Post-crisis Regulation of Asset Management

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While asset managers' behavior has not been among the root causes of the financial crisis, their industry's size and structure have generated financial stability concerns among policymakers. Global regulatory bodies nowadays agree that asset management activities are "systemically important". On the other hand, the growth in retail activities has prompted regulatory and self-regulatory bodies to enact new rules relating to conduct of business, advice and best execution. Our essay briefly reviews global reforms affecting the asset management industry, focusing first on systemic interventions and then discussing investor protection reforms. To conclude, it addresses some emerging issues that we expect to be on policymakers' agenda in the future.

Asset management is the business of selecting and managing assets acquired using investors' funds. More precisely, to distinguish this activity from other financial services and from the activity of managers of industrial firms, we focus here on asset management services provided through the channeling of investors' funds into dedicated entities that are in turn set up and controlled by a distinct financial services firms specializing in such services (Morley, 2014). In short, asset managers are 'special' in that they tend to separate their investment holdings from their management structure in a way that is functional to investors' interests.

That leaves us with mutual fund managers, private equity firms, and hedge funds [1]. As with many other financial services, a good share of the companies that offer asset management services are affiliated with larger and/or more diversified financial institutions, such as banks and insurance companies. In fact, while BlackRock, Vanguard, and Fidelity are among the largest suppliers of asset management services (Willis Towers Watson, 2017), 16 among the 25 largest global asset management companies have a bank or an insurer as parent–the remaining 9 being independent (IMF, 2015).

Asset management services can be provided on a tailor-made basis (for larger investors) or via collective investment vehicles (for smaller investors). There is significant demand for such services. Asset managers manage a sizable 25% to 33% of institutional investors' and high net worth individuals' financial assets (PWC, 2014; McKinsey, 2012). Retail investors have less of a tradition of using the services of third party asset managers, but this is increasingly the case when it comes to saving for retirement (McKinsey, 2013).

These market developments have prompted regulatory concerns and reforms. On the one hand, the size and structure of the asset management industry have generated financial stability concerns. While views diverge on vulnerability at the firm level, global regulatory bodies nowadays agree that asset management activities are "systemically important". On the other hand, the growth in retail activities has prompted regulatory and self-regulatory bodies to enact new rules relating to conduct of business, advice and best execution.

We will address systemic interventions first (Section I) and discuss investor protection reforms thereafter (Section II). To conclude, we will address some emerging issues (Section III).

Systemic interventions

It is generally accepted that asset managers are less of a threat to financial stability than banks and other financial intermediaries. Unlike most financial intermediaries, asset managers do not own the assets they invest in nor do they promise that investors will get back their capital and a preset return thereon; they 'merely' have fiduciary duties to act in the best interest of their clients, who are the ones bearing the investment risks. Hence, it is unsurprising that the industry has generally proven to be resilient in the latest periods of stress (FSB, 2017).

(1) Pension funds sometimes set-up an entity to manages their assets, but in such case they are both providing the funding and keeping control over investments.

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Headquarters of AMF, the French financial market regulator, in Paris.

"The French AMF released a guide providing best practice examples of stress tests of market, liquidity and counterparty risk."

In past years, however, increases in the size and role of some types of asset managers, in particular leveraged hedge funds, has raised systemic concerns. Further, there is growing recognition that even less leveraged, or unleveraged, intermediaries – such as mutual funds – could be a source of systemic risk. On the one hand, skewed incentives may prompt fund managers to follow the herd and exacerbate panics in the presence of a financial shock (Office of Financial Research, 2013). The reason is that no one is punished when one behaves exactly as her peers, while going it alone is much likelier to be singled out as negligent if one's choices are proven wrong. On the other hand, first-mover advantages may result in investor runs, especially when a fund's assets are illiquid (see Feroli *et al.,* 2014; Goldstein *et al.,* 2017). Given that asset managers and their funds generally do not have (direct) access to central bank liquidity, they are vulnerable to this type of redemptions which, in turn, may lead to fire sales of assets owned across the financial system (see Doyle *et al.*, 2016).

Finally, funds that make use of derivatives to replicate exposure to a given market, and/or whose assets are used for securities lending purposes are an additional source of systemic risk. This is, in particular, the case when asset managers are ill-placed to address stressed conditions due to operational deficiencies (FSB, 2017). The contribution to systemic risk is potentially even more significant when asset managers are owned by banks or insurance companies: reputation concerns may prompt the latter to provide emergency liquidity in times of financial stress. However, one has to take into account that bank or insurance ownership may also decrease systemic risk: bank affiliation should provide asset managers with (indirect) access to central bank emergency liquidity facilities.

In view of these developments, the European Central Bank indicated that it considered investment managers as a source of systemic risk (ECB 05/2016 and 11/2017, mentioning herding and parent bank step-in risks). The IMF and the World Bank, for their part, pointed out consistent findings of weaknesses in asset management supervision (IMF, 2015).

This prompted global regulatory bodies into action. The FSB, which previously favored focusing on aggregate risk, announced that open-ended funds were a source of systemic risk and issued liquidity management recommendations (2017). Similarly, investor protection considerations prompted IOSCO to issue its own liquidity risk management recommendations (2018).

Prominent national regulators jumped on the bandwagon as early as March 2017. European authorities were first to act, probably because the European asset management regulatory framework is more developed than in the US – hedge funds and private equity vehicles having been subjected to transparency and financial stability require-

ments by the 2011 Alternative Investment Fund Managers Directive (AIFM) [2].

Hence, the French AMF released a guide providing best practice examples of stress tests of market, liquidity and counterparty risk whereas Germany's BAFIN amended its risk management requirements. However, the US SEC was not far behind, releasing rules on liquidity risk management to reduce the risk of funds being unable to meet redemption requests.

The practical impact of these initiatives remains to be established. While larger asset managers have further developed their risk management frameworks, the level of readiness across the industry as a whole is deemed to be rather low – especially when it comes to liquidity risk, leverage via derivatives and stress testing.

In short, only two things are certain. First, only time will tell whether systemic regulation has had an impact and, if so, whether positive or negative. Second, regulation alone does not guarantee financial stability (Allen and Gu, 2018).

Investor protection reforms

Post-crisis asset management reforms have essentially aimed at improving retail investor protection. Financial regulators were in the driving seat, with competition and 'social' authorities also providing input – possibly contributing to the adoption of measures that are more market than consumer oriented. The thrust of the reforms has been to subject asset managers to more stringent transparency requirements, with performance and liability considerations taking a back seat.

Here again, Europe took the lead. The 2009 Directive on collective investment in transferable securities (UCITS) [3] aims at providing retail investor with better information. In particular, asset managers are required to make it easier for consumers to understand marketed instrument via the provision of a standardized product summary known as the key investor information document (KIID) [4]. More generally, the 2011 AIFM subjects all other asset managers to transparency rules covering issues such as investment strategies, pricing methodology and fees, redemption rights and historical performance.

The SEC, for its part, has focused on the disclosure of fees and expenses by alternative asset managers. It has indicated that they are often very general or even misleading and recently undertook examination actions (KPMG, 2017).

While investors generally benefit from these recent developments, disclosure still falls short of what can be expected. For example, providing information on historical performance, as prescribed by KIID rules, is bound to contribute to investors focusing on past returns, which are well-known not to be an indicator of future performance. More importantly, whether asset managers adequately communicate their objectives and results remains an open issue.

These transparency issues also have managerial compensation effects. To begin with, because remuneration of asset managers often depends upon how their performance compares with that of their peers, fuzzy disclosure facilitates rent appropriation. For example, the SEC has expressed concerns regarding the valuation of alternative products, precisely because portfolio managers' remuneration is a function of the appraisal. In addition, while investors have a preference for the maximization of risk-adjusted fund returns, asset managers have incentives to maximize investment inflow (Chevalier and Ellison, 1997).

Finally, the Madoff scandal and the Lehman default resulted in poorly performing funds being subject to increased regulatory attention. While some funds persistently perform poorly, the worse performers tend to be closed or merged into better performing funds (FCA, 2017). More generally UCITS was recently amended to clarify the responsibilities and liability standards of asset depositories responsibility.

Emerging issues

One cannot fail to notice that three rather fundamental issues seem to be off the regulatory screen, at least for the time being.

To begin with, while conflicts of interests are pervasive when it comes mutual fund families, constraining fund manager discretion does not seem to be an enforcement priority. For example, funds investing only in other funds from the same family may set up internal insurance pools without mentioning this in their prospectus (Bhattacharya *et al.*, 2013). Or, to take another example, the fact that managers strategically transfer performance across family member funds to favor those more likely to increase overall family profits (Gaspar *et al.*, 2016) could be dealt with more energetically.

Second, while operational risk has long been recognized as a crucial hazard (Biais *et al.*, 2005), asset managers are subject to no (in the US) or very minimal (in the EU) capital requirements. Obviously, capital requirements are not the only way to deal with this risk (Franks *et al.*, 2003) and arguably quite a blunt tool to deal with operational risk. Nevertheless, one would have expected more action in this area in a post-financial crisis environment.

Finally, the signature of the 2015 Treaty on Climate Change has generated significant discussion on how asset investment managers can or should be required to adopt strategies that facilitate reaching the Treaty's goals. Up to now, however, France is the only jurisdiction that has taken some measures to that end, in particular by requiring asset managers to disclose how they take climate change into account or why they do not.

(2) OJ L 174, 01.07.2011, 1-72.
(3) OJ L 302, 17.11.2009, 32-96.
(4) See also the 2014 Regulation on key information documents for packaged retail products, OJL 352,09.12.2014, 1-23.

To be sure, this is not to say that fund families, operational risk and climate change should dominate the regulatory agenda. But they certainly are as important as (if not more important than) the issues that have been regulated in the wake of the financial crisis.

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