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Regulatory brief

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Nonbank SIFIs: Up next, asset managers

Overview

When the Financial Stability Oversight Council ("Council") adopted its final rule last year for designating nonbank financial companies as systemically important (i.e., as "nonbank SIFIs"), it made clear that the Council was assessing whether certain asset management firms might also be included in its reach.[1] To assist in that decision, the Council asked the Treasury Department's Office of Financial Research ("OFR") to undertake a study that "provide[s] data and analysis on the asset management industry."

The OFR responded late last month with its study called Asset Management and Financial Stability ("Study"), which describes potential threats to US financial stability from vulnerabilities of asset managers. The Study analyzes the industry's activities, describes factors that make the industry and its individual firms vulnerable to financial shocks, and considers the channels through which the industry could transmit risk across financial markets during financial distress.

The Study suggests that the industry's activities as a whole make it systemically important and may pose a risk to financial stability. The Study explicitly takes the view that risk may arise from or be amplified by a "certain combination of fund- and firm-level activities within a large complex firm" or "a significant number of asset managers engaging in riskier activities," and the risk can be transmitted through the financial system in both cases.

The Study is therefore best viewed as a first step toward individual asset manager SIFI designations.[2] The Council, drawing from the Study, will likely focus on industry vulnerabilities (including those emanating from inadequate risk management) and how these vulnerabilities could be amplified and transmitted throughout the financial system during financial shocks. The Council will have broad discretion when making particular designations because, as the experience of insurers has demonstrated, the designation process is driven by worst-case scenarios based on the flexible standard of what "could" happen during market shocks.

Given the Council's discretion, and our understanding of the Council's rationale for designating insurers, it continues to be our view as stated in a prior brief that a few large asset managers will ultimately be proposed for SIFI designation[3] – the clock has started ticking.

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[1] See *77 Fed. Reg. 21644* (April 11, 2012) stating in the final rule's ("Rule") preamble that "the Council, its member agencies, and the OFR are analyzing the extent to which there are potential threats to US financial stability arising from asset management companies. This analysis is considering what threats exist, if any, and whether such threats can be mitigated by subjecting such companies to Board of Governors supervision and prudential standards, or whether they are better addressed through other regulatory measures."

[2] It is noteworthy that the Council did not feel the need to take this first step with respect to insurers, i.e., the Council did not suggest that the insurance industry's activities were systemically important before designating AIG and Prudential as nonbank SIFIs.

We do not believe these designations will occur before 2015 though, for the following reasons:

- The Study only touches upon hedge and other private funds (which have just begun reporting on Form PF), and it identifies several important data gaps on separate accounts and on securities lending and repo markets, so the Council may want to demonstrate more analysis in these areas.
- The Council may seek public comment on different alternatives for designating members of the industry (e.g., distinguishing between bank-affiliated and non bank-affiliated asset managers, public and private, etc.).
- It took the Council well over a year to complete the designation process for the first insurer (AIG in July 2013) after the Rule was completed in April 2012.

The asset management industry has pointed out the Study's limitations. Beyond removing little from the menu of potential industry risks, the Study does not elaborate on what "combination of ... activities" could pose risk (or amplify or transmit risk), nor does the Study detail the "riskier activities" by a "significant number" of asset managers that could cause a similar threat. Also, the Study does not address the broader policy question of whether potential threats to financial stability from asset managers can best be mitigated by designating a firm as a nonbank SIFI (i.e., subjecting it to supervision by the Federal Reserve Board ("FRB") and enhanced prudential standards under Dodd-Frank), or whether these threats are better addressed by other regulatory measures as referred to in the Rule's preamble.[4]

As a final point, the Securities and Exchange Commission ("SEC"), the primary regulator of the asset management industry, has asked for public comment on the Study (comments are due by November 1st). The fact that the SEC has taken this action demonstrates an assertion of its traditional authority and expertise in asset management (perhaps in light of the SEC's experience last year with the Council's initiative regarding money market funds) – expect the SEC to be a strong voice at Council meetings.

This **Financial Services Regulatory Brief** provides the highlights of the Study, explains what the Study means for asset managers as a practical matter, analyzes its key themes, and provides our view that a few asset managers will be proposed for SIFI designation.

[3] See PwC's *Financial Services Regulatory Brief, Nonbank SIFIs: FSOC proposes initial designations – more names to follow* (June 2013) stating "the odds of the asset management industry suffering the same fate as insurance ... have gone from 50-50 to a very strong likelihood."

[4] See footnote 1.

Study highlights

The Study is the first public study of an industry under the nonbank SIFI designation authority provided to the Council under Section 113 of Dodd-Frank. It brings together a significant amount of public data on the US asset management industry showing that the industry oversees $53 trillion in financial assets which are highly concentrated among the largest firms. While the Study implies the industry as a whole is systemically important, the Council's task under Section 113 of Dodd-Frank is much more narrow and limited – the Council must determine if there are one or more large asset management companies that meet the criteria for designation as a nonbank SIFI under the Rule and Dodd-Frank.[5]

The Study makes distinctions and draws similarities between asset management activities and those of banking and insurance.[6] Most importantly, the Study points out that asset management firms do not use their own assets or balance sheets to support their clients' and funds' investments (which industry commentators have pointed out when asserting their view of the Study's flaws). The Study states:

> [Asset management firms'] activities differ in important ways from commercial banking and insurance activities. Asset managers act primarily as agents: managing assets on behalf of clients as opposed to investing on the managers' behalf. Losses are borne by – and gains accrue to – clients rather than asset management firms. In contrast, commercial banks and insurance companies typically act as principals: accepting deposits with a liability of redemption at par and on demand, or assuming specified liabilities with respect to policy holders.

[5] Under Section 113 of Dodd-Frank, the Council is limited to designating an individual nonbank financial company, not an industry. However, under Section 120 of Dodd-Frank, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of a "financial activity or practice" conducted by nonbank financial companies could create or increase the risk of significant liquidity, credit, or other problems spreading across the financial system, the Council may provide for more stringent regulation of the financial activity or practice by issuing recommendations to a primary financial regulatory agency to apply new or heightened standards or safeguards. The Council used this authority in November 2012 to recommend that the SEC proceed with structural reforms of money market funds.

[6] Banking organizations have been designated as SIFIs under Dodd-Frank based solely on size (i.e., having consolidated assets of $50 billion or more) while insurers have been designated by the Council as nonbank SIFIs based on the criteria in Section 113.

However, the Study notes important similarities between asset managers and banks – including that they both hold "money-like liabilities":

> Some types of asset management activities are similar to those provided by banks and other nonbank financial companies, and increasingly cut across the financial system in a variety of ways. For example, asset managers may create funds that can be close substitutes for the money-like liabilities created by banks; they engage in various forms of liquidity transformation, primarily, but not exclusively, through collective investment vehicles; and they provide liquidity to clients and to financial markets.

The Study's scope is limited. First, it carves out from its discussion any risks posed by money market funds in light of the Council's earlier analysis and the recent reforms proposed by the Securities and Exchange Commission ("SEC"). Second, the Study does not address in detail the activities and risks posed by hedge funds, private equity, and other private funds. Additional analysis will be conducted through the data that these funds have begun to file on Form PF, which the OFR, SEC, and Commodity Futures Trading Commission ("CFTC") are currently evaluating.

The Study employs a three-step process in its analysis of the asset management industry.

- First, the Study breaks down asset management activities into two groups: fund-level and firm-level. Fund-level activities include asset allocation, portfolio selection, management of fund liquidity, and management of fund leverage. Firm-level activities include risk management and central functions, the possibility of sponsor support, securities lending and cash reinvestment, and management of firm capital and liquidity. The Study seeks to identify sources of risk at each level.
- Second, the Study identifies situations that it believes makes the industry and firms vulnerable to financial shocks. These include (1) reaching for yield and herding behaviors, (2) redemption risk in collective investment vehicles, (3) leverage which can amplify asset price movements and increase the possibility of fire sales, and (4) risk within the firms themselves.
- Third, the Study assesses the likelihood that in periods of stress the industry could transmit risks across the financial system through two primary channels: (1) exposures of creditors, counterparties, investors, or other market participants to an asset manager or asset management activity, and (2) disruptions to financial markets caused by fire sales.

Based on its three-part analysis, the Study takes the view that "a certain combination of fund- and firm-level activities within a large complex firm" or "engagement by a significant number of asset managers in riskier activities" could pose, amplify, or transmit a threat to the financial system. The Study notes that these threats may be particularly acute when a small number of firms dominate a particular activity or fund offering.

What does the Study mean for asset managers?

For the very largest asset managers, those with assets under management of $1 trillion or more, that are concerned about being designated, the Study (along with the Council's prior designations of AIG, Prudential, and GE Capital as nonbank SIFIs) affords them a public window into the key facts and policy concerns that will likely guide the Council's decisions and their factual underpinnings.

For those asset managers that view themselves as unlikely to be designated, it will still be important to monitor developments. The Study may be viewed as supporting additional regulation in certain areas, particularly regarding risk management practices which the Study points out are widely disparate among asset management firms:

> Risk management practices and structures vary significantly among firms. For example, although all registered investment companies and investment advisers are required by SEC regulation to have chief compliance officers, not all asset managers have chief risk officers. Regardless of the structure used, effective risk management is important for the management of operational limits, counterparty limits, and investment concentrations across funds and accounts.

Similarly the Study notes that "[d]uring interviews, asset managers suggested that counterparty risk management varies widely, with some firms establishing separate counterparty teams and others taking a fund-level approach subject to the discretion of portfolio managers. Funds are not specifically required to conduct ongoing credit analysis of their derivatives counterparties." The Study also underscores the role that independent risk managers can play to "reduce the risk of overextending portfolio mandates when they are empowered to challenge investment decisions."

From a risk perspective, the Study emphasizes the importance of identifying and monitoring key vulnerabilities (e.g., reaching for yield, redemption risk, and leverage) as well as the need to understand the correlation of risks among funds across the entire firm.

Key themes of the Study

Size & market concentration

The Study assembles public data on the asset management industry, which it describes as highly competitive and innovative (with a diverse mix of businesses and business models). It also describes the industry as highly concentrated – at the end of 2012, the top five mutual fund complexes managed 49% of mutual fund assets and ten firms each have more than $1 trillion in global assets under management (including nine US-based firms). The Study notes that economies of scale in portfolio management and administration, combined with index-based strategies, have increased concentration in recent years. Size and market concentration are viewed in the Study as potentially increasing the impact of firm-level risks, such as operational or investment risk or increasing the risk of fire sales. This focus on the market impact of size is mirrored in all of the nonbank SIFI designations issued to date, especially in the case of Prudential. Size is used as a proxy for the potential reach of a large nonbank financial company into the real economy.

Reaching for yield and herding

The Study notes that a low interest rate environment may lead some portfolio managers to "reach for yield" by seeking riskier investments, and other asset managers may crowd or herd into popular asset classes. According to the Study, these behaviors may lead to increases in asset prices and magnify market volatility and distress if the markets or particular market segments face a sudden shock.

But the Study indicates as well that market practices and regulatory restrictions can mitigate such risks. For example, fund- and firm-level investment risk management is intended to ensure investments conform to investment mandates and independent risk managers can reduce the risk of overextending portfolio mandates when they are empowered to challenge investment decisions.

Risks can also surface when investors herd into new products, particularly if the products are relatively illiquid and investors fail to anticipate their risks under different market conditions. As an example, the Study notes that mutual funds managed using alternative strategies can introduce more complex trading strategies and embed leverage more than traditional retail funds. During a market shock investors who failed to appreciate these risks could engage in heavy redemptions.

However, the Study notes that it is important to recognize that asset managers can also have a stabilizing effect on the market. As an example, asset managers with the financial strength and liquidity to buy assets below their intrinsic values could potentially help to stabilize prices.

Redemption risk

The Study includes a chart that illustrates characteristics that may make collective investment vehicles more vulnerable to redemptions. The chart notes that the most vulnerable funds are those that seek to preserve investor principal stability – such as money market funds or short-term investment funds that offer daily liquidity.

The Study further notes that bond funds could be exposed to a risk of sudden price declines if interest rates were to suddenly rise, and managers of these funds may be suddenly exposed to heavier redemptions if they have not adequately managed the fund's liquidity, given market risks and the thinly traded nature of some fixed-income markets.

Furthermore, inadequate reinvestment of cash collateral for asset management securities lending programs shows how redemption-like risk can create contagion and amplify financial stability. If securities lenders fear a loss of value in reinvested cash collateral due to market stress, they have an incentive to recall lent securities and exit reinvestment funds. Alternatively, borrowers may seek to return securities if they believe posted collateral may be at risk. The Study takes the view that losses on cash collateral investments amplified fire sales and runs during the crisis and contributed to the market freeze-up. Notwithstanding its conclusions, the Study admits that the connection between securities lending markets and cash collateral investment, redemption risk, and short-term funding markets is not well understood and is difficult to measure.

Finally, the Study states that in some circumstances, investors may believe that they can rely on the sponsor's support of the fund or product in a crisis, even in the absence of a legal or stated guarantee. Investors may hold this belief because of the way a product was marketed or because such support was provided in the past and competitive pressures (or protecting firms' reputations) may make sponsors feel that they are obliged to provide support.

Leverage

The Study notes that asset managers can use leverage at the firm-level (i.e., borrowing by the firm itself), the fund-level (i.e., fund borrowing, or closed-end funds offering both common and preferred shares), or the portfolio-level (i.e., acquiring leveraged, structured products, or trading in derivatives). Derivatives can create leverage by allowing funds to obtain exposure to market fluctuations in underlying reference assets – such as stock prices, commodity prices, or interest rates – that exceed the fund's investment in the derivative. These transactions can either (1) result in the incurrence of potential debt obligations under the derivative contract, such as with a swap or future (i.e., indebtedness leverage), or (2) provide increased market exposure without the incurrence of future obligations, such as with a purchased option or structured note (i.e., economic leverage).

The Study reports that registered funds markedly expanded their exposure to credit derivatives in the run-up to the crisis. By 2008, 60% of the 100 largest US corporate bond funds sold credit default swaps, up from 20% in 2004, according to a Federal Deposit Insurance Corporation working paper. During the same period, the size of the average credit derivative position grew from almost 2% to 14% as measured by the notional value of the position relative to the next asset value. The Study notes that the use of derivatives to boost leverage resulted in significant losses for some registered firms, which apparently did not pose any threats to the financial system.

Firms as sources of risk

According to the Study, the failure of a large asset management firm could be a source of risk, depending on its size, complexity, and the interaction among its various investment management strategies and activities:

- Distress at a large asset manager could amplify or transmit risks to other parts of the financial system.
- Concentration of risks among funds or activities within a firm may pose a threat to financial stability. Instability at a single asset manager could increase risks across the funds that it manages or across markets through its combination of activities.
- Interconnectedness and complexity can transmit or amplify threats to financial stability; large financial companies tend to have multiple business lines that are interconnected in complex ways.
- Material distress at the firm-level, or firm failure, could increase the likelihood and magnitude of redemptions from a firm's managed assets, possibly aggravating market contagion or contributing to a broader loss of confidence in markets.
- As agency businesses, asset management companies tend to have small balance sheets, and nonbank, non-insurance asset managers are not required by US regulation to set aside liquidity or capital reserves for their asset management businesses. The FRB's annual stress test requires the asset management divisions of large bank holding companies with money-like funds to set aside capital to cover the risk that they would have to support some of their funds during stress conditions.

Transmission channels

According to the Study, asset managers could transmit risks across the financial system through two primary channels: (1) exposure of creditors, counterparties, investors, or other market participants to an asset manager or asset management activity, and (2) disruptions to financial markets caused by fire sales.

Regarding the first point, the Study states that direct connections among asset managers, banks, broker-dealers, insurance companies, and other financial services providers have grown over the past decade. These industry linkages have also increased the indirect connections among asset managers. Having common service providers, such as custodians, pricing providers, or securities lending brokers, or having common, large clients as investors, could result in common difficulties in the event of widespread service disruptions or redemptions. Fund-of-funds strategies that create implicit linkages between funds could also cause stress in the event of rapid redemptions, if severe price declines in more illiquid funds in the portfolio lead to increased selling pressure on more liquid funds.

With respect to the second point (i.e., fire sales), the Study states that the following factors can increase the likelihood and severity of fire sales:

- **Large market positions and concentrations.** Fire sales may be exacerbated when a single fund or fund complex holds a large market position in a particular asset, sector, or strategy.
- **Illiquid markets.** As markets become more illiquid, potentially due to market stress, they become increasingly prone to fire sales. Asset classes that tend to be less liquid include fixed-income securities, bank loans, and derivatives such as single-name credit default swaps. Customized or "bespoke" products can be particularly illiquid if they include complex combinations of derivatives and less liquid assets.
- **Reputation risk.** If an asset manager or one of its specialized funds suffers damage to its reputation, the redemption risk for the asset manager's funds could increase fire-sale risk.
- **Crowded trades.** Crowded trades can distort market prices and increase fire sale risk. As discussed earlier, crowded trades occur when market participants have similar, correlated holdings in an asset class or trading strategy, and herding occurs. In the event of a shock, investors in crowded trades may try to sell or unwind their positions at the same time and in the same direction.
- **Leverage.** Excessive leverage can increase the risk that margin calls or other capital calls could prompt increased asset sales to cover positions. This risk is heightened in complex or less liquid funds, because

price dislocation may be more severe, and during periods of market stress

- **Transactions with liquidity "puts."** Certain transactions, such as securities lending and repo, have contractual obligations requiring liquidity upon demand and involve a large number of market participants. During periods of market stress, forced sales associated with these contractual obligations could increase the probability of fire sales.
- **Funding mismatches.** Short-term funding of long-term investments can lead to fire sales when funding liquidity is tight and investment values experience a negative shock.

Data gaps

The Study describes several areas where better data collection could facilitate macroprudential analysis, oversight, and monitoring of asset management firms and activities. Although increased data reporting requirements impose costs on firms, the Study takes the view that OFR and regulators with jurisdiction over the firms and their activities could consider the extent to which significant benefits to financial stability monitoring could merit such increased reporting.

Separate accounts

Registered investment advisers, banks, and insurance companies manage trillions of dollars in separate account assets; the top five asset management companies alone manage $5.5 trillion in separate accounts. The Study states that data about the types of assets held in these accounts, their counterparty and other risk exposures, and amounts of leverage are limited. As a result, supervisors today are unable to fully assess the nature or extent of any financial stability risks that could be amplified or transmitted by the activities of these accounts.

Securities lending and repos

The Study states that collecting transaction level and position data on securities lending between large international financial institutions, including the composition of the underlying cash collateral reinvestment assets, would improve regulators' visibility into market activities.

Section 984 of Dodd-Frank requires the SEC to adopt rules increasing the transparency of information about securities lending available to broker-dealers and investors. Such a rulemaking could fill some of the data gaps described earlier.

Similar concerns exist regarding the involvement of asset managers in repo activity. During a period of market stress in which funding liquidity is drying up, firms with large repo books and an array of interconnections may have difficulty unwinding clients' investments quickly. Because such a situation could dislocate markets and heighten fire sale risk, data on repo activity is important to monitoring developments that could indicate stress.

The Study states that, although the SEC is considering approaches to enhance transparency in the closely related securities lending market, collecting data at the transaction level and position level on the overall volume of repo transactions in all three market segments (i.e., tri-party, bilateral (that is, transactions settled between dealers on a delivery versus payment basis), and general collateral markets) would provide regulators a holistic view of asset managers, as well as interconnections and concentrations within repo markets.

Reading the tea leaves – what's next?

Given the circumstances, we believe it is difficult not to reach the conclusion that a few, large asset managers will ultimately be proposed for designation as nonbank SIFIs. The Council has great discretion and does not have to "prove" that a particular firm is of systemic significance. The insurers are the case in point: despite vigorous lobbying efforts by certain firms (and strong arguments), two have nonetheless already been designated (and a third may be on its way).

Our view is that the Council's criteria for making these designations rests more on whether the firm "could" be systemically significant in the event of failure during a future financial crisis, regardless of the likelihood of the failure. The Council essentially considered size, interconnectedness, and the lack of a national resolution regime when designating the insurers. Although size is arguably less clear in the case of asset managers (given that the assets they manage are not in fact on their balance sheets), it is hard to deny the firms are "large" (leaving accounting math aside). The other factors are clearly present, with resolution being particularly important as no comprehensive resolution regime is currently in place for asset managers.

The reality is that the regulators already have a strong sense of which firms they would like to designate. They have this view based on learnings from the financial crisis and from their implementation of Dodd-Frank. This view has likely also been shaped by the information they are receiving from the bank SIFIs through their resolution plans or through private conversations regarding regulatory matters. Last but not least, the bank SIFIs and now the insurance SIFIs – most of which have significant asset management arms – would prefer to see a level playing field with respect to the additional capital and regulatory burdens their asset management businesses now face. Macroprudential misery loves company.

We believe two to four firms will be proposed for designation in 2015.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

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