Global Financial Stability Report
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Chapter 3

The Asset Management Industry and Financial Stability

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Motivation

- Rapid growth of the industry
- Growth of bond funds
- Movement into less-liquid assets (October 2014 GFSR)
- Retrenchment by banks from market making

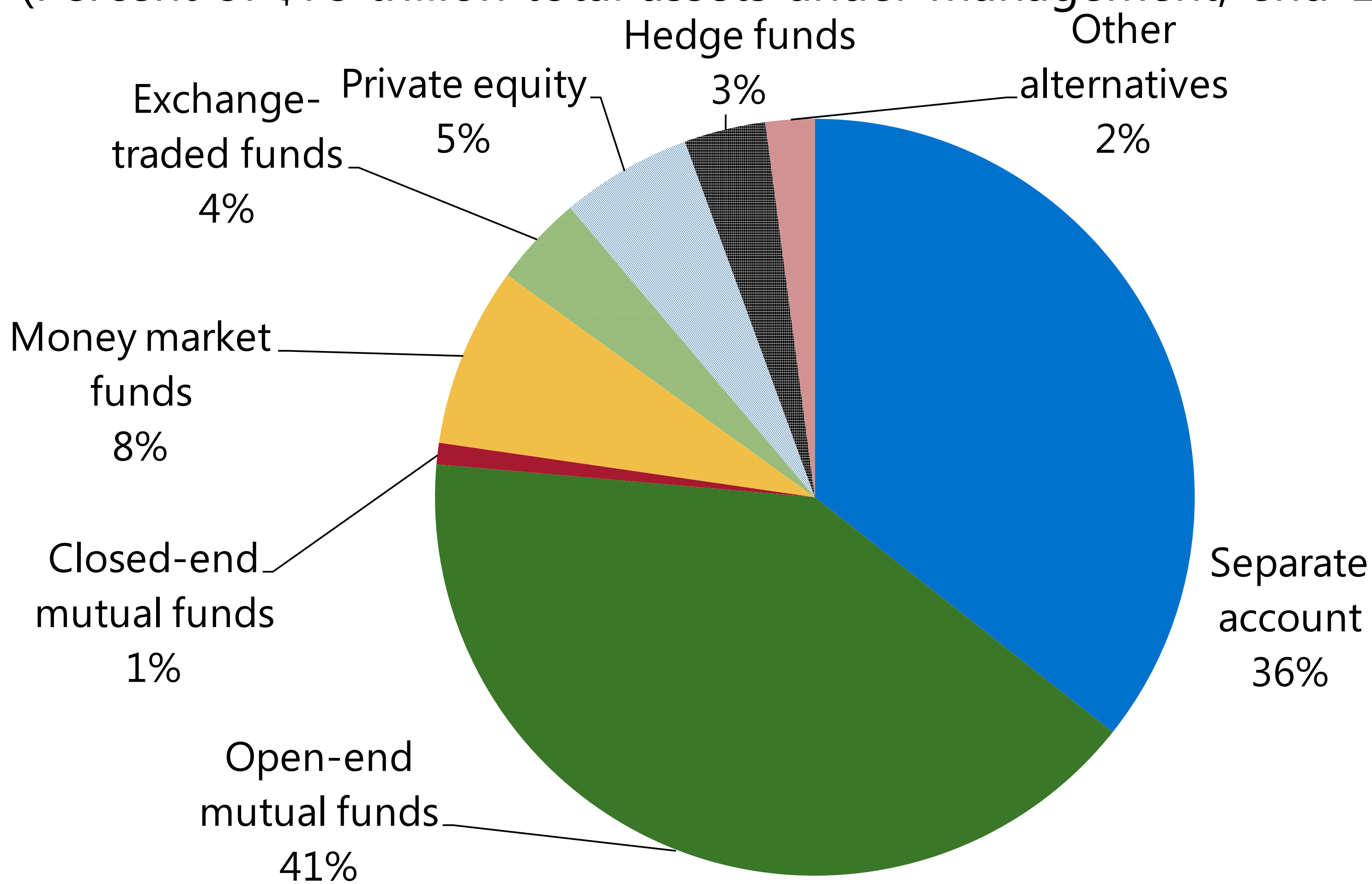
Roadmap

- Industry Background
- Conceptual Risk Channels
- Empirical Analysis
- Policy Discussion and Recommendations

Structure of Asset Management Industry

1. Asset Managers' Intermediation by Investment Vehicles

(Percent of $79 trillion total assets under management, end-2013)

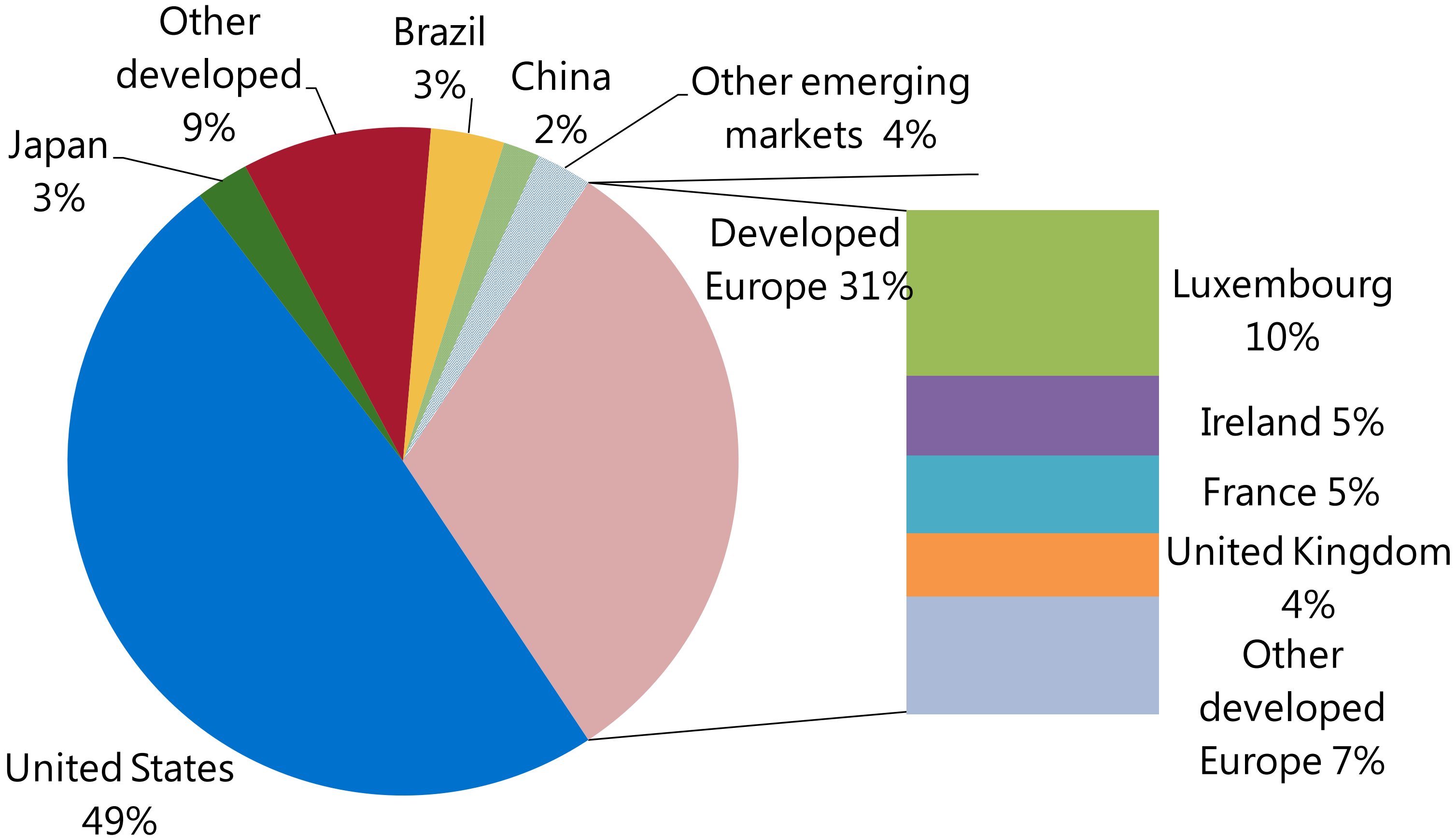


Sources: BarclayHedge; European Fund and Asset Mangement Association; ETFGI; OECD; Preqin; Pension and Investments Towers Watson; and IMF staff estimates.

Mutual Funds—domiciled in U.S. and Europe, but global investment

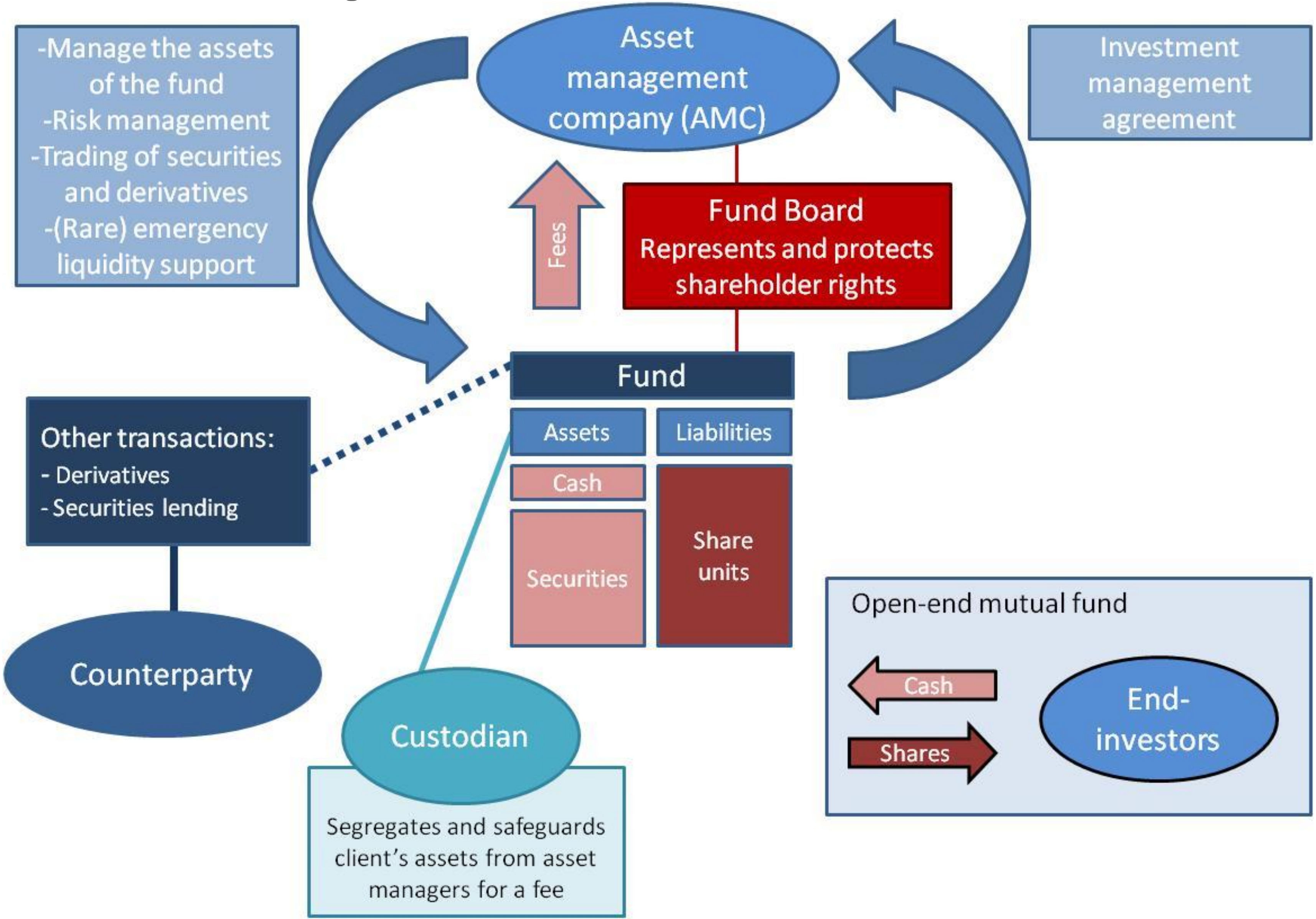
Key Domiciles of Mutual Funds

(Mutual funds by domicile, percent of total assets under management, end 2014)



Sources: European Fund and Asset Management Association; and IMF staff calculations.

Operation of a Fund



Key Known Risks

Known issues

- Hedge funds—leverage, insolvency, complexity
- MMF—constant net asset value NAV (= money-like liability), link to bank funding

…do not apply to MF, ETF

- Little borrowing
- Portfolio leverage capped
- No constant NAV
- Little insolvency risk: liabilities are "shares"—return and losses absorbed fully by investors

What are the risks from less leveraged "plain-vanilla" products?

Incentive problems of delegated investment

Information gap between managers and investors

- Benchmark based evaluation

→Excessive risk taking

→Herding

- Brand name effects(Spillovers of redemptions within fund family)

Run risk

First Mover Advantage

- Liquidity mismatch
- Managers sell liquid assets first
- Some fund share pricing rules impose cost of liquidity risk unfairly to second movers

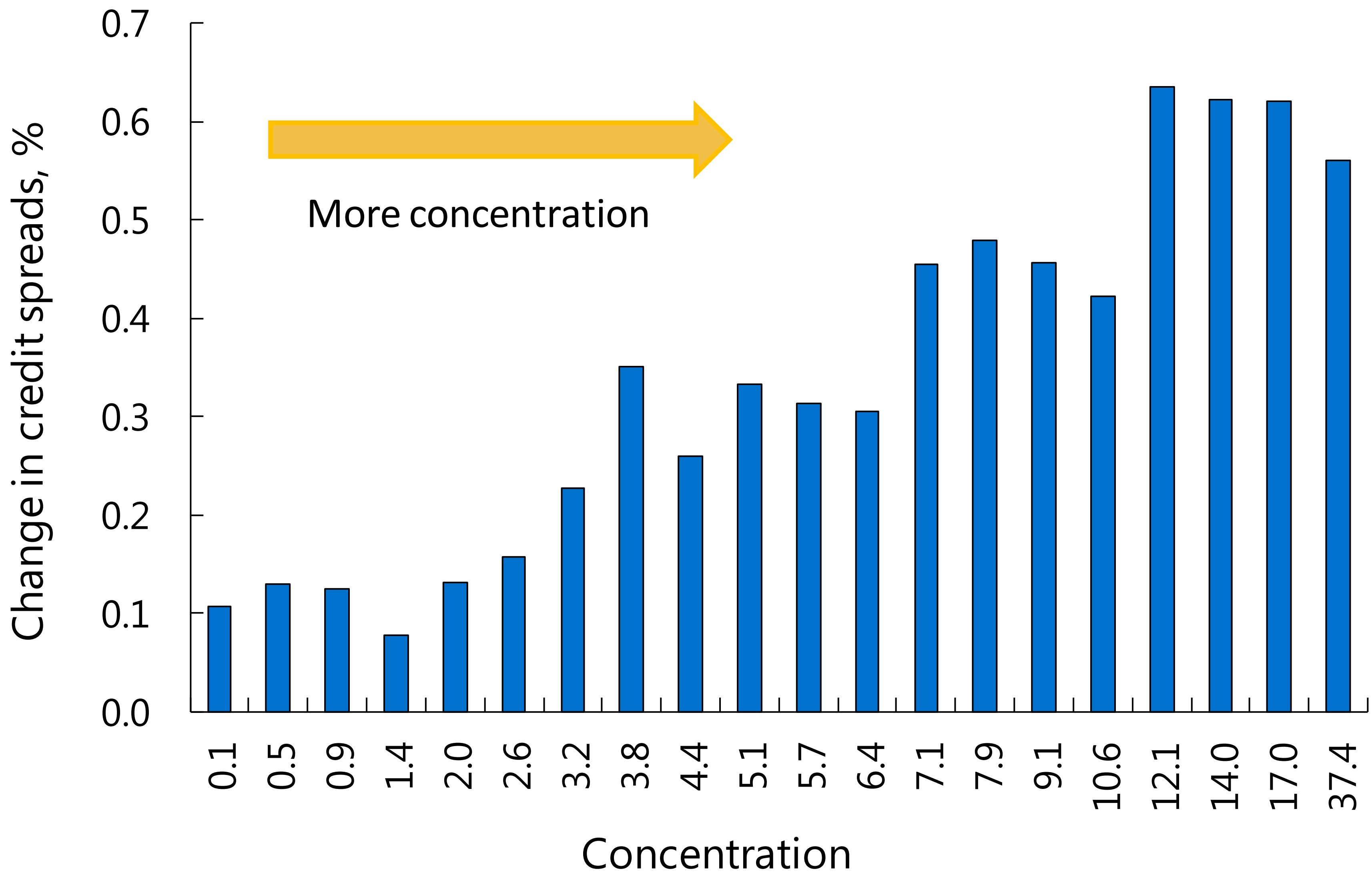
Macro-financial consequences

Price externalities—fire sales, contagion, volatility

Does mutual fund investment matter for asset price dynamics? –Yes

- Do aggregate mutual fund flows affect aggregate price indices?
  - Yes—for smaller, less liquid markets (EM assets, HY US corporate bonds) . Flows also help predict future returns➔ first-mover advantage
  - Less clear for U.S. equity, U.S. broad bond funds
- Concentrated holding by mutual fund—bad for bond spreads during 2008 crisis and 2013

Bonds Issued by Emerging Market and Developing Economies, 2013:Q1 and 2013:Q2

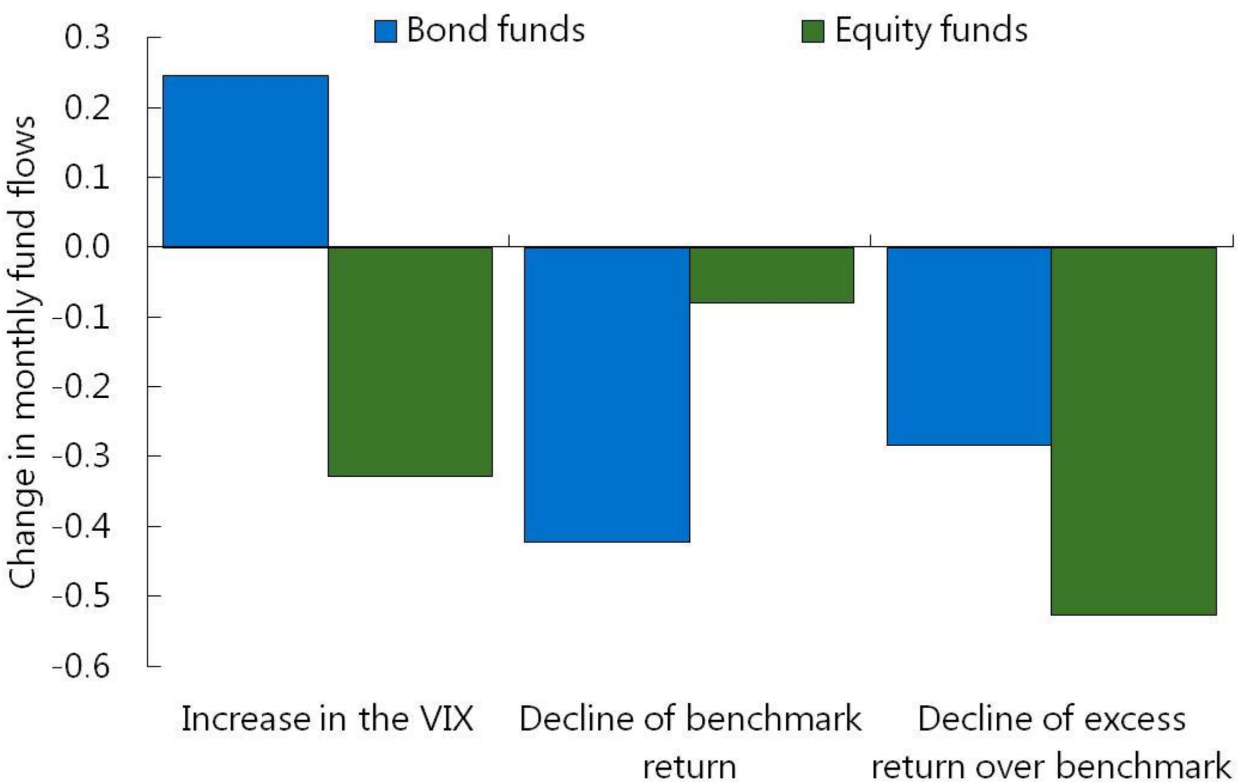


What drives run risk? (1)

- Past returns and flight to quality

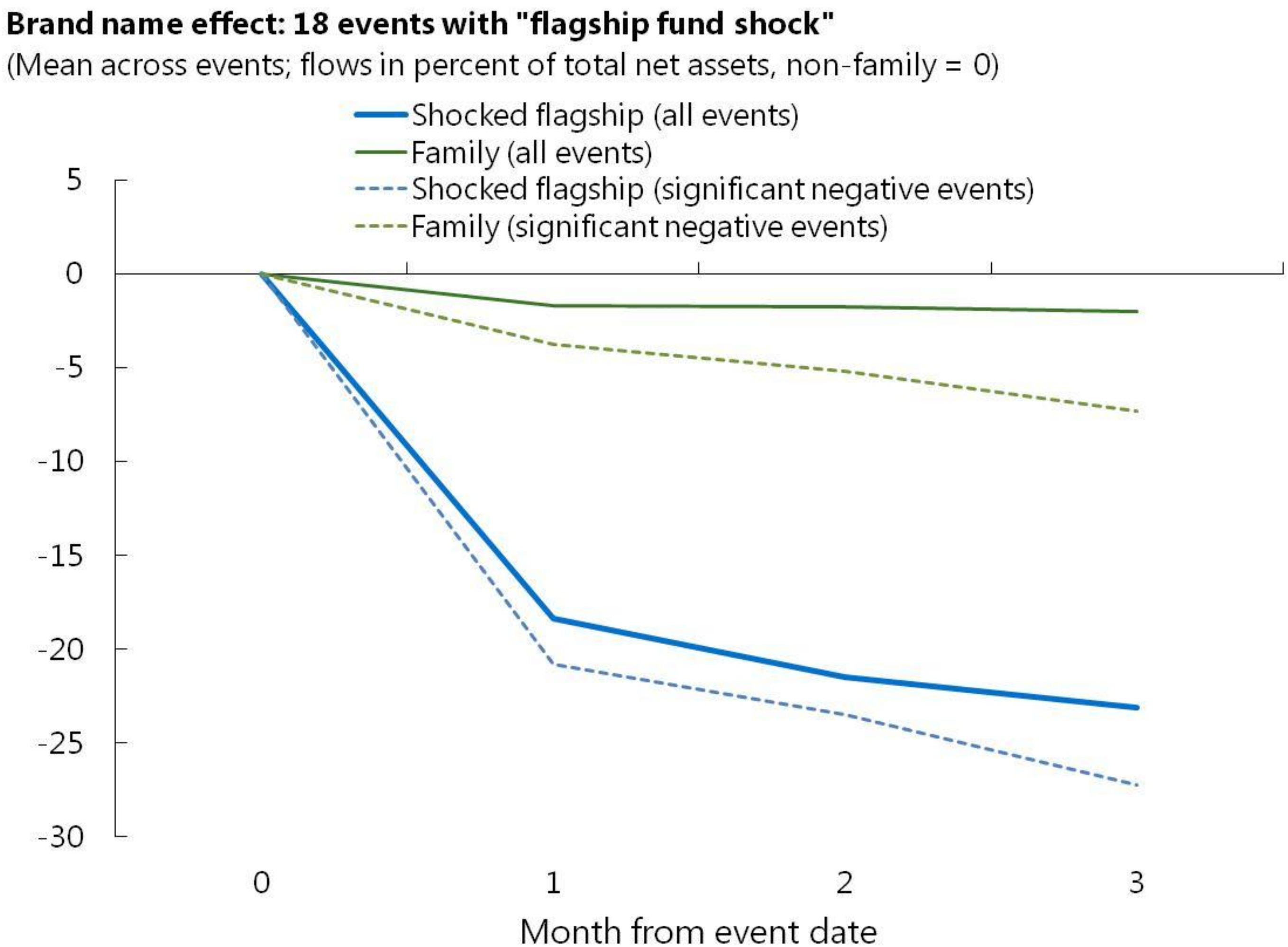
1. Sensitivity of Fund Flows to Fund Performance and Market Conditions

(The effect of a one standard deviation shock to each driver)



What drives run risk? (2)

- Some brand name effects, albeit weak

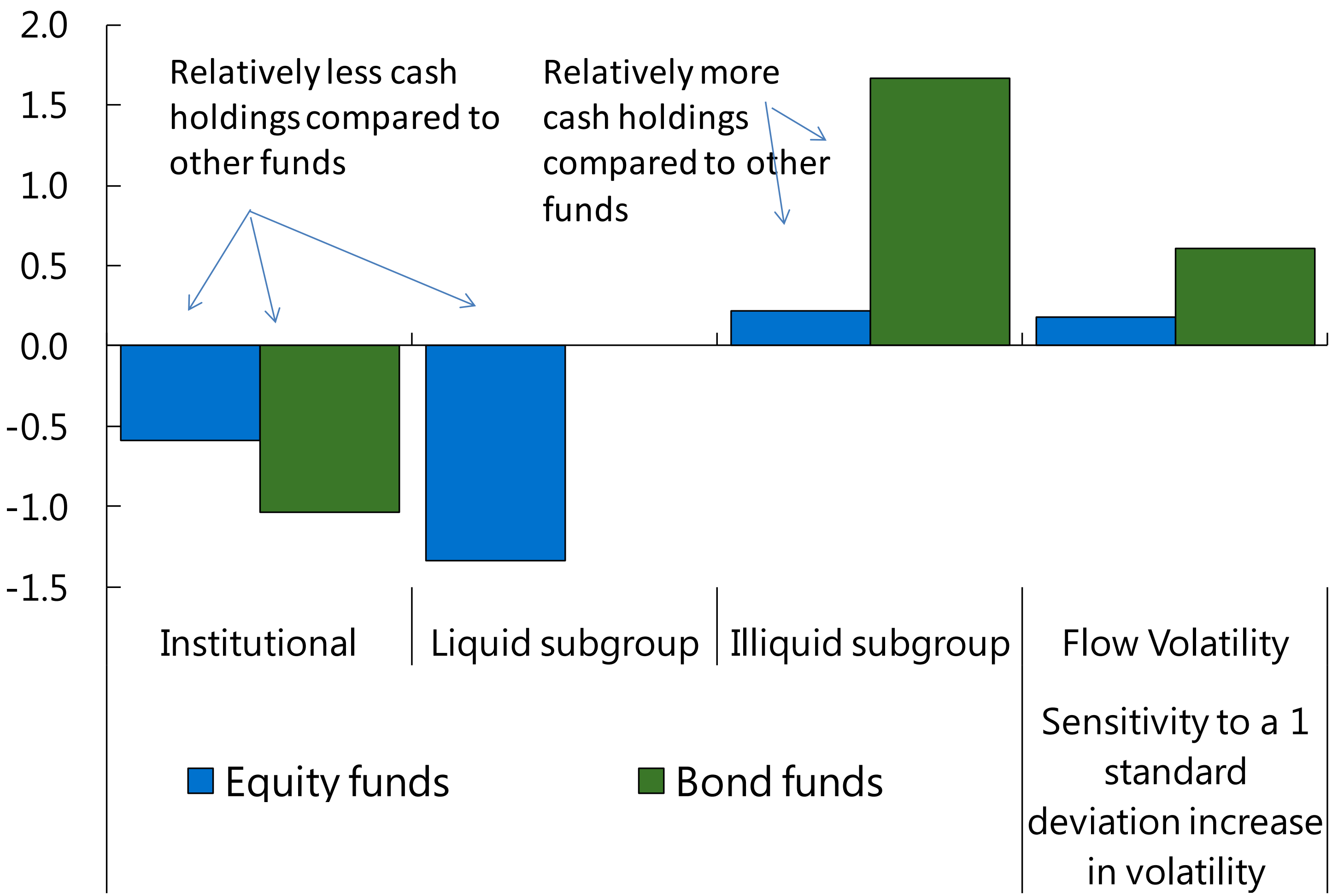


What can mitigate run risk ? (1)

Holding cash in line with funds' liquidity risk

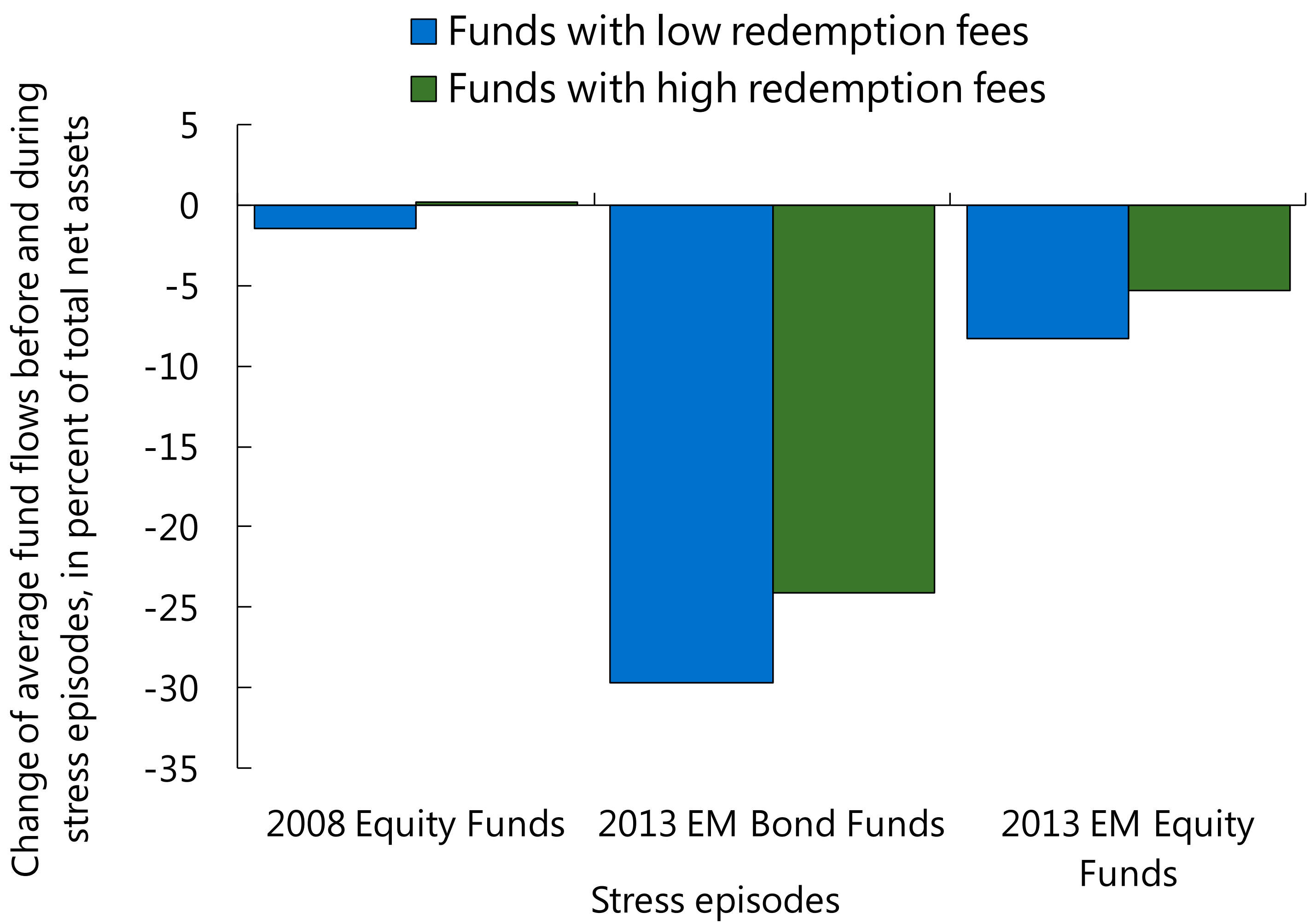
3. Differences in Cash Holdings across Funds

(In percent of total net assets)



What can mitigate run risk? (2)
Fees are effective in dampening redemptions

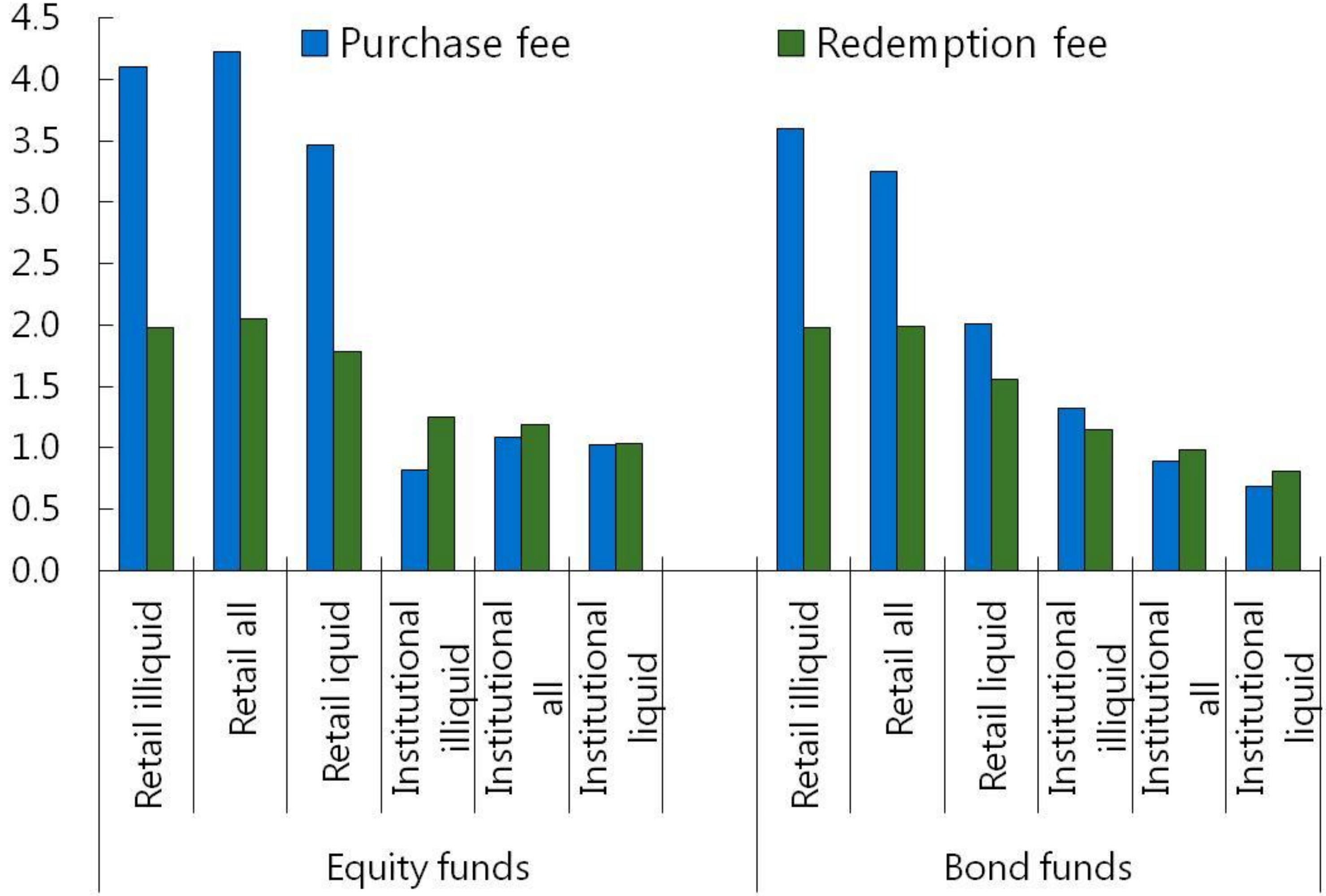
3. Redemptions during Stress Times, by Redemption Fee Levels



Higher fees when investing in illiquid assets

2. Mutual Fund Fees by Investment Focus and Clientele

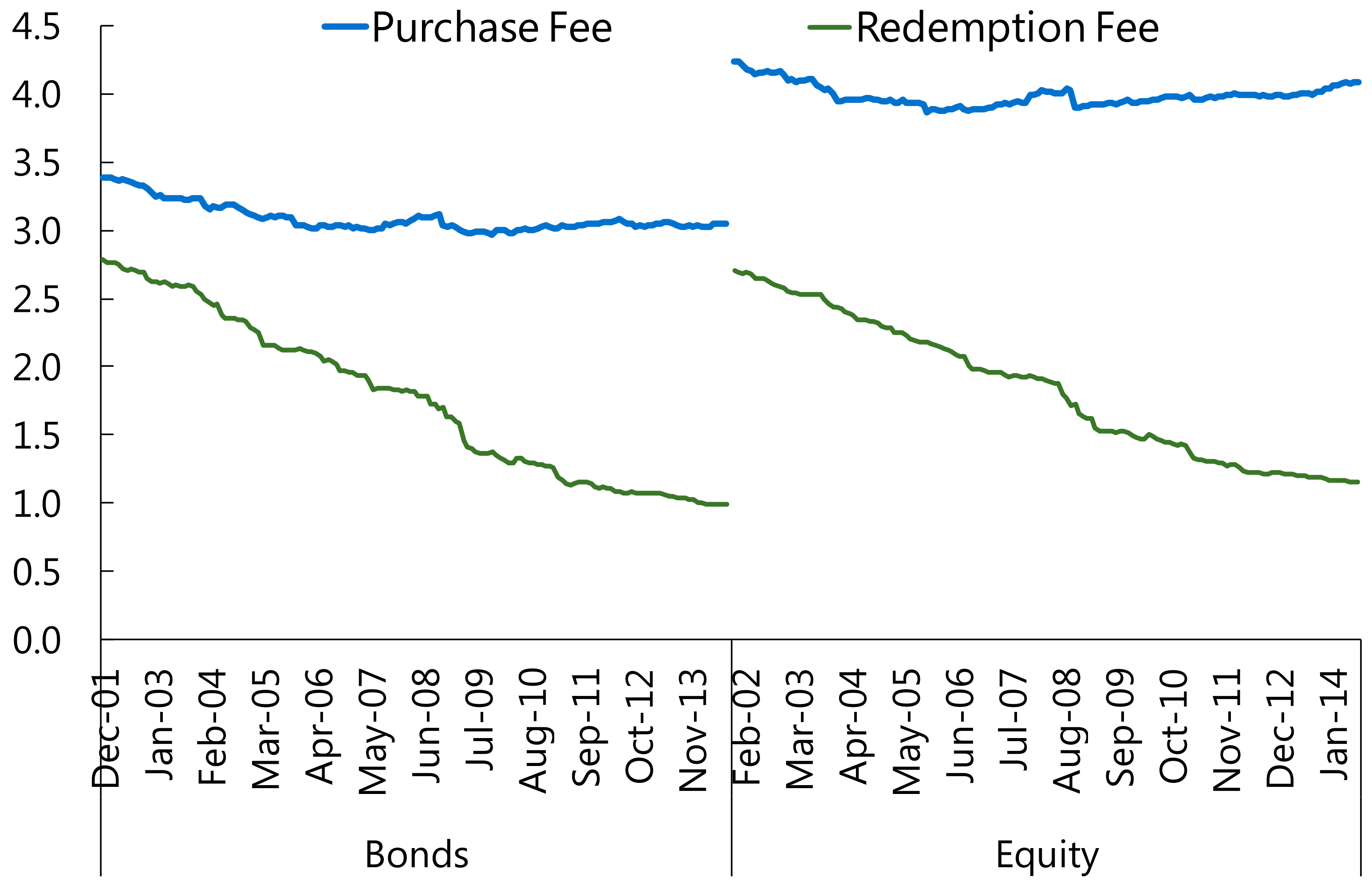
(Simple average, in percent)



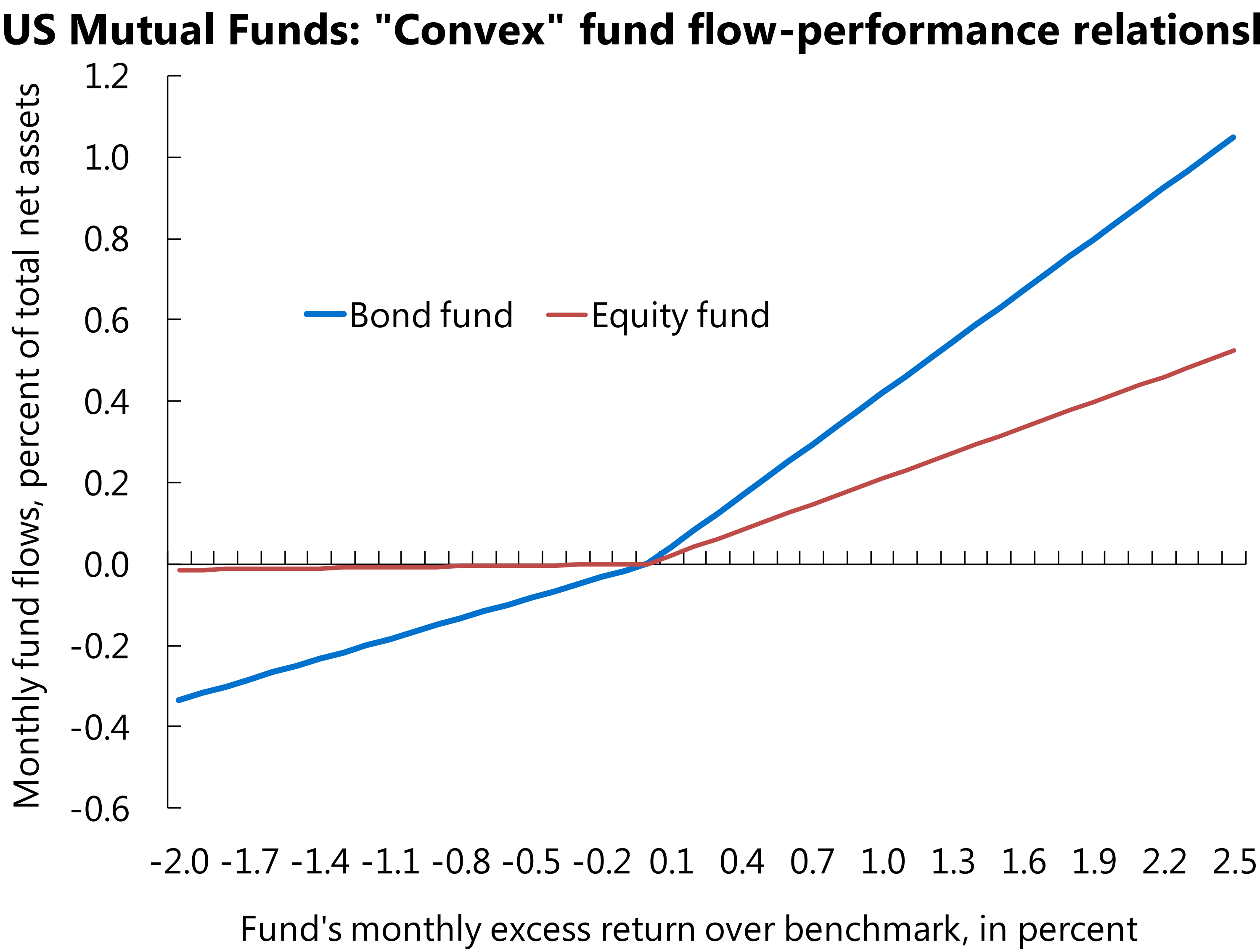
… but fees have been declining

4. Trend of Mutal Fund Fees

(Simple average, in percent)



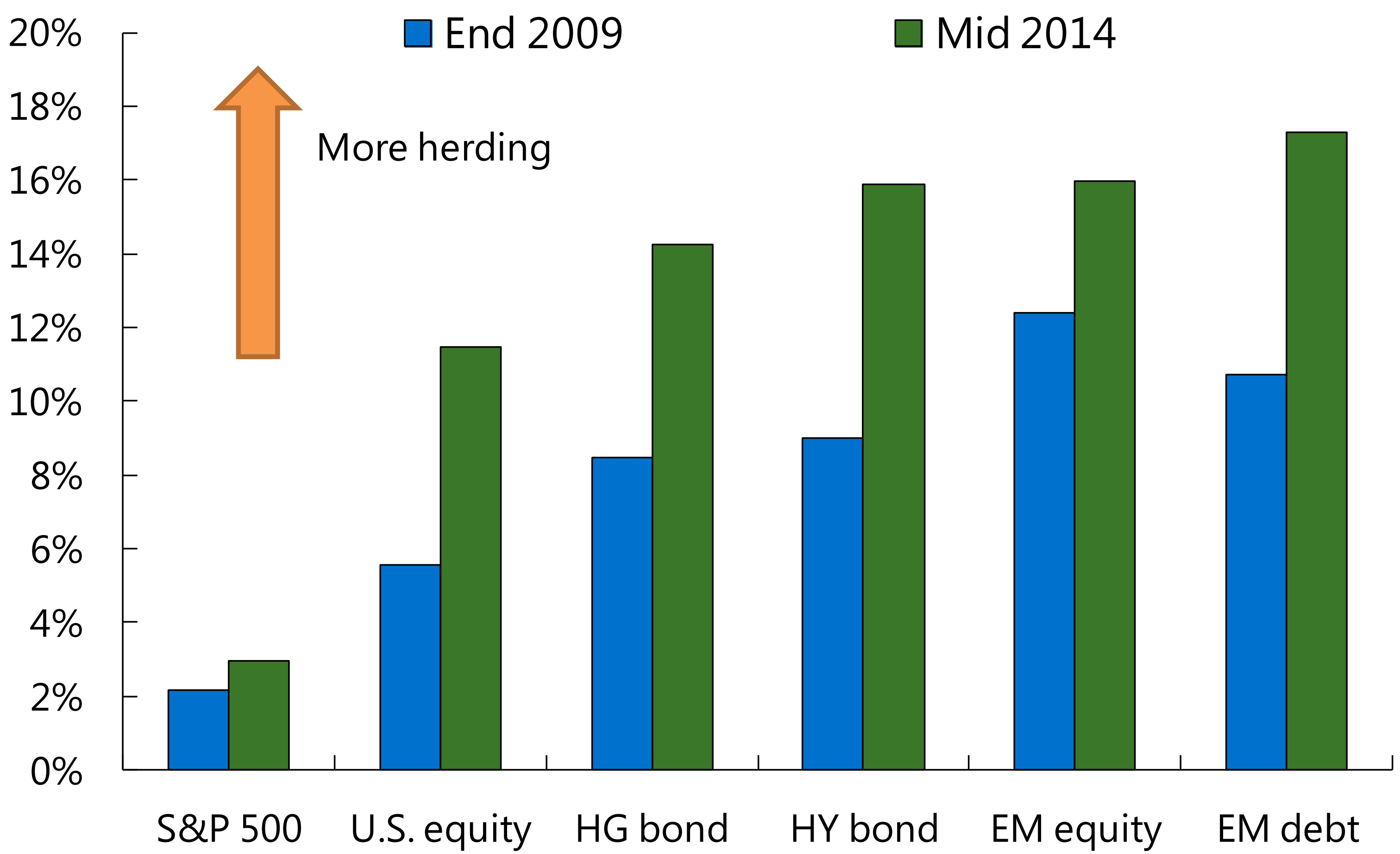
Does asset managers' behavior amplify risks? (1)
Incentives for excessive risk taking



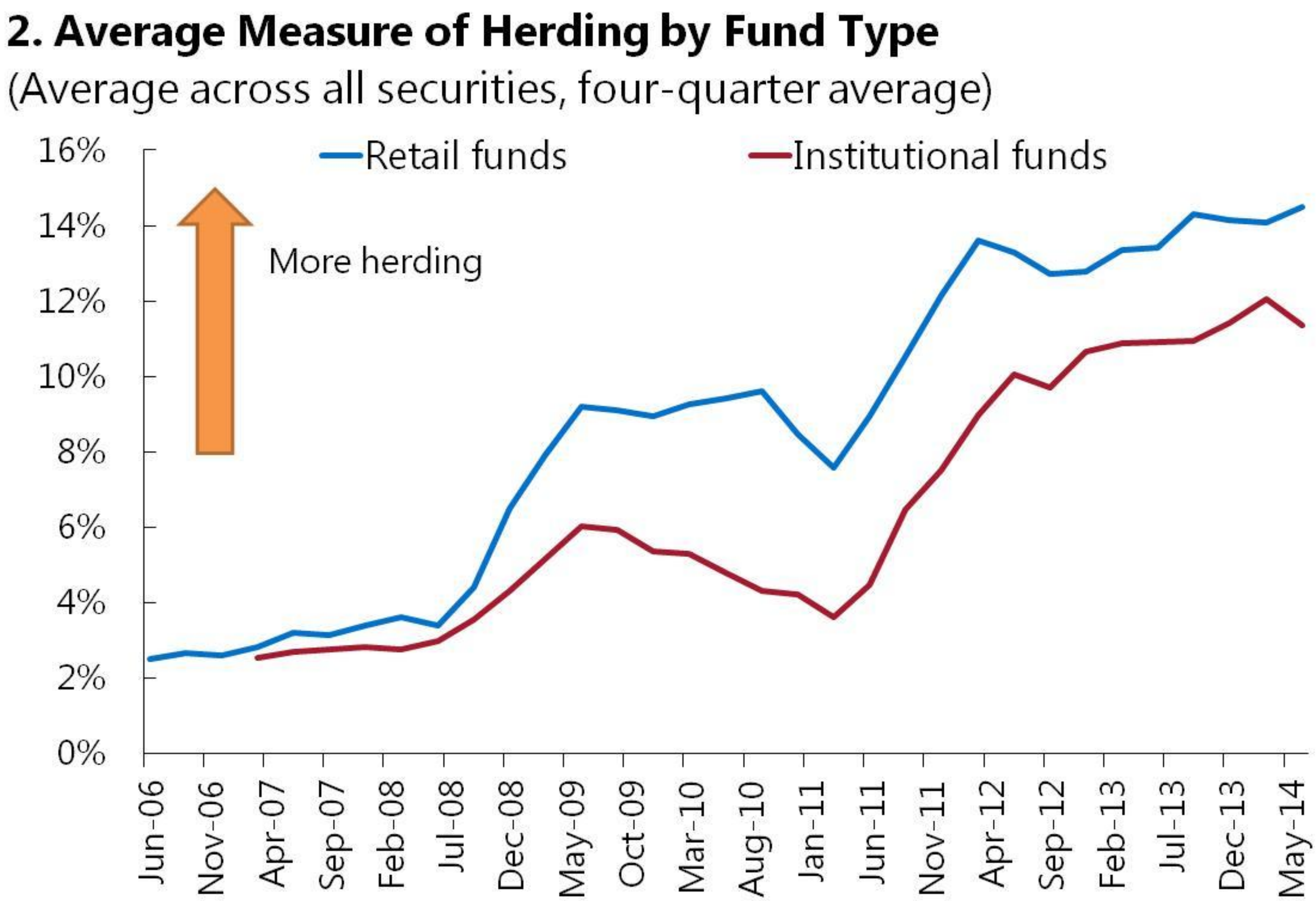
Does asset managers' behavior amplify risks? (2a) Herding

1. Average Measure of Herding by Security Type

(Mean across securities, four-quarter average)



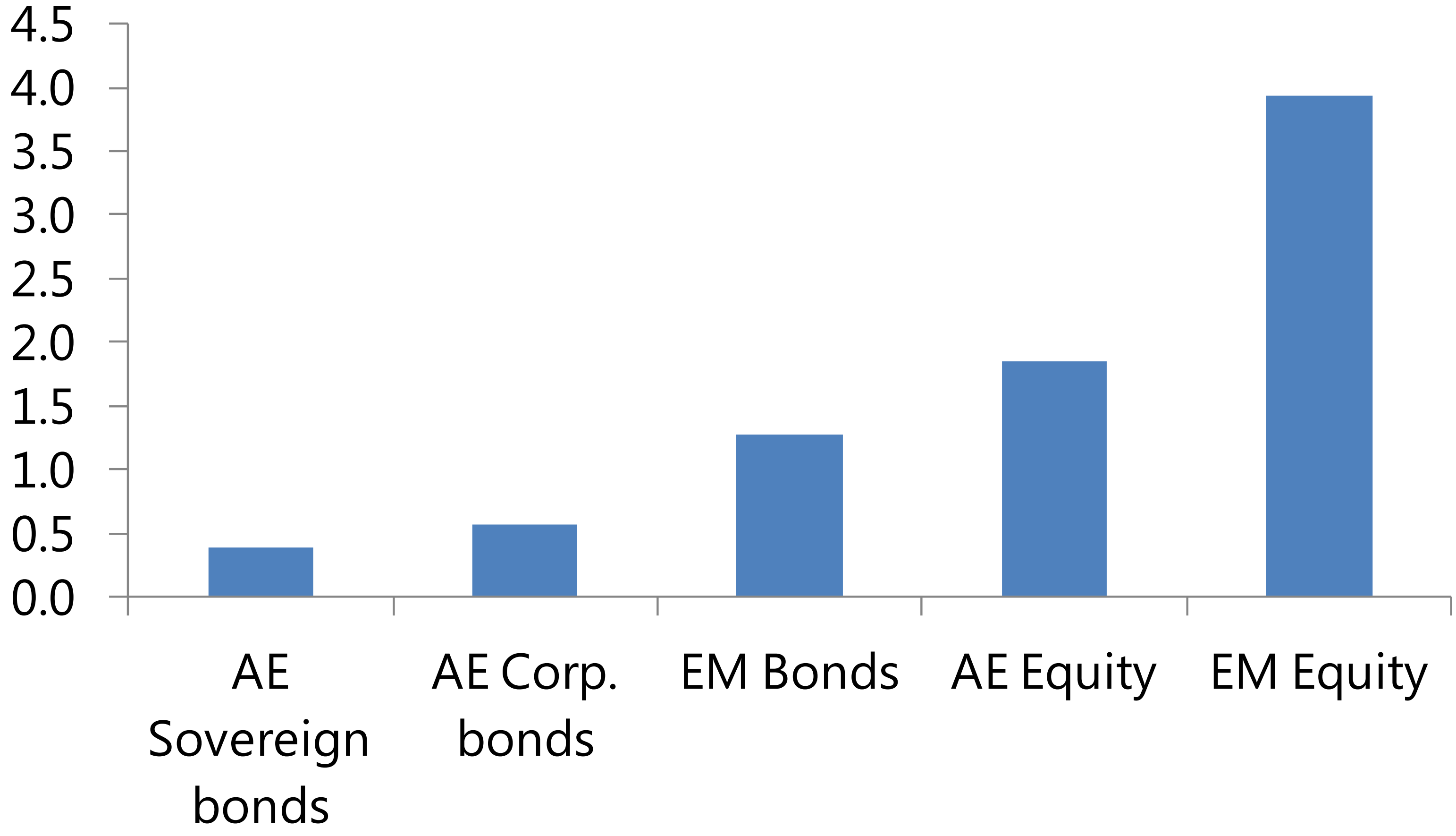
Retail funds herd more than institutional funds



Contribution to systemic risk (1)

Investment focus seems matter relatively more than size

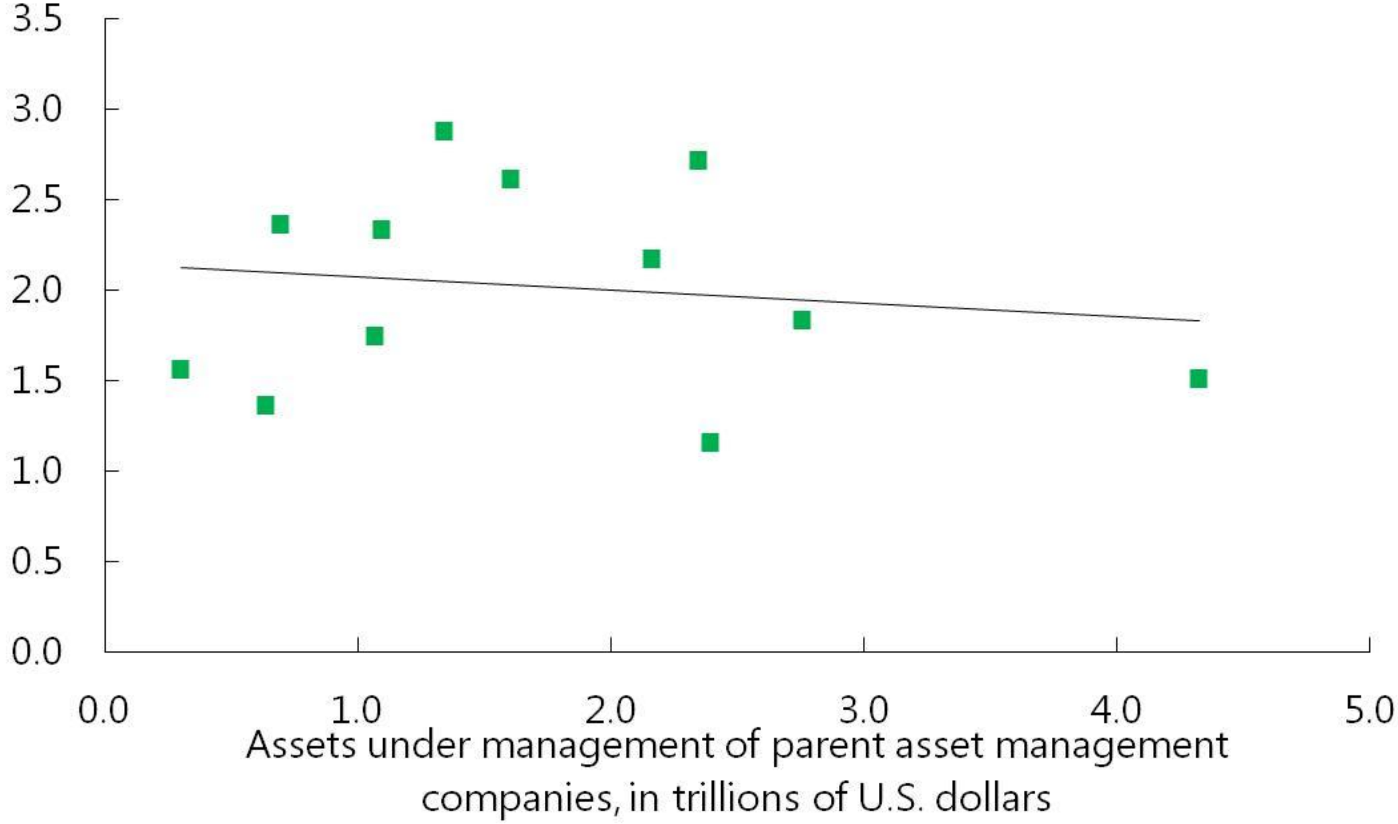
1. Average Contribution to Systemic Risk, by Investment Focus (in percent)



Contribution to systemic risk (2)
Contribution not related to AMC's size

2. Contribution to Systemic Risk of Top Fund Families, by Size of Asset Management Company

(Contribution to systemic risk averaged across funds in the same family, in percent)



Is current oversight framework sufficient to manage potential financial stability risks?--NO

- Focus on investor protection
- Regulation lacking specificity
  – Liquidity requirements
  – IOSCO principles—high-level principle-based requirements
- Hands-off supervision
  – No international guidance on supervision
  – Varying practices across jurisdictions

(One of the) Recommendations

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April 8, 2015 6:18 pm

IMF seeks stress tests for asset managers

Ferdinando Giugliano and David Oakley in London   Author alerts

The International Monetary Fund has called for a regulatory crackdown on asset managers, including the introduction of stress tests that would mirror those in place for the banking system.

The call, encompassed in one of the analytical chapters of the IMF's twice-yearly Global Financial Stability Report, will bring under closer scrutiny an industry that has expanded greatly in size and importance since the financial crisis.

Recommendations

- More “hands-on” microprudential supervision of risks
  – Regulators’ own risk analysis, stress testing
  – Better data (derivatives, securities lending)
- Incorporate macroprudential views (focus on systemic risk)

Recommendations

- Improve liquidity requirements
  - Better definition of “liquid assets”
- Reduce first mover advantage
  - (Minimum) redemption fees for funds investing in illiquid assets
  - Adjust technical aspects of fund share pricing rules

End of presentation
Thank you for your attention