Asset Managers and Systemic Risk. A Financial Intermediation Perspective

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Goal for today

- Conference question: Are asset managers systemic?
- My contribution:
  - Overview of current policy undertakings
  - Methodological insights on how to approach this problem
  - Comments on challenges in potential implementation

Heightened interest in AM industry from systemic perspective

- In the U.S.: FSOC process designed to identify and designate non-bank systemically important financial institutions

- Globally: FSB initiative. Methodology to identify Global SIFIs. Effort underway to complement already existing framework for banks and insurance firms.

Focus on what?

- FSOC AM Federal Registry Notice: Are there particular asset management *products or activities* that we should worry about?

- FSB NBNI methodology: Focus on investment *funds* and/or asset management *firms* (in progress). More recently, expansion of focus on activities as well.

Traditional view of asset management business model (stylized)

Fund balance sheet

Securities	Fund shares

Traditional view of asset management business model (stylized)

Systemic considerations through the traditional framework

- Liquidity
- Concentration in investments
- Asset liquidation (fire sales)

Fund balance sheet

Securities	Fund shares

- Leverage (debt and/or derivatives)
- Counterparty exposures
- “Run-ability”

Conceptual challenges

- Asset manager “not the owner of the assets”
- Asset manager “is just a broker acting on behalf of the investors”
- Asset manager “own balance sheet is not related to asset management activities”
- Hence, even harder to make a case, conceptually, for analysis of an asset management firm

Is this traditional view still relevant for systemic analysis?

Brief detour. Two major changes in financial intermediation:

1. From banking to shadow banking
   - Deposit-taking, loan making defining traditional intermediation
   - Modern intermediation: Emergence of specialized entities (banks and nonbanks) providing intermediation services over long “intermediation chains”

     (Poszar, Adrian, Ashcraft and Boesky, 2010)

2. Organizational transformation of the banking firm
   - From focused commercial banks to complex financial conglomerates
   - Expansion of organizational footprint from commercial banking narrowly defined to the space of specialty lenders, underwriters, broker-dealers, insurance, asset managers, …

   (Cetorelli, McAndrews and Traina, 2014; Cetorelli and Stern, 2015; Cetorelli and Jacobides, 2015)

Organizational adaptation

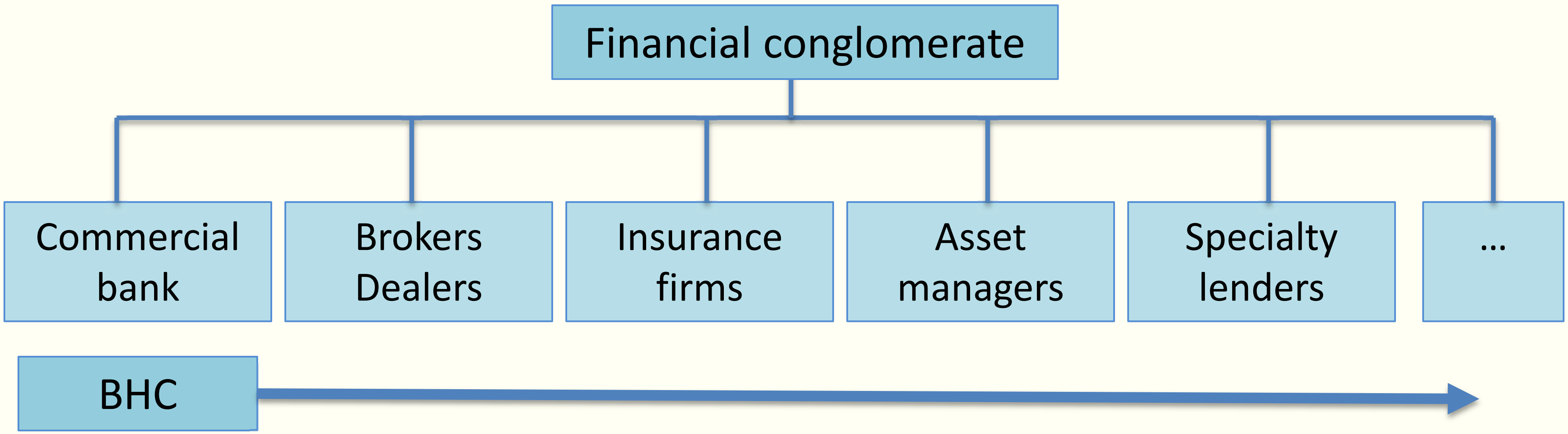
- Second change the result of the first
- Bank evolution in complex BHCs as a form of adaptation. Intermediation moves in the shadow, banks follow …

  (NYFed EPR, Special issue on Evolution of Banks and Financial Intermediation, 2012)

- Evidence of gains from conglomeration (Cetorelli and Traina, 2015)

Organizational adaptation

- Conglomeration is the organizational "solution" to integrate intermediation chains



How is this in any way relevant for analysis of asset management industry?

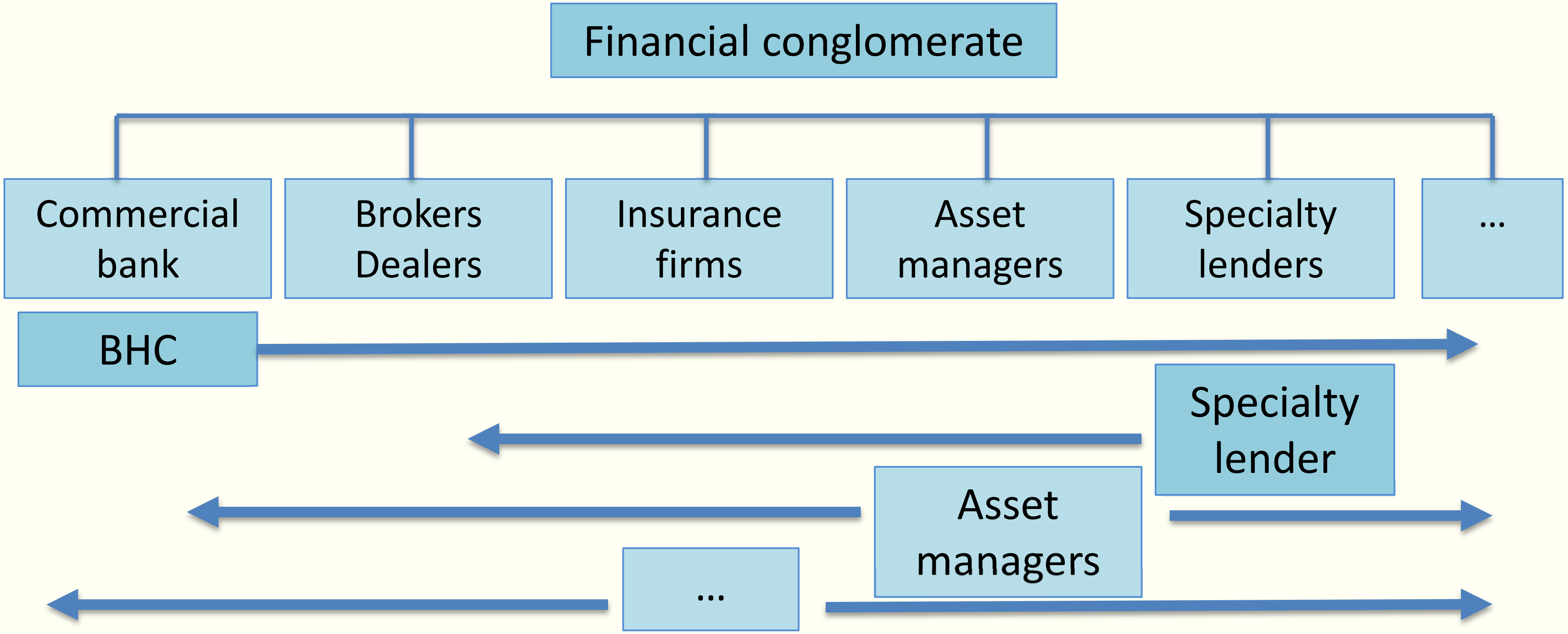
- Reality even more complex
- Evolution in the financial “ecosystem” have driven the emergence of ***hybrid intermediaries***
- The modern BHC just described is the quintessential hybrid intermediary

How is this in any way relevant for analysis of asset management industry?

- But no reason for ***nonbank*** financial firms to turn into hybrid intermediaries as well
- Financial intermediation has clear and well understood systemic implications
- Suggesting a financial intermediation angle in assessing systemic footprint of non-bank entities

Organizational adaptation from other segments of financial industry as well

- Conglomeration a path available not just to banking organizations



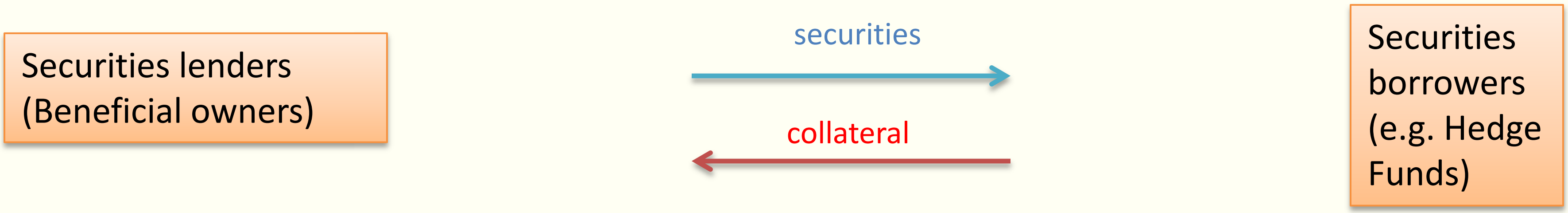
Asset managers as financial intermediaries?

- By virtue of size and scope of organizational span, largest asset managers may become financial intermediaries
- Note: not an argument on the ***entire*** asset management industry
- But considerations on systemic footprint are never about the median firm. Always about the outliers.

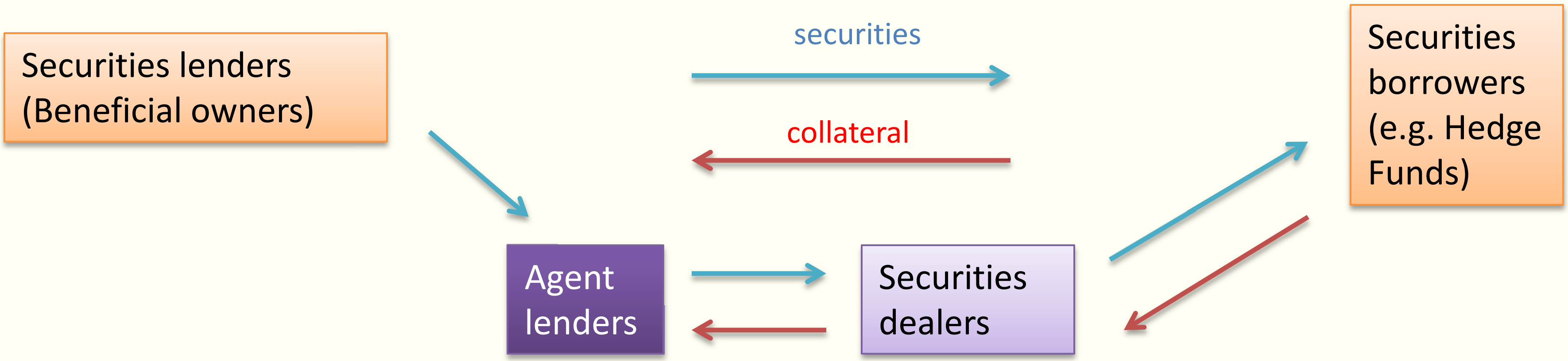
An example

- Securities lending
- Perfect example of a modern credit intermediation chain
- Multiplicity of entities and markets involved
- Intermediation activity by agent lenders
  - Provision of credit guarantees to lenders (credit transformation)
  - Management of cash collateral reinvestments (maturity and liquidity transformation)

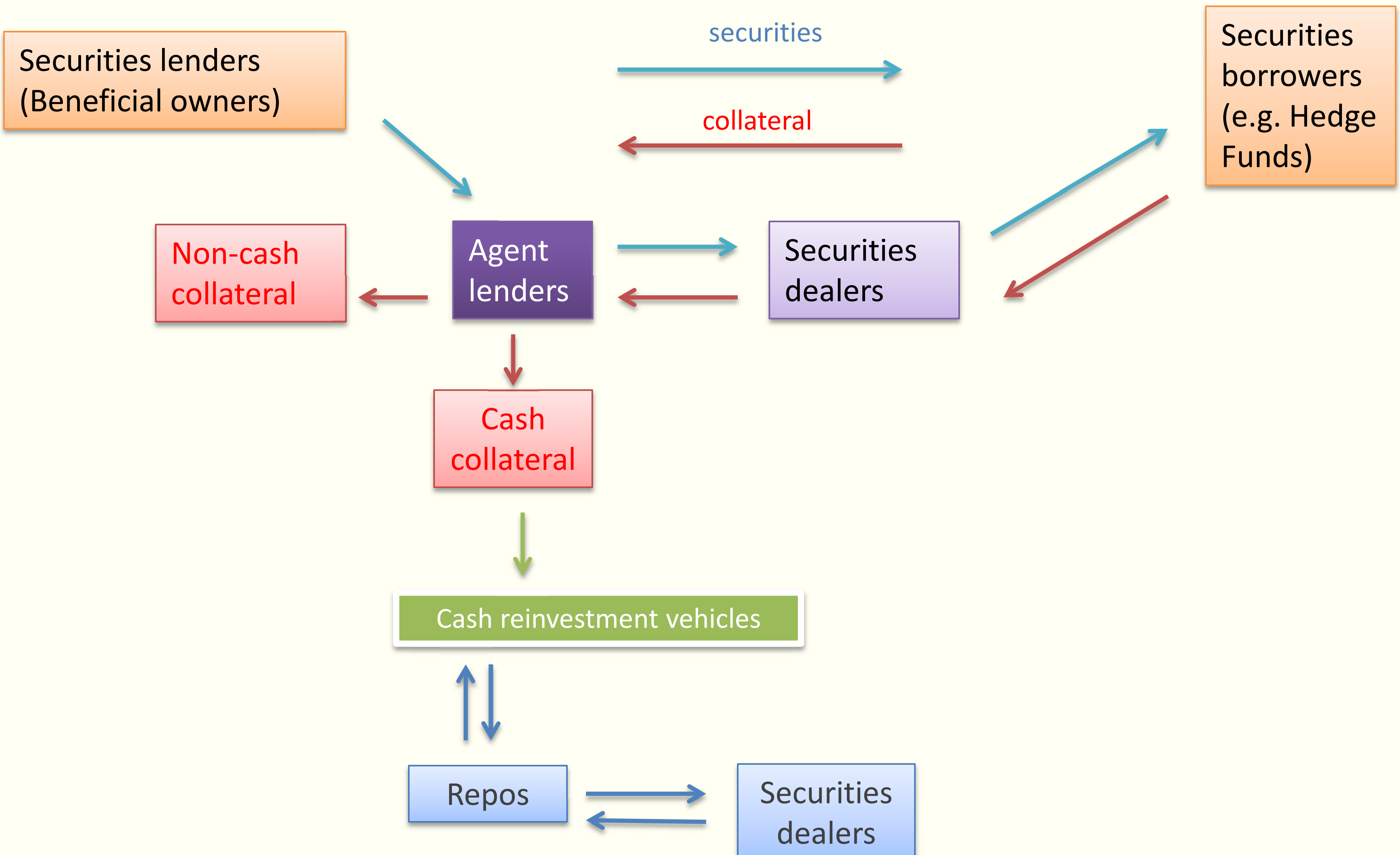
Securities lending intermediation chain



Securities lending intermediation chain



Securities lending intermediation chain



Financial intermediation risks in securities lending

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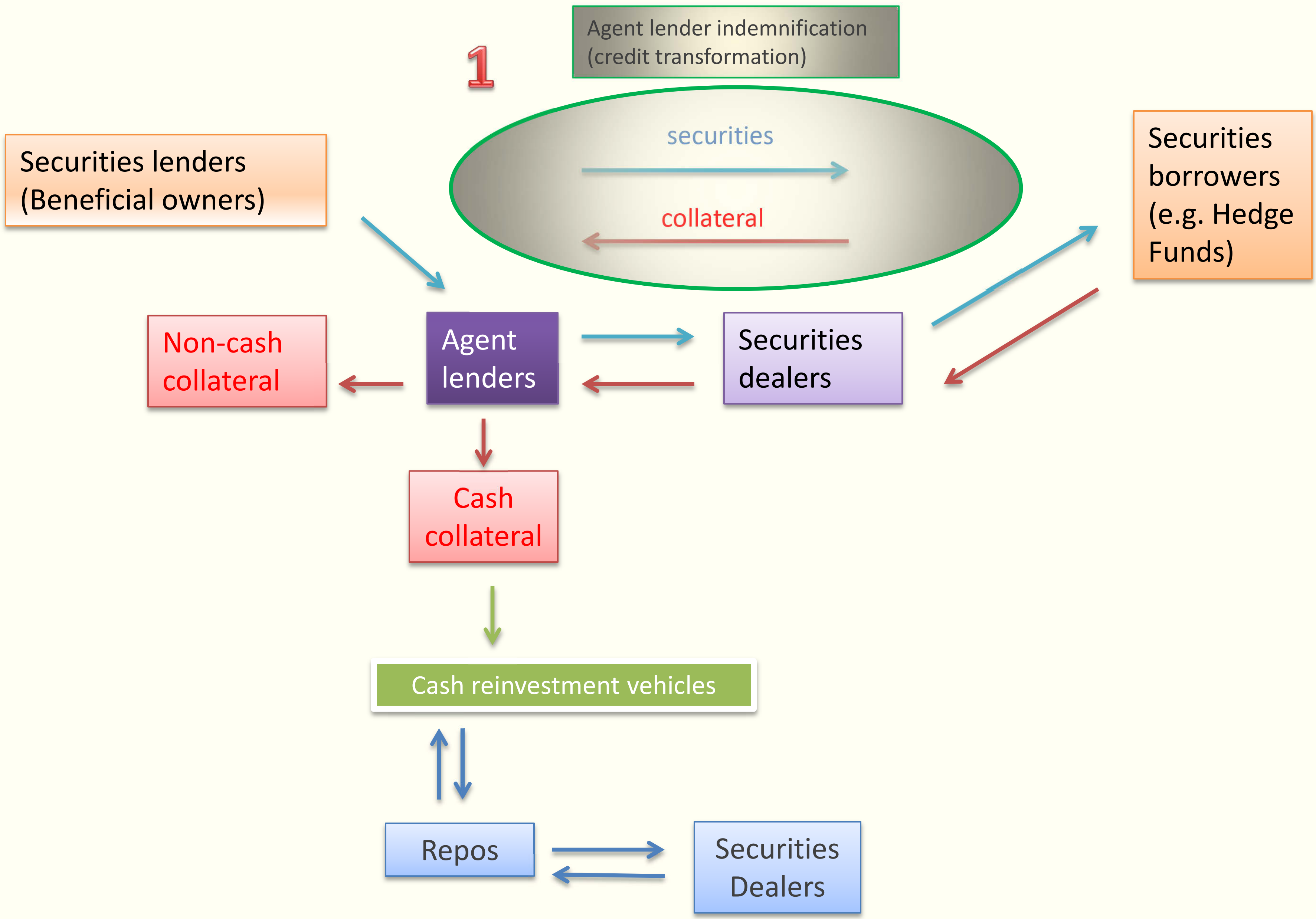
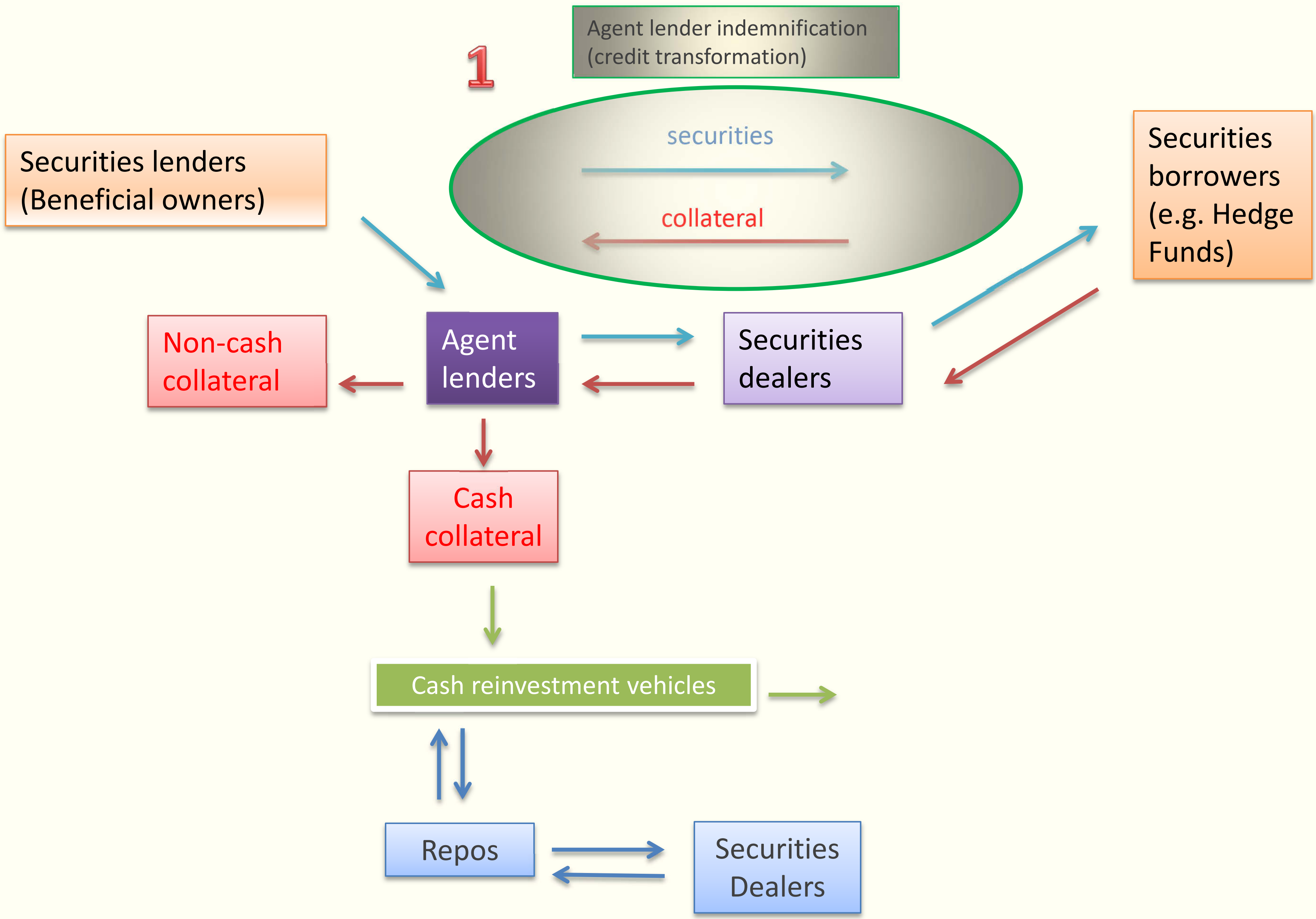
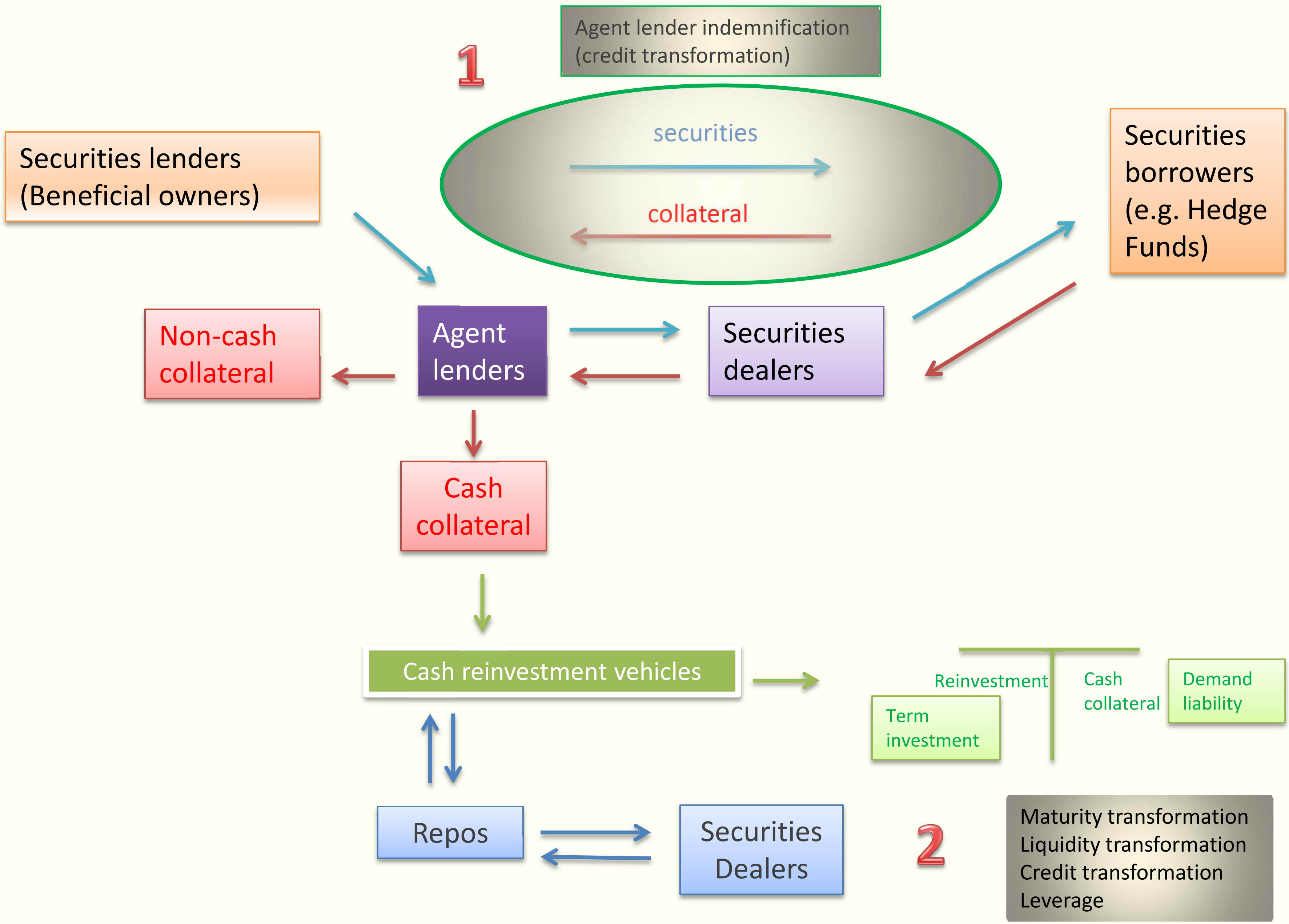


Financial intermediation risks in securities lending



Financial intermediation risks in securities lending



Potential for systemic externalities

- Not just academic digressions: Maiden Lane II, LLC was created to absorb the sec lending "balance sheet" of AIG subsidiaries

- Well-recognized activity by regulators*: " … Due to their size and close links with the banking sector, SFTs such as repurchase agreements, securities lending, … and rehypothecation are particularly relevant [shadow banking] activities to address. SFTs display structural similarities to banking activities as they can lead to maturity and liquidity transformation and increased leverage, including short-term financing of longer term assets. …"* **European Commission - MEMO/14/64 29/01/2014**

Who are the dominant intermediaries in sec lending?

- Top 5 traditional players: **State Street, BONY, JPMC, Citi, Northern Trust**

- A large asset management firm, **Blackrock, Inc.**, in two-three years from virtually no role to now larger than Citi and Northern Trust (almost combined)

- In the space of securities lending activity, ALL these firms undistinguishable from an organizational standpoint

Takeaways

- Not a statement on systemic significance by any specific firm
- A conceptual contribution. Suggesting that industry analysis through “traditional lenses” may be inadequate.
- Most asset management firms fit traditional mold
- But outliers matter most for systemic considerations

Takeaways

- Do not need to be a bank to be an intermediary
- Asset management firms may turn into hybrid intermediaries
- Systemic risks by bank intermediaries are well understood
- Insights valuable to understand potential systemicness by non-bank entities
- Applicable policy tools understood as well