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“The Age of Asset Management”—Less Risk, Not More

By Brian Reid

The following was written by ICI’s chief economist, Brian Reid, and published on FT Alphaville *on July 23. For more information on ICI’s views and research on financial stability, please visit our Financial Stability Resource Center.*

As banks learn to live under tighter postcrisis constraints, central bankers around the world are worrying about financial risks that could move from banks to capital markets and perhaps trigger the next great crisis. After the experience of 2007–2008, regulators rightly should be on guard for sources of weakness in the financial system.

Unfortunately, in their vigor, many regulators are seeing "systemic risk"—threats to the stability of the financial system—when the issue at hand is investment risk. Investment risk is a necessary part of a well-functioning economy, attracting investors willing to take known risks in hopes of gaining a reward. Systemic risk occurs when the financial system itself breaks down and is unable to perform its normal functions of matching savings to investment opportunities or facilitating economic activity.

One of the more thoughtful discussions of this issue was "The Age of Asset Management," an April speech by Andrew Haldane, now chief economist at the Bank of England. As *FT Alphaville* readers will know, Haldane speculates that rapid growth and structural changes in asset management could open new and "more potent" "transmission channels" for systemic risk.

But Haldane, like others, fails to make the crucial distinction between investment and systemic risks. In banking, the two are intertwined, because banks have a limited capacity to absorb investment losses or even fluctuations in asset prices. With their high leverage, banks that suffer even relatively small losses can find their existence and that of their counterparties under threat. So it’s not surprising that bank regulators fear that bank "de-risking" will move investment risk out of banks, only to increase systemic risk in other parts of the financial system.

Moving investment risk to other financial market participants, however, may actually reduce systemic risk. Asset managers, in particular, act as agents, hired to manage and oversee investors’ assets through separate accounts or collective investment schemes. Rather than centralize risks—as banks do—asset managers leave risk-taking to the end investors. Those investors absorb investment losses without creating the cascade of failures that can occur when banks and other leveraged financial firms experience losses.

Haldane implicitly acknowledges this point by noting that "history is not littered with examples of failing funds wreaking havoc in financial markets." But—like other banking regulators—Haldane falls back on banking models and regulatory approaches both when identifying emerging risks and when proposing solutions.

For example, Haldane highlights the potential for investor "herding" and "run" behavior that he—along with the U.S. Treasury Office of Financial Research and others—argues can lead to procyclical swings in asset prices.

The examples Haldane cites, however, are idiosyncratic and far from systemic. And arguments about "herding" and "runs" in capital markets fail both historically and conceptually. Anyone who wants to demonstrate systemic financial risk in the alleged "flightiness" of investors in regulated funds has a heavy weight of data and history to overcome.

Just as important, "run behavior" is inherently a banking concept. Banks cannot accommodate large outflows of deposits, because they hold illiquid, hard-to-value portfolios of loans and securities. Instead, banks rely on opacity and protection of depositors from losses—by government intervention, if necessary—to maintain a stable deposit base.

What Haldane and other bank regulators have not demonstrated is how fluctuating asset prices can lead to systemic financial risk in non-leveraged financial institutions. The expansion and then collapse of the tech bubble in the 1990s and 2000 caused large swings in stock prices. But that episode did not take down financial institutions or freeze the financial system, because the losses were largely borne by investors who used little leverage, not by banks.

Unlike banks, capital markets rest on transparency. In well-functioning markets, risks are clearly assigned, well understood, and knowingly accepted by all parties. As information enters the market, asset prices adjust and investors experience gains and losses. Losses may be unwelcome—but investors accept them because risks were disclosed and because they believe gains will win out in the balance.

When either the assignment or acknowledgment of risk breaks down, risks are sure to increase—and in some cases become systemic.

For example, in the tri-party repo market, custodial banks were for decades unwinding the trades intraday, leaving them and the lenders exposed to the risks of a borrower default. The risks of that practice were compounded by the methods banks and brokers used to manage and track the collateral behind these loans. This unclear assignment and acknowledgement of risks led to one of the most significant market failures during the crisis. ICI and its members have been supportive of regulatory changes to this market to ensure that it operates effectively even during future periods of market stress.

Financial products also arose that failed to assign risks clearly and provide transparency. Collateralized debt obligations (CDOs) and certain asset-backed securities had complicated capital structures that led to disastrous product failures during the financial crisis. The structuring of payoffs and underwriting standards were too complicated and poorly controlled, preventing a clear assignment and acknowledgement of risk.

For capital markets regulators, the answer to such problems is to clarify what the risks are and who bears them, so that willing investors can knowingly judge and accept risks. But in the banking world, where investment and systemic risk are intertwined, bank regulators instead resort to microprudential tools to intricately manage bank balance sheet activities and macroprudential tools to manage capital flows and banks' overall levels of risk taking. Haldane and other central bankers would bring these tools to capital markets. Haldane for example, speculates about central banks taking "an explicit role in managing the risk taking cycle and activity in the wider economy."

That would be a historic and colossal mistake.

The risk of relying on such tools in securities markets is that microprudential rules could lead more asset managers to act in a similar manner—in other words, they could increase "herding." Macroprudential rules would direct capital flows by tilting the investment landscape in favor of one set of assets over another.

Would this make the financial system more secure? The historical record is filled with examples where policymakers inflated bubbles, rather than deflating them. Replacing the collective decisions of millions of investors with the judgment of a handful of regulators in allocating capital will most certainly lead to greater fluctuations in securities prices and larger distortions, not to mention decisions driven by politics over economics. That's not the way forward to a sounder, more secure financial system.

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