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 cold 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 fro 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