Asset Managers, Systemic Risk & Policy Options

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There is a constant drum beat for additional regulation, but where is the market failure?

- The **number 1** problem judging by the FSOC’s December 18 questions for public comment is: **Asset Fire Sales**
  - Investor redemptions could lead to “asset fire sales”
  - Imbedded leverage could lead to margin calls that trigger “asset fire sales”
  - Fund redemption limits and “gates” could encourage fund investors to run and trigger “asset fire sales”
  - Securities lending could “boomerang” and trigger “asset fire sales”
  - Pressure on fund managers to stay fully invested (and illiquid) could trigger “asset fire sales”
Possible Solution 1

• Bank-like regulations and oversight will reduce the probability of investor runs
  – Put controls on fund managers & funds
    • Bank-like capital & liquidity requirements
    • Controls on investment risk
    • Additional leverage restrictions and minimum haircuts
      for repo and securities lending
  – Some suggest selected activities should be done in limited purpose banks with govt insurance
Possible Solution 2

• Provide a government-backed liquidity backstop for the asset management industry to *prevent fire sales*
  – Congress did this in 1913 for commercial banks (Federal Reserve Act)
  – Congress did this in 1932 for mortgages held in S&Ls, savings banks and insurers (Federal Home Loan Bank Act)
  – The Congress did this in 1916 for farm credit in the Federal Farm Loan Act. The Farm Credit Administration was created by executive order in 1933.
Which to Better?

• Regulating asset managers like banks would limit consumers’ investment opportunities

• No evidence gov’t regulators can pick “good” investments, and yet this is the power they seek
  • Regulators will control how the economy’s savings are invested... through both banks and asset managers
  • Economic growth will suffer
    – How much growth are you will to trade-off for the (false) promise of financial stability?

  – Asset manager returns will be forced to converge to rates of return offered by banking products

  – Regulators will actively discourage high yield products as “too risky” for financial stability
Downside for Liquidity Backstop

• If designed incorrectly, it could create moral hazard
  – asset managers could use backstop “liquidity insurance” in place of sound liquidity management
  – Its all about proper design
    • Must charge for liquidity insurance and it must be too expense to use regularly
Who Could Provide the Asset Managers’ Liquidity Backstop?

• **Federal Reserve**
  – Could require the Fed to develop and sell liquidity options on assets accepted for Tri-party repo

• **Federal Home Loan Banks**
  – Expand the Federal Home Loan Bank charter
  – Allow asset managers to join FHLBs
    • FHLB banks could provide advances
    • FHLB should be required to develop and sell liquidity insurance products to its members
    • FHLB has never lost a dime providing advances to many mortgage lenders despite the risks involved