# The A-List

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As policy makers and regulators scan the financial horizon for future systemic risks, they are looking beyond the traditional locus of banks and insurance companies towards the capital markets and large asset managers. This shift is appropriate. Capital markets – and the asset managers operating within them – play a major and growing role in intermediating between savers and borrowers. As Mark Carney, governor of the Bank of England, noted in his recent FT piece on shadow banking , “an effective financial system needs intermediation outside the traditional banking sector.” In this context, it is important to understand the roles of asset managers in facilitating asset ownership and how those managers interact with markets.

There is increasing acceptance and understanding that there would be little value in regulating asset managers – large or small – in similar ways to large banks or insurance companies. Regulation for banks reflects the fundamental vulnerabilities underlying their businesses, in which they take on liquidity and credit risk, partly funded by taxpayer guaranteed deposits. None of these features apply to asset managers. These firms do not have significant exposure to credit on their balance sheets, do not benefit from taxpayer guarantees, and are not at the firm level counterparties in trades or derivatives transactions.

The core difference is: the assets under management – and the consequent risks – belong to the underlying asset owners, not those who manage them. As Andy Haldane, executive director of financial stability at the Bank of England, recently remarked: “As an agency function, asset managers do not bear credit, market and liquidity risk on their portfolios . . . Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank.”

Fundamentally, asset allocation decisions – and therefore asset flows – reflect decisions made by owners. And asset owners change their allocations for any number of reasons and on a regular basis. Even when considering only those assets under external management, owner initiated flows substantially overwhelm discretionary allocations decisions by the asset managers. That is because asset managers can only allocate within the guidelines of clients’ mandates, whereas owners by definition have control over their assets.

These flows reflect a range of factors. For many owners, asset allocation decisions will reflect the regulatory and accounting constraints they face. For example, a defined benefit pension plan must factor in accounting rules in order to project its liabilities, and changes in those rules over the past decade have translated into noticeable shifts into longer duration strategies and larger allocations to alternative investments.

The macroeconomic backdrop is also crucial. Consider how the sustained low rate environment of recent years has pushed insurance companies into less liquid and lower credit quality sectors within fixed income in order to earn a spread relative to their liabilities.

The hunt for yield means that regulators need to consider the liquidity requirements of these asset owners. One of the lessons from the financial crisis was that some owners were enhancing returns by investing large parts of their assets in illiquid assets. When crisis hit, they faced a liquidity squeeze and were forced to sell. Once more, we are witnessing similar demand for illiquidity premia from investors searching for yield against this backdrop of extremely loose monetary policy. Inevitably, the longer the current extreme policy stance is maintained, the greater the risk of a renewed build-up of systemic vulnerabilities.

If policy makers want to address asset flows the motivations of asset owners must be taken into account: the incentives they face, and the regulatory and accounting environment in which they operate.

So what should policy makers' current priorities be? There are a wide range of issues which could benefit from their attention. First, policy makers should pay particular attention to levered investment vehicles that may magnify risks. Leverage could usefully be an initial 'screen' to identify funds that might have the potential to pose systemic risk.

With regard to the particular issue of "run risk", regulation of the redemption characteristics of collective investment vehicles would benefit from review. The characteristics of some of these vehicles can create incentives to head for the exit first at signs of trouble – so-called "first-mover advantage". A well-structured fund should avoid this incentive. Regulators around the world have recognised the importance of this issue, but the regimes they have developed address the issue in different ways. Regulators could usefully review these varying approaches and define best practices.

Standardisation of issuance in corporate bond markets in order to improve secondary market liquidity should also be encouraged. Standardisation could reduce the jungle of bonds currently in the market, enhancing transparency as well as creating a more liquid curve for individual issuers.

In these areas and others, effective and consistent regulation and supervision could improve the financial ecosystem for all market participants. That can only be achieved with a fully rounded view, which acknowledges and internalises the respective roles of asset owners, asset managers and intermediaries. Only a comprehensive, international and FSB-led assessment, which takes into account the incentives facing all these actors, can adequately address the underlying systemic risks which may lurk in today's capital markets.