)?

We doubt these definitions are helpful. If there were a very large fund which was the dominant , ie more than 50%, investor in an asset class that could create difficulty but:

a by definition if it is large enough to be dangerous it almost certainly is investing in a liquid asset class

b this could not occur in an authorised fund such as a UCITS

Q6-9. Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

Collecting relevant data from asset managers would be problematical and expensive. Most of the relevant data will be with banks as counterparties so presumably bank supervisors already have access to it. The expense question is socially relevant. Any increase in costs will be passed on in whole or in part to underlying investors. Many of these are citizens saving for their pensions, additional costs become reflected in lower retirement incomes or later retirement. The authorities should be very certain that da tai s vital before forcing extra costs on the industry.

Q6-10. Are there additional indicators that should be considered for assessing the relevant impact factors? For example, should "the fund's dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM)" also be considered for "substitutability"? Similarly, should "leverage" or "structure" of a fund also be considered for assessing "complexity"? Please explain the possible indicators and the reasons why they should be considered.

See above

Q6-11. Should certain indicators (or impact factors) be prioritized in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritization.

As noted above the indicators which link funds to banks should be prioritised.

Fidelity Investment Worldwide

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