

FSB consultation Paper

Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

ISLA industry position paper

Date 31st August 2016

Introduction

The Financial Stability Board (FSB) published a consultation paper on June 22nd 2016 which makes a number of recommendations to address perceived vulnerabilities in asset management activities.

Section 5 of this document refers specifically to the provision of indemnifications by asset management in relation to securities finance activity undertaken by asset managers on behalf of underlying clients.

The paper recognizes the importance of securities finance activity in providing liquidity and reducing settlement risk but expresses concerns that if beneficial owners require indemnification to continue the activity, any suggestion of any impairment in indemnification may lead to a withdrawal from the market and this has systemic risk implications.

Whilst ISLA is not responding to the consultation paper directly, a number of member firms have requested that we publish a position paper which outlines at a high level, some details pertaining to this section of the paper.

Asset Manager Indemnifications

A very limited number of large asset managers act as agent lenders, and in that capacity some may offer indemnifications to their underlying clients as an additional "last resort" level of protection which will cover some or all of any short fall in value should a counterparty default and the collateral held is not sufficient to replace assets lent.

However, firstly, it should be noted that whilst not all agent lenders provide indemnification to any or all of their clients, each still retains fiduciary responsibility for following the beneficial owner's instructions in relation to securities lending activity.

Indemnifications will vary across all providers (including prudentially regulated entities) and will cover different levels of loss. Some indemnifications will cover all losses under any circumstances whilst others may limit the level of liability, or the circumstances under which the indemnification can be invoked. As these are bi-laterally agreed between agent lender and beneficial owner, no two are the same and indeed an agent lender may indemnify different clients on different terms. The terms and conditions of any indemnification will be agreed with the beneficial owner at the outset of any relationship and re-visited on a regular basis.

Given the diversity and levels of liabilities covered by indemnification it is difficult to see how standardised reporting, as recommended by the FSB, will provide accurate information to regulators and increases the risk of misinterpretation.

Content

- 1 Introduction
- 2 Asset Manager Indemnifications
- 3 Indemnification models
- 4 Risk Management Techniques
- 5 Summary

Indemnifications are agreed bilaterally and no two are the same

*ICAAP is already
reviewed and agreed
with regulators*

Indemnification Models

Asset managers will monitor levels of indemnification provided and ensure that they are able to meet these liabilities. This can be done in a number of ways and will already be monitored by their local regulators on an ongoing basis.

Some asset manager employ the same or similar VaR modelling as prudentially regulated entities are required to, but all will be required to include any potential exposure in their Internal Capital Adequacy Assessment Process (ICAAP) to ensure that they have adequate capital to cover all potential liabilities.

ICAAP models will use assumptions about risk and potential losses that will be reviewed and agreed with regulators.

The asset manager may choose to reduce the capital required by utilising third party insurance to cover potential liabilities. This involves engaging with the insurance markets and defining parameters of acceptable risk.

In all cases the asset manager will provide detail to the beneficial owners of how the indemnification is backed.

Risk management techniques

Asset managers will employ rigorous and on-going risk mitigation techniques on behalf of clients including counterparty selection and monitoring, collateral management and limits on exposures. Exposures from securities lending are collateralised with cash collateral or securities with additional margin.

The Securities Financing Transaction Regulation (SFT) sets additional conditions for collateral, particularly a disclosure of risks and consequences, and the prior consent of the collateral provider in the case of security financial collateral arrangements.

Risk management has developed significantly since the financial crisis and asset managers will also undertake stress testing and scenario analysis to monitor the potential losses and to define appropriate levels of haircut applied to different collateral assets.

Summary

Asset manager are subject to regulatory oversight by local and European regulators and as such will be required to disclose liabilities and capital adequacy.

The absence of a formal capital regime does not prevent them from ensuring liabilities are monitored and accounted for.

Given the diversity of indemnifications, standardised reporting will be exceptionally difficult to impose with any accuracy and risks misinterpretation.

Regulators have oversight of all the relevant information to apply the FSB recommendations without further need of additional reporting or regulatory initiatives.

*Further regulatory
initiatives are not
necessary*
