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c/o Bank for International Settlements  
CH-4002 Basel

By email:  
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## **FSB Consultation on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities**

Ladies and gentlemen

The Swiss Bankers Association (SBA) is pleased to respond to the FSB consultation on its 'Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities' as put online on June 22, 2016.

The FSB Consultation focuses on four structural vulnerabilities associated with asset management activities that potentially could lead to financial stability risk.

- Liquidity mismatch between fund investments and redemption terms and conditions for fund units,
- Leverage within funds,
- Operational risk and challenges in transferring investment mandates or client accounts,
- Securities lending activities of asset managers and funds.

### **General remarks**

The SBA in principle supports any measures that are suited to add to a stable financial system.

However, when stipulating recommendations to address vulnerabilities that potentially could lead to financial stability risk, the term financial stability risk needs to be defined and evidence given that there is a probability that such vulnerabilities could lead to disruption of the financial system. Recommendations for additional regulations should be based on evidence of risk. Where required, more data should be collected to assess whether a risk is significant enough to merit regulatory change.

In the following we address the FSB's questions and recommendations as listed in the consultation document.

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Q1: Does this consultative document adequately identify the structural vulnerabilities associated with asset management activities that may pose risks to financial stability? Are there additional structural vulnerabilities associated with asset management activities that the FSB should address? If there are any, please identify them, as well as any potential recommendations for the FSB's consideration.

Focusing on the four structural vulnerabilities listed in the document, it is difficult to understand why a liquidity mismatch in open-ended investment funds would result in a significant financial stability risk. In principle, a liquidity mismatch could potentially lead to a first mover advantage as later redemptions could not be honoured. However, for open-ended investment funds with a focus on listed securities we are of the firm opinion that current legislation and fund liquidity risk management practices are sufficient and reliable to prevent a significant first mover advantage (requirement to maintain an appropriate level of liquidity in the fund and the ability to pass on transaction costs related to redemptions to the redeeming investors).

Q2. Do the proposed policy recommendations in the document adequately address the structural vulnerabilities identified? Are there alternative or additional approaches to risk mitigation (including existing regulatory or other mitigants) that the FSB should consider to address financial stability risks from structural vulnerabilities associated with asset management activities? If so, please describe them and explain how they address the risks.  
Are they likely to be adequate in stressed market conditions and, if so, how?

See comments to recommendations.

Q3. In your view, are there any practical difficulties or unintended consequences that may be associated with implementing the proposed policy recommendations, either within a jurisdiction or across jurisdictions? If there are any, please identify the recommendation(s) and explain the challenges as well as potential ways to address the challenges and promote implementation within a jurisdiction or across jurisdictions.

In this context it is important to note that all investors should be treated equally and that the degree of risk in a given situation derives from the behaviours of all market participants out of which investment funds only represent a fraction (others are e.g. investors holding direct investments in equities or bonds). For example, if authorities required an investment fund to suspend redemptions at a time when direct market par-

ticipants are able to dispose of assets, the fund investors would be disadvantaged relative to those accessing the market directly.

**Recommendation 1:**

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

As stated in our comment to question 1, we do not believe that in the absence of leverage, a potential liquidity mismatch could result in substantial risks to the financial system. In addition, the supervisory authority in Switzerland (like in other jurisdictions), when reviewing any new investment fund, ensures that the liquidity terms of any fund correspond with the chosen investment strategy.

**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 profiles, 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 should review its existing guidance and, as appropriate, enhance it.

It is important that liquidity risk is appropriately disclosed to investors. UCITS regulations require disclosure of potential risks in the fund prospectus and the most material risks in the Key Investor Information Document. Similarly, principle 7 of the IOSCOs Principles for Liquidity Risk Management for Investment Schemes requires an “appropriate explanation of liquidity risk”. We believe the current framework is sufficient.

**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.

We are of the opinion that UCITS and AIFMD regulations sufficiently address the liquidity risk.

When considering testing fund liquidity under stressed market conditions, the understanding of “stressed market conditions” must be clearly defined. Recommendation 3 could be taken to mean that investment funds should be required to hold liquidity to meet redemptions in any conceivable market disruption. We do not support this as it could lead to an excessive level of cash holdings and could hence negatively impact investor returns.

The FSB consultation explores the possibility of minimum standards for funds' internal liquidity risk management programmes. Any additional requirements to the status quo e.g. monitoring of prescribed liquidity buckets, should incorporate proportionality to enable implementation according to the liquidity risk of the specific fund.

An effective liquidity risk management framework will take into account the likely level of redemptions expected from a fund. Investor concentration data is a useful input into this analysis, however, this information is not always available from distributors where fund units are held in a nominee account. The FSB should consider a recommendation that encourages distributors to share concentration data and redemption patterns (including gross redemption figures) with the asset managers.

**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.

The ASB would welcome a widening of the availability of liquidity risk management tools, however, choice of tool and its use should always be at the discretion of the asset manager.

**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.

As stated above, we do not believe that there is a significant first mover advantage in open-ended investment funds.

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 to 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.

Authorities should provide guidance on stress testing. As stated above stress tests and potential market scenarios need to be clearly defined. In addition, such scenarios need to take into account differences in individual open-ended funds, e.g. fund size.

Recommendation 7:

Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of extraordinary 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.

It is appropriate for asset managers to have a clear decision-making process for liquidity risk management tools as part of the overall liquidity risk management framework (and this was included in IOSCO's January 2012 Principles on Suspensions of Redemptions in Collective Investment Schemes). We do not believe that there is a remaining (systemic) financial stability risk caused by an alleged fund investors' lack of understanding of liquidity risk management tools. Consequently we would not support additional disclosure requirements in this area.

Recommendation 8:

Authorities should provide guidance and, where appropriate and necessary, provide direction regarding open-ended funds' use of extraordinary liquidity risk management tools. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

The FSB Consultation states that the relevant authorities could "direct the application of such tools in exceptional cases where the manager is not best placed to make this evaluation" [of what is appropriate for a fund]. We do not support this recommendation. It is not clear from the FSB Consultation under what circumstances the relevant authority would be best placed (i.e. better placed than the fund manager) to evaluate the risk of a fund. Furthermore, there is a risk that if a relevant authority directs the suspension of a fund that its investors could be disadvantaged relative to other market participants (please see previous comment on treating all investors equally).

Recommendation 9:

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

While we in principle agree, such a task cannot be undertaken by national authorities.

Furthermore, it seems questionable, what the results of such system-wide stress tests would yield. In our view, all investors have to be treated equally and a ban on mutual funds or institutional investors to sell securities in a stressed situation, while individual investors cannot be stopped selling, would not be equal treatment.

Recommendation 10:

IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions. This would enhance authorities' understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level. IOSCO should also consider developing more risk based measure(s) to complement the initial measure(s) and enhance the monitoring of leverage across funds at a global level.

Agree.

Q4. In your view, is the scope of the proposed recommendations on open-ended fund liquidity mismatch appropriate? Should any additional types of funds be covered? Should the proposed recommendations be tailored in any way for ETFs?

Please see comments above. We do not believe there is proven evidence of significant financial stability risk related to liquidity mismatch in unlevered investment funds.

Q5. What liquidity risk management tools should be made available to funds? What tools most effectively promote consistency between investors' redemption behaviours and the liquidity profiles of funds? For example, could redemption fees be used for this purpose separate and apart from any impact they may have on first-mover advantage?

Above all, equal treatment of all investors in a fund must be ensured. One measure could be to limit the maximum possible redemption volume in % of fund volume on any given redemption date.

Q6. What characteristics or metrics are most appropriate to determine if an asset is illiquid and should be subject to guidance related to open-ended funds' investment in illiquid assets? Please also explain the rationales.

A frequently used measure is the time required to liquidate a certain position without having a significant effect on the security's market price. Obviously, there is also a connection to the redemption frequency of a fund. A fund with e.g. quarterly redemptions possibilities has more time for an orderly liquidating of an asset than a fund with daily redemption frequency.

One also has to consider that liquidity in a certain asset changes over time according to market conditions, investor behaviour and size of the respective asset position. While it may easily be possible to sell a USD 1m position, it may be impossible to sell a USD 10m position without having an impact on the market price.

Q7. Should all open-ended funds be expected to adhere to the recommendations and employ the same liquidity risk management tools, or should funds be allowed some discretion as to which ones they use? Please specify which measures and tools should be mandatory and which should be discretionary. Please explain the rationales.

Given the large number of investment strategies, asset classes and securities, it would not be advisable to force all funds to use the same liquidity tools. Asset managers best understand the risks in their fund and are best suited to choose the tool and method most appropriate to manage the inherent liquidity risks. Again, we fully support recommendation 4, to make a number of various tools available, however, the final decision should be left to the asset manager.

Q8. Should authorities be able to direct the use of exceptional liquidity risk management tools in some circumstances? If so, please describe the types of circumstances when this would be appropriate and for which tools.

No. This must be in the full discretion of the asset manager as he is best suited to understand the inherent risks.

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

In principle agree, however, any such undertaking should take into consideration the asset size of any particular fund. Otherwise the reporting and monitoring burden is in no relation to the potential risks.

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

It is unclear how aggregated data on leverage would help in understanding the risks to the financial system. If and when, data should be collected on single market and even securities level. Further information would be needed in order to assess the effectiveness of recommendation 12.

Q9. In developing leverage measures (Recommendation 10), are the principles listed above for IOSCO's reference appropriate? Are there additional principles that should be considered?

We agree with recommendation 10 as stated above. Leverage should always be considered as economic leverage measured on a risk-based approach (gross up of long/short position in same security).

Q10. Should simple and consistent measure(s) of leverage in funds be developed before consideration of more risk-based measures, or would it be more appropriate to proceed in a different manner, e.g. should both types of measure be developed simultaneously?

In our view a simultaneous approach should be adequate.

Q11. Are there any particular simple and consistent measures of leverage or risk-based measures that IOSCO should consider?

Simple measures of leverage can be less meaningful than more complex measures but may still be appropriate if a fund has a low level of leverage.

Where a more complex approach is merited, we believe that the calculation of leverage at a total fund level should reflect the potential maximum loss amount of a portfolio compared to the total assets in the portfolio at any moment in time.

For example, a risk based approach for interest rate derivatives such as one that scales based on DV01 might be appropriate. Under the DV01 approach, assets are netted and scaled by risk and not only by notional, providing a more accurate measure

of leverage risk on derivatives. A stress scenario can also be incorporated into this approach if required.

We caution against using a sum of notional measure because:

- Trying to reduce the sum of notional can have the effect of preventing or adversely modifying certain trades which we may assess as being an effective way to manage and control overall portfolio exposure, thereby increasing the risk to investors;
- The Sum of Notional approach can give a misleading impression of risk related to interest rate derivatives (e.g. money market futures and options), where the notional value can be particularly high and does not reflect the true risk of loss for fund investors.
- No concrete relationship can be made between the risk of the Fund's value at risk (VaR) and the Sum of Notional.

Q12. What are the benefits and challenges associated with methodologies for measuring leverage that are currently in place in one or more jurisdictions?

No assessment available.

Q13. Do you have any views on how IOSCO's collection of national/regional aggregated data on leverage across its member jurisdictions should be structured (e.g. scope, frequency)?

See comment on recommendation 11.

Q14. Do the proposed policy recommendations on liquidity and leverage adequately address any interactions between leverage and liquidity risk? Should the policy recommendations be modified in any way to address these interactions? If so, in what ways should they be modified and why?

The interaction between leverage and liquidity is given in situations of deleveraging in stressed market conditions. Any policy recommendations should therefore focus on this situation.

**Recommendation 13:**

Authorities should have requirements or guidance for asset managers that are large, complex, and/or provide critical services to have comprehensive and robust risk management frameworks and practices, especially with regards to business continuity plans and transition plans, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions.

Whilst we fully agree that business continuity plans must be in place, we do not see how regulatory guidance on orderly transfers in already stressed markets could prevent risks to the financial system.

Q15. The proposed recommendation to address the residual risks associated with operational risk and challenges in transferring investment mandates or client accounts would apply to asset managers that are large, complex, and/or provide critical services. Should the proposed recommendation apply more broadly (e.g. proportionally to all asset managers), or more narrowly as defined in Recommendation 13? If so, please explain the potential scope of application that you believe is appropriate and its rationales.

Please see our comment on recommendation 13.

Thank you in advance for taking into account our considerations. Please do not hesitate to contact us for any further information.

Yours sincerely,

Swiss Bankers Association (SBA)



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