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The Metaphysics Of Systemic Risk

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On April 18, 2016, the Financial Stability Oversight Council again warned that asset managers present systemic risk to financial stability in five key areas:


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- liquidity and redemptions;
- leverage;
- operational functions;
- securities lending; and
- resolvability and transition planning.

In a 27-page statement, the FSOC detailed its concerns and how regulators should respond to those risks.


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In response, U.S. Securities and Exchange Commission Chair Mary Jo White, who also serves as a member of the FSOC, said she supported the FSOC's efforts, which she characterized as "complementary" to the SEC's current regulatory initiatives. She noted that the SEC evaluates systemic risks in reliance on its own studies by its Division of Economic and Risk Analysis (DERA) and has responded with its own rule proposals independent of the FSOC's analysis. "Today's FSOC update thus should not be read as an indication of the direction that the SEC's final asset management rules may take," she said in a public statement.

The FSOC's paper updates its review of potential risks to financial stability "from certain asset management products and services," including hedge funds, registered investment companies, collective investment funds and commodity pools. It follows a controversial Office of Financial Research (OFR) study on "Asset Management and Financial Stability," published in September 2013, and the FSOC's Notice Seeking Comment on Asset Management Products and Activities, published on Dec. 24, 2014.

The FSOC maintains that its review, consistent with its Dodd-Frank mandate, focuses on "identifying potential risks to financial stability, rather than investment risk." The review, it says, seeks to assess whether asset management products or activities "could create, amplify or transmit risk more broadly in the financial system in ways that could affect U.S. financial stability."

We summarize the FSOC's five areas of focus here, primarily as they affect private funds and registered investment companies.

Liquidity and Redemption Risk

Mutual Funds. The FSOC notes that mutual funds, in particular, create "liquidity transformation" because they offer daily liquidity while investing in less liquid assets. During a "stress event," illiquid assets held by mutual funds may fall rapidly when shareholders redeem large amounts of their holdings. This daily liquidity thus creates "first-mover advantage" when remaining shareholders bear the bulk of the risks because funds sell more liquid assets to pay off early redeemers.

This risk is particularly acute for mutual fund investors, the FSOC says, because transaction costs associated with meeting redemptions generally are passed on to remaining investors. While mutual funds may not invest more than 15 percent of their assets in illiquid securities, this limit "does not take into account the size of a fund's position or potentially lengthy settlement times, which could delay a fund's ability to convert securities into cash," and funds may also invest in less liquid securities that are not subject to this limit. The FSOC is also focusing on whether fund borrowings through lines of credit or interfund lending could transmit liquidity stress to other entities or markets during times of market stress.

ETFs. Exchange-traded funds (ETFs) are not subject to the same types of liquidity risks, the FSOC said, because generally they redeem in kind. But, the FSOC cautioned, ETF arbitrage mechanisms may "break down in times of severe market stress," in which case bid-ask spreads may widen, creating a divergence between ETF share prices and net asset values.

Hedge Funds. The FSOC noted that hedge funds restrict investors' ability to redeem and thus are not subject to the same kinds of liquidity risks that mutual funds experience. But, during times of stress, hedge funds may experience liquidity issues when they are forced to sell illiquid assets.

FSOC's Views. Among other things, the FSOC believes that mutual funds should adopt "robust liquidity risk management practices" and guidelines for limiting investment in illiquid securities, coupled with enhanced reporting and steps to remove "first-mover advantages."

Leverage Risk

Hedge Funds. The FSOC helpfully notes that leverage involves risk because it can magnify potential direct or indirect losses. These risks "may have implications for U.S. financial stability." The relationship between a hedge fund's level of leverage, and the potential financial stability implications "is highly complex." While the FSOC has found available data contained in Form PF are helpful, it believes that available information is not adequate to fully asses these risks and potential mitigants.

Mutual Funds and ETFs. The FSOC notes that some "alternative strategy funds," particularly highly leveraged funds, do not represent a large part of total assets under management but have experienced significant growth and have received "a disproportionate share of industry net inflows."

FSOC's Views. Citing "a need for further analysis," the FSOC is creating an interagency working group to analyze and better understand whether hedge funds pose potential risks to financial stability. The FSOC "welcomes the SEC's efforts to limit the amount of leverage that registered investment companies" can use through derivatives and will monitor the effects of the SEC's regulatory changes.

Operational Risk

The FSOC is concerned that a disruption or failure of a large service provider could transmit risk to the broader financial system. Reliance on technology by the asset management industry "calls for greater understanding of potential risks."

Securities Lending Risk

The FSOC believes that reinvestment of cash collateral by securities lenders (generally excluding mutual funds) creates a potential risk to financial stability. The FSOC "encourages enhanced and regular data collection and reporting" in this area.

Resolvability and Transition Planning

The FSOC believes that "the rapid failure or closure of a large, global asset manager," particularly during times of market stress, could create potential challenges and risks to financial stability. The FSOC welcomes the SEC's efforts to propose a rule to address transition planning.

Our Take

The Dodd-Frank Act created the FSOC to identify and control systemic risks to the U.S. financial system. But the act does not clearly define systemic risk, and the FSOC has not addressed this uncertainty.

While an ongoing analysis of systemic risks is important to the stability of the U.S. financial system, the FSOC should distinguish between analysis and recommendations for action. That is, it is not useful to discuss the possibilities of what could happen without discussing the probability that those events may occur.

Thus, the FSOC should determine the likelihood that a destabilizing event will occur before it recommends actions to correct those events. Without this determination, the FSOC will require the financial system to undertake changes that could be costly and that could even increase, rather than decrease, the likelihood of destabilization.

Nowhere is this dilemma more evident that in the area of asset management. It should come as no surprise that the SEC's recent regulatory initiatives address the FSOC's enumerated concerns about potential risks to financial stability. The SEC's proposed rules and statements concerning liquidity risk management, limits on investment company use of derivatives, enhanced reporting by private fund advisers, and transition planning appear designed to head off potential regulation from empowered bank regulators who are not as well-positioned as the SEC to regulate those risks.

The SEC appears to be gradually shifting toward prudential regulation in response to pressure from FSOC.

On a positive note, the FSOC paper did not suggest that it should move toward regulating funds or asset managers as "systemically important financial institutions," or SIFIs. Perhaps this omission suggests that the FSOC is moderating its approach and applying a kinder, gentler approach in the road to promoting financial stability, rather than wielding a club and insisting that everyone should be regulated as a bank. Or, more likely, it is simply reacting to the recent U.S. district court decision to overturn the FSOC's decision to designate MetLife as a SIFI.

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