FSB policy recommendations to address structural vulnerabilities in asset management activities. February 2017.

INTRODUCTION

As part of its work on understanding the potential risks to financial stability, the **Financial Stability Board** (FSB) launched a project in March 2015 to analyse vulnerabilities in asset management.

The document focuses on assessing recent changes in the structure of asset management activities, identifying and prioritising potential sources of vulnerability that could affect the global financial system, evaluating the role of existing policies in mitigating potential risks and making recommendations.

In a separate but closely linked move, the FSB announced in July 2015 that it had decided to wait to finalise the assessment methodologies for non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs) until its work on structural vulnerabilities in asset management activities had been completed, so that the analysis of potential financial stability issues arising from asset management firms and their activities can feed into the revised methodologies from the NBNI G-SIFIs study.

The work was based on fifty responses by asset managers and associations, banks, pension funds and other financial intermediaries and individuals.

Global assets under management, not counting ETFs (exchange traded funds) and institutional funds, have swollen to above the levels seen prior to the 2007-09 crisis, from USD 18 trillion immediately post-crisis to USD 31 trillion in 2015. Expansion has been mainly in the USA and Europe, which contribute a half and a third, respectively, of the world's mutual fund industry. The core concern of the report is to make sure the structure of the asset management industry and its funds does not encourage the taking of unwise risks.

The FSB identified four major structural vulnerabilities associated with asset management activities:

1) Liquidity mismatches between fund investments and redemption terms and conditions for open-ended fund units;

2) Leverage within investment funds;

3) Operational risk and challenges at asset managers in stressed conditions; and

4) Securities lending activities of asset managers and funds.

Of these, the issues of liquidity mismatches and leverage are seen as the key weaknesses. The document describes each of these vulnerabilities alongside an analysis of mitigating policy recommendations to address the risks.

RECOMMENDATIONS

The recommendations aim to set out a broad framework that will help national and regional authorities to address structural vulnerabilities by data gathering, risk monitoring and other appropriate policy measures.

Policy recommendations on liquidity mismatches focus on open-ended funds, including ETFs but excluding money market funds.

Recommendations on leverage cover all types of funds (public and private, closed- and open-ended, ETFs included) that may use leverage (via borrowing or arising from derivative positions).

The single recommendation on operational risk applies only to asset managers who, because of their scale, complexity and/or the type of services they offer, might be considered critical in terms of the risk their activities pose to the financial system.

Finally, the securities lending recommendations concentrate on the actions of the agent lender – the asset manager – and particularly the indemnification terms they offer their clients.

The final proposed recommendations are summarised below:

This document describes the fourteen policy recommendations to address structural vulnerabilities in asset management activities, broken down into four areas of potential risk: nine recommendations on liquidity, three on leverage, one on operational risk and one on securities lending.

Recommendations regarding mismatches between funds' liquidity and their redemption frequency

The following policy recommendations seek to address the residual risks of liquidity mismatch among open-ended funds. Liquidity transformation may also be an issue for ETFs linked to less liquid underlyings. These recommendations may require tailoring to suit the peculiarities of ETFs.

• *Lack of information and transparency*

1) **Recommendation 1**: Authorities should collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to risks they may pose from a financial stability perspective. They should review existing reporting requirements and enhance them as appropriate to make sure they are adequate and required reporting is sufficiently granular and frequent.

2) **Recommendation 2**: Authorities should review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-ended funds to investors regarding fund liquidity risk, proportionate to the liquidity risks funds may pose from a financial stability perspective. Authorities should enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency. In this regard, IOSCO [i.e., the International Organization of Securities Commissions] should review its existing guidance and, as appropriate, enhance it.

• *Gaps in liquidity management both at the design phase and on an ongoing basis*

3) **Recommendation 3**: In order to reduce the likelihood of material liquidity mismatches arising from an open-ended fund's structure, authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behaviour during normal and stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

4) **Recommendation 4**: Where appropriate, authorities should widen the availability of liquidity risk management tools to open-ended funds, and reduce barriers to the use of those tools, to increase the likelihood that redemptions are met even under stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

5) **Recommendation 5**: Authorities should make liquidity risk management tools available to open-ended funds to reduce first-mover advantage, where it may exist. Such tools may include swing pricing, redemption fees and other anti-dilution methods. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

(Swing pricing is a net asset value adjustment mechanism that ensures that subscribers or reimbursers are the ones who take part or all of the costs associated with the portfolio restructuring, thereby protecting existing fund investors).

6) **Recommendation 6**: Authorities should require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management and so mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be done. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

• *Adequacy of liquidity risk management tools to deal with exceptional circumstances*

7) **Recommendation 7**: Authorities should promote (through regulatory requirements or guidance) clear decision-

making processes for open-ended funds' use of exceptional liquidity risk management tools, and the processes should be made transparent to investors and the relevant authorities. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

8) **Recommendation 8**: While asset managers have the primary responsibility to apply exceptional liquidity risk management tools to the open-ended funds they manage, authorities should provide guidance on their use in stressed conditions. Where jurisdictions consider it appropriate, authorities should also provide direction in extraordinary circumstances regarding open-ended funds' use of such liquidity risk management tools, taking into account the costs and benefits of such action from a financial stability perspective. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

• *Additional market liquidity considerations*

9) *Recommendation 9*: Where relevant, authorities should give consideration to system-wide stress testing that could potentially capture the effects of collective selling by funds and other investors on the resilience of financial markets and the financial system more generally.

Leverage within funds

• *Leverage within funds as a potential structural vulnerability*

The following policy recommendations are intended to address the residual risks associated with leverage within all types of funds that use leverage (both financial and synthetic).

10) **Recommendation 10**: IOSCO should identify and/or develop consistent measures of leverage in funds to facilitate more meaningful monitoring of leverage for financial stability purposes, and help enable direct comparisons across funds and at a global level. IOSCO should also consider identifying and/or developing more risk-based measures to complement the initial measures with a view to enhancing authorities' understanding and monitoring of risks that leverage in funds may create. In both cases, IOSCO should give consideration to appropriate netting and hedging assumptions and where relevant build on existing measures.

11) **Recommendation 11**: Authorities should collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which may pose significant leverage-related risks to the financial system, and take action when appropriate.

12) **Recommendation 12**: IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions based on the consistent measures it develops.

Operational risk and challenges at asset managers

• *Operational risk at asset managers as a potential structural vulnerability*

The following policy recommendation is intended to address the residual risks associated with operational risk, including challenges in transferring investment mandates or client accounts.

13) **Recommendation 13**: Authorities should have requirements or guidance for asset managers to have comprehensive and robust risk management frameworks and practices, especially with regards to business continuity plans and transition plans, for example, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions. Such risk management frameworks and practices should be commensurate with the level of risks that the asset managers' activities pose to the financial system.

Securities lending activities of asset managers and funds

• *Securities lending activities as a source of potential structural vulnerabilities*

The following recommendation is intended to address residual risks posed by agent lender business in which asset managers are (and may in the future be) involved.

14) **Recommendation 14**: Authorities should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

The document that presents these 14 recommendations also describes the recommendations that need further work, particularly those being worked on by IOSCO. Most of this work is focused on the recommendations on liquidity (1 to 8) and on leverage (10 and 12). The FSB mandates IOSCO to review and enhance its principles and guidelines where necessary to include these framework recommendations by end-2017, in the case of the liquidity recommendations, and by end-2018 in the case of the leverage measures.

Links:

Policy recommendations to address structural vulnerabilities from asset management activities.

Entire document.