Letter from the President

Tackling Systemic Risks: Are they extinguished — or do they lurk in the shadows?

Vol. 86

The reforms introduced to the global banking system in recent years through Basel III have been credited with sharply reducing systemic risk in the financial sector. The banking system is now better able to handle external shocks. But the question remains: Has overall systemic risk in the financial system been reduced, or has at least some systemic risk been transferred to non-bank non-insurer financial institutions via the unintended consequences of these regulatory reforms, shifting systemic risk to large asset managers—like squeezing the toothpaste tube at one end.

Tough Basel III rules at the heart of reform

Regulatory reform since the financial crisis eight years ago has been widespread and extensive, covering most financial activities in the capital markets and affecting the operations of most financial institutions. The Basel III reforms that have imposed capital, liquidity and leverage requirements on the banking system stand out as the centerpiece of reform, both in Canada which escaped the worst of the financial crisis, and many other jurisdictions in global markets. The Basel reforms are designed to strengthen and improve the resilience of the banking system from financial shocks. Many institutions, banks and managed funds proved susceptible to financial shocks in the housing and mortgage markets, spreading to over-the-counter (OTC) derivatives markets and then to other asset classes. This resulted in the failure and near-failure of many banking institutions, including the largest global investment banks. As banking institutions came under pressure, their response in terms of lending and asset sales amplified the financial shock across the financial sector of those countries, reverberating into the real economy and leading to recessionary conditions.

The Basel III reforms—higher capital and liquidity requirements, and reduced leverage—have reduced systemic risk, but they have also caused the banking system to retrench lending and financing activity, and pull-back on securities market-making operations. The recent deterioration in liquidity in corporate credit markets and the repo and securities lending markets (the inter-financial system financing mechanism) can in part be traced to reduced market-making at bank dealer operations as capital is aggressively rationed and allocated to more productive balance sheet activity such as underwriting. (This shrinking bond market liquidity is described in my mid-June 2015 President's Letter.)

Less liquid bond markets have made it more difficult for major buy-side institutional participants in debt markets to position portfolios, whether reducing exposure through adjustment in securities positions and hedging, or increasing exposure through securities positioning or leverage through repo trading, in response to anticipated changes in interest rates, economic and financial developments, or geo-political events. For example, the difficulty in finding counterparties to lift offers or hit bids for large transactions in securities has made portfolio adjustments at large institutions more challenging.

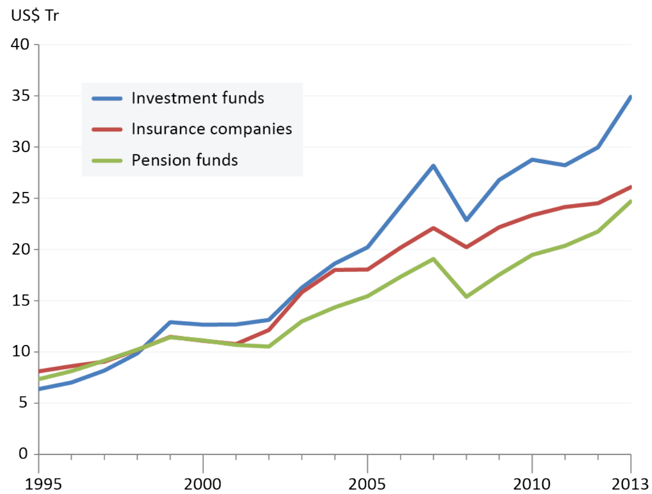
The focus on systemic risks for the large non-bank non-insurer asset managers reflects consolidation and the sheer size of the large asset managers in the United States and Europe—e.g. BlackRock, PIMCO, Fidelity and the Vanguard Group—as well as the deteriorating bond market liquidity and increased investor interest in high yielding corporate debt and related ETF products.

Large non-bank asset managers: The case that they are not systemically important

In March 2015, the Financial Stability Board and the International Organization of Securities Commissions (IOSCO), representing global securities regulators, issued a consultation paper to assess the methodologies to identify non-bank non-insurer globally systemically important institutions. The largest asset managers have made a vigorous defense of these financial institutions as not systemically important. The arguments have been varied, including their role as agents, their limited leverage, their limited integration in the financial sector and real economy as lenders, and conflicting evidence about the impact of asset size. In summary, these institutions do not represent a source of systemic risk, though their actions can have a significant impact on market stability.

Allianz SE argued that a distinction should be made between "systemic relevance" where an entity such as a large asset manager could be passively exposed to external shocks in the markets, and "systemic risk" where the entity is itself the source of a system-wide shock to the markets. In the former case the entity should be subject to general prudential regulation to insulate the institution from external shocks while in the latter case the institution should be subject to institution-specific "disruptor" regulations, such as additional capital and liquidity requirements, targeted on the institutions defined as systemically important.

Assets by Type of Institutional Investors



Source: OECD

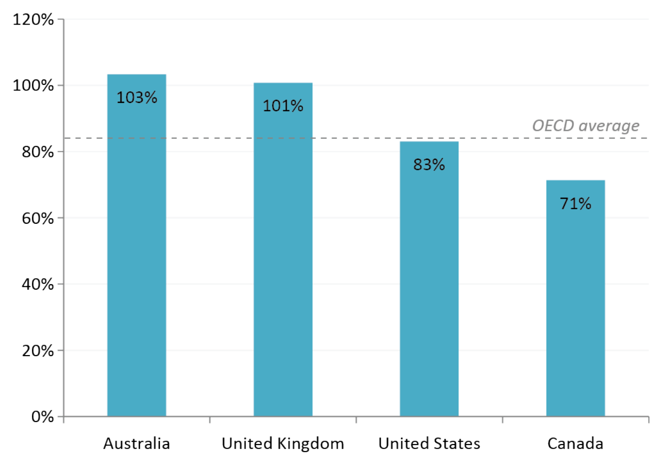
In this paradigm, distress or disorderly failure of an institution because of its size, complexity and systemic interconnectedness could initiate a shock across the financial sector, penetrating the real economy as a result of its market exposure through balance sheet size and leverage, and it's lending and financing operations across the financial sector and the economy. The impact of a significant financial or economic shock on the large asset managers, mutual funds, private investment funds and pension funds, could trigger widespread portfolio adjustments, exacerbating a collapse in asset prices. However, the resulting impact on the financial sector and economy would be less than at the banks, without the protections of Basel III, given the integration of the banking system in lending and financing patterns in the economy, and the significant balance sheet leverage of banks. That said, the large-scale portfolio adjustments that could be unleashed by these large asset managers, particularly if faced with the pressure of client withdrawals of funds, could exert a major impact on asset prices in a financial crisis.

New direction for the multinational regulators

The FSB and IOSCO issued a statement on June 17, 2015 that the largest asset managers are not systemically important in global markets, but could in a financial crisis exacerbate a collapse in asset prices through their independent actions in the marketplace. The direction of reform is not, therefore, to impose specific regulations on individual institutions to mitigate systemic risk, but to refocus on containing market liquidity risks, and recommend rules such as "gating" or restrictions on client withdrawals from mutual funds, limiting exposure to invested asset classes, and restricting leverage through direct borrowing and repo trades.

The Canadian government and securities regulators will likely follow the FSB and IOSCO approach to conclude that large non-bank non-insurer asset managers are not systemically important. The Office of the Superintendent of Financial Institutions (OSFI) and the provincial securities regulators regulate the largest mutual funds. These regulators will move in lockstep to introduce rules proposed by the multinational regulatory bodies unless already in place, modifying the existing rule framework to limit the cascading effect on asset prices in the event of a financial meltdown.

Pension Fund Assets
Assets to GDP Ratio in 2013



Source: OECD

The largest government pension funds are another matter, as these managed funds fall outside the ambit of OSFI and the provincial securities regulators. These large tax-exempt funds have a massive presence in the Canadian capital markets, in terms of asset holdings, trading activity and securities lending and repo trading. These pension funds present a similar threat to domestic capital markets as the large mutual fund managers or other large non-pension funds. These large pension funds in Canada, however, have made considerable strides to improve their risk management practices since the 2008 financial crisis, and the Boards of these pension funds will be monitoring closely the FSB and IOSCO recommendations to address liquidity risks and asset exposure, particularly in an environment of deteriorating debt market liquidity and weak market conditions. We have also seen some of the largest asset managers in global markets already take some independent steps to mitigate the liquidity problem, such as more execution in smaller-sized transactions and trading on electronic trading platforms, building lines of credit, setting up their own repo trading desks and moving to more "buy and hold" strategies.

A sigh of relief for Canadian institutions and regulators

The conclusion of the FSB and IOSCO that large non-bank asset managers are not "systemically important" to the capital markets will be welcome relief for these institutions, enabling them to avoid the onerous institution-specific regulations governing capital, liquidity and leverage. Moreover, this decision and its underlying rationale would enable the Canadian federal government to exempt the largest asset managers, including the largest pension funds, from the Capital Markets Stability Act—the legislation that grants the federal government authority to oversee and impose regulations to address systemic risk in national capital markets. This move would avoid a confrontational and divisive battle that could upset momentum for the Cooperative Capital Markets Regulatory System.

However, it is important that regulators impose appropriate rules across these financial institutions in the marketplace to ensure asset exposure or potential constraints on liquidity of the large asset managers will not jeopardize the viability of these institutions and destabilize domestic markets. Since the large Canadian pension funds are not subject to oversight by federal or provincial regulators, specific measures to mitigate portfolio exposure and liquidity problems would be left to the Boards and management of these pension funds.

Conclusion: Ensuring capital markets continue to hold up well

Capital markets have held up fairly well since the financial crisis in 2008, despite continual buffeting from sluggish and uncertain economic conditions, the Greek debt crisis, and vulnerable markets in China. There is, however, no certainty that global markets are immune from a major financial shock. The global banking system is far more resilient, better able to withstand a severe market downturn. In the years since the financial crash, the non-bank non-insurer asset managers have expanded their profile and involvement in global markets. It is valid to question the relevance of systemic risk in the non-bank non-insurer sector. Even if there is a consensus that systemic risk is now well contained across the financial sector, regulators, governments and designated "overseers" need to review the adequacy of existing rule framework for the largest asset managers to ensure prudent management of liquidity, portfolio exposure, and leverage.

Yours sincerely,

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July 2015