Shadow Banking and Financial Stability: Regulators Propose Framework for Nonbank Noninsurers

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On March 4, 2015, the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) issued a second consultation paper concerning the methodology they propose to use to identify nonbank noninsurer (NBNI) global systemically important financial institutions (G-SIFIs). This paper comes on the heels of a first consultation document, issued in January 2014, which elicited significant commentary from the public, and it is the latest major pronouncement by the international regulatory community regarding the treatment of financial institutions — such as insurers, asset managers and broker-dealers — said to be part of the "shadow banking" system. In February 2015, the Financial Stability Oversight Council (FSOC) issued a notice for public comment regarding certain features of the asset management business. Most recently, the International Monetary Fund (IMF) also discussed the asset management industry as part of its global financial stability report.

The term "shadow banking" broadly refers to a set of institutions that are engaged in financial intermediation and maturity transformation but are not subject to traditional banking regulation. The term can sometimes be confusing in that some entities that are said to comprise the "shadow banking system" are actually subject to regulation tailored over the years to their specific business and funding models. Although much of this regulation focuses on market conduct and customer protection, there are also important provisions governing liquidity management (to safeguard customer redemptions or insurance payouts) and insolvency (again, to protect customer assets, whether in the insurance or securities context).

That said, regulators are concerned that some nonbanks may engage in activities or deal in products that, at sufficient scale, could present financial stability concerns should market conditions significantly deteriorate. Regulators are concerned, for example, that funds could be susceptible to massive withdrawal requests by investors as happened with some money market mutual funds in the financial crisis, which could be the functional equivalent of the runs more broadly on banks and investment banks experienced in the 1930s and in 2008. In such a case, regulators say, the financial system needs to be prepared for "disorderly failures" of NBNIs.

To address the issue of disorderly failure, in an extension of the approach used for banks and insurers, the FSB focuses on individual entities. The basic purpose of the FSB consultation is to identify criteria and methodologies for designating NBNI firms for which "financial distress" or "disorderly failure" would "cause significant disruption to the global financial system and economic activity across jurisdictions." The FSB's latest consultation outlines four categories: finance companies, market intermediaries (*e.g.*, securities broker-dealers), investment funds and asset managers. For each category, the FSB lists a series of indicators that it proposes to use to make a G-SIFI determination for NBNIs. Of these, the asset manager category is new. The first consultation document only presented an assessment methodology for investment funds. According to the FSB, the comments to the original consultation led it to the "dual approach" of distinguishing between asset managers and investment funds.

The potential consequences of this exercise could be significant. The FSB describes a detailed process for reviewing NBNIs in collaboration with national regulators to identify NBNI G-SIFIs. Even though the FSB's G-SIFI list will not be self-executing and

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thus will not automatically bind national authorities to regulate those entities differently, the identification at the very least will suggest to authorities a premise upon which to review those entities under national financial stability laws. For asset managers and funds, this kind of regulatory scrutiny will be new.

The FSB consultation crystallizes a fundamental question about how best to address the financial stability concerns that regulators articulate in connection with funds and asset managers: Should the focus turn on designating entities, or should it focus on regulating products and activities? In its February 2015 notice, the FSOC's questions and narrative suggest a greater focus on understanding products and activities in the asset management business. Moreover, the IMF's most recent financial stability report states that its analysis suggests that "larger funds and funds managed by larger asset management companies do not necessarily contribute more to systemic risk: the investment *focus* appears to be relatively more important for their contribution to systemic risk" (emphasis in original, p. 93).

In describing its "dual approach" regarding funds and asset managers, however, the FSB explains that the approach "is not designed to focus on or to address potential financial stability risks that could be posed by the asset management entities as a whole or particular activities that are commonly conducted across the asset management sector. Instead, this Consultative Document focuses on activities of an individual entity to assess the potential impact to the financial system of the distress or failure of such entity for which designation may be the more appropriate tool. The focus is on activities or risks that are best addressed through a designation-based approach." The FSB, in other words, appears to be approaching the issue in a hybrid fashion, asking whether products and activities concentrated in one firm create a basis for designation.

Of course, the fact that the FSB will review funds and asset managers should not create a prejudgment that any single one would be designated in any given year of review. Indeed, the FSB has already indicated that certain categories of asset managers and funds, such as sovereign wealth funds and multilateral development banks, will be exempted from its review. Even so, the FSB proposes to assess funds and asset managers above a certain threshold size to see whether their distress or disorderly failure could lead to financial stability risks through three mechanisms: counterparty exposure, severely distressed asset liquidation and failure to provide critical services to a significant part of the market. It proposes to make these assessments by relying on indicators falling into the following categories: size, interconnectedness, substitutability, complexity and global activity.

The foregoing suggests that discussion will continue over whether an entity-based or activity-based approach best suits regulating for financial stability risks posed by NBNIs. Regardless of the approach, the discussions on NBNI portend a shift in the oversight of asset management activities from a preponderant focus on customer protection to increased sensitivity to financial stability. The regulators' recent pronouncements identify a number of elements that will be central to this shift, the most significant of which appear to be the following:

Leverage. This factor is identified both by the FSOC and the FSB, where leverage is captured by a number of the indicators under the size and interconnectedness factors. Most funds, by investing guideline or regulation, are not highly levered. Nevertheless, leverage has proven to be an important factor contributing to financial instability. During the crisis, institutions that failed or were on the verge of failure had extremely high leverage.

Liquidity Risk Management and Stress Testing. This subject, again, is treated by both the FSOC and the FSB. The indicators under the complexity category in the FSB consultation document appear mostly to address this issue. In their recent public comments on NBNIs, both Chair Mary Jo White of the SEC and Vice Chairman Stanley Fischer of the Board of Governors of the Federal Reserve have alluded to liquidity as an important prudential consideration. Liquidity has traditionally been a significant focus of fund regulation in the United States, regardless of the size of the fund. Nevertheless, the financial crisis of 2008 showed — famously in the case of Lehman Brothers — that liquidity problems quickly can turn into solvency problems.

Market Position. Some of the indicators under the substitutability, interconnectedness and size categories seek to determine the importance of the fund and its holdings in comparison to the market as a whole (including the market for the assets held by the fund). The indicators under global activity also may be addressing this issue, on the theory that the broader the reach of the fund, the greater the impact of its disorderly failure or distress. In general, jurisdictions for which banks have had balance sheets comparable in size to annual GDP have been strict about capital rules and other prudential safeguards. The largest fund in the U.S., by contrast, is less than $350 billion in assets. Although a number of asset managers have over $1 trillion in assets under management, such figures are not necessarily reliable indicators of impact given the differing assets and strategies used by the many funds that comprise what the asset managers are tasked with overseeing.

Resolution. This discussion forms a comparatively more significant part of the FSOC's notice. In certain jurisdictions, there are liquidation and resolution schemes for winding down certain types of NBNIs. Nevertheless, the experience with the failure of Lehman Brothers underscores the importance of better understanding the impact of the failure of an entity. Moreover, it is important for resolution regimes to be consistent and be designed to help maintain financial stability, which means addressing complexities of cross-border resolution.