YourTreasurer

CIPFA Scottish Treasury Management Forum

Informative Presentation

The Changing Face of Investment Regulation

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The Changing Face of Investment Regulation

Background

Pre-globalisation each country had a broadly similar institutional investment approach:

1. Placement with domestic banks for short, medium & long term deposits
2. Segregated domestic mandates for fixed interest bonds & equity portfolios

Post-globalisation in the 1980's a feeding frenzy took place which included:

1. Creation of global investment banks with branches in major world financial centres
2. Development of a range of complex derivative product structures
3. Widespread use of off-balance sheet special purpose vehicles (SPVs) by banks
4. Launch of unit trusts to attract retail & institutional investor monies
5. Launch of open-ended investment companies ('OEICs') to attract a wider global investor base
6. Significant growth in the so-called 'shadow banking' sector (of which more later...)

........encouraged by a lighter touch 'principle-based' regulation approach.

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So why was lighter touch regulation considered adequate?

The relatively benign markets in the years before the 2007 financial crisis, created a climate of complacency and fostered a belief that the global financial markets were safer than ever due to:

1. The use of sophisticated risk management tools to support complex derivatives trading
2. The ability of banks to securitise asset portfolios in off-balance sheet SPVs and so create additional capacity for lending by transferring credit risk to investors
3. The strong, stable demand from institutional and retail investors for investment products with higher returns
4. The global operations of the major banks and the diverse international appeal of these unregulated hybrid products which spread the risks across a broad spectrum
5. The widespread use of mark-to-market ('M2M') valuations for pricing purposes
6. Reassurance provided by the independent credit rating agencies

....because perhaps a 'principle-based' risk management approach is easier to implement on a global basis?

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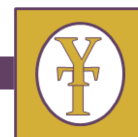
So were any other risk factors overlooked?

Yes – Liquidity:

In hindsight, there appears to have been a general failure to recognise that the biggest risk of all to global financial markets was a liquidity crisis - for the following reasons:

1. If no global support strategy is in place among regulators & central banks, then any settlement problems would have a serious knock-on effect on institutions around the globe.
2. If banks lose confidence in each other, they would tend to avoid lending to each other and so interbank market liquidity would grind to an abrupt halt.
3. If liquidity were to be compromised, then perceived weaker banks would experience a run on deposits, despite protection schemes being in place.
4. If no liquidity contingency plans are in place for the non-banking investment community then blind panic would arise, necessitating suspension of redemptions or the ‘fire-sale’ of assets.
5. Where there is a general lack of liquidity, portfolio assets would tend to be grossly under-valued resulting in severe capital losses and the possible closure of funds.

....So have these assertion been borne out by actual events?



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- Key Events Timeline

June 2007	USA Sub-prime mortgage crisis spreads to the off-balance sheet structured investment vehicles (SIVs) market which were funded by a combination of FRNs and ABCP
July	2 Bear Stearns' hedge funds that invested in sub-prime assets (including FRNs and ABCP) filed for bankruptcy due to a lack of liquidity and forced-sale of assets
August	BNP Paribas suspends withdrawals from its 3 investment funds - inability to access value of portfolio assets
September	Most MMFs suspend purchases of ABCP as fears grew about the quality of underlying collateral – also Northern Rock is nationalised by UK Government
October	Bank MMF sponsors voluntarily 'lift out' FRN holdings of mortgage-related SIVs at par value
November	Global banks begin to close their SIV operations and take the assets back on balance sheet at par while independents SIVs' are allowed to fail
2008	
August	Reduction of $435 billion (37%) in ABCP holdings by investors over last 12 months
September	Collapse of Lehman Brothers ; the U.S. Reserve Primary Fund 'breaks the buck'; major run on MMFs; Federal Reserve allows MMFs to access liquidity and provides insurance guarantee
October	HBOS rescued by Lloyds TSB takeover; Lloyds Banking Group (40%) and the Royal Bank of Scotland Group (82%) require UK government 'bail-outs'
2009	**The 'shadow banking' sector debate starts in earnest ....**

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So what is the 'Shadow Banking' Sector?

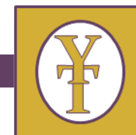
A network of market-funded (rather than bank-deposit-funded) unregulated financial intermediary activities, undertaken by entities that do not accept bank deposits such as:

1. Hedge funds
2. Money Market Funds (MMFs)
3. Non-depository banks (e.g. investment banks)
4. Structured investment vehicles (SIVs) – also referred to as special purpose vehicles (SPVs)
5. Non-bank financial institutions

but which also includes unregulated activities undertake by regulated entities (e.g. investment banks) such as:

6. Credit default swaps (CDS)
7. Securities lending

.....**Estimated market size of the 'shadow banking' sector is $60 trillion!!**



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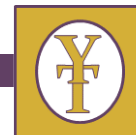
Why were Regulators concerned about the 'Shadow Banking' Sector?

While regulators acknowledged that the globalisation process had created banks that (for systemic reasons) were considered 'to big to fail', fortunately for them the central banks - as 'lenders of last resort' - were able to provide financial support to banks during the crisis. However the 'shadow banking' sector was a different matter as:

1. No information was available centrally on where the perceived 'toxic' assets were held
2. No formal mechanisms were in place (in most jurisdictions) to provide central bank support
3. Legal requirements had forced many funds to value and sell portfolio assets at 'fire-sale' prices
4. In practice, SPV credit risk remained with the underlying sponsors - often banks

As a consequence, regulators blamed the unregulated 'shadow-banking' sector for escalating the systemic risk problem.

.....and so regulation is now being extended to the 'shadow banking' sector !!



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What Action is being taken by European/UK Regulators?

Changes to investment regulation falls into three main categories, namely:

1. UK Banking Reform
2. Alternative Investment Fund Managers('AIFM') regulation
3. Specific MMF Regulation

In addition, the European Union has passed the **European Markets Infrastructure Regulation ('EMIR') Directive** which requires all derivative transactions (including bilateral transactions) to be reported to a registered Trade Repository

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.... So let us look at each of the main categories in turn...

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UK Banking Reform :

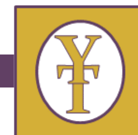
This will be covered in more detail by Arlingclose this afternoon but in summary it involves:

1. The separation of retail & investment banking
2. More onerous regulatory capital, liquidity and leverage hurdles being placed on banks
3. Retail depositors & SME's ranking ahead of other creditors in the event of solvency problems
4. 'Bail-in' powers being introduced where certain creditors may incur capital 'haircut' losses

Key Points to Note:

1. Sophisticated creditors (including Local Authorities) could incur substantial 'haircut' credit losses in the future;
2. The more onerous regulatory hurdles are likely to reduce the appetite of banks to take wholesale call or fixed deposits; BUT most of all.....

.... Placements with banks could carry more risk than some 'shadow banking' products!!



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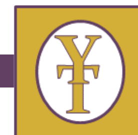
Alternative Investment Fund Managers('AIFM') Regulation:

Assuming that the UK Banking Reform risk conclusions are reasonable, then the regulation of the AIFM (i.e. 'Shadow Banking') sector is something to be welcomed by Professional Investors for the following reasons:

1. The European Alternative Investment Fund Managers Directive ('**AIFMD**') creates a legal framework for the regulation and oversight of alternative fund management activities
2. The regulatory approach broadly mirrors that used by the existing UCITS market - where about £1.4 trillion is successfully managed in the UK
3. The restrictive requirements for liquidity, diversification and leverage applicable to a UCITS Fund do not apply to a qualifying AIF mutual fund structure (known as a '**QIAIF**')
4. A QIAIF tends to be more efficient to run as only Professional Investors (and not Private Investors) are permitted to invest
5. The robust governance framework will provide additional reassurance for Professional Investors – with an independent trustee/custodian oversight function required to be in place

......So what are the potential implications for Local Authorities?



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Potential Implications of AIFM Regulation Changes for Local Authorities

On the whole, they should have positive implications:

1. Attractive alternative to wholesale Bank deposit placement
2. Efficient access to a broader range of investment assets
3. Opportunity to enhance investment returns
4. Choice of direct segregated investment mandate and/or via indirect QIAIF mutual fund structure
5. Minimum subscription for QIAIF's tend to be substantially lower than for segregated mandates
6. QIAIF redemption profiles can be aligned with underlying cash management requirements
7. Investment advice available from your existing regulated treasury consultants

NB - However, this will require a change of risk management mindset - moving away from external support possibilities towards risk/reward considerations.

.....BUT one problematic area remains, the proposed regulatory treatment of MMFs !!

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Why are MMFs considered as part of the Shadow Banking System?

Regulators believe that MMFs have contributed to the amplification of global systemic risk for the following reasons:

1. The sheer size of the sector - estimated at over $4.2 trillion
2. They possess ‘money-like’ attributes of bank deposits BUT they do not have ‘bank-like’ insurance, nor can they access central banks for liquidity support
3. Sponsor support may have material consequences for the balance sheets of bank sponsors.

“Narrow banks in mutual fund clothing”

(Paul Tucker, Deputy Governor, Bank of England)

....so what is the current thinking on MMF regulation?

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What is the current thinking on MMF regulation?

Securities and Exchange Commission (SEC)

1. Institutional MMFs should be required to move from stable to variable net-asset-values (‘**NAVs**’) to reduce the risk of ‘first-mover’ advantage and a run on a fund

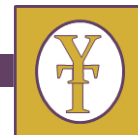
   and/or

2. MMFs to impose ‘fees’ and suspend redemptions (i.e. ‘gate’) to slowdown redemptions once a fund’s liquidity assets falls below 15% of total assets

+ European Commission.......

3. MMFs to maintain a cash buffer of 3% of total assets value to help keep the financial system stable
4. Uniform rules to ensure minimum level of daily & weekly liquidity assets
5. Binding rules on types of investment assets, single counterparty exposure and restrictions on short-selling

....and so what is the industry response?



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Industry Response

In general, the industry welcomes any proposals to make MMFs even more resilient, provided that:

1. Any changes preserve the key features that have made them so valuable to both investors and businesses that rely on them for funding
2. Any changes preserve choice for investors by ensuring a continued robust global industry

The Institutional Money Market Funds Association (‘**IMMFA**’) continues to have constructive dialogue with the European Securities and Markets Authority (‘**ESMA**’) and has put forward the following counter proposals:

1. Implement further transparency, liquidity buffers and ‘know your client’ requirements
2. Impose liquidity fees and redemption gates in stressed market conditions
3. Any transactions between a MMF and its sponsor be clearly defined in regulation and either prohibited or require explicit prior approval

However IMMFA opposes the cash buffer proposal on economic grounds as well as the proposed change from a constant to a variable NAV as it is unlikely to prevent a run in stressed market conditions

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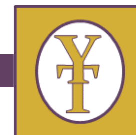
So what is my personal view on the MMF regulation debate?

1. The Regulators response is understandably skewed towards minimising systemic risk **BUT** they have lost sight of treating customers fairly and the fact that it is an investment product
2. The 'constant' versus 'variable' net-asset-debate is a red-herring that can easily be covered by enhanced sales practices and prominent investment risk warnings
3. The alleged advantages of VNAV for investors is a flawed argument since:
   - It tends to be forgotten that MMFs are 'hold to maturity' funds, so why apply a sales spread to Money Market Instruments that are unlikely to be sold?
   - In severe stressed market conditions, there is no such thing as a real market price as either 'Fire-sale' or 'fiction' becomes the mark-to-market price....
4. The real 'elephant in the room' remains as to how the shadow banking sector will be able to access liquidity in severe stressed market conditions !!
5. However, the increased transparency and the recent proposed enhancements by the industry are positive moves which for too long were vetoed by compliance departments

My prediction is that constant NAV funds will continue to be permitted here in Europe subject to liquidity fees and redemption gate safeguards.



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So in summary what does "The changing face of Investment Regulation" mean for Local Authorities?

On the whole, the changes should be welcomed by Local Authorities as.......

1. It will pave the way for more dynamic investment opportunities post the DMO placement era
2. It will provide access to a wider and regulated range of alternative investment structures
3. Potential to enhance liquidity provision, enhance yield and reduce investment costs
4. It will provide additional investment opportunities to both Council and Pension funds
5. Lower entrance threshold via QIAIFs and so accessible for smaller local authority investment pools

However, in return Local Authorities will require to embrace more sophisticated risk management tools including scenario-modelling & stress-testing

....But on the whole, I have no doubt that exciting times lie ahead !!

Q & A Session

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