Systemic risk and the investment professional

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The Age of Asset Management

The CFA's *Future of Finance* initiative indentified 6 themes. One of these involves the safeguarding of our financial system – that is, promoting financial stability and minimizing systemic risk. It is to this theme that I now turn – and one on which our next guest will comment. Let me start with some rather startling questions:

Is our profession a source of systemic risk? Do the investment flows that we intermediate contribute to financial fragility? Might asset management firms, like banks, be "too big to fail"? Are we part of the problem or part of the solution? What should be the regulatory response?

These are the concerns being raised by the regulators. The US Office of Financial Research (OFR) has penned a report identifying the great ocean of capital flows as a source of systemic risk.[1] The Financial Stability Board (FSB), the Basel-based body which guides the global approach to financial regulation, is conducting a consultation with similar questions in mind.[2] And in a major address entitled "The Age of Asset Management?" a Bank of England senior highlighted investment flows as the "next frontier for macro-prudential policy."[3] All three of the above query the degree to which the investment firms in which we work might constitute *systemically important financial institutions*.

The regulatory tide has turned towards us. How did this happen? How should we respond?

Lessons in systemic risk

Let us first take a step back. Our global financial system is big, complex and accident-prone.[4] That it is big is beyond doubt. You all know the numbers. China's reserves exceed $3.6 trillion; the Fed's balance sheet – 4 trillion; daily FX turnover – 5 trillion; Federal debt outstanding - $17 trillion; globally managed assets - $80 trillion; and the downturn notwithstanding the notional value of global derivatives have risen to $700 trillion. Now the interesting thing about big numbers is that even a small percentage of a big number is still a big number. Thus a 10% change in China's holdings generates $360 billion of sales - and another 360 billion of purchases. A 5 % rise in US interest rates will add (over time) 850 billion to the US budget deficit – annually. A 3% shift in global asset preferences triggers over $4 trillion in securities

[1] "Asset Management and Financial Stability," The Office of Financial Research, 30 September, 2013

[2] "Assessment methodologies for identifying non-bank non-insurer global systemically important financial institutions," 8 January 2014

[3] "The Age of Asset Management?" speech by Andrew Haldane, Executive Director, Financial Stability, Bank of England, 4 April, 2014, http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf

[4] "The Future of 'Risk-Free' Assets," Robert Jenkins, Global Public Investor, 2014.

transactions. And a mere 1 percent of derivative contracts gone wrong could cause some $7 trillion in losses. Yes, the numbers are big.

The numbers are not only big in absolute terms they are big *relative* to the size of the economies they are meant to support. Indeed, the business of finance has soared as a percentage of total economic activity. In 1980 the financial sector in the OECD represented less than 10 pct of Gross Domestic Product. By 2007 it had reached over 30%. Transaction volumes have exploded. The total within the US economy alone – that is, the total turnover of equity trading, government and corporate debt, FX and exchange traded derivatives was 2.6 times GDP in 1970, 6.4 times by 1980 and some 52 times by the year 2000.[5]

Beyond this general "*financialization*" of western economies there exists an unprecedented degree of complexity and interconnectivity. Thus subprime problems in Pittsburg popped up as write-downs in Dusseldorf. The prospect of "Grexit" threatened Europe and beyond. More recently taper tantrums at the Fed triggered tremors in Turkey.

Finally, we must add leverage to the mix. At the center of our financial universe is the banking system – creator of credit; counterparty to trading; generator, manager and transmitter of both risk and liquidity. When the banking system freezes, our financial system fractures. The banking system freezes when losses threaten to overwhelm banks' loss-taking ability. And their loss-taking ability is determined by the degree to which their risk-taking is funded with equity versus debt. In other words, financial stability hinges on the amount of capital in bank balance sheets. Going into the recent crisis most of the world's largest, complex and interconnected banks were excessively leveraged. Loss-absorbing capital was wafer thin. Not surprisingly market confidence evaporated quickly.

What *is* surprising is that regulators have failed to embrace the lessons of the debacle. Leverage remains excessive. Yes, new global standards have been agreed in Basel. They tighten definitions of banking risk and place an overall cap on leverage. But as currently set, the rules permit the balance sheets of banks to balloon to 33 times their equity. At that level, bank asset values need fall only 3 per cent to wipe out 100 percent of capital. A mere 1 percent drop leaves the institutions geared 50 times; a 2 percent fall, 100 times. How confidence-inspiring is that? At the next sign of stress how long do you suppose bank creditors will wait around to find out? How long will *you* wait? Now consider that some banks' balance sheets are equal in size to their home nation's GDP and you will grasp central bankers' admission that we have yet to eliminate the problem of too big to fail. How can this be? Might bank lobbying explain it? Yes, authorities are discussing further reductions in leverage – to perhaps 20 to 25 times. Do you find that reassuring?

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Now what does all this have to do with us? Well, three things. First, we have a big stake in the banking rules from Basel - for the ultimate object of *banking* reform is to restore and enhance financial stability. And I can think of no segment of the financial sector that has a greater stake in stability than the

[5] "Too much finance," IMF Working Paper, Jean-Louis Arcand, Enrico Berkes, and Ugo Panizza, June 2013

investment management industry. Alas, no one has been less vocal on the subject. Just ask yourself: What was our industry's public position on too big to fail? What is our stance on too big to bail? What have we said about too big to jail? Is it possible that some institutions are just too big to manage? These are key questions of our time. For six years the reform debate has raged. For six years, with very few exceptions, we have kept our heads down and kept our mouths shut. In their struggle with the banking lobby politicians and regulators needed help. We might have made a difference. We would have made some friends.

Second, although we rarely pocket the same pay we are tarred with the same brush. Even at the very best of times, the niceties of "buy side" versus "sell side" are lost on the layman. But our continued reluctance to comment on the recklessness and fecklessness of investment banking has meant that neither public nor politician adequately distinguish between investment banking and investment management. We missed a golden opportunity not only to secure a seat at the reform table but to better differentiate ourselves in the process. To the man in the street, we are all investment bankers now.

Third, as you can see, we are next on the list. Why? Well, excessive leverage in the banking system leaves it vulnerable to collapse. Authorities suspect this. Western governments cannot afford a re-run. Treasuries know this. The public would not tolerate a repeat performance. Politicians fear this. So, the failure to resolve the issue of "too big to fail" risks spawning a regulatory campaign to spot and control any and all threats that might lead to bank failures. And so regulators look for threats. And when one starts looking one soon discovers that the world of capital flows is big, complex and could well overwhelm the meager capital buffers of our creators of credit. "Gees, we better try and control the investment flows as well." BlackRock is big therefore it must be systemically important. If it is systemically important it should be subject to regulaton." Well, regulators already do control the investment *firms*. But neither we nor they can control the investment *flows*. They might as well try to hold back the tides or abolish greed and fear.

What's to be done?

So what is to be done? Well we need to stand up and we need to speak out. We have begun to do so. The CFA's Future of Finance initiative is mobilizing our membership to take a more active part in the financial issues of our day. I am very encouraged by the response and will support it in every way I can. But as an *industry* we are off to a bad start. Yes, we work *behind the scenes*. But the first time the *public* saw us get involved in financial reform was last year when we fought the extension of European bank bonus rules to our own investment industry. Though the right thing to do it was an unseemly debut.

Our industry's next foray into the fray was to pick a fight with the US authorities over the issue of Constant Net Asset Value money market funds. Reasonable regulators argued that if investors were led to believe that a fund would never break the buck, then the vendor had better have the wherewithal to pony up when it did. Alternatively they said; "Call it a floating NAV product. They do in Europe; why not in the US?" US firms fought it and, for the most part - "won." Bad move.

A third opportunity now presents itself. That FSB consultation is part of a push to better understand and regulate the world of shadow banking. Non-bank, non-insurance financial intermediaries constitute the new hunting ground. Investment management falls squarely within the scope. Now at one level, the authorities' new-found interest in our industry is a good thing. When liquidity crises strike, it is as important to know the people who *have* the money as well as the one's who need it. But at another level this development is dangerous. Why? Because it distracts from the main issue – excessive leverage in the banking system that leaves it and therefore our financial system vulnerable to changes in the capitalist tides.

Our opportunity lies in doing now what our industry failed to do for the last six years. We need to show we are part of the solution and not part of the problem. We need to demonstrate that we are different. We do not deploy excess leverage. We do not act as principals. We are not subsidized by the tax payer. We are not too big to fail, bail or jail. When our clients supply funding or credit, it is most often 100 pct equity-backed. Even the hedge industry averages $1/10^{th}$ the level of leverage deployed by the banks.

Indeed, in order to drive home the distinction we must be prepared to point fingers at the excessive leverage that regulators continue to permit in the *banking* system. We can both make our case *and* a major contribution by highlighting the job left undone. But we have to speak up. The OFR has raised the issue. The Bank of England has tabled the question. The FSB has passed us the podium. We need to grab it and offer a series of sound and hard hitting lessons in leverage. Money management firms – both large and small alike must send the same message. For unless authorities are to deny investors access to their money, those huge flows that we intermediate will most assuredly move in unexpected and at times exaggerated ways. In the case of money managers the clients will take the losses that result. But the authorities must ensure that the equity requirements protecting the banking system are sufficient so that the banks can take theirs – without taking down the system and without recourse to the taxpayer.

The current regulatory barrage is the understandable consequence of the recent traumas. Regulators and policymakers are right to act. But we must not confuse pronouncements with progress. The new banking regulations do not address excess leverage; they enshrine it. As a result, our system remains vulnerable and regulators are coming our way. I am sure the exercise will be instructive but it risks complicating our mandate without making the financial system safer. Fortunately, we are being given a rare second chance to have an impact. We must seize the occasion to play a part in the process.

It is not too late to make a difference

Our industry is far from perfect but it *is* crucial to finance. We convert streams of savings into the rivers of capital that fuel economic growth. We offer investors the opportunity to diversify their assets into areas and at a cost that few could achieve on their own. Are we important to the system? Yes. Are we a threat in any major way? No. But we must make the case and we must help regulators understand where the real threats lie. To date we have done neither.

Ladies and gentlemen, our profession was not responsible for the last market meltdown. But if we don't change tack we will most certainly share the blame for the next one. Curiously, the latest regulatory onslaught offers the opportunity to make a major difference to the future of finance. Please help.

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