Other People's Money: How Asset Management Poses Systemic Risk and What to Do About It

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It is a pleasure to join so many distinguished regulators, academics, and industry representatives to discuss the future of systemic regulation for the asset-management industry – an issue critical not only to policy-makers, but also to companies trying to anticipate the regulatory and legislative requirements that increasingly determine success or failure in the financial-services industry. This conference is particularly well-timed given the imminent deadline on FSOC's request for views, the new global proposal for systemic designation in this sector, SEC work on new rules for MMFs and asset managers, and a seemingly-endless array of rules with far-reaching impact on the competitiveness of banks in a business line vital to franchise value.

Even though firm-specific designation for asset managers is less immediate – at least in the U.S., many substantive actions are in the works with far-reaching strategic implications. Time does not permit me to go through this litany, so I will instead focus on two key systemic-risk questions raised by asset and investment management, especially when these activities are conducted outside of banking organizations subject to consolidated regulation:

- What do asset and fund managers do apart from putting investor money into designated cubbyholes? Put another way, just how much fun can asset managers have with other people's money? What risks are embedded in active-management strategies that may pose credit, liquidity, operational, or other risk to investors? Do the rules imposed on funds to date – e.g., new redemption restrictions – protect funds at the expense of investors? Because the cost of like-kind counterparty and customer protection at large banks mostly falls on shareholders, not fund investors, do non-bank asset managers enjoy a competitive edge? When combined with the broader prudential standards – costly as all get-out – for large banks, do policy drivers spell a near-term transfer of asset- and fund-management services to non-banks?

- What happens to investments housed in asset-management and fund vehicles under stress? Can the manager find other people's money fast and return it to rightful owners from both an operational and liquidity perspective? What happens to asset-management customers if central counterparties blow and how do asset managers handle claims to them under applicable "waterfalls?" If the business shifts to non-banks, do these systemic risks grow worse absent a resolution regime designed for entities that hold other people's money?

I think these questions apply across the industry, although post-crisis rules attempt to answer them for banks engaged in asset management, albeit at considerable cost especially for G-SIBs. Even the largest managers housed outside prudential-regulatory frameworks and resolution regimes are not bound by comparable standards and, thus, subject to similarly punishing cost. Regardless of policy benefits, costs are costs and an exemption from them provides formidable competitive force.

We thus need to consider not only the potential for near-term challenges to financial stability, but also longer-term restructuring in the industry that could lead to still more worrisome risk. For the largest banks, these competitive risks are particularly important because of increasing efforts to isolate asset management from low-margin activities like custody that are unsustainable under current bank rules absent an asset-management earnings kicker. As a result, the biggest bank players in this business are under the most acute stress, laying the groundwork for rapid transformation with uncertain systemic-risk ramifications.

Baseline Scenario Risk

I'll turn in a moment to thinking about what happens if something seriously systemic blows and, then, how asset managers fare under acute stress. But, even under ordinary, foreseen circumstances – the baseline scenarios for which banks must plan in their stress tests – significant distortions in asset and fund management result from the different prudential frameworks that govern different firms. As I said, this could well pose systemic risk depending on how the industry reconfigures and who has how much resilience when severely-adverse stress scenarios rattle the sector.

Asset and fund managers have long disputed risk worries like these because they argue that risk resides only with investors, not with those who manage holdings on their behalf. This may well be the case with index funds, but how true really is it in actively-managed funds, especially under current interest-rate conditions?

In my opinion, a significant amount of embedded credit, trading, liquidity, and operational risk is increasingly being taken in many asset- and fund-management strategies in hopes of achieving alpha. Investors go for yield and thus may not fully understand risk, even when disclosures about derivative or similar trading strategies clearly provide useful descriptions.

Several regulatory initiatives – e.g., new rules seeking to limit fund redemption risk – protect funds, if not investors, from at least some of these risks, but this approach is in sharp contrast to the prudential standards applied to banks, especially the largest ones. For example, liquidity risk at banks is being addressed through two new liquidity-risk standards, with the most recent shortfall under them calculated by global regulators as over $1 trillion despite hundreds of billions in low-risk, low-yield assets banks have taken on since the crisis. Banks and their shareholders pay the opportunity cost of these assets, not to mention that of the very high leverage-capital requirements now imposed on these same holdings. Over time, bank investors will suffer because shares will be worth less, but this long-term, slow death for bank shareholders is in sharp contrast to the heart attack fund investors could experience under comparable liquidity risk.

Another major worry: asset and fund managers are, I believe, no more immune to operational risk than banks engaging in like-kind activities. Operational risk includes cyber-security, fraud, system malfunctions, and natural or man-made disasters. Is any financial institution immune? Of course not, but only large banks have to hold operational risk-based capital against them. The methodology of this capital charge is suspect, but its cost is clear and it doesn't apply to non-banks. Again, investors in non-bank funds take this risk, not the manager, but there is little, if any way, for the investor to protect itself from it absent costly advance planning and buffers at the asset manager.

What Happens When Scenarios Go Severely Adverse?

Another major cost now being borne by the largest banks comes in connection with recovery-and-resolution plans. Sometimes called "living wills," these plans must address an array of scenarios and show how a bank withstands catastrophic stress or, if it can't, how it would go bust under the Bankruptcy Code without undue reliance on central-bank liquidity or other government backstops. To make sure resolution is viable under both bankruptcy or, should worse come to worse, the Dodd-Frank orderly-liquidation protocol, the biggest banks must not only prove that they are bullet-proof, but also issue lots of loss-absorbing debt to insulate taxpayers from risk. None of this is cheap, to say the least.

What must non-bank asset and fund managers do to ensure they can handle systemic risk? Some have argued that this isn't their worry because investors – not fund managers are at risk if the systemic bell were to toll. Losses might ensue, but none for which the manager is at fault because investors always selected their holdings and thus rightly take this risk.

This is, though, only the case if investors first really know what risks they are taking and, then, can get their hands on their shares and decide what to do with them in a stress scenario. If a manager's systems shut down or rehypothecation complicates identification of beneficial owners, especially in commingled accounts, investors will be at such risk that many may panic. Fees and gates may prevent this from turning into a systemic liquidity freeze, but only at potential risk to all but the savviest investors who get out before the manager's lights go out. And, if the fund itself holds positions that absorb liquidity risk either directly or as a result of this flight to quality, then it too could be a big loser. Global regulators have rightly focused on this in their resolution proposals for companies that, like asset and fund managers, hold other people's money, but nothing is even close to ready in the U.S. to implement this resolution plan, especially outside of banking organizations.

And, even if operational and liquidity risk are under control, an array of additional risks put asset and fund managers squarely in the systemic bull's eye. Several major firms in this business are rightly worried about what will happen if a central counterparty blows, as managers are usually the counterparty to clearing transactions at these CCPs as well as on other financial-market utilities critical to the market's infrastructure. Without capital and related prudential buffers, managers may be hard pressed to handle calls on their default funds, let alone waterfalls that pose risk to third-party investors under their aegis.

Under baseline scenarios, asset and fund managers enjoy significant cost advantages because day-in, day-out prudential rules applicable to the largest banks don't cover them. Some of this is warranted because fund managers aren't banks and don't have direct access to the FRB; some of it not so much, especially given the systemic-risk potential when very large companies hold other people's money in current, complex, and cross-border financial markets that are structurally different in many respects than the old-line management model on which much public- policy still relies.

Conclusion

In our practice, we focus on what we call "policy drivers" – that is, the regulatory, legislative, and public-policy decisions that increasingly determine competitive success in the financial sector. Think about it – interest rates, macroeconomic growth, and related exogenous factors in the business climate affect all asset and fund managers essentially the same – traditionally, competitive edge derives from ability to foresee these factors, as well as to sell services better, contain costs more carefully, and otherwise just operate on a strong business model. This model is the one for which we all trained and it's the one on which all too much strategic planning still relies.

I say "all too much" because the post-crisis environment has added an additional factor that defines shareholder return: policy-driver edge. When the same business is conducted in like-kind firms under like-kind policy drivers, winners and losers are dictated by the market. But, when the same business is in a company under a different set of policy drivers, these dictate its bottom line even if every other aspect of its strategy is like that of its competitor. Indeed, policy drivers can take the edge off success in the marketplace – some rules are so costly as to force even the best firms to start their competitive efforts well behind the rest of the pack.

I know this because I've mapped these policy drivers across key fund- and asset-management business lines at major institutions active in this arena. Holding all other factors equal and then costing out the policy drivers to see who wins and loses is a sobering exercise for banks and a startling one for non-banks. Markets will shift either because banks recognize this and change their asset-management business model or because the force of these policy drivers will dictate success once these banks redefine their business model and exit key activities. Either way, the industry changes, and not without considerable systemic risk, in my view.