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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 347

Marshall Blume
(215) 898-7633

Chester Spatt
(412) 268-8834

Statement of the Shadow Financial Regulatory Committee on
Asset Management and Systemic Risk

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Recently, the Office of Financial Research (OFR) issued a report, “Asset Management and Financial Stability,” focusing upon investment management firms, which received considerable attention when the Securities and Exchange Commission (SEC) circulated it for public comment. The Financial Stability Oversight Council (FSOC) requested that OFR study whether such firms should be subject to “enhanced prudential standards.” The report focuses primarily on investment vehicles other than money market mutual funds.

Investment management firms are different from banks, particularly with respect to leverage. When a bank takes on leverage and incurs losses, its capital base is reduced and possibly eliminated. Such leverage can thus lead to insolvency and liquidation, and the quantity of loans in the economy can diminish.

In contrast, the assets controlled by an investment management firm are not owned by that firm, but rather by investors in the investment fund managed by that firm. When there are losses, the investors in a fund managed by an investment management firm bear these losses; however, the viability of the investment management firm is not directly affected. To be sure, the revenues of the firms, which are tied to assets under management, would decline; however, expenses can be readily adjusted downwards. The OFR report argues that such a decline in revenues for a large firm would lead to systemic risk. The Shadow Financial Committee finds this part of the report unpersuasive.

The report cites four activities of the investment management industry that may lead to systemic risk: (1) reaching for yield and herding behavior, (2) redemption risk, (3) leverage, and (4) failure of an investment management firm. As addressed above, the concern about the fourth point is misplaced. The other activities are inherent to the investment process. Designating larger firms as systemically important and placing restrictions on these firms would have little effect on how the industry invests the funds under its control. If large firms faced investment restrictions, investors would just gravitate towards smaller firms without any effect on systemic risk. If regulators were to deem a particular investment strategy as inducing systemic risk, the regulators would need to address this concern with respect to all investment management firms and not just the largest.

To illustrate, in today's environment many investors are "reaching for yield." Some investors are increasing their allocation to high-yield bonds. Other investors are using leverage by shorting near-term governments and investing the proceeds in longer-term bonds, often using derivatives, to play the yield curve—the so-called carry trade. These activities would occur whether or not an investment management firm would be subject to enhanced prudential standards. If yields rise and prices fall, these strategies would incur losses, which would be greater with increased leverage. These losses have nothing to do with the issue of systemic risk.

Although not mentioned in the OFR report, a potential source of systemic risk involves the potential mispricing of the assets in a fund and the destabilizing activities of investors to exploit such mispricing, but again subjecting certain firms to enhanced prudential standards would not mitigate this risk. The SEC is currently considering a proposal to address this issue within the money market mutual fund context, but without subjecting investment management firms to enhanced prudential standards.

Throughout its report, the OFR calls for collection of additional data to identify sources of systemic risk. In collecting such data it is important to evaluate the potential social benefits versus the private costs. Given its expertise and legal authority, the SEC and CFTC, rather than the OFR, should take the lead role in collecting and evaluating such additional data. Only if these agencies find clear evidence of systemic risk in the investment management industry, should the FSOC consider designating major asset firms as systemically important.