INVERCO COMMENTS TO THE FSB RECOMMENDATIONS PROPOSALS FOR ADDRESSING STRUCTURAL VULNERABILITY OF ASSET MANAGEMENT ACTIVITY

INVERCO\(^1\) welcomes the opportunity to comment on the FSB consultation document on “Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities”. Prior to answering the questions raised in the document, the following general observations are to be made:

1. The general assessment of the approach that the FSB holds on the vulnerabilities of asset management activity is positive, given that compared with previous documents of the FSB, it is recognized that issues concerning financial stability raised by asset managers are different from those of banks and insurers, as the first act as “agents” on behalf of their clients and therefore are the customers who bear the investment risk, which advises against automatic transfer of the approach of risks of banking and insurance activities, to the asset management activity.

2. The document acknowledges that most open-ended funds have been resilient during the crisis and have not been a cause for concern from a financial stability perspective, citing as unique examples some money market Funds (category to which, in any case, most of the recommendations of this document are not aimed)\(^2\) and the known case of Long-Term Capital Management, which dates back almost 20 years ago.

Additionally, the fact that many of these recommendations are already included in the Community legislation and therefore also in Spanish\(^3\), it is anticipated that the practical impact of these recommendations, if they are approved, would be very limited in Spain.

3. In some of the Recommendations (e.g. 12), a reference is made to the periodic collection of information by IOSCO. While the availability of consolidated information is essential to assess systemic risk in the financial markets, it should be recalled that in recent years, reports to ESMA and the European Central Bank have been added to the need to report to the CNMV, which multiplies the operating cost for the managers. Therefore a clarification should be included in the document, concerning that the collection of information should be always taking advantage of existing reports regarding recipient, format, content and frequency, avoiding generating new reporting requirements in those jurisdictions where referral information to supervisors already exists.

4. It should be noted that in the recommendations relating to securities lending, no comments have been made because it is an operative that the Spanish Managers cannot carry out, for it is not permitted by Spanish regulation.

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\(^1\) INVERCO, is the Spanish Association of Investment and Pension funds. It represents 5,039 CIS with assets amounting to 255,338 million Eur (98.7% of total assets in Spain), 1,335 Pension Funds with assets amounting to 104,518 million Eur (99.8% of total assets in Spain) and 24 UCITS registered for marketing in Spain with assets amounting to de 80,000 million Eur.

\(^2\) In particular those related to liquidity, which represent 9 out of 14 (p. 8, last paragraph).

The answers to the specific issues raised in the consultation document are included below:

A) GENERAL ISSUES

1.- 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.

As mentioned in the introduction, it is viewed positively that the document recognizes the specificity of the asset management activity in relation to banking and insurance activities, and also the recognition of the good overall performance of the Investment Funds during the financial crisis.

The vulnerabilities identified by the document have also been identified and addressed in the context of UCITS and Alternative Investment Managers Directives. That is why most of the recommendations have already been incorporated into the European and Spanish legislative framework, without identifying any additional vulnerability to those already incorporated in the document.

2.- 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?

In general, the proposed measures adequately address the identified vulnerabilities.

3.- In your opinion, are there any practical difficulties or unintended consequences that might be associated with the implementation of the proposed recommendations, both within one or several jurisdictions? If so, identify the recommendations and explain the challenges and ways to address these challenges and promote the implementation within one or several jurisdictions.

In general, no, although conducting stress tests covering the entire financial system, as stated in Recommendation 9th, may pose practical difficulties, because of the volume of information to add by supervisors and because not all investors behave the same way with respect to redemptions/sales of assets in stressed market conditions.

B) ISSUES RELATED TO RECOMMENDATIONS ON LIQUIDITY (RECOMMENDATIONS 1 TO 9)

4.- 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?

First of all, a positive assessment should be made on the recommendations regarding that supervisory authorities should widen the availability of liquidity management tools to Funds, and reduce barriers to their use in order to increase the ability of the Funds to meet redemptions, even in situations of stressed market.
In any case, the approach should be that supervisory authorities establish which liquidity management tools are considered appropriate/compatible with the regulation and, where appropriate, provide guidance for their use, so that there is greater legal certainty in their use, but the decision on which specific tools to use and when to use them should be left to the Managers. If it is established that its use may be imposed exceptionally by supervisors (pg. 20, para. 2), the regulation or guidance issued should specify the exceptional circumstances.

As for recommendations regarding increased disclosure to be provided to supervisors and investors on liquidity, the following considerations can be made:

- With regard to the disclosure requirements to supervisors (content, detail and frequency) on liquidity, it is considered positive that supervisors have the information needed to enable them to assess the liquidity risks that each of the Funds represents for the system. It is considered that the Spanish legislation amply satisfies those requirements⁴.

- In connection with the increase of investor disclosure, it must be taken into account that the idea behind both the UCITS's KID and the document provided by the PRIIPS Regulation is to provide clear and easily understandable information to avoid overloading the investor with data and information that are of no use. Therefore, extend into too much detail on how the Fund manages liquidity risk does not seem appropriate for the investor. Additionally, in terms of liquidity risk of the Funds, it should be noted that under the UCITS Directive and in the case of the Spanish regulation, also for Alternative Investment Funds (AIFs), the investor disclosure requirements on liquidity risk, both pre-contractual and once invested in the Fund, are detailed enough.

- As a complement to the recommendations made, it should be taken into consideration when measuring liquidity risk, the degree of concentration of unitholders of the Fund, i.e., those investors with significant holdings whose exit would entail redemption orders of high amounts.

Finally, as to whether there should be additional Recommendations tailored to ETFs, we believe there should not, i.e., the recommendations made in the document should also apply to ETFs. Virtually all ETFs trading on European exchanges and being offered to a European investor public (professional and retail) are authorized as UCITS structures, conforming to the directive’s own prescriptive liquidity risk management requirements, as well as to the more recent ESMA 2012 Guidelines on ETFs and other UCITS issues (as revised in 2014) which have expanded liquidity requirements to received collateral from OTC derivative transaction, as from “efficient portfolio management techniques” (i.e. repo and securities lending).

5. What liquidity risk management tools should be available to the Funds? Which tools promote more effectively the consistency between the behaviour of investors regarding redemptions and the liquidity

⁴ The Circular 3/2008 of September 11th of the CNMV, on accounting standards, annual accounts and reserved information statements of collective investment schemes requires that the SGIIC provide the CNMV with a generally monthly detailed information about many aspects, among others:

- Detailed information on the securities and deposits that integrates the investment portfolio of the CIS or compartment and the different cash accounts on the last day of each month, as well as movements in both cases during the period. In addition, regarding the deposits / repos / current accounts, the type of entity with which has been agreed and the expiration date, among other things, are reported in detail.

- Regarding the less liquid securities in which up to 10% of overall assets can be invested (Article 48.1 j) of the Regulations of Collective Investment Schemes), the net daily balance on estimated realizable value is reported.

- In relation to the liquidity coefficient, mandatory in Spanish regulations, information should be provided regarding monthly average of asset's daily balances of the CIS or compartment in One-day repos on Public Debt, as well as the cash, deposits or sight deposits in the depositary or, if the depositary is not a credit institution, the credit institution designated in the booklet, subject to the liquidity coefficient.
profile of the Funds? For example, the redemption fees could be used for this purpose separately and apart from the impact they could have on the first-mover advantage.

The availability of liquidity management tools to the Funds should be regulated flexibly given that they are measures aimed to protect the investor. In particular, “swing pricing” is a very efficient tool as it passes on the costs of adjusting the portfolio to subscriptions and redemptions (both “full swing price” and “partial swing price”),

Also, consistency in rules governing the use of these tools must be ensured, preventing that the use of a single measure is promoted by a rule and discouraged by another. This inconsistency could happen in the case of redemption fees, which are used in the Funds whose investment policy is to achieve a specific target return, guaranteed or not, and that apply when redeemed before the maturity period of the Fund, with the purpose to achieve the target and protect investors who remain until maturity. This is a fee whose use is covered from the perspective of liquidity management and protection of participants but which, to the detriment of shareholders, may no longer be used under MiFID II, to the extent that its mere use could convert the Fund into a complex product.

6.- 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.

As liquidity is a multi-dimensional factor, there are several metrics to define whether an individual security is liquid or less liquid, depending on its nature and on the characteristics of its underlying market. Such metrics should not be prescriptive or be subject to more specific guidance for open-end funds. The degree of “liquidity” of a given security is in a constant state of flux, evolving with the broader market environment, and should therefore be left to the sole appreciation of the individual asset managers.

In the Spanish legislation there is a definition of liquid assets in relation to money market instruments which states: “they shall be deemed liquids provided they can be sold at limited cost in a reasonably short time”, which can be extrapolated to the consideration as liquid of any asset. The short term should be considered for the UCITS taking into account that, as a general rule, they must provide daily redemptions to its shareholders. On the other hand, the normative/legislation itself limits investments in illiquid assets to a maximum 10% overall CISs capital.

However, in case of regulating/issuing guidance on metrics on asset liquidity, the following issues should borne in mind:

- Variable-income assets: Traditional measures to determine liquidity of quoted assets in regulated markets, mostly in equity markets, as for example, the average volume negotiated in the issuer’s main market, have become out of date due to the increase of alternative platforms (Turquosi, Chi-X, Bats Europe). In this sense, all negotiating platforms should be taken into consideration when measuring liquidity of quoted assets in order not to underestimate the liquidity of the assets of a given portfolio.

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5 Article 57.e) of the Delegated Regulation on organizational requirements of MiFID II, pending ratification by Parliament and the Council, includes, among the elements that determine the complexity of a financial instrument, the “inclusion of any explicit or implicit exit charges that have the effect of making the investment illiquid even though there are technically frequent opportunities to dispose of, redeem or otherwise realise it”.

Fixed income assets: Given the lower degree of transparency and information of the markets, it would be difficult to regulate standard metrics. There are cases where the same issue may be classified either as liquid/illiquid by different management companies. Therefore, for fixed income assets, it should be advisable to set a theoretical model, more or less standardized based on a qualitative classification of issues which takes into consideration both the qualitative classification assigned (expected maximum sales volume for a day, speed of widening of the bid-ask ..) as well as the specific characteristics of the issue (nominal value in the portfolio, bid ask spread).

7.- 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.

The use of a broader set of liquidity risk management tools should become an established practice within individual jurisdictions. Regulation should usefully create a framework for these tools to be used, and perhaps under certain circumstances also require supervisory authorities to impose them, but should definitely not limit their use or prescribe one over another.

While it must be set as mandatory, as Spanish legislation does, for managers to have a policy of liquidity management which includes conducting liquidity stress tests and, among others, avoid precisely the mismatch between Funds’ investments and the conditions of redemptions, the decision on which liquidity tools to use, between those provided in the regulations, should lie with the managers, who must have sufficient discretion to use one or the other.

8.- Should the Authorities be able to direct the use of exceptional liquidity management tools under certain circumstances? If yes, describe the kind of circumstances in which it would be appropriate and what tools.

As set forth in the answer to question 7, the decision on the use of these tools should lie with the manager. Only certain measures restricting the rights of shareholders and that could have greater impact, such as suspension of redemptions, should be made subject to prior authorization by the supervisor.

Moreover, supervisor authorities when detecting exceptional illiquidity situations affecting a certain market or financial markets in general (closure of a market, geopolitical events, and technological failures in information systems) should instruct fund managers to use particular measures for managing liquidity and allow suspension of subscriptions and redemptions of funds which operate in such markets.

C) ISSUES RELATED TO LEVERAGE IN FUNDS (RECOMMENDATIONS 10 TO 12)

9. In the development of the measures on leverage (Recommendation 10), are the set principles suitable as reference for IOSCO?

Yes.
10.- 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?

It should begin by establishing simple and consistent measures in line with the currently existing UCITS and DGFIA regulations/normative.

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

In the European Union, in both UCITS and DGFIA framework, measurement systems on leverage of Funds have been established, although for different purposes. In the area of UCITS, said measurement is intended to account for compliance with the maximum leverage limit. In the DGFIA, where there is no such limit, the measurement is established for purposes of information and determination of the existence of disclosure requirements for certain FIAs.

Since different methodologies to measure leverage are detailed in both Directives, they should be considered by IOSCO in its recommendations.

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

The methodologies of UCITS and DGFIA Directives have functioned properly, and are of general application in the European market, which accounts for about 40% of total global assets under management, so it would be desirable that they were taken into account by IOSCO to establish its standard measurement of leverage.

13.- 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)?

In the case of the European Union, for FIAs resorting substantially to leverage and therefore are likely to present a systemic risk, the leverage should be reported to ESMA. Based on this compilation work already done by ESMA, it would be appropriate to:

- Limit the collection of information on leverage to those vehicles that, because of the use they do of it, may pose indeed a systemic risk. In the European case, they would only be the AIFs that systematically use leverage.

- Minimize the burden of reporting this information. In Europe, ESMA should be the entity that provides to IOSCO this information about leverage, since it already receives it from the Funds under the Alternative Investment Funds Directive (AIFMD), avoiding introducing new reporting requirements, in addition to those that asset managers already have to perform to national supervisors, ESMA and the European Central Bank.

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7 In the European legislative framework already exists harmonization on how to measure leverage. In the case of the UCITS Directive, in the CESR (now ESMA) guidelines on risk measurement and calculation of total exposure and counterparty risk for UCITS, dated April 19th, 2010 and in the DGFA, Commission Delegated Regulation No 231/2013 EU of 19 December 2012, with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision in the area of DGFA.

8 For UCITS, leverage through the use of derivative instruments is limited to the total net value of the portfolio.

9 The DGFA does not establish restrictions on the use of leverage, but incorporates special disclosure requirements to Funds resorting substantially to leverage, information that is shared with ESMA (the European supervisor), and it even includes the possibility that the supervisor imposes restrictions on leverage if it considers that the stability and integrity of the financial system may be threatened.
Bank. In addition, the frequency and format of the information collection should be the same, taking advantage of models already established at European level.

Finally, if supervisor authorities were to act on the basis of the information gathered, objective criteria should be established determining in which cases supervisor authorities may act in order to mitigate systemic risk and the type of measures that may be imposed as for example the AIFMD already does.

14.- 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

Yes.

D) OPERATIONAL RISK AND CHALLENGES IN THE TRANSFER OF INVESTMENT MANDATES OR CUSTOMER ACCOUNTS

15.- 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.

Taking into consideration that these recommendations seek to reduce systemic risk, they should only be applied to asset managers that are large, complex and/or that provide critical services. This does not preclude that, from the perspective of investor protection, which exceeds the scope of the FSB document, a proper risk management should be required to all managers (regardless of their size, complexity, etc.), which in the Spanish case is well established in the applicable normative/regulations10.

Business continuity and transition plans lie at the core of good corporate governance and we deem that asset management companies genuinely serving their clients’ interest already implement such plans as a matter of principle and ahead of other considerations, e.g. the reputational fall-out from any operational disruption.

E) SECURITIES LENDING ACTIVITIES BY ASSET MANAGERS (RECOMMENDATIONS 14 AND 15)

In relation to securities lending, it is important to state that the contribution of this operative to systemic risk must be regarded from a twofold perspective. Although it may generate certain risks, which are contemplated in the FSB document, securities lending is an essential tool to solve defaults in the settlement of transactions, having a relevant role in mitigating systemic risk.

However, the questions of this section have been left unanswered, as in Spain the regulation does not allow asset managers to perform this activity.

Madrid, September 20th, 2016

10 Circular 6/2009 of December 9th, of the CNMV, on internal control of the Managers of collective investment schemes and investment companies.