Insight

Doing more harm than good: the FSB's Approach to Designating Asset Managers

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Asset managers are, for the second time in little over a year, defending themselves against threats from the Financial Stability Board (FSB) of sweeping "systemically important" designations that would drastically expand the authority of regulators and expose funds and their investors to superfluous burdens and costs.

The FSB is a global regulator established in 2009 that is tasked with "promot[ing] financial stability." It is located in Basel, Switzerland, and is comprised of Member States that include each of the members of the G20 in addition to Hong Kong, The Netherlands, Singapore, Spain, Switzerland, and the European Union. Each Member State is represented by its home country's financial regulators, where the larger economies are represented by multiple bodies. For example, the United States is represented by the Federal Reserve, the Securities and Exchange Commission (SEC), and the Department of the Treasury. According to the FSB's "First Annual Report," released on January 29, 2015, since its inception, FSB has released a number of reports and policy recommendations (called "consultations"), including several intended to build a framework for identifying "systemically important" banks, insurers, and non-bank non-insurer financial institutions.

Most recently, on March 4, 2015, FSB released their second consultation suggesting methods to assess whether or not certain investment funds and asset managers should be considered a Non-Bank Non-Insurer Global Systemically Important Financial Institution (NBNI G-SIFI). In it, the FSB proposes a "materiality threshold" of $100 billion in assets under management, at which a fund would be considered a NBNI G-SIFI. According to a response to the consultation from the Investment Company Institute (ICI), this arbitrary materiality threshold produces a pool of 14 funds, all of which are already-regulated U.S. funds, that would be subject to stricter oversight by the FSB and additional restrictions by the U.S. regulatory bodies.

The FSB's consultation does not go so far as to suggest specifically what further regulations should apply if these 14 U.S. funds are designated as NBNI G-SIFIs, but, under Dodd-Frank, funds designated as SIFIs are subject to extensive regulation, such as fees and minimum capital requirements. These regulations result in widespread costs of compliance, most (if not all) of which end up being passed on to the investors.

While uncertainties surrounding the logistics of implementation of these new regulations make it difficult to pinpoint the exact costs, there is no question that they will have a significant, measurable impact on the individuals participating in the affected funds. For example, in a May 2014 report, AAF estimated that, as a result of capital requirements alone, investors could see their returns reduced by as much as 25% or $108,000, forgoing several multiples of their initial principal in lost returns over the course of a working life. That is no small number, and that doesn't even take into account the potential costs to investors that would arise as asset managers are forced to raise their fees and limit their product selection in an effort to offset the regulatory burdens.

Further complicating things, in 2013 the Financial Stability Oversight Council (FSOC) ordered the Office of

Financial Research (OFR) within the Department of Treasury to conduct a study on asset managers as they relate to financial stability and whether or how to consider asset management firms as SIFIs for enhanced prudential standards and supervision under Dodd-Frank. Following the study and extensive public comment, FSOC concluded that it should not designate asset managers as systemically important solely on the basis of their size. Instead, FSOC decided that it should take a more open-ended approach and consider whether any of the various activities of asset managers render them systemically important, seemingly deferring to the SEC's rulemaking authority over these funds.

To be sure, there is inherent value in proper reforms that reduce excessive risk and strengthen confidence in U.S. financial products and systems, but arbitrary and redundant designations that impose high costs on consumers are ineffective and overlook other, less harmful approaches to curbing systemic risk. FSB's proposed designation of systemic importance on asset managers that fall above their arbitrary materiality threshold would do more harm than good and is an inappropriate attempt to achieve the FSB's end goal.