By electronic mail: Secretariat of the Financial Stability Board, Basel, Switzerland (fsb@bis.org)

7th April, 2014

Dear Sir/Madam,

RE: CONSULTATIVE DOCUMENT – ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK, NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (8th January 2014)

Please find attached the response of the UK's Investment Management Association (IMA) to the above consultation. We are grateful for the opportunity to comment.

We set out in the response our credentials but would like to note here that the IMA's purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

Our response to the questions raised in the public consultation is included as an annex to this letter. Please do not hesitate to contact me on +44 20 7831 0898 or at Richard.Metcalfe@investmentuk.org, should you wish to discuss any points in more detail.

Yours faithfully,

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Annex: IMA response to NBNI G-SIFI consultation by FSB and IOSCO

Introductory remarks

*"…efforts to extend the failure-*prevention *paradigm of bank capital regulation to financial entities that are already subject to failure-*management *regulatory schemes implies an institutionalization of the concept of too-big-to-fail." SEC Commissioner Daniel Gallagher, Speech on capital, Jan. 15, 2014*

The IMA[1] welcomes the opportunity to respond to this consultation. We appreciate the challenges in trying to extend to collective funds a framework developed for determining the systemic significance of banks. We further note that the funds universe contains a range of structures and investment styles. Our response covers the full range, referring where relevant to hedge funds (or, in the EU vocabulary AIFs) as well as 'real money' (or UCITS).

The world of collective funds is directly regulated (viz, UCITS legislation in Europe), in a way that not only affords protection for investors but also controls key aspects of how funds interact with markets and counterparties. Limits on leverage and requirements for diversification of investments (and, where relevant, counterparties) provide a significant check on the impact that such a fund may have on the market and vice versa.

Moreover certain activities – or, to be precise, the exposures resulting from certain activities – are the subject of existing or proposed legislation. Thus, OTC derivatives must be margined, whether centrally cleared or not. In the case of non-cleared derivatives, the requirements are triggered when the use of the instruments is systemic in scale. All derivatives must also be reported, to a trade repository, which in Europe includes listed derivatives as well as OTC.

A more obvious and broadly understood consideration is the difference between deposit-taking and investment management. The former entails a promise to repay a defined amount of money (ie, whatever the customer has deposited) and that is why deposit insurance has a role to play. Confidence in the viability of the banking *system* arguably depends on such measures relating to the integrity of a claim on individual banks. The latter activity (ie, investment management) not only segregates the customer's money from that of the financial institution managing the fund, separating the fate of the institution from the customer's money; it also necessarily means that the amount of money coming back to the customer will vary. Investment management consists of a promise to direct investments, predominantly in securities, in line with an agreed policy, with every chance that the amount that the customer receives back will have changed over time. In fact, the investor typically commits money to the fund

[1] The IMA represents the asset management industry from a UK perspective. Our members include independent fund managers, the investment arms of banks and life insurers, and the in-house managers of occupational pension schemes. They are responsible for the management of over £4.5 trillion of assets from the UK on behalf of domestic and overseas investors.

precisely because of that ability for the sum to change in size. This distinction means that geographical diversification (whether of investments or sales) by a fund manager carries completely different implications from diversification by a bank (whether of investments or deposit-taking).

Moreover, there is a high degree of substitutability in fund management. Fund management in the UK shows a remarkably low 'HHI' concentration score: on a scale that in theory extends as high as 10,000 (a complete monopoly), the score is in practice just over 300. Competition in fund management, which entails a global market in skilled staff, means that there is often likely to be a fund that covers a similar asset class in a comparable way. It also means that there will be a wide range of other funds, offering investors opportunities (and risks) in other areas.

The definition of 'systemic' remains unclear. As regards, price dynamics, we accept that a dramatic decline in the prices of financial assets can send a signal about the economy, although the chain of cause and effect here has never been convincingly established. (Leaving aside phenomena such as flash crashes, why would markets fall significantly, if not for underlying reasons of concern about economic performance?) We note concerns about herding in financial markets and address this question in our response.

We support scrutiny of funds activity where the scale and nature displays a combination of virulent factors. Based on past behaviour, this will be in truly exceptional cases. We believe that an emphasis on a combination of factors will afford the best chance of detecting possible distress. Strictly speaking, this should only matter to the extent that other entities would then suffer via contagion. Any such scrutiny should exploit existing reporting mechanisms to the full, rather than adding new ones.

We note that central counterparties (CCPs) are currently the subject of unfinished deliberations on recovery and resolution. Certain steps that some CCPs wish to have the power to take could spread loss to the customers of funds, in a way that is inconsistent with the mission of CCPs to insulate the system from credit failure. It could also spread that loss very widely, beyond the financial system to what is in effect the real economy. We believe it is vital that if such CCP power is on balance deemed desirable, then it does not become a back-door to systemic contagion.

We request a further round of consultation with industry, beyond the current one, to address the following two considerations:

1) **To scrutinise proposed measures**. The current consultation makes no proposal as to the measures that would apply to any funds that were in practice designated as systemic;
2) **To calibrate the leverage indicator**. A strong consensus appear to be emerging that further attention needs to be paid to leverage (more so than outright size) and for those funds that have the ability to rapidly change their level of leverage.

Q1-1. In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

We do not believe there are any other channels that need be considered. Moreover, we believe that the credit (counterparty risk) channel is the one that is most potentially significant. Liquidation of positions can have an impact on prices, but this would appear to be a serious issue only in the presence of significant leverage (just as leveraged purchases can contribute to asset-price bubbles).

Counterparty exposure – or any other form of credit risk posed by a fund – is the only way in which distress unequivocally could be transmitted directly from one entity to the next. To the extent that a fund suffered large losses that somehow compromised its ability to extinguish any form of debt it had incurred, there could be direct contagion. This will be exacerbated disproportionately, the greater the leverage involved.

What one might call '*in*-direct contagion' is another matter. In times of heightened financial anxiety, one entity's failure or distress can cause an adverse reaction in relation to other entities, if they are of a similarly vulnerable nature. Thus, one bank suffering from a collapse in house prices can (and in 2008 did) raise uncomfortable questions about other banks with similar exposures, or even just the potential for similar exposures.

'Indirect contagion', however, has two important characteristics. Firstly, for it to even be able to exist, there has to be i) a known pathology that is ii) inherent in the business model (with runs, in the case of banks and shadow banks, being the only incontrovertible example). Secondly, any propensity for contagion is in practice mitigated by the degree of substitutability, which is generally and rightly recognised as being of a very high level in most fund strategies. One fund being in difficulty (as the current consultation posits) can therefore only influence attitudes towards other funds to the extent that those alternatives are not independently viable.

It is true that, in theory, a number of funds could be exposed to a common set of factors: say, leverage in large, speculative positions in a narrow, volatile asset class or sub-class. Absent such coincidences, however, there is no inherent pathology in funds. Moreover, even within the same strategy, performance can vary significantly between funds (such that poor – or even terminally bad – performance at one cannot be assumed to feature at another, even if one accepts the premise that such underperformance is in any way systemic in nature). On top of that, the diversity of strategy types available through funds provides a further safeguard.

Leveraged investment can clearly give rise to a different dynamic from regular redemptions, however large in scale those may be in future. If investor sentiment weighs against an asset or asset class, even governments may have to accept that. High or rapidly increased leverage, on the other hand, creates a demonstrably less stable vehicle, with potential consequences for asset prices that are to do with leverage more than economic fundamentals. ;

The two channels, other than counterparty/credit risk, identified by FSB-IOSCO are liquidation and criticality.

Liquidation is explicitly envisaged and catered for in fund structures. No one would buy them otherwise. And if anything, funds act as a stabilising influence, having the potential to 'internalise' any simultaneous demand for redemption from one investor against a new purchase by another, leaving the underlying investment in place and reducing short-term volatility. But, even where this does not happen, it seems as difficult as it is pointless to somehow try to legislate for liquidations, when these are an inherent part of interaction with financial markets. Investors acting as individuals can just as easily place an order with a broker to liquidate assets, as sell fund units. However long-term the investors' plans may be, those clients and the funds that they buy need to be able to liquidate positions.

Naturally, it may make sense for an individual fund to agree contractually with investors to place controls on liquidation, for instance in order to reflect illiquidity in the asset in which the fund invests. This is rightly a well established technique[2]. The IMA further believes that funds should have significant flexibility to 'soft-close' to new money, if in the manager's view it becomes harder to operate effectively in a market once a fund is above a certain size. Subject to certain conditions (including transparency to investors) managers should not have to wait for supervisory approval, at the point when they reasonably believe a soft close is justified.

As regards the willingness or ability to provide a "critical function", the consultation cites one example of potentially affected parties: "borrowers". Funds can of course take credit risk on other parties, every time they buy a bond or (if relevant) write a credit derivative. Yet it seems unlikely to us that any one fund or funds could be considered "critical" to the credit (lending) channel, at least as long as there are banks (and of course shadow banks) performing that particular function.

Anecdotal evidence from IMA members does suggest that, after the economic crisis of 2007 et seq, funds were quicker than banks to resume risk-taking on both banks and the broader economy. Their ability to do so, however, acted as a counterbalance to the ill health of the banking system and was, in essence, supported by the very fact that they do not operate the fractional-reserve model that is intrinsic to banking.

On the subject of the credit channel, it is worth noting that the majority of funds adhere to the totality of the advice: "Neither a borrower nor a lender be"[3] We have discussed l

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[2] UCITS managers have various mechanisms to manage liquidity in fund units, particularly adjustments relating to redemption, viz a) frequency; (b) charges; (c) deferral; (d) suspension; (e) in specie payment,

[3] Hamlet, Act 1, Scene III (speech by Polonius)

above lending and the contrast with fund activities. As regards funds' propensity to 'borrow', the first and obvious point is that collective investment schemes – and, for that matter, what the consultation refers to as 'separately managed accounts' – do not fund themselves in that way. The customer's purchase of units in a fund is more akin to equity investment, even where the fund itself might manage a portfolio of credit-sensitive instruments. (That equity-like participation in turn eliminates the first-mover advantage that exists in relation to bank deposits; and which is made worse by the ability of banks and securities dealers to move cash and other assets between group entities. The only time, in our view, when this first-mover advantage can possibly materialise is when the investor exposures are to a shadow bank. We do not consider funds generally to constitute shadow banks, so we would suggest focusing only on exceptions to this rule.)

As sources of potential credit exposure to a fund, that leaves certain identifiable exposure (for example, arising from activities such as derivatives). We agree that these activities and exposures should continue to be the subject of regulatory attention, in proportion to their scale and significance. As the consultation makes clear, use of derivatives is more likely to be a feature of hedge funds, though it is also covered under UCITS legislation in the European Union, as well as legislation that is not specific to funds but which brings them into scope along with other types of party. A prime example of such legislation is 'EMIR', with its requirements to clear, report and risk manage derivatives, both privately negotiated (OTC) and listed. Also relevant will be rules on initial margin for non-cleared derivatives.

As regards possible criticality in other respects, we agree that substitutability is the key consideration. As discussed above, the IMA's view is that no one fund can easily be considered "critical". Even if a fund were truly unique in its investment strategy, perhaps along the lines of LTCM's statistics-based aspirations to seek out arbitrage in spreads to government bonds, the fact that it was the only fund offering such a strategy did not in itself make that strategy crucial. Any fund's performance will certainly matter to the investors in that fund. And a fund's leveraged use of instruments that gave rise to counterparty exposure would demonstrably raise separate issues. But the uniqueness or otherwise of a strategy does not in itself make it or the fund deploying that strategy critical.

The IMA regularly measures the converse of substitutability, ie, concentration, in UK-based (collective) fund management. Specifically, we calculate the Herfindahl-Hirschmann Index number, as it relates to market share. As of end 2012, this stood at a very low figure of 308, which had not changed since 12 months earlier. With a maximum possible score on the HHI scale of 10,000, and the threshold for moderate concentration standing at 1,000, the UK collective fund management industry is clearly one with strong evidence of robust competition.

To recap, we believe credit risk (or potential credit exposure) should overwhelmingly dominate the consideration of whether a fund is potentially significant in some way.

Classic credit risk (such as occurs in lending) entails a probability of default at a particular point in time: the point when obligations are actually due. Counterparty (or 'presettlement') risk on the other hand can give rise to a need to replace a counterparty before their obligations fall due (the size of the exposure being variable, because they are the product of changes in market prices for some underlying security or rate). Counterparty risk, therefore, requires attention to potential for the size of the exposure to vary (and, of course, to vary considerably, where leverage is involved). Counterparty credit risk, in other words, involves the sensitivity of the fund to changes in asset prices underlying derivatives, since such changes are what drive the quantum of credit exposure.

Credit risk could also take the form of settlement risk – the failure, for example, to deliver securities against cash paid out. But protections exist against settlement risk, through the use of third parties and delivery versus payment.

As mentioned above, funds do not borrow money from their clients, so we ignore this as a channel for transmission of credit shock. This, of course, contrasts with bank deposits (and shadow banks), which are i) economically equivalent to loans and ii) likely to be one of many forms of bank indebtedness, including interbank borrowing and bond issuance.

As regards liquidation, Fund clients explicitly and deliberately take on the risk of market-price changes. Indeed that is what they pay fund managers to do: to identify and take agreed levels of risk, in the expectation of earning reward.

Forced liquidation of assets by one entity (which the consultation posits as a form of distress) could trigger mark-downs in the values ascribed by others to the same (or similar) assets, if the size of the liquidation was sufficient to weigh heavily on the market at a given time, which will tend to be the case when leverage is involved. However, it is not necessarily the case that such mark-downs will spread distress. Such sales could, of course, represent a buying opportunity for others, unless of course market conditions were already such that a general 'risk-off' episode was inevitable; in which case, the mere fact that the sales were happening through funds would, in our view, be incidental and, moreover, only exacerbated by dead-weight costs that eroded returns.

Relevant here is the fact that collective funds generally are required to be a) fully invested (long) in b) a particular asset class. As such, the funds will tend to dampen market volatility rather than add to it. Fund managers have an incentive to sell only after careful consideration, as they must look to long-term performance. Moreover, the short-term incentives align, in that selling lowers the amount of funds under management, on which managers' fees are based.

Q2-1. Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

As outlined above, we believe that the potential for systemic impact is clearly limited to certain, special circumstances. With that proviso, the impact factors set out in the consultation appear relevant, if only when they appear in a certain combination.

We do not believe that 'complexity' can be meaningfully defined, especially in relation to funds, whose structure is generally quite simple, particularly in comparison with corporate structures (not least, those that prevail in other parts of financial services). In these circumstances, the fact that a funds "activity" is deemed global is not just 'not bad' – it is to be welcomed. This is because that activity is investment, rather than intermediation via a balance sheet. The advantages (to fund customers) of being able to diversify investment portfolios globally are well known. The advantages to companies, in a financial world that is increasingly constrained by enforced bank subsidiarisation, of being able to attract funds from a geographically diverse range of sources are there to be appreciated by anyone who cares about economic growth. Furthermore, a diverse investor base brings with it the potential for heterogeneous responses to events, if we bear in mind the existence of differing nationally based influences on investing behaviour - such as recession, inflation, property bubbles.

Q2-2. Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector-specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

We do not believe there are other types of entity that merit attention, with the possible exception of central counterparties (CCPs) in derivatives, even though a special regime applies in any case. Notwithstanding that special regime, recovery and resolution of CCPs remains problematic, in our view, to the extent that this could spread losses from a limited group of financial market intermediaries (particularly clearing members plus the CCP itself) to the wider economy, notably by dipping into fund assets, given that they represent the savings of the real economy.

Q3-1. Is the proposed scope of assessment outlined above appropriate for operationalising the high-level framework for identifying NBNI G-SIFIs? Are there any practical difficulties associated with the proposed scope of assessment?

Care will need to be taken to provide sufficient consistency in approach, at the same time as sufficient flexibility to take account of the specific investment strategy deployed. More importantly, perhaps, over and above that consideration, supervisors will in our view need to have regard for any ability for the risk profile of a given fund to change dramatically.

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please

provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Leverage remains a potentially crucial factor but clearly is only truly significant when it is on a large scale, above a threshold size of fund (and probably only in the presence of significant leverage elsewhere in the system). As such, we agree that it is important to limit the pool of firms for which more detailed data could be sought, not just to avoid an unnecessary burden on funds but also to better focus supervisory efforts.

At that point, given the importance of fund investments to the economy at large and more specifically to the capital markets, both primary and secondary, it will be important to establish a rigorous assessment of whether and how any individual fund has systemic implications. It will be helpful to have in place a system that is effective in tracking any actual or potential rapid increase in leverage (and therefore risk exposure), prioritising those types of fund that have this ability.

Q3-3. Are there any practical difficulties in applying the materiality thresholds?

Care would need to be taken to focus on the fund that is able to incur exposures, whether to market risk or credit risk, rather than an entity that was incidental to it. An umbrella fund, with distinct (insolvency remote) sub-funds, is convenient for investors, without altering the fact that is the sub-funds that incur the risks.

Q3-4. In your view, what is the appropriate threshold level, taking into account the range given above (USD 400-600 billion in GNE), for hedge funds? Please also provide reasons with data to back it up.

We do not have data to allow us to comment fully on this question. The levels set out, however, suggest that a relatively low level of leverage is being targeted as the trigger for systemic significance. It may be that the trigger should be set at a higher level, making the methodology more tolerant of leverage. We note that much higher levels of leverage are being contemplated for the banking world (under the emerging leverage ratio), in spite of that model's inherent fragility. We suggest that more work needs to be done on the optimal level of leverage in the system as a whole, as well as in its component sectors and individual entities.

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on "global activity"? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

Unless the global activity clearly satisfies the conditions for transmission of distress, then we do not believe it is necessary to incorporate a materiality threshold into the proposed methodology. The financial system remains as international as global trade, if not more so, and that raises the possibility that failure of a relatively small entity can have disproportionate impact. However, while a relatively small bank (eg, Northern Rock) can legitimately be seen as a microcosm of the fractional-reserve banking system more broadly, a fund is subject to its own, idiosyncratic supply-demand characteristic. Other things being equal, it is also likely to be more substitutable. Furthermore, geographical diversification of investments by funds has well documented, demonstrable benefits.

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

We believe the proposed definition is the most practical. Please note, however, our comment above about sub-funds operating under an 'umbrella'!

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

The IMA believes the description overstates the systemic importance of asset management entities. As outlined above, we believe there are specific and measurable characteristics and circumstances that raise the possibility of systemic impact, particularly in combination. The focus should therefore be on such circumstances, ie, high amounts of leverage and counterparty exposure, especially when positions are a) heavily concentrated in b) a market of limited size.

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

We agree that the focus should be on individual funds. The asset manager, as agent, needs to be able to wind-down its operations in a controlled way, if necessary, but that is entirely distinct from the handling of the funds and client assets, which are held separately and remotely. Families of funds could in theory operate in a similar way to each other but, as it takes a particular, virulent combination of factors (leverage, etc) to create any potential for systemic risk, then it would still be essential to analyse each fund separately, to ensure that the factors are all in place, especially as small, subtle differences in investment strategy can make a large difference to outcomes.

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

As already explained above, we believe the approach should explicitly be calibrated to look at a combination of factors. In other words, the factors should be cumulative, rather than alternative. If one was to adopt the cumulative-factors approach that we advocate, it would in practice capture activities – both existing and potential – that might be of concern. Thus, use of derivative contracts is not in itself problematic, unless the counterparty exposures that could potentially affect others prove excessive.

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

We do not believe alternative indicators are necessary. As outlined above, we believe the key issue is the combination of certain factors, among which size on its own is not diagnostic. We specifically question the relevance of the ratio of unencumbered cash to GNE (or gross AUM), if only because measures regarding collateralisation will apply in systemic situations.

Q6-6. For "cross-jurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

The existing requirements around custody arrangements in particular mean that a key investor concern is addressed. Such custody arrangements do of course support cross-border investments, to the benefit of investors in funds and the companies whose securities the funds hold. We do, however, acknowledge that a wide geographical spread of counterparties could, if combined with other factors (as described above), spread distress.

Q6-7. Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

GNE is a crude and potentially misleading measure, since it does not capture the risk in the sense of the size of exposure or its volatility. As such, even if the GNE threshold was be set at a much higher level, there would still be a need to monitor other factors relevant to the positions measured under GNE. Net AUM is a more straightforward measure and, insofar as a pure size threshold is relevant, can be implemented relatively simply. Its meaningfulness is another matter.

Q6-8. Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

We agree that there is considerable room for nuance in investment strategies and that any system of monitoring the activities and potential impact of funds should be sensitive to this. As mentioned above, it appears particularly important to us that supervisors are equipped to detect rapid increases (and, just as importantly, any potential for rapid increases) in leverage and counterparty exposure. Furthermore, any attempt at focusing on families of funds would, in our view, need to be sensitive to nuances in strategy (*qv*).

Q6-9. Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

It is important in our view to take full account of existing mechanisms for reporting, to which funds are subject. Thus, derivative positions must be reported to a trade repository under EMIR, together with related collateral and valuations. In the EU, under UCITS legislation, authorised funds within the Eurozone must also report to the European Central Bank. There is in addition the likelihood that securities financing transactions will have to be reported, under EU legislative proposals (which the IMA in principle supports).

Given that the approach proposed by FSB-IOSCO allows – correctly, in our view – for a degree of national discretion, within an internationally agreed framework, then there is also scope to rely on existing national (or EU-wide) reporting regimes. Given the rather tenuous nature of the argument that funds are systemic, and given their importance to savers' long-term financial objectives, it is important to avoid imposing deadweight costs on such entities.

Q6-10. Are there additional indicators that should be considered for assessing the relevant impact factors? For example, should "the fund's dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM" also be considered for "substitutability"? Similarly, should "leverage" or "structure" of a fund also be considered for assessing "complexity"? Please explain the possible indicators and the reasons why they should be considered.

We agree that, in some circumstances, the size of a fund in relation to a given market sector could matter. But the selling of positions in such markets will clearly become dangerous to the system only when there is a clear transmission mechanism, meaning that other factors would have to be present at the same time. (*Please see our response to Q 1-1!*)

Q6-11. Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

The IMA believes that, while it is legitimate to consider whether systemic risk can arise in financial activities other than banking, the clear distinction between such balance-sheet business and other forms of financial service should strongly influence the regulatory approach. This distinction has two main implications: 1) for any methodology that may in the end be developed to determine individual systemic significance; but also 2) for any measures that may be mandated for individual entities that are specifically designated a NBNI G-SIFI (albeit the question of measures is not strictly speaking within the scope of the current consultation).

The FSB with IOSCO is proposing to use size (of fund) as a threshold indicator of potential systemic significance, with further indicators applying thereafter. It explicitly ignores likelihood of failure (or of distress), concentrating instead on the consequences of any such failure (or distress). The IMA respectfully notes that failure (or distress) on the part of a fund typically means something qualitatively different from failure of a bank, in its mechanics and in its interaction with the rest of the financial system. The IMA does, however, believe this distinction is well understood in policy circles, resting as it does on the clear difference between fractional reserve banking on the one hand (which is, in essence, what creates the potential for bank runs) and the explicit acceptance by investors of risk exposures that a fund entails.

Given this, we agree that it is important to focus on those (cumulative) indicators that indicate exceptions from the normal approach seen in collective funds. This contrast would be particularly strong when the comparison is with those funds that are already subject to regulation that rightly imposes standards of risk diversification and liquidity of investments. A prominent example of such legislation is the suite of UCITS directives in the European Union. (Where separately managed accounts were concerned, it would also be noteworthy that some client types would themselves be subject to regulation, namely insurance companies and pension funds. Moreover, those funds that are operated by the asset-management arms of banks or insurers are, of course, themselves subject to extensive regulation, potentially including SIFI designation.)

Naturally, certain individual entities may have the potential to prove systemic, to the extent that they have the power to diverge from a core business model that is systemically neutral (or even beneficial). Such power might exist, for example, where it was unconstrained as to leverage. Moreover, such scenarios do point towards certain indicators set out in the CP.

By way of analogy from outside the scope of the current paper, an insurance company that accumulated large, concentrated counterparty exposures – especially in instruments of variable liquidity and sensitive to assets that are clearly inflated (such as housing at certain points of the cycle) – could demonstrably raise questions about the impact that its default would have. It would be taking on credit risk on its own balance sheet, like a bank (and unlike fund managers), possibly with comparable levels of leverage. Its impact would, of course, depend on the extent to which systemic regulation of other parts of the financial world, especially banks, was ineffectual.

The immediate question in such a circumstance is, of course, what remedies are (or should be) available. Transparency to supervisors as to the size and distribution of the exposures is essential, and could take appropriate account of any risk mitigation, notably by means of collateral. ('Appropriate account' could include any propensity towards runs on collateral.) Also relevant is the extent to which central clearing reduces the counterparty exposures and insulates other market participants from counterparty default (provided that CCP recovery plans do not themselves potentially compromise the fund's integrity).

In other words, the ability of an entity to be systemic (whether as a result of its core business model or because it is deviating from that) may already be addressed, at least in part, and limited through existing legislative and regulatory measures. In the case of funds, for example, constraints on concentration of investments (or, indeed, counterparties) are hard-coded into EU legislation, to the benefit of customers of those funds and, at the same time, financial-market dynamics.

This being so, as a general proposition, we support the FSB-IOSCO approach of flexibility within an international framework. We further believe that supervisory transparency is without doubt the appropriate starting point, since there is a threshold question as to if and how funds may be systemic.

We have confined ourselves in this response mainly to comments on the proposed methodology for (collective) funds. We do, however, note that care will be needed in the approach to those market intermediaries on whom fund managers may rely for access to markets. There are aspects of the work of intermediaries which clearly do entail risks – notably, from the IMA's point of view, in relation to client-assets – and these should be given due weight. There are other aspects, though, especially including market making, which are important variously for capital raising and asset-portfolio management and where increased costs will tend to have a negative impact not only on customers but also on the very system whose stability one is trying to safeguard. Measures which tend to hamper the provision of short-term liquidity might easily increase price volatility, rather than dampen it, particularly in times of stress. Since the term 'systemic risk' appears to now encompass market dynamics, we caution against any measures which tend to make markets 'thinner', which will also make prices more volatile.

FSB Key Attributes of Effective Resolution Regimes

The IMA supports the framework set out by the FSB in its October 2011 paper, 'Key Attributes of Effective Resolution Regimes for Financial Institutions'.

From FSB 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2011)

"An effective resolution regime (interacting with applicable schemes and arrangements for the protection of depositors, insurance policy holders and retail investors) should:

(i) ensure continuity of systemically important financial services, and payment, clearing and settlement functions;

(ii) protect, where applicable and in coordination with the relevant insurance schemes and arrangements such depositors, insurance policy holders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;
(iii) allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;
(iv) not rely on public solvency support and not create an expectation that such support will be available;
(v) avoid unnecessary destruction of value, and therefore seek to minimise the overall costs of resolution in home and host jurisdictions and, where consistent with the other objectives, losses for creditors;
(vi) provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;
(vii) provide a mandate in law for cooperation, information exchange and coordination domestically and with relevant foreign resolution authorities before and during a resolution;
(viii) ensure that non-viable firms can exit the market in an orderly way; and
(ix) be credible, and thereby enhance market discipline and provide incentives for market-based solutions."

We note that, absent certain of the indicators set out in the NBNI G-SIFI consultation, collective funds will generally raise no concerns. One possible exception is principle iv, where an expectation of public support could easily arise, but only if a fund has been designated as a G-SIFI in the first place.

We also note the importance ascribed in the Key Attributes, entirely correctly in our view, to segregation of client assets. This is an issue that is relevant more broadly, crucial though it is to the world of investment funds. It arises notably in the world of cleared derivatives, where the ability of a clearing member to deploy client assets for its own investment objectives can give rise to customer detriment, of potentially systemic dimensions. The same principle would apply, in extremis, to the ability of a clearing house to control client assets. We would therefore propose vigilance with regard to any exposure to CCPs that have the ability to haircut or otherwise expropriate client receivables.

The CP does not touch on the measures that might apply to any fund that was in fact designated systemic. Given the reasoning set out in our response, we believe that the most useful approach will be to: emphasise closer dialogue with and monitoring of the funds in question; making use of existing reporting mechanisms; backed up where truly appropriate by tools such as stress tests; all within a framework that prioritises dialogue internationally between supervisors.