A macro-prudential approach to asset management

The risks stemming from non-bank financial intermediation (NBFI) have been subject to scrutiny from regulators worldwide since the Global Financial Crisis. The banking regulation tightening that followed, the desire to reduce the economy's dependency on bank financing in a number of jurisdictions, as well as the low (including negative) interest rates policy, have resulted in an increase of the share of NBFI in the global financial system. In addition, several recent events have illustrated the fact that shocks that either spread through or originate from the NBFI world may have a potentially significant negative effect on the real economy, which amounts to say that they are of potential systemic relevance.

Those concerns warrant some nuances in two ways.

First, although parts of the NBFI ecosystem might indeed offer products that have bank-like features and would then call for bank-like regulation – in the spirit of the well-known «same activity, same risk, same regulation » principle – the NBFI world, overall, is extremely diverse and generally, much different from banks. Asset management, in particular, follows an agency business model. Asset managers do not take risk as principals. The events put forward as examples of NBFI vulnerabilities differ widely from one another and, therefore, each of them calls for a careful and specific analysis. There are many more differences than similarities between (1) excessive exposures of banks vis-à-vis an unregulated family office that turns out to have taken unsustainable leveraged positions (Archegos 2021), (2) an economy-wide shock on risk aversion that then translates into a dash for cash, putting unbearable pressure on the price of money market funds that should in principle be easily substitutable for demand deposits (March 2020 episode), and (3) poor interest rate risk management models that lead to cumulative fire sales by pension funds, following ill-advised macroeconomic policy announcements (the UK gilt market turmoil on leveraged LDI funds, 2022).

Second, the nature of the risk that regulators aim to address also needs to be precisely defined: indeed, most assets in the NBFI world (with the notable exception of insurance and pension funds) are valued at market price and managed on behalf of investors. It is the purpose of NBFI agents to intermediate between issuers of securities and end-investors. As such, they transmit investors' preferences to the underlying market, and pass on price movements to their investors. Those mechanisms should not be perceived as detrimental, even though they may have external effects on other market participants. Quite the contrary, such intermediation is necessary for the financial system to perform one of its core economic function: pricing risk. Yet, regulators should address as a matter of priority those cases where features of the system generate excess volatility. It also means that there may be cases where shocks on fundamentals create room for economy-wide problems, even though the NBFI sector worked as intended. This may cause the use on exceptional occasions of unconventional monetary policy instruments and create moral hazard issues. That debate is out of the scope of this paper.

This paper focuses on the asset management industry. The international work so far has focused on liquidity risk of money market funds on the one hand, and open ended funds on the other (there is currently a work stream dedicated to leverage in NBFI, which is another fundamental aspect of macro-prudential stability). Despite the heterogeneity of the wide array of products in the asset management industry, two main takeaways have emerged from these works:

First, investment funds need to be acknowledged and understood as investment products, in the sense that investors carry the economic risks associated with the underlying assets. Any contractual feature that generates a different expectation from investors is likely to result in excessive volatility due to arbitrage by investors. This is the case in particular for NAV smoothing techniques ('amortised cost accounting') of certain types of money market funds, which create a confusion by making investments products contractually comparable to demand deposits, even though the contractual promise is not internally consistent (as investors are still supposed to bear all the risks of the assets). More broadly, any mechanism that may create a first mover advantage by not adequately passing on to investors the full cost of their own decisions, including redemption demands, is conducive to such problems.

Second, investment funds must ensure that the promises they make to investors are consistent with their investment policy and suited to their investors. In particular, funds that invest in illiquid assets should be structured in a way that reflects that illiquidity. In addition, a large range of tools should be available to manage liquidity stress, to ensure that managers have the capacity to act in the best interest of their investors at all time.

These themes are not new to securities market regulators as they are crucial to protect investors. A major breakthrough was made by the FSB in its 2022 Progress Report[1] with the concept of «repurposing existing tools». The idea behind this concept is that ex-ante requirements aim at ensuring that investors are treated fairly and are offered a contractual promise that is internally consistent – a principle that should be familiar to all securities

[1] FSB Enhancing the Resilience of the Non-Bank Financial Intermediation – Progress Report November 2022

market regulators – and addresses financial stability concerns to a large extent. The FMA, AMF, CONSOB and CNMV, therefore, strongly support that concept.

Conversely, in its 2022 Effectiveness Review[2], the FSB acknowledged that countercyclical regulatory requirements such as liquidity buffers could have unintended consequences and prompt pro-cyclical behaviours from investors and managers. The FMA, AMF, CONSOB and CNMV support the view that such countercyclical regulatory requirements are very unlikely to be useful as a means to reduce risks to financial stability. This is because asset managers take decisions on behalf of investors. Consequently, forcing asset managers to act in a countercyclical fashion – that is, in practice, against the preferences of their investors – cannot be a suitable solution. That concern is not completely new to the banking universe, where there is much debate around the « usability » of buffers, but it is even more acute in the asset management sector – where fiduciary duty stands as a cornerstone. Two additional arguments stand out against macroprudential measures: (i) asset management decisions should be taken by asset managers themselves, and not by public authorities, or wrong incentives would be provided, and (ii) the actual use of a direct intervention power by a public authority on a subset of investment funds would likely be interpreted as a widespread concern, which could trigger investor panic.

Instead, a combination of ex ante requirements on liquidity and leverage and a wide availability of liquidity management tools (LMTs) to be used by asset managers to act in the best interest of investors, with authorities stepping in only in the direst cases, seems, therefore, the best way forward. Those tools and requirements turn out to also be relevant to address more traditional concerns of securities market regulators, but they should also be grounded explicitly in the financial stability mandate that most securities market regulators are already endowed with.

Next steps at European level

There are four priorities that stand out in our view:

The first one is to ensure a wide availability and greater use of LMTs in all kinds of open-ended funds. The recent AIFMD-UCITS review will allow for a significant progress in this respect making most common LMTs available across Member States, although level 2 measures as regards the use of those tools are still in the making. Given the strong reluctance of asset managers to adopt LMTs, one key issue is to make sure that LMTs are appropriately calibrated so they are effectively used. Nevertheless, the use of LMTs cannot substitute the need to offer appropriate redemption conditions aligned with the liquid nature of the fund's assets. To this end, the recent FSB recommendations[3] on the redemption conditions of open-ended funds should be fully implemented, in particular regarding ELTIF funds.

[2] FSB Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds – December 2022

[3] FSB Revised Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – December 2023

The second relates to the review of Money Markets Funds Regulation (MMFR). The key priority of this review should be to remove any first mover advantage and any confusion with on-demand/bank deposits by banning amortised cost accounting (for Low Volatility Net Asset Value / LVNAV and Constant Net Asset Value /CNAV alike). These NAV smoothing techniques are intrinsically detrimental to financial stability and amount to making false claims to investors who are led to believe that they enjoy a contractual commitment to a stable NAV, whatever the value of the underlying assets might be. If that were the case, then the fund would act as a deposit and should be regulated as such. The other key area should be to review liquidity requirements upwards. Such an increase should remain moderate for VNAV funds, as price adjustments will create a natural incentive to limit redemption pressure. Liquidity requirements should remain expressed in terms of cash and not be mixed up with less liquid assets such as government bonds.

In a more strictly macro-prudential fashion, two key priorities should be explored:

The EU would strongly benefit from the introduction of a truly consolidated supervisory approach for large cross border asset management groups. The structure of such groups has evolved and it is now common that the portfolio management teams, the risk management teams, and the funds are supervised by different NCAs in different countries, which creates coordination issues. This is particularly relevant in times of stress where there needs to be a close dialogue between supervisory authorities and asset managers. In addition, it is also relevant outside the context of a crisis. For instance, asset managers that have a large market footprint can be expected to display correlation in their investment behaviour across different funds – even though those funds are managed for investors with different investment profiles. From a supervisory standpoint, there would be a strong benefit in being able to assess risk exposure at the level of all the funds managed by a given asset manager.

In practical terms, a consolidated supervisory approach should rely on a supervisory college gathering relevant NCAs and ESMA (and possibly the ECB as an observer). The primary responsibility of this supervisory college would be i) to understand the group's overall risk exposures; ii) to assess the robustness of risk management frameworks within the group; and iii) to perform stress tests against economic stress scenarios to assess the resilience of the asset management group and each of its funds. The stress tests could be defined by ESMA, who could recommend using ex-ante powers – such as those of Article 25 of AIFMD regarding leverage limits.

To ensure that crosscutting decisions taken by the supervisory college are effectively implemented, a "lead NCA" for each group should be nominated (e.g. the licensing authority or the authority in which jurisdiction is the highest AUM for that group). The coordination actions would not interfere with the powers granted to each NCA by European legal texts. To provide asset managers with some benefits in return, that consolidated approach would need to be grounded in some regulatory requirements, e.g. acknowledging intragroup service provision arrangements.

The second priority should be to address the problems on data sharing.

In some Member States, central banks collect data for monetary statistics that are not readily available to market supervisors. Some market supervisors, on the other hand, are in the process of enriching their own national reporting which may imply an additional cost for asset managers (in a minority of Member States, like Spain and Italy, the securities market supervisor already has granular portfolio monthly data), but data will potentially remain deeply fragmented unless a more centralised supervisory approach is pursued. The goal should be to have a single data hub that would include both valuation and granular portfolio data fully available to the relevant NCAs (those who participate in supervisory colleges) as well as the ECB (these data may also be helpful to perform stress-testing exercises for the banking and insurance sector). We hope to see some progress in this direction in connection with the renewed AIFMD and UCITS reportings and the momentum in support of the sharing and re-use of supervisory data at European competent authorities' level, which could come from the recently released proposal by the European Commission.

Lastly, building on these data sharing arrangements, system-wide stress tests could also be envisaged to better understand the vulnerabilities of each asset management group and its interconnections with other participants in the financial system. This stress tests should be done in coordination with the ESRB. Their outcome will likely be of high value for the decision making process on the side of asset managers with regard to the implementation of LMTs, as well as on the side of competent authorities for challenging such decisions from a supervisory perspective.

15 April 2024