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CLIENT ALERT

Financial Stability Oversight Council (FSOC) – Update on Review of Asset Management Products and Activities

The Financial Stability Oversight Council (FSOC) continues to increase its scrutiny of financial stability issues presented by asset management products and activities. A recent statement regarding the FSOC's ongoing review of asset managers indicates an increased interest in expanding data collection efforts from the industry and potentially extending regulatory oversight to the industry similar to the banking sector. An interagency group has been formed with a mandate to submit a report on related issues specific to hedge funds during the fourth quarter of 2016.

The action comes at a time when policymakers and market participants continue to express concerns about low levels of liquidity in the bond markets that merit consideration by the industry. Bank-run collective investment funds (CIFs) as well as pension funds and insurance companies are under the FSOC's scrutiny either directly or in relation to their engagement as counterparties with asset managers. It is unclear, however, whether the Securities and Exchange Commission (SEC) will implement the suggestions regarding leverage and data collection. A separate statement by SEC Chairman Mary Jo White noted that many of the FSOC's initiatives fall beyond the SEC's jurisdiction.

In summary: On April 18, 2016 the FSOC released an update on its ongoing review of potential risks to financial stability that may arise from certain asset management products and activities. The review of risks to financial stability focused on (1) liquidity and redemption; (2) leverage; (3) operational functions; (4) securities lending; and (5) resolvability and transition planning. The update recommended steps to mitigate financial stability risks in the area of liquidity and redemption and stated the FSOC's intention to more closely monitor the risk posed by leverage in pooled investment vehicles and separately managed accounts. The release follows steadily increasing interest in the topic by the FSOC over the past several years, including active discussion during recent FSOC meetings, a request for public comment in December 2014 and a public conference held in May of 2014.

The FSOC's continued interest in the potential risks to financial stability posed by asset management products and activities merits close attention by the industry. The FSOC's statement that pooled investment vehicles pose financial stability concerns, indicates that no one regulator currently has "a complete window into the risk profile of hedge funds," and highlights multiple gaps in data from the sector. This suggests strongly that it will continue to build its case for future regulatory action.

Liquidity and Redemption: The FSOC's keenest interest and most aggressive positions have been taken in the area of liquidity and redemption risk. The FSOC believes pooled investment vehicles raise two potential financial stability concerns. First, the FSOC believes that liquidity mismatches between frequent redemptions and investing in less-liquid assets may cause rapid declines in the price of the assets held by a pooled investment vehicle during periods of large redemptions. Second, the FSOC believes that redemption rights create a "first-mover advantage" for investors to redeem shares in times of stress and thereby transfer the burden of meeting future redemption requests from less liquid assets to investors who remain in a fund.

To address these concerns the FSOC made six recommendations, but without providing timeframes for implementation. In particular, the FSOC recommended that industry participants establish "robust liquidity risk management practices for mutual funds, particularly with regard to preparations for stressed conditions by funds that invest in less-liquid assets." In addition, the FSOC recommended that regulators tighten guidelines around holdings of assets with limited liquidity, enhance reporting and disclosure of liquidity profiles and liquidity risk management practices, pursue the adoption of tools to allocate redemption costs more directly to investors who redeem shares, expand public disclosure of external sources of financing employed by funds and adopt other measures to mitigate liquidity and redemption risks that are applicable to CIFs and similar pooled investment vehicles offering daily redemptions.

Leverage: The FSOC also dedicated significant attention to potential risks arising from the use of leverage by mutual funds, hedge funds, CIFs and separately managed accounts. The FSOC believes that leverage can magnify the impact of asset price movements on a fund's net assets and performance and may result in interconnections to other market participants through which financial stress could be transmitted to the broader financial system.

To address the concerns raised by leverage in hedge funds, the FSOC has established an interagency working group to evaluate leverage in hedge funds, assess the sufficiency of existing reporting requirements, and consider standards governing the measurement of leverage, including risk-based measurements. It suggested and rejected a range of specific potential leverage ratio measures, implying a strong intent to extend bank-like oversight in the sector. A report on the issue by the interagency group has been requested for the fourth quarter of 2016. In addition, the FSOC cited its support for actions taken by the Securities and Exchange Commission to limit leverage in other pooled investment vehicles.

Securities Lending: The FSOC highlighted its interest in addressing financial stability risks raised in the securities lending and repo markets as well. They specifically identified as a financial stability risk "reinvestment of cash collateral by lenders, usually in the repo markets." Those lenders are large institutional investors such as pension funds, insurance companies, sovereign wealth funds and endowments. They did not, however, urge the SEC to finalize its May 2015 proposed rule to require hedge funds to report monthly securities lending activities.

Conclusion: While the FSOC does not have direct authority to write rules for the managers of pooled investment vehicles, industry participants should begin to assess liquidity risk management policies, procedures and practices against the FSOC's recommendations. In addition, the SEC has issued a number of proposed rule makings regarding data collection that, if finalized, could dramatically increase regulatory burdens on managers of pooled investment vehicles.

In response to these changes, managers should consider taking a fresh look at their holdings, lending arrangements and fund redemption terms and should continue to stress test these factors against hypothetical market liquidity events, and/or large investor redemption requests, to ensure they will hold up to both potential market events and increasing regulatory scrutiny.

For additional information, please contact:

Amy Matsuo
Principal and National Lead
Financial Services Regulatory Risk Practice
T: 919-380-1509
E: amatsuo@kpmg.com

Tracy Whille
Principal
Financial Services Regulatory Risk Practice
T: 212-954-2691
E: twhille@kpmg.com

Ken Albertazzi
Partner
Financial Services Regulatory Risk Practice
T: 212-954-4904
E: kalbertazzi@kpmg.com

Deborah Bailey
Managing Director
Financial Services Regulatory Risk Practice
T: 212-954-8097
E: dpbailey@kpmg.com

Barbara C. Matthews
Managing Director
Americas Financial Services Regulatory Center of Excellence
T: 202-533-3443
E: bcmatthews@kpmg.com

Authors:

Barbara C. Matthews, Managing Director, Americas Financial Services Regulatory Center of Excellence, bcmatthews@kpmg.com

Andrew Devlin, Senior Associate, Financial Services Regulatory Risk Practice, andrewdevlin@kpmg.com

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