Asset management: Coming out of the shadows

Financial Stability Board addresses structural vulnerabilities from asset management activities.

On 12 January 2017, the Financial Stability Board (FSB) published its Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities.

Over the last decade, global assets under management have risen from US$53.6 trillion in 2005 to US$76.7 trillion in 2015, equating to 40 per cent of the global finance system. The growth of the asset management sector has provided a welcome alternative source of liquidity to traditional bank funding, but with the increasing importance of the co-called 'shadow banking' system comes a need for regulators to gain a clearer understanding of how asset management funds function and in cases of stress, the problems they could present to the health of the wider financial system.

FSB set out 14 policy recommendations to address four main areas that could present a risk to financial stability: liquidity mismatch in open-ended funds; leverage within investment funds; operational risk and challenges at asset managers in stressed conditions; and securities lending activities of asset managers and funds.

Liquidity mismatch in open ended funds

'Liquidity mismatch' refers to open-ended funds that allow for immediate redemption by investors, but these funds often hold investments in relatively illiquid assets. If market prices dropped sharply and liquidity deteriorated, investors could withdraw, forcing funds to convert illiquid assets into redemption cash at short notice.

Although many funds have access to short-term financing to bridge this gap, the FSB considers that if there were to be an unanticipated large loss causing several investors to withdraw at once, that financing may not be sufficient.

The FSB worries that significant redemptions from funds, combined with significant consequential asset sales, may lead to material price declines, or increases in price volatility in the secondary markets, that would be serious enough to impair market access by borrowers and trigger market contagion.

Some jurisdictions already have measures in place to combat these risks. The FSB cites jurisdictions which limit investments in illiquid assets to between 10 per cent and 15 per cent of total assets. There are also post-event measures, such as redemption gates, or withdrawal limits or suspension of withdrawals. However, these measures are aimed at protecting investors, are not uniformly applied and do not take into account the wider impact on the financial system.

The FSB suggests three areas for improvement in relation to liquidity mismatch: information and transparency; liquidity management systems; and liquidity management tools.

Information and transparency: The FSB recommends that national authorities should collect information on the liquidity profile of different funds (Recommendation 1). This might include funds' liquidity risk management, portfolio liquidity and liquidity of individual portfolio holdings, and contingent sources of funding.

US$76.6 trillion

Global assets under management

The growth of the asset management sector has provided a welcome alternative source of liquidity to traditional bank funding

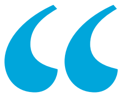
Recommendation 2 suggests greater transparency and frequency of investor disclosure requirements, with the goal being to reduce the perception that daily redemption of fund units equates to liquidity of fund assets. Additional disclosure could include, for instance, the availability of liquidity management tools and their potential impact on investors.

Liquidity management systems: The FSB's principal recommendation is that authorities require, or suggest guidance on, the alignment of a fund's investment strategy with its terms of redemption (Recommendation 3); the more liquid a fund's asset pool the sooner redemption can be achieved. It is suggested that a fund's redemption terms could be dynamic and capable of adapting to the makeup of a fund's asset pool.

The FSB also suggests an increase in the availability of risk management tools (Recommendation 4), especially those that would help reduce "first-mover advantage", which otherwise rewards investors that pull out of funds by imposing lower charges (Recommendation 5).

Authorities that require or provide guidance on stress testing should inform both the funds and authorities of potential management system issues (Recommendation 6).

Liquidity management tools: As a corollary to its suggestion that funds should have liquidity risk management tools in place, the FSB also suggests that there be clear decision-making processes which dictate when the management tools can be used (Recommendation 7). The suggestion is that the process itself be made



A build-up of leverage can create and/or amplify risks to the global financial system

transparent to both investors and the relevant authorities.

Transparency on this issue aims to remove any potential stigmas attached to the use of risk management tools. Recommendation 8 follows on from this, suggesting that authorities should also provide guidance on the use of liquidity risk management tools in stressed conditions.

Leverage within investment funds

Leverage within investment funds, in addition to synthetic leverage resulting from the use of financial derivatives, is seen as problematic. The FSB notes that a build-up of leverage can create and/or amplify risks to the global financial system through direct and indirect channels.

This is in part because leveraged funds are more sensitive to changes in asset prices, and investors may be more inclined to redeem from leveraged funds that experience stress because these funds may be perceived to be riskier.

Although the FSB notes that there are certain measures in place to counteract leveraging risks—derivatives exposures are controlled through netting agreements and collateralisation requirements for instance—these are not seen as sufficient protection for the health of the wider financial system. A lack of leverage limits and consistent accessible data on leverage remain serious issues.

To tackle this, the FSB put forward three recommendations: development of consistent leverage measures; national collection of data on leveraged funds; and collection of aggregated data across jurisdictions.

The development of consistent leverage measures: Under Recommendation 10, the International Organisation of Securities Commissions (IOSCO) would identify and develop consistent measures of leverage. This would assist with the assessment of leverage in the financial system generally, and would be particularly valuable when seeking to identify whether a fund's use of leverage should be subject to additional assessment using risk-based measures.

National collection of data on leveraged funds: Recommendation 11 is that authorities should establish a monitoring framework that allows them to collect data on leverage in funds under their oversight. This would potentially require authorities to create systems to analyse and aggregate that data.

Collection of aggregated data across jurisdictions: Finally, Recommendation 12 is that IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions, allowing authorities to monitor leverage at a global level.

Operational risk and challenges at asset managers

Although operational difficulties and business transition issues at asset managers have not typically caused problems for the wider financial system, the FSB considers that they could still be a risk if they were to occur during a period of stressed market conditions.

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Policy recommendations by FSB to address main areas of risk

There is a risk, for instance, that if investors could lose confidence in a fund, this could lead to redemptions. If the asset manager is big enough, this could in turn affect market prices of investment assets.

One scenario in particular is highlighted by the FSB, namely where an asset manager, itself under stress, needs to transfer client accounts. In this situation, difficulties are foreseen with the termination of derivatives contracts, where contracts need to be closed out or re-established in difficult market conditions. Issues are also envisaged with the replacement of ancillary services, such as IT, securities lending agents and custodial services. There would in addition be legal and regulatory issues associated with the transfer of client accounts.

The FSB notes that methods of managing this risk are employed widely but not uniformly across all jurisdictions. These include requirements for the establishment of appropriate operational risk management processes; a requirement for business continuity plans; requirements as to the establishment of external custodians; and regulatory reform to promote the central clearing of standardised OTC derivatives.

Recommendation 13 is therefore that authorities should have requirements or guidance for asset managers to have comprehensive and robust risk management frameworks, especially with regard to business continuity plans. It is also hoped that authorities would share their experiences and approaches used to identify and address operational challenges and difficulties.

Three recommendations put forward by the FSB

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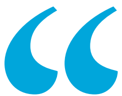

Regulation often addresses causes of the previous crisis while creating unintended circumstances that could trigger the next one

Securities lending activities of asset managers and funds

The FSB also looked at the securities lending activities of asset managers, noting an issue arising where large asset managers are acting as agent members, especially those that offer borrower or counterparty indemnifications.

Here the FSB notes two potential regulatory gaps. The first concerns potential losses linked to indemnification-related exposures. Unlike agent lender banks, agent lender asset managers do not face capital requirements related to their indemnification exposures in any jurisdiction. Under stressed conditions, an asset manager may find itself unable to meet its indemnity obligations.

Second, the FSB considers that there is an opacity risk in relation to indemnifications. Again, this is due to a mismatch between the regime applied to the banks and the regime applied to asset managers.

For bank-affiliated asset managers, the FSB recommended that the Enhanced Disclosure Task Force improve public disclosure for banks on any indemnifications provided as agent to securities lending clients. Such a recommendation does not exist for asset managers offering securities lending indemnities.

Taken together, the FSB worries that this could lead to a situation in which an asset manager, unable to meet its indemnity commitments, precipitates a contraction of securities lending activities more generally.

The FSB's Recommendation 14 is that relevant data be collected on the agent lender activities of asset managers in order to better assess risks to financial stability associated with any indemnification provided. This could then lead to requirements that asset managers providing indemnification adequately cover potential credit losses from their indemnifications.

A desire for greater transparency runs through the FSB's report. Indeed, it seems to be seen as the cure-all for most of the perceived structural risks associated with asset management funds.

However, the FSB's recommendations occasionally stray into the unworkable. For instance, requirements that redemption delays be fixed according to the nature of the underlying asset class are likely to be seen as going too far into the relationship between fund manager and investor. Moreover, the additional regulatory burden may be met with opposition from all sides: funds will voice opposition to the increasing cost of compliance, while regulators themselves may have a diminished appetite for more expensive and time-consuming market surveillance during a period in which they are already grappling with the implementation of a raft of new measures governing the global financial system. Stability is the right goal to aim for but regulation often address the causes of the previous crisis, while creating unintended consequences that could trigger the next one.

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