FEDERAL RESERVE BANK of NEW YORK

Non-bank financial intermediation and systemic risk. Asset management

Nicola Cetorelli

Prepared for the FRBNY Financial Advisory Roundtable meeting
November 10, 2017

Outline

- The rationale behind the “activity” vs “entity” approach. A brief history
- A financial intermediation angle
  - Liquidity transformation in open ended funds
  - Credit transformation in securities lending
- Advocating what should be obvious: activity *and* entity approaches are complementary and not substitute

Activity-based vs Entity-based analysis

- Distinction originates with systemic risk focus in asset management (AM) space
- Result of post-crisis impetus toward designation. FSOC in US, FSB globally
- Has led to distortions in positive analysis and to the creation of a less-than-productive dichotomy
- Parallel with banking: deposit taking and loan making are traditional *activities* with well-recognized systemic implications. Dedicated tomes of regulation and supervisory manuals.
- Yet, no objection to the argument that *some* banking *entities*, by virtue of their scale and scope might deserve extra monitoring

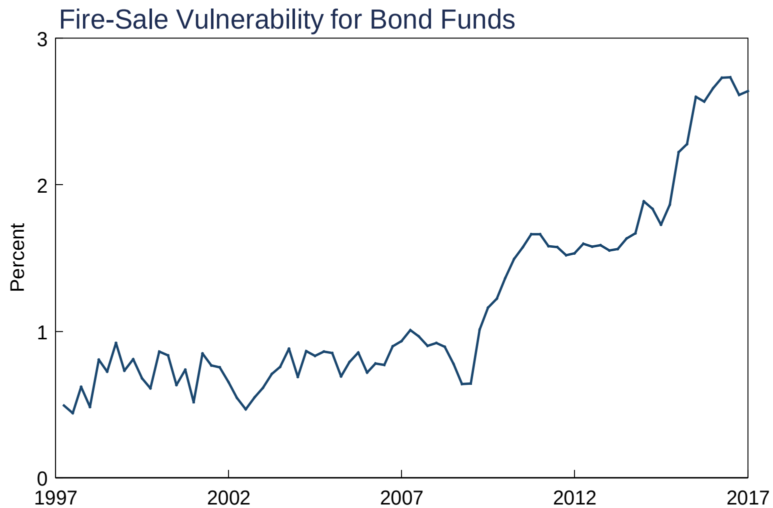
Current state of regulatory debate

- Focus on AM activities and identification of potential systemic footprint
  - FSOC Review of AM Activities and Products (2016)
  - FSB Policy Recommendations to Address Structural Vulnerabilities from AM Activities (2017)
- Subsequently, focus on entities
  - FSB NBNI (Non Bank, Non Insurance)-GSIFI assessment methodology
- But little appetite to pursue second leg
  - US Treasury Report on AM and Insurance (2017)

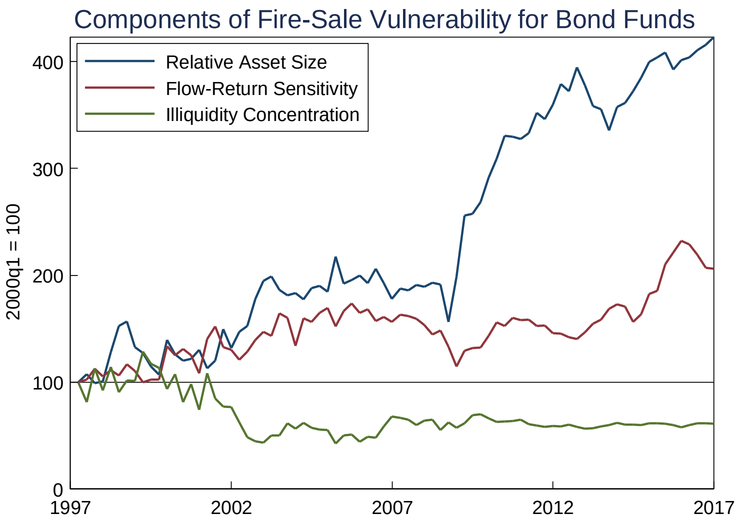
AM activities and systemic risk

- Focus on open ended mutual funds
  - High frequency (e.g. daily) redemptions
  - Illiquid asset allocations
  - First mover advantage
  - Potential for large redemptions during stress events
  - Asset sales and potentially large (fire sale) price impact on less liquid assets
  - Also potential credit effect

Increasing fire sale vulnerabilities over time



This chart shows the spillover losses among mutual funds, as a share of fund category assets caused by fire sales following a two-standard deviation shock to equity and bond returns.



Drivers of aggregate funds' spillover losses:

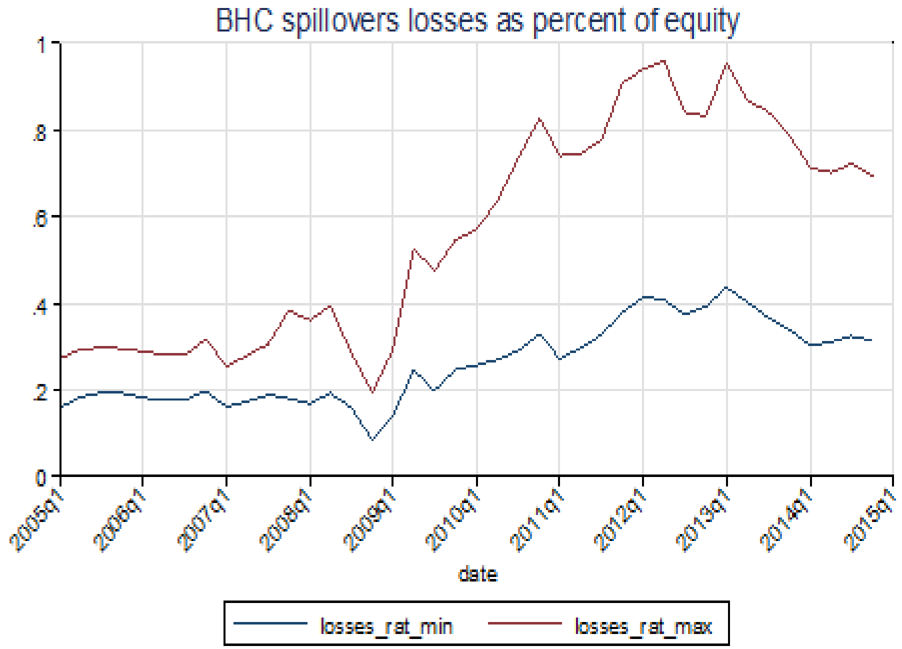
Overall increasing funds' asset size

Increasing flow-return sensitivities

(**Cetorelli, Duarte and Eisenbach, 2017**)

Asset sale spillover to banks increasing as well

1. Size of transmission spillover increasing since 2009. Probably reflection of increasing size of MFs
2. Peak at 2012 and then decline. Not driven by change in size of MFs. One likely factor a change in asset commonality



Back to entities

- Standard argument against a systemic risk focus on AM entities: The asset manager is an *agent* and not a *principal*
  - Acts on investment mandate
  - The manager does not own the assets
  - Balance sheet of an asset manager firm separate from balance sheet of funds under management

Back to entities

- But ownership of assets *per se* may be irrelevant for systemic considerations
- Asset manager as an aggregator and a coordinating device. Not that different from Diamond's bank as a "delegated monitoring" or Boyd and Prescott's bank as a "coalition of agents"

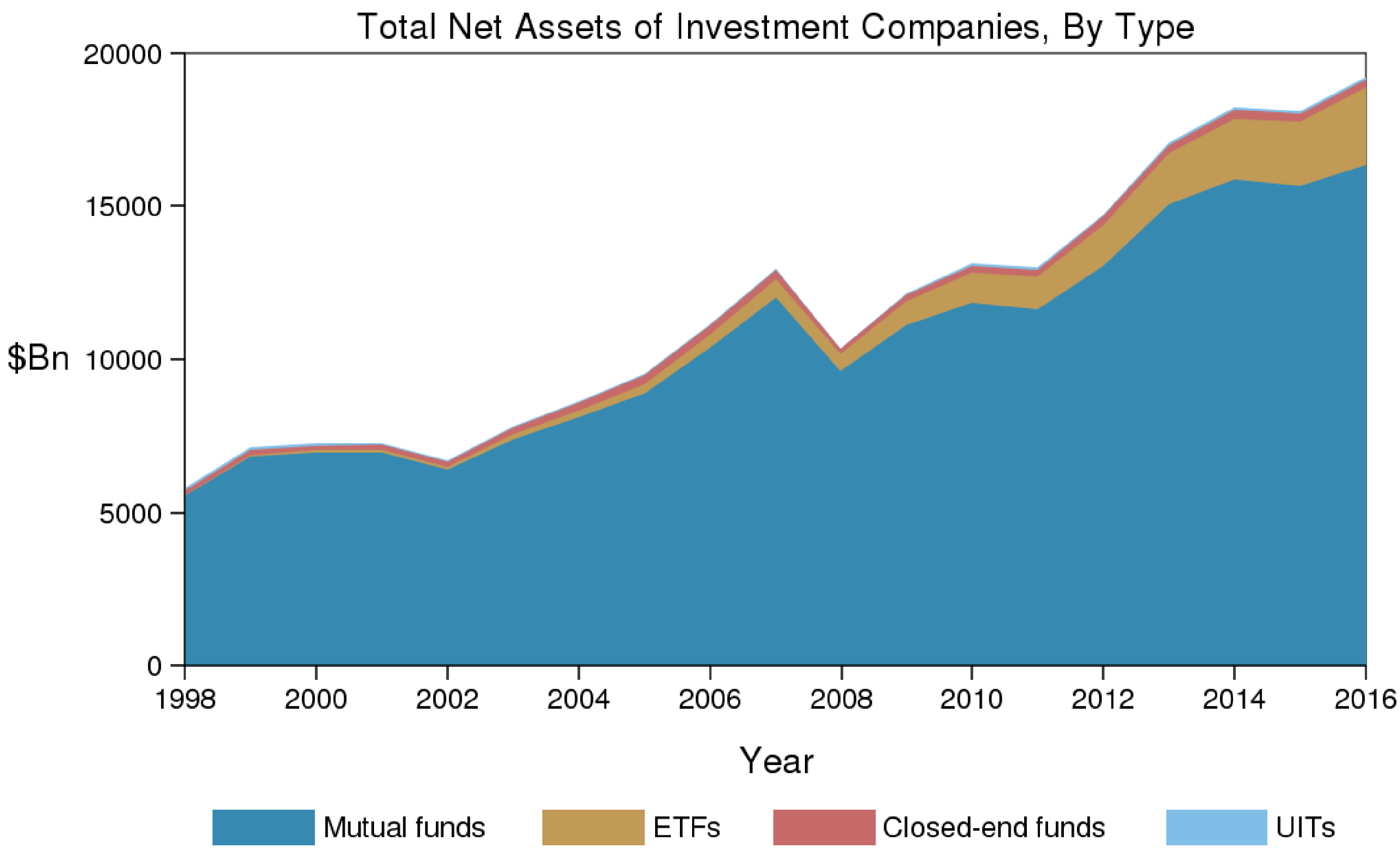
Back to entities

- Even accepting the agency argument, the description for the *average* firm may not fully apply in the cross section
- By virtue of scale and scope, certain asset management firms could operate in violation of the agency-based model and act as a principal instead
- Plenty of instances of “hybrid” firms outside AM:
  - AIG pre-crisis in credit derivatives + securities lending
  - Large BHCs expansion in insurance, investment banking, asset management itself
- Note: entity-based monitoring of asset management already in place for BHCs with asset management arms!

Example of securities lending

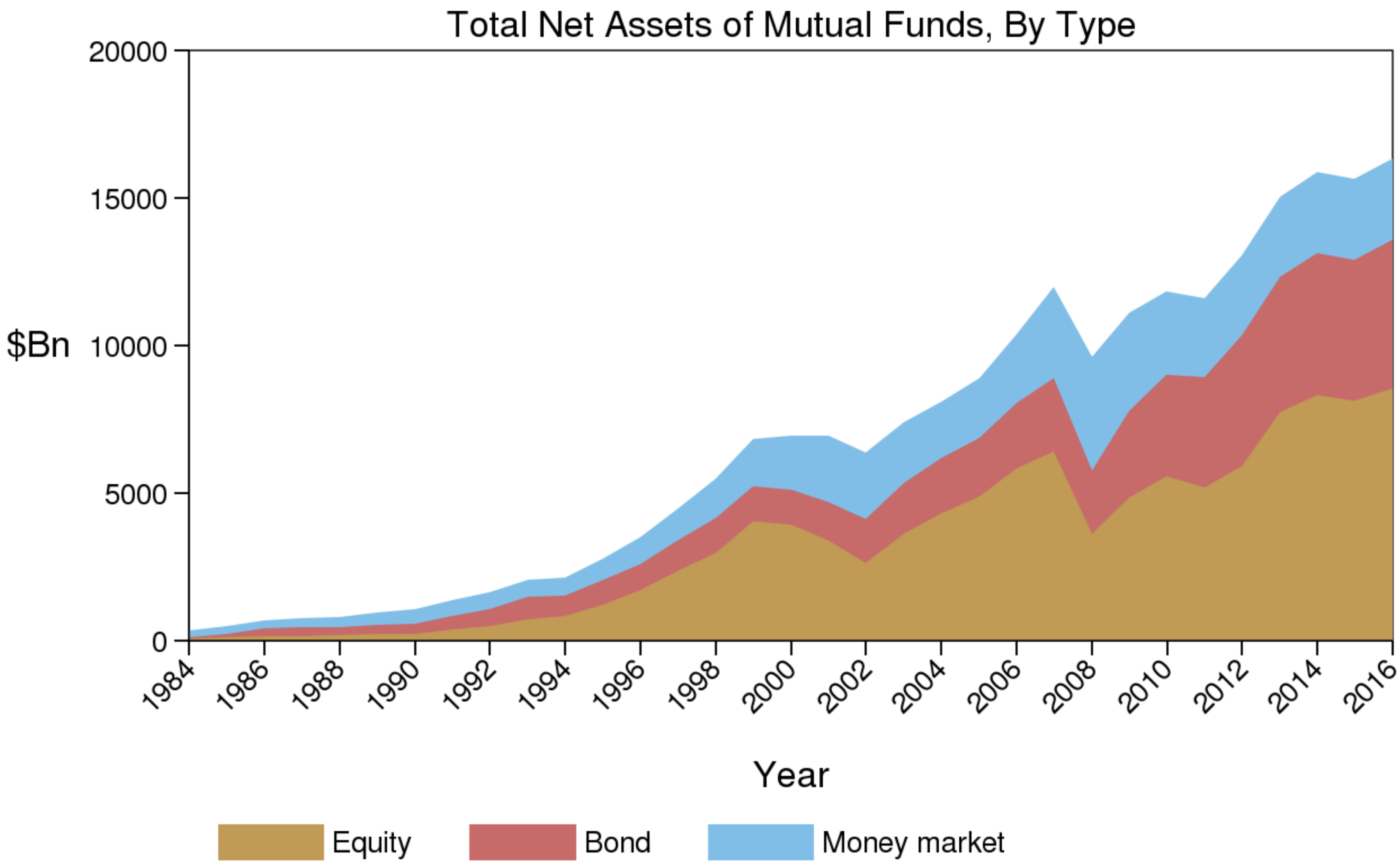
- FSB 2017 (but first in FSOC Annual Report 2014) identified role of agent lender in securities lending as an instance where asset management firms can take on principal roles (with their own balance sheet on the line)
- FSB issued a specific policy recommendation that captures asset management firms acting as agent lenders (FSB 2017, Policy Recommendation 14)

Reference charts



Note: Total net assets are as of the end of the year

Source: Investment Company Institute



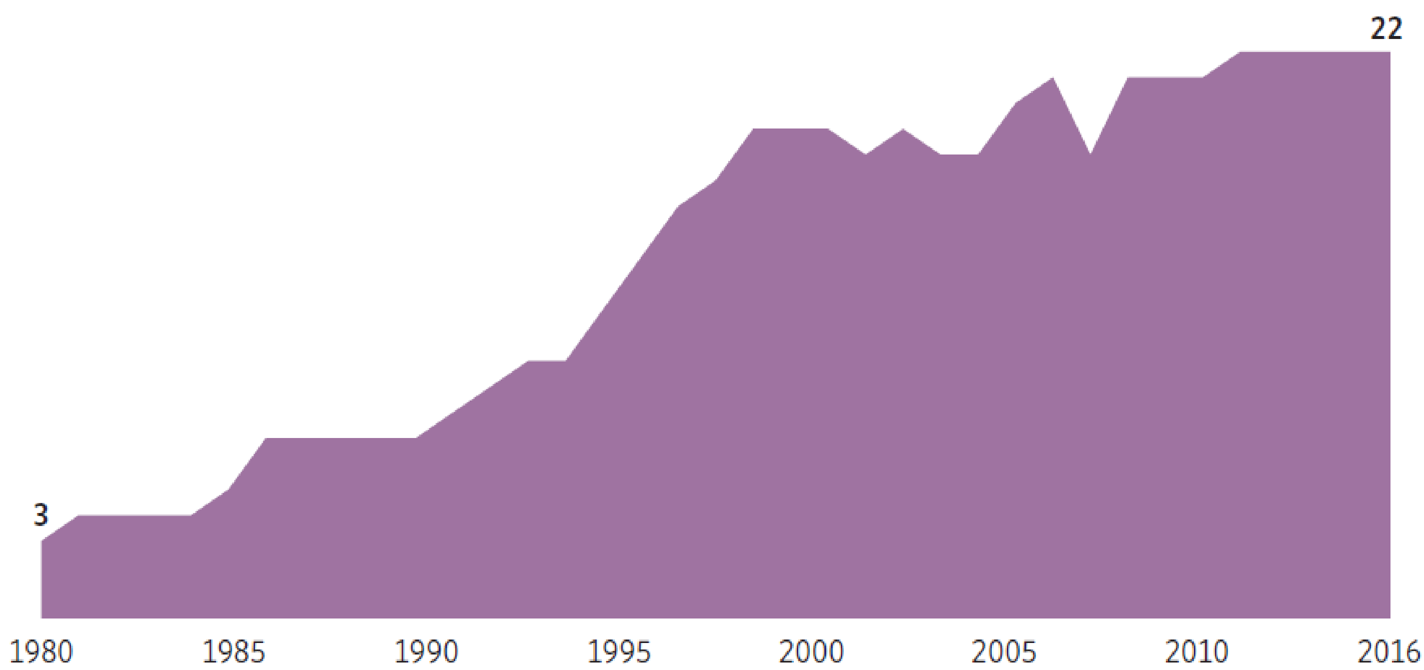
Note: Total net assets are as of the end of the year

Source: Investment Company Institute

FIGURE 1.3

Share of Household Financial Assets Held in Investment Companies

Percentage of household financial assets; year-end, 1980–2016



Note: Household financial assets held in registered investment companies include household holdings of ETFs, closed-end funds, UITs, and mutual funds. Mutual funds held in employer-sponsored DC plans, IRAs, and variable annuities are included.

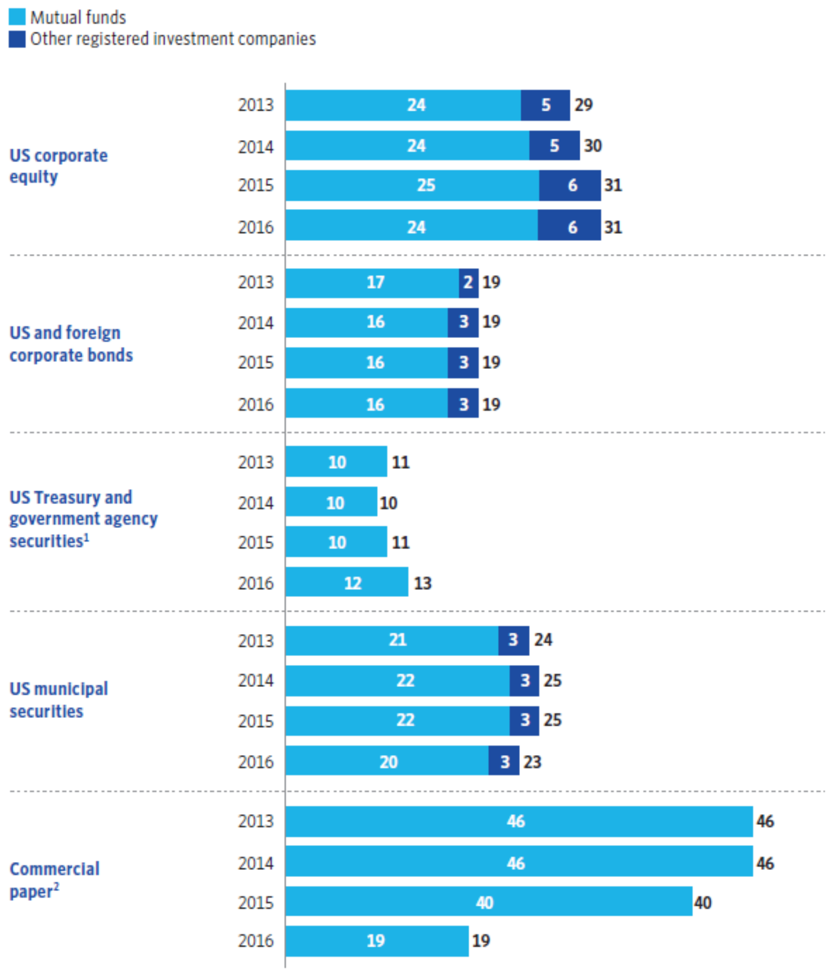
Sources: Investment Company Institute and Federal Reserve Board

Source: 2017 Investment Company Fact Book, Investment Company Institute

FIGURE 1.6

Investment Companies Channel Investment to Stock, Bond, and Money Markets

Percentage of total market securities held by investment companies; year-end, 2013–2016



[1] Total US Treasury and government agency securities held by other registered investment companies was less than 0.5 percent in each year.

[2] Other registered investment companies held no commercial paper in each year.

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute, Federal Reserve Board, and World Federation of Exchanges

Source: 2017 Investment Company Fact Book, Investment Company Institute

FIGURE 1.10

Share of Mutual Fund and ETF Assets at the Largest Fund Complexes

Percentage of total net assets of mutual funds and ETFs; year-end, selected years

	2005	2010	2015	2016
Largest 5 complexes	36	42	45	47
Largest 10 complexes	47	55	56	58
Largest 25 complexes	69	74	75	76

Note: Data include only mutual funds and ETFs registered under the Investment Company Act of 1940. Mutual fund data do not include mutual funds that invest primarily in other mutual funds. ETFs registered as UITs and ETFs that invest primarily in other ETFs are excluded.

Source: 2017 Investment Company Fact Book, Investment Company Institute