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April 7, 2014

Mr. Svein Andresen
Financial Stability Board
c/o Bank for International Settlements
CH – 4002 Basel
Switzerland

Re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions from January 8, 2014

Dear Mr. Andresen:

The Institute of International Finance is pleased to provide comments on the FSB-IOSCO Consultative Document "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions – Proposed High-Level Framework and Specific Methodologies" of January 8, 2014. This letter has been produced under the guidance of the IIF's Non-Bank Non-Insurer Working Group. In offering these comments, we believe it is important to reiterate the industry's support for targeted and proportionate measures designed to strengthen regulation and thus make the global financial system more stable.

The IIF fully recognizes the importance of the FSB's work (in cooperation with other agencies) on identifying sources of systemic risk. This is a very challenging task which, if done correctly, can reinforce financial stability but if not, could have unintended detrimental consequences on financial markets, those they serve, and economic growth. The Institute therefore appreciates the continued openness of the FSB and relevant agencies to industry perspectives and those of other stakeholders on this important subject.

Key Considerations:

- 'Size' is not the primary, nor should it be used as the dominant, indicator of an NBNI entity's global systemic risk.
- Existing regulations and the significant counterparty risk-reducing derivative reforms already in train should be taken into account when interpreting whether indicators actually pose a systemic risk.
- The IIF fully endorses the approach chosen by the FSB and IOSCO to focus on investment funds and not asset managers. Further, in the case of investment funds leverage is the most important indicator of systemic risk.
- The IIF calls for a transparent methodology that uses reliable data, objective metrics that are risk-based and risk-sensitive, is consistently applied across jurisdictions, and provides clear incentives for reducing systemic risk.

- We encourage the FSB and IOSCO to generally shift their focus to activities when identifying and regulating sources of systemic risk in the NBNI space. High substitutability and mobility suggest that entity-targeted approaches will be less than effective.
- The history of failed NBNI entities should be used to calibrate both the qualitative and quantitative aspects of the assessment methodology.

Singling out of certain entities may distort markets and competition

At the outset, we wish to emphasize that the IIF has consistently drawn attention to the shortcomings of approaches to systemic risk which rely on designating individual entities[1] and the application of additional policy measures to these entities on a blanket basis. We believe such approaches increase moral hazard[2] and create market distortions arising out of such entities being seen as 'special' and potentially too big to fail, as well as distorting competition. Whilst the FSB and IOSCO clearly have work to do in finalizing the methodology and have indicated an open mind about policy measures to be applied to any identified NBNI G-SIFI, the IIF would argue strongly from the very beginning that applying additional policy measures to a few individual entities is likely to be ineffective and would neither offset the additional risk resulting from this moral hazard nor act as an effective means of offsetting potential market distortions. This is especially true in highly substitutable markets like asset management and financial services.

It is likely that the designation of certain entities as NBNI G-SIFIs will result in 'systemic' activities shifting from a G-SIFI to other, non-designated entities. For example, designation of an investment fund as 'systemically relevant' and applying additional and costly policy measures to it and not to its competitors would likely render the fund unattractive and prompt investors to redeem a substantial portion of its assets and to transfer them to a competitor that offers the same product or service without the regulatory burden due to the highly substitutable nature of the industry.

However, it is not at all obvious that a simple reallocation of business within the regulated industry and towards non-systemic entities will be the outcome. Instead, the effect may well be to drive some activities outside of the regulated sector. Such movement is unlikely to reduce systemic risk, but it would make the activities less visible. The incentives created could equally likely result in changes in business models and product mixes whose effects on systemic risk are hard to know in advance.

Regulatory focus should be on activities rather than on entities

To cope with these challenges the IIF has consistently argued that policy should focus primarily on the underlying activities involved and their associated risks, should be sufficiently forward looking, and should take into account the variety and complexity of activities rather than focusing on a few of the entities that conduct those activities.[3] In general, we believe that the application of targeted regulation to properly identified risks on an activity- or industry-wide basis is the most appropriate response.[4] There-

[1] Throughout this submission we use the word 'entity' as a generic term to describe all NBNIs, which include both finance companies and investment funds.
[2] "There is reasonable concern that designating a small number of nonbank-affiliated firms would increase moral hazard concern"; *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, p. 7 (http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf).
[3] See *IIF*: "Shadow Banking": A Forward-Looking Framework for Effective Policy, June 2012, p. 1 (http://www.iif.com/regulatory/article+1099.php).
[4] "(…) potential contagion effects are best contained by directly addressing them, rather than by trying to indirectly address them through designating a large number of nonbank-affiliated institutions under section 113 of the Dodd-Frank Act. This direct approach would, I believe, yield maximum financial stability benefits at the lowest cost to

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fore we applaud the FSB and IOSCO for asking Q6-4, which recognizes that it may be more appropriate to assess asset management activities than it is to attempt to identify and regulate risk in asset management and in capital markets by designating a few individual funds G-SIFIs. We agree and encourage the FSB and IOSCO to shift their focus to activities. This approach should not only apply to asset management but to all other NBNI sectors as well.

However, and recognizing the G20 mandate to the FSB and IOSCO to assess whether there are any entities that should be designated as NBNI G-SIFIs, we provide the following comments on the proposed assessment methodology. As with all other areas of the G20 reform agenda the IIF will look to engage proactively and constructively with the FSB and IOSCO throughout the development of the NBNI G-SIFI regime.

Methodology should use risk-based and risk-sensitive metrics

In producing a methodology that seeks to measure the systemic importance of entities, it should be transparent and designed in such way that it is adequately reflective of systemic importance by using reliable data, objective metrics that are risk-based and risk-sensitive, consistently applied across jurisdictions, and provide clear incentives for reducing systemic risk. While the industry acknowledges the need to avoid undue complexity, a balance must be made between having a simple approach and having an adequately risk-based approach. The benefits of an overly simple approach would be outweighed by the problems caused by a methodology that is not fully reflective of underlying sources of systemic risk. As we point out below, the proposed methodology seems to be a good starting point, but will require additional work and careful calibration.

Data sources are available and should be exploited

In its consultative document the FSB and IOSCO on several occasions mention that *"(o)ne of the key challenges in assessing the global systemic importance of NBNI financial entities is the difficulty in obtaining appropriate and consistent data/information."* While we agree that *"data availability varies widely and is likely not to be consistent across jurisdictions"* this does not mean that meaningful data is not available in general. For example, fund managers in the United States have to file information such as financial statements, comprehensive holdings (including derivatives exposure) and custody information with the U.S. Securities and Exchange Commission (SEC).[5] A thorough analysis of this trove of information should provide valuable insights into the functioning of the investment fund industry and provide a better understanding of the risks that it may or may not present. Insights developed through analysis of this data should also be published to facilitate discussion and enable both better informed proposals such as this and comments on them.

Moreover, for much of the finance company sector accurate information is also readily available. In addition to the many finance companies that are either subsidiaries or affiliates of banks, as acknowledged in the FSB paper, many non-bank owned companies are subject to forms of regulatory supervision. These include the U.S. Financial Stability Oversight Council's (FSOC) non-bank systemically important finan-

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financial intermediation, financial firms, and financial supervisors"; *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, p. 11.

[5] Information is filed on forms such as 13D, 17h, ADV, N-CSR, N-MFP, N-Q, N-SAR, and PF. Over 2,300 advisers covering over 18,000 private funds and pertaining to $7.3 trillion in private fund assets have filed form PF with the SEC; see *SEC Division of Investment Management*: Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports, pp. 5 et seq. (http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf).

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cial institution process established under the Dodd-Frank Act and the German regulatory requirements for finance companies to report information to supervisors.

In general, data transparency and availability has increased significantly in recent years. In fact, it was one of the main regulatory initiatives initiated by the G20 to increase market transparency by moving over-the-counter (OTC) derivatives trading onto organized platforms. Regulators are in the process of implementing new rules requiring the reporting of data on the trading of OTC derivatives to trade repositories. This will provide regulators with a full picture of all OTC derivative positions for the entities they regulate and enable market-wide risk monitoring. The collection of all this market data only makes sense if it will be studied to determine if there are additional risks that should be addressed and to design specific and targeted regulation. Confidentiality of this data on a national basis should not preclude the FSB and IOSCO from developing methodologies involving these data thus enabling national supervisors to identify G-SIFIs on a national level and based on objective data and criteria.

We are convinced that meaningful data is available and can be collected with reasonable effort. If certain data should not be readily available the focus should be on generating this data or meaningful proxies instead of defaulting to supervisory discretion to bridge any gap in data availability.

Additionally, the FSB and IOSCO should provide NBNI entities formal opportunities to participate in the process, which should include the opportunity to engage directly with the FSB and IOSCO and present data and other information for consideration in the designation process. Further, the FSB and IOSCO should afford an assessed NBNI entity advance notice of its potential designation and allow the NBNI entity to comment on and respond to the narrative assessment prepared in support of its designation.

Use of supervisory judgment and discretion should be avoided

Against this backdrop, we do not share the conclusion that *"supervisory judgment likely needs to play a bigger role in methodologies for identifying NBNI G-SIFIs compared to the G-SIB or G-SII methodologies"*. We are afraid that the proposed International Oversight Group will not be able to guarantee international consistency. Instead, too great a reliance on supervisory judgment and discretion may in fact undermine the credibility of the intended approach. Supervisory discretion may not only include a temptation to respond to political pressures but also make criticism of measurement and policy all the more challenging.[6]

In contrast, the IIF supports the use of an objective approach, where measures of systemic risk should be based on the consistent and transparent use of common metrics that are objectively indicative of global systemic risk. Thus, ensuring data quality and consistency is essential to achieve a level playing field.

Learning from history

In justifying the initial focus of the NBNI G-SIFI assessment the FSB and IOSCO refer to "*historical examples of financial distress or failure in these three factors that had an impact on the global financial system*". Unfortunately, this claim is not further specified. In the case of NBNI entities we are aware of two examples from the investment fund industry—Long Term Capital Management (LTCM) and Reserve Management Company (sponsor of the Reserve Fund)—and General Motors Acceptance Corporation (GMAC) as an example pertaining to finance companies. In our view, these examples deserve detailed

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[6] See *Hansen, Lars Peter*: Challenges in Identifying and Measuring Systemic Risk, Working Paper, February 11, 2013, p. 2 (http://www.nber.org/chapters/c12507.pdf). – Lars Peter Hansen, together with Eugene F. Fama and Robert J. Shiller, received the Nobel Price in Economic Sciences 2013.

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analysis to understand the sources of systemic risk connected to the respective business models. Upon closer examination, these instances demonstrate activity rather than entity related risk.

LTCM managed the Long Term Capital Portfolio, a private fund with approximately $5 billion of assets[7] that experienced significant distress in September 1998. As the *President's Working Group on Financial Markets* observed, LTCM, from its inception, had a prominent position in the community of hedge funds, both because of the reputation of its principals—among them two 1997 Nobel laureates in economics with substantial reputation in the economic theory of financial markets—and also because of its capital stake.[8] Compared with the trading practices of other hedge funds and other trading institutions the LTCM Fund stood out with respect to its opaqueness, its low degree of external monitoring, and its high degree of leverage. At the time of its near-failure the LTCM Fund was the most highly leveraged large hedge fund reporting to the U.S. Commodities Futures Trading Commission (CFTC). The use of excessive leverage with a mismatch of funding resulted in an inability of the fund to withstand market movements. The fund was unable to meet margin calls and had to liquidate positions. A consortium of banks acquired capital interests in the fund for approximately $3.65 billion and over the next year, the positions were unwound in an orderly fashion with a small profit.

The President's Working Group on Financial Markets concluded that "excessive leverage can greatly magnify the negative effects of any event or series of events on the financial system as a whole. (…) Although LTCM is a hedge fund, this issue is not limited to hedge funds. Other financial institutions, including some banks and securities firms, are larger, and generally more highly leveraged, than hedge funds. (…) The near collapse of LTCM illustrates the need for all participants in our financial system, not only hedge funds, to face constraints on the amount of leverage they assume".[9] Based on its findings the *Working Group* recommended a plethora of regulatory and statutory measures covering, disclosure and reporting, supervisory oversight, counterparty risk-management, capital adequacy, etc. many of which were implemented or are being considered again in light of the experiences with the impact of leverage during the recent financial crisis.

Reserve Management Company managed the Reserve Primary Fund that "broke the buck" in 2008 due to its investments in Lehman Brothers debt securities. Reserve Management Company had less than $100 billion in assets under management across all of the funds it managed for clients, ranking it #81 among U.S. asset managers overall as of December 31, 2007, and #14 against managers of money market mutual funds (MMMFs). Cash management products were the only strategies managed by Reserve Management. Following this incident at the height of the financial crisis, investors who were already fearful about liquidity made significant redemption requests to similar MMMFs, and the Federal Reserve, the U.S. Treasury and certain foreign agencies stepped in to create a series of programs to calm the markets. Investors in the Reserve Primary Fund ultimately received 99.04% of their assets, and Reserve Management Company ceased actively managing money.

This episode demonstrates that the contagion effect is not necessarily a function of size at all. The run on MMMFs did not occur because of the size of the Reserve Fund but because of what its vulnerability made

[7] LTCM's balance sheet on August 31, 1998, included over $125 billion in assets. Using the (non-deteriorated) January 1, 1998, equity capital figure of $4.8 billion, this implies a balance-sheet leverage ratio of more than 25:1; see *The President's Working Group on Financial Markets*: Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Apr. 1999, p. 12 (http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf).
[8] Id, pp. 10 et seq.
[9] Id, p. viii.

investors fear about the balance sheets of other funds.[10] The combination of characteristics of MMMFs and certain of their investor demographics present unique risks that differentiate them from other investment funds and warrant specific regulation. In fact, the recent experiences have led to targeted regulatory proposals both in the United States and in the European Union.[11] The structures of the regulatory reforms already made and currently pending in the money market fund sector demonstrate the appropriate structural approach to the regulation of asset management and the capital markets broadly. Specifically, money market fund regulation is not targeted at only a few large funds or even at all funds labeled 'money market.' On the contrary, all MMMFs are already regulated differently than other investment products and additional reforms seek to identify types of funds and investors that exhibit the characteristics believed by regulators to be most problematic and regulate them appropriately as a class—and differently from those that do not present those risks.

In the case of LTCM as well as in the case of the Reserve Fund distress in specific products ultimately led to the closure of the asset management firm that sponsored those products because each firm was relatively small and lacked diversification in the strategies they managed. While in each instance the product level distress had market impact, the ultimate closures of the asset management firms that managed the products were hardly newsworthy.

Beyond LTCM and the Reserve Fund, there have been multiple examples of hedge funds dissolving or experiencing heavy losses with no systemic impact. As a conservative estimate, over one hundred major hedge fund product closures have occurred since 2006 with little evidence of systemic impact. Importantly, fund size is not relevant without further analysis of the strategy employed, quality of the risk management and application of relevant regulation. For example, whereas a large index fund has very little risk, a large, highly leveraged actively managed fund with poor margining and poor collateral management theoretically could create risk to its trading counterparties, since such funds are difficult to transfer in specie. In practice, it is difficult to imagine this scenario transpiring today given improved industry practice and regulatory focus on derivatives and on private funds.

With regards to captive finance companies and historical examples it is worth considering the specific case of GMAC during the recent financial crisis: GMAC was founded in 1919 to provide auto loans to consumers buying GM cars and loans to GM auto dealers buying cars for their lots. Over the years, GMAC became one of the world's largest automotive financing companies and was a dependable source of profit for GM, its parent company. As the *Special Inspector General for the Troubled Asset Relief Program* has observed GMAC traditionally operated a low risk business model. The business model dramatically changed in the 1980s when GMAC expanded its business to providing subprime mortgages. By 2006, GMAC had developed into the 10th largest mortgage producer in the U.S. During the financial crisis, Residential Capital LLC, the mortgage division of GMAC, accumulated nearly $10 billion in losses. GMAC finally received three taxpayer-funded TARP (Troubled Asset Relief Program) injections totaling $17.2 billion.[12] In assessing the background for this rescue package it is important to observe that "Treasury's rescue of GMAC was markedly different from other auto bailouts because GMAC was the only company in the auto bailout whose business model extended beyond the auto industry. GMAC was one of

[10] See *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, p. 3.

[11] See Proposal for a Regulation of the European Parliament and the Council on Money Market Funds, COM(2013) 615 final, 4.9.2013 (http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2013/com_2013_0615_en .pdf); *Securities and Exchange Commission*, Release No. 33-9408, Money Market Fund Reform, Amendments to Form PF, June 5, 2013 (http://www.sec.gov/rules/proposed/2013/33-9408.pdf).

[12] See *Special Inspector General for the Troubled Asset Relief Program*: Taxpayers Continue to Own 74% of GMAC (Rebranded as Ally Financial Inc.) from the TARP Bailouts, January 30, 2013, p. 4 et seq. (http://www.sigtarp.gov/Audit%20Reports/Taxpayers_GMAC.pdf).

the nation's largest subprime lenders. Taxpayers were not just bailing out an auto finance company, they were bailing out one of the nation's largest lenders of subprime mortgages."[13]

As the *Special Inspector General for the TARP Program* has concluded and as we will discuss in more detail below GMAC's business model—in line with the business model of any typical finance company—generally entailed low risk. This changed only when GMAC significantly altered its business model with its subprime business finally dominating the traditional auto lending.

We conclude that a methodology to identify NBNI G-SIFIs should recognize historical precedent and should be able to identify another LTCM, Reserve Fund or GMAC during the build-up of systemic risk. We acknowledge that this is not an easy task. In our view history leads to the conclusion that the potential for systemic risk may rather be embedded in the failure of a certain asset class or a specific business model than in the operations of a single firm.[14] However, where a single firm has caused systemic disruption it generally results from highly leveraged operations which have accumulated significant under-protected exposures or have caused disruption through their lack of substitutability.

General regulatory framework should be observed

In addition, the NBNI G-SIFI methodology should be framed in the context of the wide range of existing regulation and of other regulatory measures introduced post-crisis. For example, funds established under the Investment Company Act of 1940 (1940 Act) in the U.S. or UCITS (Undertakings for Collective Investment in Transferable Securities) in the European Union face specific restrictions with regards to the use of leverage that are much more restrictive than those applied to even the largest G-SIB banks. This hard-wired resilience should be taken into consideration since it does not only serve to provide investor protection on an individual basis. On a collective level, the liquidity and diversification requirements also have positive repercussions on the stability of the financial system as a whole.

In addition, a multitude of new measures have been introduced since the crisis to safeguard against and reduce systemic risk. For example, the initiative to move OTC derivatives trading onto organized platforms with counterparty risk managed through a Central Counterparty (CCP) is intended to reduce systemic risk and to increase transparency. The broad scope of these and other new regulatory measures should allow the FSB to reserve G-SIFI designation only for those circumstances in which other regulatory actions clearly would be insufficient to address or limit the perceived systemic risks. Finally, the sufficiency of existing or pending regulation should be evaluated carefully and taken into account in the design of any additional requirements for NBNI G-SIFIs. It is essential that any additional measures do not ignore or replicate what is already in place.

Objective assessment may yield a null set

Finally and most importantly, it is not necessarily the case that NBNI entities that present a global systemic risk do in fact exist. We will argue below that given the unique nature of the business models in question, and the differences between NBNIs and banking and insurance, a well-calibrated risk-sensitive methodology may yield a null set of NBNI G-SIFIs.[15] Furthermore, with respect to investment funds, the

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[13] Id, p. 3.

[14] See *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, p. 6.

[15] A similar assessment with regards to domestic NBNI SIFIs in the U.S. was provided by Governor Tarullo: "All this suggests to me that the initial list of firms designated under section 113 of the Dodd-Frank Act should not be a lengthy one. (…) The potential for systemic risk contagion effects really reflects the potential failure of an asset class or business model more than a firm. These risks are, at least presumptively, more effectively addressed head-

characteristics of the industry, many of which the Consultative Document acknowledges, in particular the high degree of substitutability and investor mobility demonstrate that entity targeted designation and policy measures would be ineffective and inefficient and targeted regulation on an activity- or industry-wide basis would be the most appropriate response.

Specific comments:

In addition to the general comments presented above, the Institute would like to offer the following answers to select specific questions raised in the Consultation Document:

> **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?

In principle, we share the assessment that the three identified transmission channels—exposures (counterparty channel), asset liquidation (market channel), and critical function or service (substitutability)—can transmit systemic shocks through the financial system. Nevertheless, we also share the view that the *"diversity in the business models and risk profiles … makes it difficult to derive a comprehensive view"*. Moreover, one should keep in mind that these transmission channels had originally been identified when scrutinizing the banking industry. While we do not challenge the applicability of the transmission channels in its original context we conclude that certain channels will not be relevant with regard to certain NBNI business models. For example, we share the assessment that substitutability is not an issue for the investment fund industry since investment funds—by the nature of their business—are in fact highly substitutable.

> **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?

We are concerned that key terms of the methodology—starting with 'systemic risk' but also extending to terms like 'significant disruption,' 'wider financial system' and 'economic activity'—are opaque and require definition, modeling and measurement in this context. We are concerned about leaving things vague and potentially follow a 'know it when you see it'-approach which will by necessity lead to a substantial amount of regulatory discretion. This, in turn, may not only lead to a temptation to respond to political pressures but also make criticism of measurement and policy all the more challenging.[16]

In our view the high-level framework does not adequately cover economic disruptions in the aftermath of a hypothetical failure of a NBNI financial entity.

on."; *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, p. 6.

[16] See *Hansen, Lars Peter*: Challenges in Identifying and Measuring Systemic Risk, Working Paper, February 11, 2013, p. 2.

Size:

The framework should recognize that 'size' is of secondary importance for assessing the systemic risk emanating from NBNIs. Two entities of the same size can present widely varying risk profiles depending on other indicators more directly related to potential systemic risk. For example in assessing investment funds the framework should first look to leverage before considering size, or at least provide that size be analyzed on a risk-sensitive basis.

De facto, the proposed approach is likely to overemphasize size and could result in size being counted multiple times as a determinant of systemic importance. For example, a large financial company with a large share of cross-jurisdictional assets may be penalized twice for being large—once through the size indicator and another through the cross-jurisdictional indicator. This is also true for substitutability because the underlying assumption is that the larger an entity's market share in particular activities, the more systemically important it is. However, large market share is also usually a function of the size of an entity. Hence, by recognizing large market share in different activities, the framework basically reflects the size of an entity several times. Given these interactions between size and the other indicators, it could be seen that the size indicator is the overriding, if not sole, determinant of G-SIFI status.

The preoccupation with size and the potential multiple counting is a serious methodological flaw. The scale of an entity should not only be associated with creating potential systemic risk, but also recognized for its potential to mitigate systemic risk. Economies of scale produce technological advantages and offer greater scope for robust risk management infrastructure. Smaller entities, on the other hand, may have limited resources to apply to risk management. Large portfolios of business create significant diversification benefits and portfolio effects, and hence provide shock absorbers to systemic risk, particularly when geographic, client and counterparty diversification are included in the picture.

An emphasis on size could also be pro-cyclical in times of market stress adding additional costs to flights to quality and industry consolidation. Rather than fail, a struggling entity may simply be acquired by a competitor—with such corporate transaction sometimes explicitly supported by regulators. These larger, diversified entities have a more stable business platform to withstand pressure under various market scenarios and shifting client preferences. For example, while one investment fund product may lose assets, another may gain assets. Likewise, a closure of one fund or one product category is unlikely to cause a large entity to close. In addition, larger entities tend to offer products with less correlated risks and returns in contrast to specialized entities that take concentrated positions or directional exposures in their products.

Substitutability:

In general, the proposed substitutability indicators mostly show only that an entity has a large share in particular market activities, but do not accurately reflect either the contribution of the activity to systemic risk or the difficulty of finding substitutes for the provision of such activities that could pose a threat to financial stability.

Substitutability in terms of systemic risks presents itself because critical services need to be replaced in a timely fashion. In the case of banking this may mean for example that payment functions continue to operate seamlessly the day after failure, or that entities that need to roll over finance can do so without interruption. The preservation of critical functions is a core element of continued regulatory and industry work in banking recovery and resolution for this reason. While we acknowledge that substitutability is an important criterion for assessing systemic risk we conclude that the scale and unique nature of NBNI entities will lead to very low scores with regards to their substitutability indicators.

Specifically, in the case of **investment funds**, substitutability is not a major point of concern. Investors invest by choice. They do not have to invest in a certain sector or market. If a fund returns its money to investors, those investors are not compelled to immediately invest in another investment fund. Substitutability creates stress if the immediate replacement of its critical functions causes stress. In the case of funds therefore substitutability is not critical. We therefore endorse the approach in the Consultation Paper that substitutability is not a systemic risk transmission channel for investment funds.

For **finance companies** the market share/substitutability indicator is not just a question of relative market share within their own sector, but needs to be taken in the context of all providers of such financial activities, which would include the banking sector. When viewed in this context substitutability would be of little concern as even the largest NBNI financing providers are small when compared to a range of large banks, and therefore their portfolios could be readily absorbed. In addition, the market structures in the respective product markets should be taken into consideration. In fact, in the case of finance companies that primarily serve consumer markets, such as auto finance companies, consumers in some countries do not necessarily rely on credit provided by a finance company but more often pay for the products in cash. In such an environment the existence—or non-existence—of a finance company is irrelevant for the functioning of the respective product market even if a single finance company may have a high market share in the (limited) financing market.

Moreover, in the event of the distress or failure of finance companies that finance assets, the firm's clients would typically not be affected. Access to the asset being financed would continue while ownership passed to the finance company's creditors, who would have the right to continue to receive lease payments. This characteristic makes this type of finance companies substitutable by a diverse range of providers of funding including mainstream banks, hedge funds or other institutional investors.

Complexity:

Compared with global universal banks (in particular G-SIBs), both investment fund and finance company business models are simpler. Typically they are specialized in producing and selling one specific product: investment funds on the one hand and on the other hand leasing and financing solutions for a certain product. The respective businesses are generally operated in lean legal structures and this is reflected in plain balance sheets. In case of a failure the operations of these companies can easily be dissolved without any significant repercussions on the business partners.

An effective risk-sensitive analysis should focus on the relative complexity and opacity of an entity's business. As the financial crisis demonstrated, it is more difficult for regulators and market participants to understand and effectively address risks presented by relatively complex and non-transparent companies. Thus, an assessment of systemic importance should focus on activities that are highly complex and for which exposure and other information necessary to analyze risk is not readily available.

Global activities (cross-jurisdictional activities):

We also believe that the proposal provides disincentives to geographic diversification. While some of the benefits of diversification may have been shown by the crisis to have been overstated, we believe that diversification of entities by geography is an effective means of spreading risk, provided that these risks are properly managed. Designating entities due to their cross-border activities would not only create disincentives to geographic diversification, but also disregard the potential benefits of cross-border activities, especially in certain emerging market jurisdictions.

Interconnectedness:

Interconnectedness, especially as reflected in leverage for us seems to be the most relevant basic impact factor.[17]

Indicator Weights:

As opposed to previous and comparable consultations the FSB and IOSCO do not provide a proposal as to the weighting of the various suggested indicators. In addition to the fact that we have reservations as to the appropriateness of certain indicators as such we also would object to an equal weighting of all indicators. Since most of the indicators are to some extent correlated this would pose us with a special concern. Given the specific correlations between size and the other indicators it could be argued that at least the weight of 'size' should be limited in order to prevent double- and multi-counting.

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?

As an initial focus we have little comment, and would not suggest that there are other entities that should be brought in scope.

The IIF endorses the approach to focus on investment funds and not asset managers, and further detailed comments on this issue are provided in the relevant section below.

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

As noted above, we believe there is too much subjective assessment or supervisory judgment currently proposed. Therefore, in our view, the proposal does not present a sufficiently objective methodology and does not provide for a robust, measurable or objective process. Further, our comments below raise concerns with individual indicators and measures, and we believe that practical difficulties do exist and can be demonstrated. Therefore, in advance of the detailed comments below, it is our position that the methodology requires additional detail and modification before it can be operationalized and considered robust.

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).

In general, the Consultation Paper does not provide any arguments or data to support the proposed materiality thresholds or explains how 'balance sheet total assets', 'assets under management (AUM)' and

[17] This assessment is supported by the fact that "the extent of the leverage of the company" is the first of a number of indicators FSOC has to take into consideration when determining whether a nonbank financial company poses a threat to the financial stability of the United States; see Section 113(a)(2)(A) Dodd-Frank Wall Street Reform and Consumer Protection Act.

‘gross notional exposure (GNE)’ indicate potential risk to the global financial system. We reiterate our general concerns with regards to ‘size’ as an indicator for systemic risk.

Specifically in the case of investment funds, the total AUM provides limited insight, as the asset mix could be invested in many different ways and present a vast spectrum of ’riskiness‘ into which size provides no meaningful insight. The largest funds have a significant percentage of their clients’ assets invested in long-only passive strategies in highly liquid markets. Long-only strategies appear to present minimal risk from a systemic perspective, and passive strategies present even less potential for systemic risk. Thus, any threshold that simply connects to size seems to some extent arbitrary. We reiterate our argument that risk metrics that are risk-based and risk-sensitive should be devised to identify potential SIFIs. At a minimum, leverage should be recognized by normalizing the balance sheet size and the AUM respectively with a leverage ratio—as suggested in the consultation paper under Indicator 2-4 (finance companies) and Indicator 2-1 (investment funds).

If the FSB and IOSCO, for reasons of simplicity, want to use (improved) size metrics to provide the initial filter of entities for assessment we would argue that the thresholds are too low to be indicative of systemic relevance let alone potential risk. They are also inconsistent with the G-SIB methodology.

To bring the NBNI G-SIFI assessment in line with the G-SIB and G-SII framework the FSB and IOSCO should consider that the smallest G-SIB is operating with total assets of $243bn (as of 12/31/2013).[18] Therefore, to be consistent with the G-SIB methodology and to account for the lower risk profile of NBNIs, the threshold for all entities should be increased to at the very least €200bn, which is the level at which banks have to report information under the G-SIB methodology.[19] Below that banks are presumed not to be globally systemically risky, and further, as recognized in the proposal and discussed below, NBNI entities in general are inherently much less risky than banks.

In principle, the thresholds should be carefully set and rather calibrated downwards in the course of the assessment process than set too aggressively in the first place. It should be considered that any SIFI assessment will require the dedication of significant resources within the scrutinized entities and this will lead to according internal and external costs.

Regardless of where the thresholds are ultimately set, they should include an inherent adjustment to accommodate the growth of the financial system such that the thresholds do not become more inclusive over time than is intended at their establishment.

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

We do not foresee more difficulties than posed by any similar data collection.

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[18] Excluding the two smallest banks whose systemic significance results from payment and custodial activities—activities in which neither investment funds nor finance companies are engaged—no G-SIB has in fact less than $650 billion in assets; see *Federal Deposit Insurance Corporation*, Global Capital Index - Capitalization Ratios for Global Systemically Important Banks (GSIBs), Data as of second quarter 2013 (https://www.fdic.gov/about/learn/board/hoenig/capitalizationratios2q13.pdf)

[19] See *Basel Committee on Banking Supervision*: Globally systemic important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013, p. 2 (http://www.bis.org/publ/bcbs255.pdf)

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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 once again reiterate our general concern with regards to 'size' as an indicator for systemic risk; any threshold that simply connects to size seems to be an arbitrary measure and not reflective of risk. We believe that risk-based and risk-sensitive metrics should be applied to identify potential SIFIs.

We further understand that the threshold is designed only as an initial filter, but we nonetheless wish to raise concerns with the GNE metric. The Consultation Paper notes: *"GNE is calculated as the absolute sum of all long and short positions … (and) provides a complete appreciation of all the leverage that is employed by a fund to gain market exposure."* However, such a measure is too simplistic and does not consider the riskiness of the asset mix and leverage with which a fund operates. This problem may be overcome by normalizing the GNE with a leverage ratio as suggested in the Consultation Paper under Indicator 2-1.

Instead of referring to a pure GNE we would suggest multiplying a hedge fund's AUM with its leverage ratio to receive a normalized AUM figure. Using AUM for non-leveraged funds and 'normalized AUM' for leveraged funds an identical threshold of €200bn can be applied for all investment funds to provide a filter for initial assessment.

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).

As the assessment methodology aims to identify NBNI SIFIs of global relevance—as opposed to purely domestic relevance—it seems reasonable that the FSB and IOSCO should at least consider an additional materiality threshold focusing on 'global activities'. However, such a threshold should be focused on systemic risk and therefore not be based on a simple metric that has no relevance to potential global systemic risk such as the number of jurisdictions in which operations are conducted. An entity may have a large presence in a particular jurisdiction, but an extremely small presence in others. In such a case, it would not be relevant to consider the entity as posing a global systemic risk based purely on the number of jurisdictions in which it operates. Rather any threshold should connect to the materiality of interconnections across jurisdictions and the likelihood that the particular type of interconnections could lead to systemic consequences if the entity were to experience financial stress. This could be achieved by analyzing the number of jurisdictions in which the respective entity is of systemic relevance such that, if experienced financial stress in any of these jurisdictions (or in all of them), it may transmit it to others.

In addition, the proposed framework should be revised to focus on the potential for activities to cascade across jurisdictions, as a company that is active in a number of jurisdictions does not necessarily present a global, cross-jurisdictional risk. For example, finance companies can have businesses that are confined, or 'ring-fenced', in a particular jurisdiction (i.e., lending and funding activities are confined to market participants in a particular jurisdiction). Especially with regards to their assets, finance companies rely heavily on the certainty of titles and the enforceability of claims in bankruptcy proceedings under national law. Consequently, finance companies sometimes operate in a fragmented legal structure. Thus, the failure or financial stress of a ring-fenced operation would be contained to the respective jurisdiction and not be likely to cascade to other operations of the finance company or market participants in other jurisdictions and, therefore, such a company would be unlikely to present global systemic risk.

Sector-specific methodologies: Finance companies

Q4-1. In your view, does the proposed definition of finance companies 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?

In principle, we consider the definition of 'finance companies' to be generally appropriate, but we offer the comments below.

First, we would like to point out that the focus of the funding of finance companies does not necessarily have to be on wholesale funding sources. As we will explain further below (see our answer to question Q4-2) the funding structure—in our view—is not a constituting element of finance companies. Rather than focusing on the type of funding, the framework should consider the concentration or variety of funding sources, as diversification in funding sources can serve as a source of stability during times of financial stress.

Q4-2. Do you think that the above description of systemic importance of finance companies adequately captures potential systemic risks associated with their financial distress or disorderly failure at the global level?

In general, we do not share the view that finance companies provide services or financing products that are both vital for the functioning of the economy—and thus entail systemic risk—and could not easily be substituted. In our view, the market share of finance companies is not just a question of relative market share within their own sector, but needs to be taken in the context of all (potential) providers of such financial activities, which would include the banking sector, against which finance company balance sheets are very small. When taken in that context the portfolio of even the largest finance company could be readily absorbed, and the financial services replaced by a combination of the banking and non-banking sector.

While the activities of finance companies are economically important, they are still substitutable, operating within a highly competitive market, which could easily absorb the drop in supply created by the failure of one firm. In Europe alone, there are approximately 1,400 leasing firms and more than 600 consumer credit lenders that possess the relevant specialized skills. In particular, the marked share of an automotive leasing company could seamlessly be taken over by captive or non-captive competitors.[20] The required sector knowledge does not have to be developed first, since it does exist in those companies already. Consequently we do not see "*barriers to entry such as the specialist expertise required to operate in certain markets*".

Hence, a default of a finance company would only have a limited impact on its customers. Leasing comprises a large proportion of a typical finance company's balance sheet. Under a leasing arrangement the finance company retains ownership of the asset, and these assets are carried on the balance sheet at depreciated value. In that regard it is very different from, for example, a traditional banking collateralized loan, such as a mortgage, where the bank lends money to the customer and has a security interest over the asset.

[20] When Chrysler filed for bankruptcy to reorganize itself on April 30, 2009, GMAC announced it would replace Chrysler Financial in providing Chrysler dealers with inventory financing and would lend money to consumers to buy Chrysler vehicles; see *GMAC Financial Services*, Press Release "GMAC Financial Services Enters Agreement to Provide Financing for Chrysler Dealers and Customers", April 30, 2009 (http://media.ally.com/index.php?s=20295&item=122678).

Recoverability of the value of the assets usually is not a major issue because the performance of manufactured products is to a large extent predictable and the depreciation schedules usually take a conservative view. Thus, the balance sheet carrying value of an asset (such as a lease) is likely to reflect its market value and, as a result, a portfolio could be easily absorbed at a value close to its carrying cost. Further, and as a result, it is unlikely that an unanticipated sharp decline in the values of leased assets would occur, and such reliability of value makes transfer of assets, such as leases at close to carrying cost likely with competitive interest. Therefore, the customer of a finance company will not be precluded from the continuing use of the product despite the failure of any given finance company.[21]

The impact of such a failure is further reduced by prudent risk management. Finance companies often purchase residual value insurance or guarantees, or enter into buy-back arrangements with asset manufacturers to protect themselves from falls in asset values. Finance companies who take on residual value risk exposure, will monitor asset values closely, and reflect movements in their financial accounts.

With regards to funding sources, independent, as well as financial companies affiliated with a manufacturer or another commercial company, often try to position themselves as distinct players in the financial markets and to diversify funding sources and their investor base to optimize funding costs, minimize refinancing risks and to secure liquidity at all times. This funding mix often includes both a variety of unsecured and secured instruments but also deposits from retail customers. Particularly, some major finance companies operate significant direct bank operations and compete successfully for retail depositors. These deposit taking arms of finance companies are prudentially regulated and therefore subject to local supervision of their activities, capital requirements and resolution planning, reducing the risk of losses having a systemic impact.

Finance companies typically use wholesale funding as part of a broader financing mix. In this context wholesale funding contributes to diversifying funding sources and to reducing dependencies on certain markets or instruments. In fact, finance companies have significantly increased the diversification of their funding sources since the recent financial crisis thus making them even less susceptible to the ebbing of certain sources.

We share the FSB's view that funding can become a problem "*if (finance companies) are highly leveraged or if their funding is relatively short-dated compared to the maturity of their assets*". But, liquidity problems emanating from a maturity mismatch are neither necessarily connected to wholesale funding nor are they exclusive to finance companies. In fact, these problems can become relevant for any market participant who requires funding, independently whether this market participant belongs to the industrial sec-

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[21] Similar arguments were raised during the deliberations of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S. House of Representatives:
"Ms. KILROY. (…) It is my understanding that nondepository captive finance companies do not pose the types of risks that warrant such treatment. Nondepository captive finance companies typically provide financing on a nonrevolving basis only to customers and to dealers who sell and lease the products of their parent or affiliate. As such, they are involved in only a narrow scope of financial activity. Equally important, their loans are made on a depreciating asset, a fact taken into account when the loans are entered into. If they are not a depository institution, they therefore have no access to the Federal deposit insurance safety net. It is my understanding that it is the intent of the committee that nondepository captive finance companies are not the types of finance companies that should be subjected to stricter standards under section 1103 of this legislation; is that correct?
Mr. FRANK of Massachusetts. The gentlewoman is correct. (…) Financing companies are not depository institutions. They provide financing for the sale of that particular product in that company. It is again inconceivable to me that somehow they would rise to the level of risk that would justify the Systemic Risk Council stepping in.
Ms. KILROY. Thank you, Mr. Chairman"; Congressional Record – House, December 9, 2009, H14431 (http://www.gpo.gov/fdsys/pkg/CREC-2009-12-09/pdf/CREC-2009-12-09-pt1-PgH14427-2.pdf).

tor, the services sector or the finance sector. Consequently, this issue is frequently regarded and should be treated as a general task for prudent risk and liquidity management.

Detailed funding data will reveal that most finance companies in fact operate with matched funding structures. As opposed to banks, maturity transformation is not part of the business model of a finance company. Therefore, their funding structures are much more resilient to external shocks than those of banks. In particular run-off of liabilities matches run-off of assets and so rollover risk, a key cause of concern during the crisis, is of low concern and not a key-driver for systemic risk within finance companies.

Q4-3. Are the proposed indicators appropriate for assessing the relevant impact factors? For example, for consistency purposes the methodology uses "intra-financial system assets" and "intra-financial system liabilities" as defined in the G-SIB framework, but should it consider other indicators that are more tailored to a finance company's business model and risk profile? Also, should the methodology focus not only on OTC derivative exposures but also centrally-cleared derivatives in assessing "interconnectedness" and "complexity"?

The indicators in the proposed framework are very general in nature and, as the proposed framework recognizes, are based on indicators that were developed for G-SIBs. As a result, the indicators do not address the unique aspects of a finance company's business model and risk profile. Thus, before the FSB finalizes the framework, the FSB should analyze finance company-specific data and develop the indicators based on these data, similar to the process that was undertaken for the development of the G-SIB framework. If data is not currently available, the FSB should work with national authorities to collect the necessary data before finalizing the framework.

Size:

We reiterate our general reservations with regards to indicators based on 'size' and refer to our answer to Q2-1. We do not share the view that the volume of the balance sheet "*is a key indicator for determining systemic importance*".

Interconnectedness:

With regards to 'interconnectedness' we question the relevance of indicators 2-1 and 2-2. As we have argued in our answer to Q4-2 we do not think that wholesale funding (as reflected in intra-financial liabilities) is *per se* a matter of concern for finance companies. It should be seen as part of a company's general funding strategy and its funding mix. If dependencies should exist, these will be detected by analyzing the 'borrowings split by type' (Indicator 2-3). On the asset side 'intra-financial system assets' were suggested as indictor *"(c)onsistent with the approach taken in the methodology for identifying global systemically important banks (G-SIB) by the BCBS*". Whereas analyzing intra-sectoral lending makes perfect sense while assessing the banking industry "*lending to financial institutions or holding of securities issued by other* (sic!) *financial institutions"* is not part of the business model of finance companies.

An analysis of a finance companies funding mix—as contemplated by indicator 2-3—will find on the finance company's balance sheet positions such as borrowings from financial institutions as well as securities which have been issued by the company itself or by a special purpose vehicle within the course of an asset-backed-transaction. However, it should be mentioned that lenders and investors who provide funding and commit credit lines or who invest in securities are predominantly institutional investors such as insurance companies and banks. These investors are subject to their own regulatory provisions. These regulatory requirements ensure that institutions do not build up excessive risk to one particular finance company. Large exposure limits as stipulated in Europe by the Capital Requirement Regulation (CRR)

and the Capital Requirements Directive IV (CRD IV) are intended to safeguard against this kind of risk concentration.

Substitutability:

With respect to 'substitutability' we reiterate our concern regarding the relevance of this factor and in doing so refer to our answer to Q4-2.

Complexity:

As we have argued in our response to Q2-1 we think that finance companies operate a less complex business model as compared with large banks. Against this backdrop any indicator trying to identify 'complexity' will not lead to meaningful results. If the FSB nevertheless wanted to apply certain indicators we would recommend modifications: In order to provide a better sense of the risk profile of a derivatives book, derivatives should be evaluated both on the exposure amount and the notional amount (not only the notional amount, as suggested in Indicator 4-1). More specifically, the framework should account for the increased risk presented by an uncollateralized derivative compared to a collateralized derivative. Further, the framework should consider the purpose for which derivatives are used. For example, derivatives used for hedging tend to mitigate risks, and, in contrast, derivatives used for speculative purposes are more likely to amplify risks.

Further, existing practices, regulations, and the significant counterparty risk-reducing derivative reforms already in train, should all be taken into account. For example, the initiative to move OTC derivatives trading onto organized platforms with counterparty risk managed through a CCP has virtually eliminated counterparty risk. Against this backdrop any indicator in a methodology or any potential policy measure should not inadvertently discourage risk mitigating activities and the hedging of specific risks.

Global Activities:

With regards to 'global activities' it brings many benefits through diversification and portfolio effects and as such reduces systemic risk. When looking for potential systemic risk, any indicator should not be based on nominal figures, e.g. the number of jurisdictions in which a finance company conducts operations or the size of cross-jurisdictional assets and liabilities; rather the indicators should connect to a potential global systemic relevance of a finance company and global systemic risk. This could be achieved be analyzing in how many jurisdictions the finance company is systemically relevant and if financial stress in any of these jurisdictions (or in all of them) may cause a global systemic crisis.

The indicators should also observe that finance companies can have businesses that are confined, or 'ring-fenced', in a particular jurisdiction. Especially with regards to their assets finance companies rely heavily on the certainty of national titles and the enforceability of claims in bankruptcy proceedings under national law. Consequently, finance companies sometimes operate in a fragmented legal structure. Thus, the failure or financial stress of a ring-fenced operation would be contained to the respective jurisdiction and not be likely to cascade to other operations of the finance company or market participants in other jurisdictions and, therefore, such a company would be unlikely to present global systemic risk.

Q4-4. Are there additional indicators that should be considered for assessing the relevant impact factors? If so, please also explain the possible indicators and the reasons why they should be considered.

We acknowledge the intentions of the FSB and IOSCO to maintain consistency between the various G-SIFI methodologies. However, since the G-SIB methodology was developed first, all other methodologies by necessity are to some extend biased. We are afraid that this does not give enough attention to the specific business models of finance companies and any idiosyncratic risks that may be entailed in these business models. For example, there may be the need for stronger differentiations with regard to the respective assets on the balance sheet. The business risk of an automotive leasing company may be different from the risk of an aircraft leasing company, be it only for the size of the various tickets and the granularity of the customer base. We are concerned that the risk profile of the companies which are captured by the definition of the Consultation Paper significantly varies without this being reflected in the methodology.

As noted above, the FSB should reconsider its framework for finance companies after analyzing finance company-specific data and developing appropriate indicators based on these data and analyses.

Q4-5. 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 solutions including possible proxies that could be collected or provided instead.

Yes. Not all of the required figures are standard reporting parameters and readily available. They would have to be calculated exclusively for the G-SIFI assessment. Therefore, the IIF endorses the approach that only finance companies exceeding the initial threshold should be subject to providing metrics in support of the assessment of individual indicators.

Moreover, market share data, which is related to 'substitutability,' are not readily available, because a range of companies (including banks) provide financing in many of the categories in which finance companies are active. As a result, at this time, it is difficult to develop a complete understanding of the industry for many finance categories (including, for example, auto loans). Thus, as noted above, the FSB should collect and develop more data before finalizing the framework.

Q4-6. Should certain indicators (or impact factors) be prioritized in assessing the systemic importance of finance companies? If so, please explain which indicator(s) and the reasons for prioritization.

As a general matter and as frequently noted above, we believe that the FSB should collect and analyze more finance company-specific data before finalizing the indicators used in the framework.

However, with respect to the proposed indicators, we refer to our general comments above and challenge the assessment that the size of financial companies, as measured by total globally consolidated balance sheet assets should be a "*key indicator for determining systemic importance*". We believe that the focus on size without considering risk sensitivities of particular assets and liabilities, as well as the potential multiple counting creates a methodology that is not truly reflective of the systemic risk posed. An analysis of size should be risk-sensitive, and the scale of an entity should not only be associated with creating potential systemic risk, but also recognized for its potential to mitigate systemic risk.

Generally, we do not think that 'complexity' and 'substitutability' are major issues with regards to the business model of finance companies. As we argue above (see our response to Q4-2) we do not believe

that finance companies as such operate a business model that upon failure creates significant disruption for the broader economy and thus entails systemic risk. With regards to the products and services rendered we think there is sufficient (potential) competition; if a finance company defaults the assets and the business could easily be taken over by competitors.

In our view, ‘global activity’ brings many benefits through diversification and as such reduces systemic risk. When looking for potential systemic risk, any indicator should not be based on nominal figures, e.g. the number of jurisdictions in which a finance company conducts operations; rather the indicators should connect to a potential global systemic relevance of a finance company and global systemic risk. This could be achieved be analyzing in how many jurisdictions the finance company is of systemic relevance and if financial stress in any of these jurisdictions (or in all of them) may cause a global systemic crisis (see our response to Q3-5).

Therefore, the indicators of interconnectedness should be prioritized in determining the systemic risk of finance companies.

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Sector-specific methodologies: Investment funds

> **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?

In general, we regard the proposed definition as practical but insufficient. Although some entities are clearly included, the status of others is less clear.

For example, it is our understanding that pension funds do not fall under the definition provided within the Consultation Paper. Whereas pension funds collect contributions from a multitude of investors they typically do not issue units or shares which could be redeemed. If redemptions are possible at all, they usually are only permissible under specific circumstances and are subject to an excise tax and additional penalties. With regards to the transmittal channels pension funds are thus even less systemically relevant than regular investment funds. However, this conclusion can only be obtained from the proposed methodology by inference, and therefore in order to be practical this distinction should be made explicit.

> **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?

As the FSB and IOSCO observe, the asset management industry exhibits certain characteristics which lead to very different risk profiles when compared with those of other financial entities and this explains why asset management entities and activities have been regulated differently historically.

As noted above, we endorse the recognition that funds and managers are highly substitutable so that substitutability is not considered a transmission channel of systemic risk for funds. We support the assessment that *"the fund industry is highly competitive with numerous substitutes existing for most investment fund strategies"*. Indeed, investors are sometimes more committed to a certain individual as opposed to a certain investment fund or a certain asset management company. It is a frequently observed phenomenon in the fund industry that investors tend to reallocate their funds once a reputable fund manager transfers to another asset manager. While we agree with the statement above we also note that investment funds do not provide a critical function that requires intermediation. Many investors can and do invest directly in securities rather than investing through a collective fund.

However, we would also again draw attention to the criticality of substitutability, and that this is an additional, and in fact stronger, argument to assign investment funds a very low value with regards to substitutability as a risk factor. Substitutability is only of concern from a systemic point of view if timely replacement is critical and difficult. Investors have a choice, and the exit of one fund from a given market does not create an immediate need to be replaced to prevent severe economic and market disruption, as would in the case of say banking payment systems. If a fund exits a market its competitors absorb its share and new players may emerge to take up that portion of investors that wish to re-invest. The exit of a fund therefore creates a business opportunity and promotes competition, both economic goods, rather than create a risk through lack of substitutability.

With regards to the other two transmission channels we would make the following comments:

Asset liquidation (Market Channel):

We agree with the statement in the consultation paper that *"the manager acts as an 'agent', responsible for managing the fund's assets on behalf of investors according to its investment objectives, strategy and time horizon"*. Consequently, *"investment management is characterized by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio"*. The risk of loss is disclosed to and accepted by investors, and should that loss materialize is directly absorbed by those same investors. If the value of an investment in a fund declines, the fund has not failed and neither has the manager.[22] The fund has certainly performed worse than the investors and the manager may have hoped, but everyone involved accepted the possibility of asset price declines. Furthermore, asset price declines occur on a regular basis, particularly for funds with daily NAV calculations, and do not come as shocks to investors. Consequently, detrimental market developments, and even large losses are not run-inducing. In fact, funds regularly act as shock absorbers in times of market stress and funds flow into markets where prices have declined.[23]

The above arguments are readily supported by data. Research has demonstrated that during periods of market stress dating back to 1945 and through the most severe financial crises, mutual fund investors have not reacted precipitously to financial market shocks.[24] For example, in the 17-month period November 2007 to March 2009, U.S. equity funds experienced net cash outflows of $281mn. The majority of these outflows ($205mn) occurred during the peak of the financial crisis, July to December 2008. However, over these six months the net outflows amounted to just 3.6 percent of equity fund assets. While we concede that funds may experience increased redemptions in periods of high volatility and market stress there is no historical evidence that redemptions of fund investors have induced fire sales by equity and bond funds and led to a collapse of securities prices and to the materialization of systemic risk. There is no empirical evidence to assert that they may do so in the future.

Further, existing regulations protect both the liquidity needs of investors and the stability of asset prices. In major jurisdictions mutual fund assets have to be broadly diversified and such funds must maintain liquidity for redemptions. For example, in the United States the SEC has existing requirements for the maintenance of no less than 85% of a registered open-end fund's assets in liquid securities, which are defined as any assets that can be disposed of within seven days at a price approximating market value, and allows for redemptions in kind pursuant to Rule 18f-1 of the 1940 Act.

We fully support the statement that there *"are also important aspects worth considering that may dampen the global systemic impact of a fund failure. For instance, depending on national regulation, asset managers may temporarily implement specific liquidity management tools such as swing pricing, anti-dilution levies, redemption gates, side-pockets, redemptions in kind or temporary suspensions."* Hence, despite very low probability of a run occurring, even if a run on a fund should eventuate the industry has statutory

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[22] We exclude MMMFs with a constant net asset value (CNAV) from the scope of our analysis of asset liquidation (market channel).

[23] For example, Wolseley plc, a UK operating company supplying heating and plumbing products, was supported by its shareholders and other investors, including large investment funds, following a profit warning in 2009 at the peak of the financial crisis. Shareholders/investors provided capital through a £1 billion rights issue and equity placing launched in March and completed in April 2009. Due to difficult market conditions and the credit crunch, Wolseley had risked insolvency. It is now a profitable company. See *Wolseley plc*, Results of Rights Issue, April 22, 2009 (http://www.wolseley.com/index.asp?pageid=69&newsid=31)

[24] See *Investment Company Institute*: Public Feedback on OFR Study on Asset Management Issues, November 1, 2013, Appendix B (http://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf).

rules and circuit-breaking mechanisms in place which would prevent such a run from inducing the *"forced liquidation of positions"* and thus temporary distortions in market liquidity and/or prices.[25]

Given disclosure to investors, regulation in place and fund structures which provide protection in times of stress, the contrast between a bank deposit and an investment in a fund is stark. Fund investors invest indirectly in the underlying assets in the fund, and investors are entitled only to their net asset value when they decide to redeem out of a fund. As opposed to bank deposits investors do not have the expectation that their investment will be returned in full and thus a 'run on a fund' is intrinsically unlikely.[26]

Finally, the discussion of this transmission channel seems to describe both fire sale and contagion risk. The extremely low likelihood of fire sale risk to asset management has been addressed above. As for contagion risk, leading policy-makers have observed that SIFI designation would be an inappropriate regulatory response. It is widely understood that regulating any potential market or contagion risk requires broad activity- or market-wide regulation to be effective. Assuming such a risk exists, it cannot be mitigated effectively by regulating a handful of investment funds differently than their competitors.[27]

The IIF therefore comes to the following conclusion on this issue: With regards to investment funds, and while funds may experience periods of higher than normal redemption, where funds maintain readily saleable assets and/or circuit-breaking mechanisms to deal with periods of high redemptions (as required by law/regulation in many instances) asset liquidation in our view is not a transmittal channel for systemic shocks.

Exposures (Counterparty Channel):

Some investment funds may employ leverage on behalf of their clients as part of the investment strategy of a particular investment fund or product. In the investment management context, we define 'leverage' as a strategy that creates investment exposure by a fund greater than the net asset value of the fund. Leverage in funds can occur in a number of ways, primarily through borrowing and the use of derivatives. Asset management clients benefit from the potential upside provided by leverage, and similarly bear the risk of any increased asset price volatility. However, our analysis shows that for investment funds exceeding $100bn AUM their leverage is very close to, or equal to 1.0. That is, they operate with 100% equity capital, which is an entirely different risk exposure than other entities in the financial sector (in particular

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[25] For example, there may be protective provisions included in the fund prospectus forming part of the terms and conditions of investment, including:

1. Suspension of Net Asset Value: A fund may suspend the determination of the NAV of a fund or asset class so that subscriptions or redemptions are not possible if, among other reasons, markets or exchanges are closed or dealings are restricted or suspended, or the fund board determines that reliable valuation of assets is not possible because of exceptional volatility or similar circumstances.
2. Deferral of Large Redemptions: A fund may defer for a period of time aggregate redemptions from investors which form a significant proportion of fund, or require prior notice of such redemptions.
3. Redemptions in Kind: A fund may require that large redemptions are redeemed "in kind" without sale of the securities.

[26] As already mentioned, CNAV MMMFs are excluded from the scope of our analysis. CNAV MMMFs are a very specific case and as such have led to targeted regulatory proposals both in the U.S. and in the EU. See fn. 11 (p. 6).

[27] "Furthermore, the rationale for regulation provided by the potential for contagion effects is really an argument for sound regulation of the type of financial firm or instrument under consideration. If a small money market fund's travails can provoke a run on the entire industry, then all such funds should be subject to requirements that reduce the fragility of their business model. The potential for systemic problems would be essentially as great in an industry structure with many mid-sized funds as in one with a small number of large funds"; *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, pp. 5 et seq.

banks and insurance companies for which leverage is an inherent aspect of their business models), and as such poses little or no risk to counterparties and the broader system.

In considering leverage and the potential impacts of leverage on the markets, it is important to understand that leverage can occur not only at the product level, but also at the end-investor's portfolio level. Importantly, the use of leverage is not limited to assets managed by investment funds. As we saw in the 2008 financial crisis, many wholesale and retail investors who had employed leverage on their own balance sheets were forced to liquidate investments to meet their individual liquidity needs and margin calls.

The use of leverage in a number of investment products is subject to extensive regulation. For example, U.S. mutual funds are subject to specific leverage limitations, both in connection with borrowing and the use of derivatives. In the European Union regulatory regimes under both the UCITS (Undertakings for Collective Investment in Transferable Securities) and the AIFMD (Alternative Investment Fund Managers) framework similarly include explicit limits or disclosure obligations related to leverage. In fact, these limits are much tighter than the limits on even the largest G-SIBs.

While private funds in the United States are generally not subject to regulatory leverage restrictions, many agree to abide by leverage limits in their offering materials and provide transparency to investors regarding current leverage levels. Additionally, regulatory and market changes implemented since 2008 have significantly reduced exposures and the systemic risk that a private fund can pose. Central clearing, netting of risk positions, mandated changes to documentation and collateral practices, increased dealer requirements and other changes have significantly reduced counterparty risk, fundamentally changed trading practices, improved dealer risk management and therefore mitigated the potential impact of the insolvency of a private fund.

In principle, we concede that losses on investments where leverage is employed, if exposures are significant and have not been adequately managed, can generate losses to counterparties (borrowers, trading partners) and may ultimately destabilize entities who might be systemically important in their own right. As above however, we believe that only a limited subset of investment funds could conceivably present such risk.

Therefore, for the reasons described above, we strongly believe that in the context of investment funds <u>posing a global systemic risk</u> under the FSB SIFI Framework that the only transmission channel that is relevant to the SIFI analysis is the exposure (counterparty) channel via leverage and this is where attention should be focused. However, since substitutability and asset liquidation are in principle valid transmittal channels for systemic shocks the non-applicability to investment funds should be interpreted as a strong indicator that the systemic relevance of investment funds is per se significantly lower as compared to other business models where all possible transmittal channels are of relevance and importance. If every of the three channels were given a weighting of one third the value for substitutability and asset liquidation in the case of investment funds would be zero.

Further, existing practices, regulations, and the significant counterparty risk-reducing derivative reforms already in train, should all be taken into account when interpreting whether such leverage actually poses a systemic risk. Also, as leverage can be employed by funds large and small, if existing regulation and reforms are found wanting to manage the risk of leverage in the investment fund industry, then any necessary additional reforms, after due consultation, should be applied sector-wide and focused on the activity, rather than only a small set of investment funds. Taking all of the above into account, and as mentioned earlier, we believe that once the assessment methodology has been appropriately calibrated and run its course that in the case of investment funds it should yield a null set of entities who truly pose a global systemic threat.

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.

Asset managers themselves are not direct participants in the capital markets. They do not act as lenders or counterparties, and accordingly they have very small balance sheets, and limited interconnections—particularly when compared to other financial institutions like banks and insurance companies—and none with respect to the assets they manage. Therefore, asset management entities present no systemic risk at the company level. Thus, we consider option (iii) as inappropriate to the issue of systemic risk.

With regards option (iv)—asset managers and their funds collectively—it could be claimed that this is relevant in the case of a 'reputational crisis' in which a negative incident with regards to a certain fund damages the reputation of the respective asset manager and leads to a 'run' on all of its investment funds under management. As we have explained above (see our answer to Q6-2) there is not only no empirical evidence to support such a theory.[28] The distinctiveness and the independence of the various funds and their respective investor base render such an event extremely unlikely. Further, existing regulations protect both the liquidity needs of investors and the stability of asset prices. Additionally, as the FSB and IOSCO have observed, there are resilient mechanisms in place to dampen any potential systemic impact of a potential 'run'. *"For instance, depending on national regulation, asset managers may temporarily implement specific liquidity management tools such as swing pricing, anti-dilution levies, redemption gates, side-pockets, redemptions in kind or temporary suspensions."* Hence, despite the very low probability of a run occurring in the first place, even if a run on all the funds of a certain asset manager should take place the industry has statutory rules and circuit-breaking mechanisms in place which would prevent such a run from having systemic consequences.

We therefore fully support the statement that *"(e)conomic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund. It is therefore the portfolio of assets that creates the respective exposure to the financial system"*. We also support the conclusion that *"the manager acts as an 'agent', responsible for managing the fund's assets on behalf of investors according to its investment objectives, strategy and time horizon"*. The asset management business is an 'agent' business and not a 'principal' business. Consequently we strongly endorse the FSB and IOSCO approach of focusing on the fund level in designing the initial assessment methodology. Further, following the above arguments we would strongly state that options (iii) and (iv) should be excluded from all future or expanded methodologies as asset managers themselves pose no systemic threat.

Option (i) has the further advantage of being in line with other recently adopted regulation. Specifically, in September 2013, the Basel Committee on Banking Supervision (BCBS) and IOSCO took a similar approach in the context of margin requirements for non-centrally cleared derivatives. The BCBS and IOSCO determined a threshold above which initial margin would have to be exchanged. With respect to investment funds, they clarified that the threshold would apply at the individual fund level as long as the fund is a distinct legal entity that is not collateralized by, or otherwise guaranteed or supported by, other investment funds or the fund adviser in the event of fund insolvency or bankruptcy.[29] Therefore, the

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[28] To the contrary, a major IIF member headquartered in Europe during the financial crisis had to temporarily close three funds to protect investors (primarily because of the inability of the group to value these funds fairly). This did not trigger outflows from the other funds of this group. Rather, while the crisis worsened the MMMFs managed by this group experienced significant inflows.

[29] See *BCBS/IOSCO*: Margin requirements for non-centrally cleared derivatives, September 2013, p. 9, Fn. 10 (http://www.bis.org/publ/bcbs226.pdf).

BCBS and IOSCO decided to address counterparty risk at the level of the single investment fund rather than at the level of the fund complex or the asset manager.

The consultation paper does note that considering families of funds is an option particularly where they follow a similar or identical investment strategy. We acknowledge the potential merit of this argument from a theoretical perspective but miss a specific and objective definition of 'family of funds'. Such a 'family' should not be confused with a specific product line, for example a class of diverse funds operated under a single brand name, but in fact covers a multitude of different asset classes and geographic markets.

Investment fund managers sometimes operate 'families of funds' or 'parallel funds' which are legally separated but follow the same investment strategy and have structurally identical holdings. Usually these funds have been marketed under a 'white label' concept in cooperation with different sales organizations, or may be similar funds offered in different jurisdictions, or to different classes of investors. They can be considered as having similar risk characteristics. However, they are separate legal entities with separate assets and different counterparties. Most importantly the investors in each fund are different, and are very much independent. This means that if, for example, one fund in a family experiences higher than normal redemptions, there is no direct conclusion that any other fund in the family will also experience such redemptions. This is also a key differentiator between investment funds and banks: Whereas every investment fund of an asset manager has a separate balance sheet and a separate set of investors banks operate with a single balance sheet and a single set of shareholders and creditors thus making them much more susceptible.

Consequently, while there may be merit in exploring the family of funds option further, we recommend an assessment of activities rather than entities. If the family of funds concept is explored we support that the initial focus should only be on individual investment funds, and that the development of the methodology for investment funds should only consider a family of funds if the individual fund methodology has been operational and itself been assessed.

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.

The IIF has consistently argued that policy should focus primarily on the underlying activities involved and their associated risks on a market-wide basis, should be sufficiently forward looking, and should take into account the variety and complexity of activities rather than focusing on individual entities that may conduct those activities. Above all, the design of policy should be internationally consistent and coordinated. In general, we believe that the application of targeted regulation to properly identified risks on an activity- or industry-wide basis—and regardless of the entity that may employ such activity—will be most effective and efficient and is therefore the most appropriate regulatory approach.[30]

As above, in the case of investment funds, the assessment of potential systemic risk should be focused on the activity of leverage, but fully take into account existing practices and regulation in considering whether such systemic risk actually exists. The methodology should therefore follow the development of the G-SII methodology in applying non-equal weights to the five indicators, and we advocate in this instance applying a zero or very low weight to all indicators other than leverage. Irrespectively, funds without lev-

[30] To name only a few examples for such industry-wide regulation we refer to bank regulation (capital, liquidity), regulation of mutual funds (leverage, liquidity, transparency, disclosure) or the regulation of derivatives markets (central clearing, minimum margin requirements).

erage will score very low on all the rest because they do not present the risk of disorderly failure and associated systemic and moral hazard risks that the FSB SIFI framework is intended to address.

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.

See above (in particular responses to Q6-2, Q6-4) where we put forward the position that the only appropriate indicators are those relating to leverage, which are the indicators of complexity and interconnectedness, and that those two indicators should be constructed to focus on leverage.

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 IIF does not believe that the use of service providers in other jurisdictions is an appropriate measure of global systemic risk. Systemic risk occurs when the failure of an entity causes flow-on distress or market disruptions. While use of local service providers, including custodians, is generally required for investment in local markets, the use of such service providers is, for the type of funds in scope for potential designation under the consultation, regulated by the funds primary regulator, and not an indicator of systemic risk. Custody of fund assets is subject to strict requirements and typically requires the use of highly regulated financial institutions.

The clearing and settlement of cross-border securities transactions requires access to systems in different countries and/or the interaction of different settlement systems. As a result, funds use custodians, particularly global custodians with large subcustody networks, to facilitate cross-border investment activity. The use of a local custodian is therefore an unavoidable consequence cross-border investment. The requirements for use of such custodians are regulated by the home jurisdiction primary regulator of the fund, and highly regulated custody services are viewed as a risk-mitigating measure intended to ensure that fund assets remain bankruptcy remote in the case of stress on the custodian.

The mere act of using a custody agent outside one's own borders in no way indicates the presence of cross-jurisdictional risk. It is unclear if the suggestion in Q6-6 is intended to supplement or replace indicator 5-1, but, in either case, there is little difference between proposed indicator 5-1 and the suggestion related to service providers in Q6-6. If risk presented by cross-border investment is to be measured, then it should be measured by reference to cross-border counterparty exposures and other systemic risks, rather than a simple metric based on service providers.

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

We reiterate our argument that 'size'—irrespective of being measured by 'AUM', "net AUM' or "GNE'—is not a useful indicator of systemic risk. We refer to our answers to questions Q3-2, Q3-4, and Q6-4.

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

We do not believe that the definition of "investment strategies (or asset classes) with less than 10 market players globally" is a workable metric, and is not sufficiently clear for the purposes of a robust or meaningful assessment.

Firstly an investment strategy is not consistently defined across the industry and many strategies overlap. For example, an emerging market fund will overlap with a global growth fund and a global bond fund and a global currency fund. We would propose that it is not possible to measure how many players are in each investment strategy with any certainty, nor does an investment strategy necessarily require substitutability. Further, such a metric would stifle innovation. There would be little incentive to provide new investment strategies and products to investors if first-providers were to be scrutinized in this way.

Secondly, with regards to asset classes, if there are fewer than ten funds investing in a particular asset class it is not a direct measure of systemic risk. To the contrary, given the low barriers to entry and highly competitive nature of the investment fund business, such a small number of funds in an asset class probably indicates that the asset class is irrelevant to the global financial system because there is too little value in it. Furthermore, even if there were only say two emerging market equity funds in the world that in no way indicates their exit from the market would cause stress as funds are just one of many sources of market activity, nor for all the reasons noted elsewhere regarding substitutability does this necessarily create a problem.

We therefore propose that this metric be carefully reconsidered. We do agree that if a single fund were the sole or majority investor in a given market, and were for some reason not substitutable, then the liquidation of that fund could cause extreme stress in that market. However, such a scenario is highly improbable in a market of any global relevance and existing regulations both at the fund and the market level (e.g. shareholder limitations) make such a case virtually impossible to consider.

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.

Yes. Not all of the required figures are standard reporting parameters and readily available. They would have to be calculated exclusively for the G-SIFI assessment. For managers with a large number of funds administrative costs would be large. Therefore, the IIF endorses the approach that only funds exceeding the initial threshold should be subject to providing metrics in support of the assessment of individual indicators.

Besides that, we believe there are definitional problems with regards to certain indicators. Leaving aside our assessment that these indicators are inappropriate, defining a strategy or category in a way that can be applied globally and actually capture the appropriate data would be very difficult.

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 strongly believe that in the context of investment funds posing a global systemic risk the only relevant transmission channel is leverage and this is where attention should be focused. Thus, any methodology and any indicator should be centered around the identification of leverage.

In addition to the Leverage Ratio (Indicator 2-1)—which measures the leverage currently used by the fund—we could imagine an indicator that reflects the institutional framework and the maximum level of leverage that could theoretically be employed under such framework. For example, funds established under the 1940 Act in the U.S. or UCITS in the European Union face specific restrictions with regards to the use of leverage. This hard-wired resilience should be taken into consideration since it does not only serve to provide investor protection on an individual basis. On a collective level, the liquidity and diversification requirements also have positive repercussions on the stability of the financial system as a whole.

Another indicator should be established to consider the degree to which the company is already regulated by one or more primary financial regulatory agencies. This would reconcile the FSB methodology with the statutory requirements in the U.S. demanding such a consideration to be made when deciding on a SIFI designation of nonbank financial companies on a national level.[31]

However, besides existing practices and regulations the significant counterparty risk-reducing derivative reforms already in train should also be taken into account when interpreting whether leverage actually poses a systemic risk. Also, as leverage can be employed by funds large and small, if existing regulation and reforms are found wanting to manage the risk of leverage in the investment fund industry, then any necessary additional reforms, after due consultation, should be applied sector-wide and focused on the activity, rather than only a small set of investment funds.

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

We refer to our response to Q6-2 and Q6-4 where we advocate prioritizing, and preferably solely focusing on, leverage as a source of systemic risk. Therefore the indicators of complexity and interconnectedness (and only in the context of leverage) should be prioritized and given the bulk, and we would argue 100%, of the weighting in determining systemic risk.

With regards size (responses to Q2-1, Q3-2 and Q3-4) we do not think that this is a meaningful indicator. If 'size' is to be used it must be risk-sensitive.

We do not think that 'substitutability' is a relevant factor for investment funds (responses to Q2-1, Q6-2). As the FSB and IOSCO have observed *"funds generally are highly substitutable products, as many products exist and compete in the market"*. Further there is no critical need for substitutability in the investment industry which if not met immediately upon the failure of a fund would create systemic disruption.

[31] See Sec. 113(a)(2)(H) Dodd-Frank Wall Street Reform and Consumer Protection Act.

As we have argued before (see our answer to Q6-8) we do not think that there are relevant ‘niche strategies’ which could significantly challenge this assessment.

With regards to ‘global activity’ it brings many benefits through diversification and portfolio effects and as such reduces systemic risk. When looking for potential systemic risk, any indicator should not be based on nominal figures, e.g. the number of jurisdictions in which a fund invests, or the number of jurisdictions in which the fund is sold (see response to Q6-5); rather the indicators should connect to a potential global systemic relevance of an investment fund and global systemic risk. This could be achieved be analyzing in how many jurisdictions the respective fund is of systemic relevance and if financial stress in any of these jurisdictions (or in all of them) may cause a global systemic crisis (see response to Q3-5).

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Conclusion:

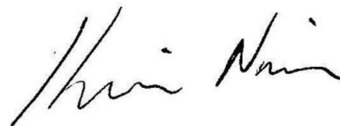
As we have stated in various occasions, we have fundamental concerns about designating individual entities as systemically important and applying different policy measures to these. However, given that the G20 Leaders have set this mandate to conduct an assessment process, we suggest that the methodology should be sufficiently transparent, adequately reflective of systemic importance by using reliable data, objective metrics that are risk-based and risk-sensitive, and consistently applied across jurisdictions. The methodology should provide clear indications of how companies can reduce their systemic importance. Further, any development of policy measures should be reflective of the results of the assessment process, and include an opportunity for the public to comment on the proposals. We would argue that few if any entities will be identified, and existing regulation and identified areas of true systemic risk should inform that process.

Given the issues identified above, and the importance of the task at hand, we propose that further consultation on a revised methodology would be appropriate before finalizing an approach.

We hope these comments are useful as the FSB and IOSCO consider the way forward in this area. Given the complexity of these issues, we believe direct dialogue with the industry is essential and appreciate the FSB and IOSCO’s willingness to engage in that dialogue. The IIF and its Non-Bank Non-Insurance Working Group stand ready to provide additional views or clarifications.

Should you have any questions on the issues raised in this letter, please contact Kevin Nixon (knixon@iif.com), or Thilo Schweizer (tschweizer@iif.com).

Very truly yours,



Kevin Nixon

cc: David Wright, IOSCO