THE ASSET MANAGEMENT INDUSTRY AND FINANCIAL STABILITY

SUMMARY

Financial intermediation through asset management firms has many benefits. It helps investors diversify their assets more easily and can provide financing to the real economy as a "spare tire" even when banks are distressed. The industry also has various advantages over banks from a financial stability point of view.

Nonetheless, concerns about potential financial stability risks posed by the asset management industry have increased recently as a result of that sector's growth and of structural changes in financial systems. Bond funds have grown significantly, funds have been investing in less liquid assets, and the volume of investment products offered to the general public in advanced economies has expanded substantially. Risks from some segments of the industry—leveraged hedge funds and money market funds—are already widely recognized.

However, opinions are divided about the nature and magnitude of any associated risks from less leveraged, "plain-vanilla" investment products such as mutual funds and exchange-traded funds. This chapter examines systemic risks related to these products conceptually and empirically.

In principle, even these plain-vanilla funds can pose financial stability risks. The delegation of day-to-day portfolio management introduces incentive problems between end investors and portfolio managers, which can encourage destabilizing behavior and amplify shocks. Easy redemption options and the presence of a "first-mover" advantage can create risks of a run, and the resulting price dynamics can spread to other parts of the financial system through funding markets and balance sheet and collateral channels.

The empirical analysis finds evidence for many of these risk-creating mechanisms, although their importance varies across asset markets. Mutual fund investments appear to affect asset price dynamics, at least in less liquid markets. Various factors, such as certain fund share pricing rules, create a first-mover advantage, particularly for funds with high liquidity mismatches. Furthermore, incentive problems matter: herding among portfolio managers is prevalent and increasing.

The chapter does not aim to provide a final verdict on the overall systemic importance of the potential risks or to answer the question of whether some asset management companies should be designated as systemically important. However, the analysis shows that larger funds and funds managed by larger asset management companies do not necessarily contribute more to systemic risk: the investment *focus* appears to be relatively more important for their contribution to systemic risk.

Oversight of the industry should be strengthened, with better microprudential supervision of risks and through the adoption of a macroprudential orientation. Securities regulators should shift to a more hands-on supervisory model, supported by global standards on supervision and better data and risk indicators. The roles and adequacy of existing risk management tools, including liquidity requirements, fees, and fund share pricing rules, should be reexamined, taking into account the industry's role in systemic risk and the diversity of its products.

Prepared by Hiroko Oura (team leader), Nicolás Arregui, Jonathan Beauchamp, Rina Bhattacharya, Antoine Bouveret, Cristina Cuervo, Pragyan Deb, Jennifer Elliott, Hibiki Ichiue, Bradley Jones, Yoon Kim, Joe Maloney, Win Monroe, Martin Saldias, and Nico Valckx, with contributions by Viral Acharya (consultant), and data management assistance from Min-Jer Lee, under the overall guidance of Gaston Gelos and Dong He.