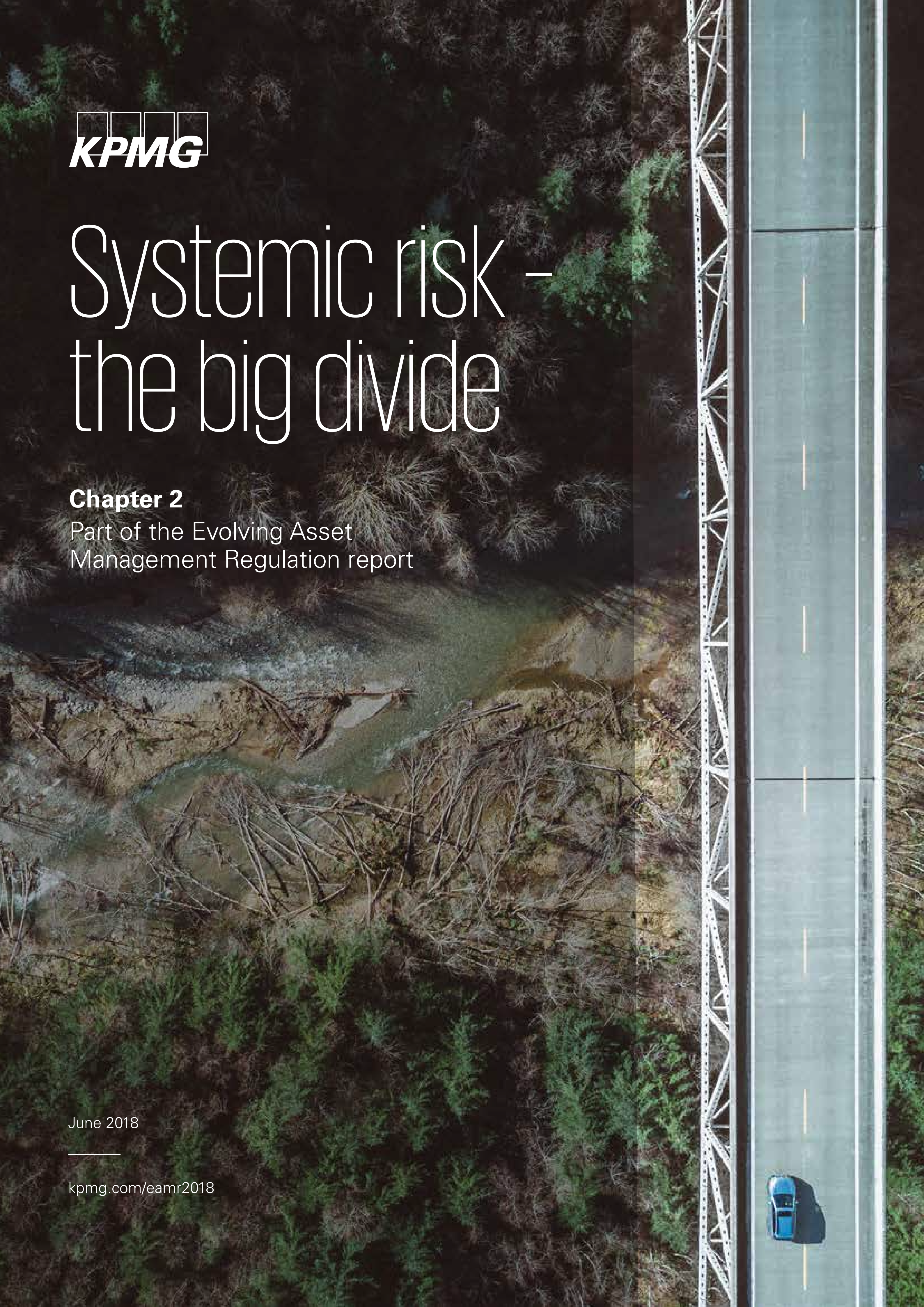

Systemic risk – the big divide

Chapter 2

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Systemic risk - the big divide

Nowhere is the difference in approach of the **US** and the rest of the world clearer than in the systemic risk debate. Where once, Dodd-Frank[1] and MiFID II/MiFIR[2] progressed in lockstep, today views on the systemic risk that investment funds present could hardly be more divergent.

Outside the US, the ongoing application of a banking policy mindset to open-ended funds is creating considerable tension within the global industry.

The FSB[3] issued 14 policy recommendations to address what it describes as structural vulnerabilities from asset management. It is revisiting assessment methodologies for identifying non-bank, non-insurance globally systemically important financial institutions (NBNI G-SIFIs) – a major bone of contention for the industry.

Meanwhile, IOSCO[4] has issued revised guidelines on liquidity risk management in funds and is working towards globally-accepted measures of leverage.

[1] US Dodd-Frank Wall Street Reform and Consumer Protection Act
[2] Markets in Financial Instruments Directive, revised and Markets in Financial Instruments Regulation
[3] Financial Stability Board
[4] International Organization of Securities Commissions
[5] European Securities and Markets Authority
[6] Undertakings for Collective Investment in Transferable Securities
[7] Alternative Investment Fund Managers Directive

Are asset managers and funds systemically risky?

The FSB acknowledges that open-ended funds have been generally resilient and have not created financial stability concerns in recent periods of stress and heightened volatility, with the exception of some money market funds. It is concerned, though, that open-ended funds investing in less actively traded assets, but which offer daily redemption for investors, could amplify downward repricing of these assets and market illiquidity if investors try to redeem at the same time.

Of the FSB's 14 policy recommendations, nine relate to liquidity management, and the others to leverage, securities lending and operational risk management. Within **Europe**, many of these recommendations are already in place in EU or national requirements, but a few – such as industry-wide stress testing – are new.

The FSB's policy recommendations require regulators to collect and share more information from fund managers and to review disclosures to investors.

> "open-ended funds have been generally resilient and have not created financial stability concerns"

The FSB also highlighted that although non-bank financial entities that are dependent on short-term funding to support lending activities have declined since the crisis to eight percent of shadow banking assets, these entities tend to have relatively high leverage. To address the lack of a consistent measure of leverage, the FSB suggested that IOSCO develop globally-agreed risk based measures and collect national and regional leverage data.

Meanwhile, in February 2018, IOSCO published its final report on Recommendations for Liquidity Risk Management for Collective Investment Schemes.

These recommendations are accompanied by a "good practices" document, which provides practical examples of measures to address liquidity risk management, for the use of supervisors, fund managers and investors. Hot on its heels, the European Systemic Risk Board (ESRB) issued five recommendations addressed to the European Commission and to ESMA relating to liquidity risk management and leverage.

The final IOSCO recommendations replace the existing principles of March 2013 and include new recommendations on contingency planning. They also consider additional liquidity management tools, the profile of the investor base and the fair treatment of investors.

Of particular note is that the recommendations do not reflect the FSB proposals relating to system-wide stress-tests or the prescriptive use of pre-selected liquidity "buckets", depending on the underlying assets' contingent liquidity state.

In this sense, the recommendations are in synch with the US Treasury report.

The **Singapore** regulator is one of a number of national regulators to have issued consultations on new guidelines for liquidity risk management that reflect the IOSCO recommendations.

The ESRB's five recommendations were more prescriptive, however. It believes that the increasing size of the investment fund sector, coupled with perceived susceptibility to changes in market dynamics and structure, warrants legislative action. It is specifically concerned about mismatches between the liquidity of underlying assets and a fund's redemption policy.

It wishes ESMA[5] to develop guidance by June 2019 on the stress testing of liquidity risk in individual funds and on assessing the extent to which leverage in funds contributes to the build-up of systemic risk. In particular, ESMA should provide guidance on the design, calibration and implementation of macro-prudential leverage limits.

The ESRB tasks the European Commission to have implemented changes to the UCITS[6] Directive and AIFMD[7] by December 2020.

Germany is on the hawkish side of the argument. Its central bank warned in December 2017 that the growing interconnectedness of German investment funds are contributing to systemic risks. The Bundesbank argued that the portfolios of many funds overlap significantly and expressed particular concern over multi-manager funds, which invest in other funds. As of June 2017, assets that funds hold in other funds amounted to EUR 406 billion, or 23.5 percent of overall assets held in funds in Germany.

The Bundesbank report echoes recommendations made by the FSB, which proposed the introduction of redemption gates, swing pricing and side pockets to control liquidity risks. The report also chimes with ESMA's stated aim to subject asset managers to tougher scrutiny on whether they pose a systemic risk.

Switzerland has not taken such a strong line as Germany, but the regulator is implementing reporting requirements for derivative transactions. From 1 January 2019 asset managers are obliged to clear certain over-the-counter derivatives through a central counterparty.

US takes a different line

The **US** Treasury is at pains to disagree with nearly all of the above. The Treasury noted in its late 2017 report[8] that the performance of the asset management industry during periods of financial stress demonstrates that the types of industry-wide "runs" that occur in the banking industry during a systemic crisis have not materialized in the asset management industry, outside money market mutual funds.

Since the turn of the century, it said, aggregate net flows — either total net redemptions or subscriptions — into equity and debt funds have rarely exceeded more than 1 percent and 2 percent of total assets under management on a monthly basis, respectively. This trend even continued through the financial crisis, when mass redemptions would have been most likely.

The Treasury believes the asset management industry should not have been targeted in the wake of the financial crisis, through the passage of Dodd-Frank, the actions of the FSB and other international bodies. A framework emerged that assessed systemic risk posed by specific financial entities. Asset management firms have been evaluated for systemic risk and subjected to some enhanced regulatory standards. Yet they have legal, structural and operational characteristics that make them different to banks, the Treasury noted.

> "Asset management firms….have legal, structural and operational characteristics that make them different to banks"

The Treasury's position is that "entity-based evaluations of systemic risk are generally not the best approach" for mitigating risks arising in the asset management and insurance industries. The Treasury, however, supports shifting to an activities-based framework, which would identify certain business activities as having higher systemic risk.

Funds are not "shadow banks"

The US Treasury is not enthusiastic about the FSB categorizing mutual funds as "shadow banks". It noted that FSB reports often use the term "shadow banking" to describe credit intermediation involving activities outside the regular banking system. The Treasury said it preferred the term "market-based finance". Applying the term shadow banking to registered investment companies is particularly inappropriate, it said, as the word "shadow" could be interpreted as implying insufficient regulatory oversight or disclosure.

The Treasury outright rejects the need for stress testing of asset management firms. It recognizes the possibility of liquidity risk that may arise during mutual fund redemptions, but believes a strong liquidity risk management framework is a more effective approach.

Prudential regulation of asset management is unlikely to be the most effective regulatory approach for mitigating risks, it said. Asset managers and investment funds, in contrast to banks, are not highly leveraged and do not engage in maturity and liquidity transformation to the same degree. Any decline in the value of a fund's assets results in a corresponding reduction in the investor's investment, whereas a bank's obligation to its depositors and creditors remains the same, even if the bank suffers losses on its asset exposures.

While the Treasury endorsed the principle of appropriate risk management in the asset management industry, it does not support prudential stress testing of investment advisers and investment companies, as required by Dodd-Frank. The Treasury said it supported legislative action to amend Dodd-Frank to eliminate the stress testing requirement.

While the Treasury said it strongly supported continued US participation in international standard setting bodies, such as the FSB and IOSCO, it said this would be solely to promote US interests. Moreover, the Treasury believes the US should play a bigger role in these bodies, particularly with respect to financial market supervision and asset management "where our firms and markets are the largest in the world". It demanded that US agencies that have seats on the FSB, IOSCO, or other international bodies, should "more effectively coordinate their representation on behalf of the United States".

[8] https://www.treasury.gov/press-center/news/Pages/A-Financial-System-That-Creates-Economic-Opportunities---Asset-Management-and-Insurance.aspx

In addition, the Treasury recommends improvements to the FSB's and other bodies' processes to better promote transparency, accountability and appropriate representation. It particularly encouraged the FSB to expand its practice of posting summaries of the comments raised in consultation processes and changes made to address such comments. It recommends that US representatives on the FSB and IOSCO boards review processes to ensure that they use a collaborative process that includes economic analysis and subject-matter expertise.

It finally recommended that the US members of the FSB should work to revise the G-SIFI framework so it takes into account the differentiated ways that sectors are structured and manage risks.

The Treasury also wants the SEC to take over some of the functions of the FSOC[9], which was created by President Obama after the financial crisis to deal with systemic risks. While the FSOC should maintain primary responsibility for identifying, evaluating and addressing systemic risks in the US financial system, the Treasury believes it should "look to the SEC to address systemic risks through regulation within and across the asset management industry in the United States".

Are ETFs systemically risky?

IOSCO launched its second examination of the exchange-traded fund (ETF) industry, which was published in early 2018. IOSCO was looking at recommendations to strengthen the oversight of ETFs in order to protect investors, considering whether market distortions might be caused by the rapid growth of ETFs. IOSCO had said, in its first exam, in 2017, that it would review the global ETF industry, particularly the rise of leveraged, inverse and synthetic ETFs.

Paul Andrews, Secretary General of IOSCO, said questions needed to be asked about whether ETFs could cope with pricing or liquidity shocks as central banks withdraw from emergency support measures and tighten monetary policy. IOSCO also assessed whether ETFs were creating changes in market structure that could result in the misallocation of capital. It was concerned that large institutional investors could manipulate the prices of ETFs to create profitable trading opportunities.

[9] Financial Stability Oversight Council

In the end, IOSCO decided not to issue specific recommendations for ETFs, but noted that it was continuing to monitor liquidity stresses in the global ETF market, with a focus on authorized participants and market makers. The IOSCO 2013 ETF Principles may be reviewed at a later date, it said.

In September 2017, **Germany**'s BaFin[10] became the latest national regulator to warn that ETFs could pose potential risks to financial market stability. It said ETFs are not yet a threat to market stability but could become a danger. It warned that sudden massive sell-offs by ETFs "could cause a problem", particularly in products that invest in less-liquid assets. The regulator said it may take regulatory action in future.

The Central Bank of Ireland (CBI), which supervises Europe's largest ETF domicile, launched an information-gathering exercise on ETFs during 2017. Its Discussion Paper highlighted the low proportion of active ETFs in Europe and asked industry participants for feedback on whether "alternative approaches to full portfolio transparency should be permitted for active ETFs".

In November 2017, the CBI held a conference in order to inform regulatory policy development. The key topics deliberated upon were the suitability of the current regulatory regime under UCITS and MiFID II for ETFs, risks potentially associated with Authorised Participants, and investor protection.

The regulator is now considering whether to relax portfolio disclosure rules for ETFs to facilitate a broader range of investment strategies, by changing the substance or timing of disclosure. It is expected to release proposals in late 2018.

In **France,** the AMF[11] completed an in-depth investigation into ETFs after it raised concerns about liquidity and the industry's rapid growth. On 24 March 2018, the regulator proposed three amendments to its ETF policy: to widen the options for funds to repay "in kind"; to implement an action plan in the event of significant valuation or liquidity problems; and to draw up a continuity plan in the event of a default or counterparty issue. The deadline for responses was 24 May 2018.

With the exception of ESMA guidelines published in 2012, there are not yet specific **EU** rules for ETFs. The discussion in various EU countries could pave the way for ESMA to outline a more uniform approach to transparency, including a mechanism to limit the requirement for active ETFs to disclose portfolios on a daily basis.

[10] Bundesanstalt für Finanzdienstleistungsaufsicht
[11] Autorité des Marchés Financiers
[12] Financial Conduct Authority
[13] Securities and Futures Commission
[14] Member of European Parliament

Ireland's CBI in December 2017 suggested a new regulatory framework for ETFs to enhance investor protection. The CBI said the current regulatory framework may not be able to deal with all the complexities of ETFs. It recommended there could be "an ETF chapter" in the forthcoming review of UCITS or a specific pan-European regime for ETFs.

On the other hand, Megan Butler, executive director of supervision for investment, wholesale and specialists at the **UK**'s FCA[12] , said regulators "need to be careful" that they understand the dynamics between ETFs and markets before coming "to the conclusion that there is a need for extensive new regulatory interventions" for ETFs.

Counter-arguments and mixed messages

Fund managers have cautioned against imposing a specific regime for ETFs in their responses to IOSCO's consultation. This, they say, could involve increased compliance costs and a narrowing of the range of eligible investments. They argue that ETFs do not pose any greater liquidity risk than mutual funds.

These arguments are espoused by the **US** Treasury, which recommended that the SEC move forward with a "plain vanilla" ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders. To this end, the SEC should either re-propose or propose a new rule on ETFs for public comment.

Adopting a plain vanilla ETF rule would not only reduce cost and delay for new entrants, said the Treasury, it would also enable ETF sponsors to avoid the potential for costly updates to existing exemptive relief orders when introducing new products, and help reduce uneven treatment between ETFs. Likewise, a plain vanilla ETF rule would enable the SEC staff to focus efforts on more novel and more difficult ETF exemptive relief applications.

ESMA and other policy-makers have expressed concern about the growth in the ETF market, which comprises mainly passively-managed funds. At the same time, the **European** Commission and some national regulators have suggested that retail investors are better off investing in passive funds.

Hong Kong, too, has entered the debate. The SFC[13] issued in January 2018 a research paper on the local ETF market. It considered the risk of ETF prices decoupling from net asset values (NAVs), the reliance on authorized participants, the liquidity of underlying assets, actively-managed ETFs and the growth of passive investing in general. It concluded that at this time the various regulatory initiatives already in train for funds are sufficient to address these issues. It maintains a watching brief.

"ESMA and other policy-makers have expressed concern about the growth in the ETF market."

Further uncertainty for European Money Market Funds

After three years of heated debate, the Money Market Funds Regulation (MMFR) was finally agreed by both the **European** Parliament and the Council at the end of 2016 and comes into force on 21 July 2018.

But a new, and very significant, issue has now emerged. A letter from the European Commission to ESMA in early 2018 described the practice of share cancellation as incompatible with the MMFR. This has caused further uncertainty for money market funds and their investors.

The MMFR is silent on the practice of share cancellation as a mechanism to preserve a fund's NAV, which is commonly used when interest rates are negative. However, the European Commission's recent letter to ESMA says that, according to its legal analysis of the regulation, the use of the reverse distribution mechanism, which is often referred to as "share cancellation" or "share destruction", is not compatible with the MMFR.

The debate intensified further with a letter from the MEP[14] MMFR negotiating team to Commissioner Dombrovskis. An explicit position was not taken on the practice of share cancellation as part of the negotiations, it said.

At the time of writing, the MEPs and the industry awaited the Commission's response and ESMA's reaction. If the Commission's opinion holds sway, it could sound the death knell for constant net asset value funds and cause major disruption for investors and managers.

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