“***Systemic Risk and the Investment Industry***”

Speech by Robert Jenkins, FSIP

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The Age of Asset Management

Is the investment profession a source of systemic risk? Do the investment flows that we intermediate contribute to financial fragility? Might asset management firms, like banks, be “too big to fail”? Are we part of the problem or part of the solution? What has been the regulatory response? What should it be?

These are the concerns being raised by the regulators. The US Office of Financial Research (OFR) has penned a report identifying the great ocean of capital flows as a source of systemic risk.[1] The Financial Stability Board (FSB) - that Basel-based body which guides the global approach to financial regulation, has conducted consultations with similar questions in mind.[2] And in a major address entitled “The Age of Asset Management?” a Bank of England senior highlighted investment flows as the “next frontier for macro-prudential policy.”[3] All three of the above - and indeed many others, query the degree to which the investment firms in which we work might constitute *systemically important financial institutions*. Yes, the regulatory tide has turned towards us. How did this happen? How should the industry respond?

Lessons in systemic risk

Let us take a step back. Our global financial system is big, complex and accident prone. That it is big is beyond doubt. You all know the numbers. China’s reserves exceed $3.6 trillion; the Fed’s balance sheet – 4 trillion; daily FX turnover – 5 trillion; US Federal debt outstanding - $18 trillion; globally managed assets - $80 trillion; and the financial crisis notwithstanding the notional value of global derivatives now exceed $650 trillion. These are really big numbers.

Now the interesting thing about really big numbers is that even a small percentage of a really big number is still a big number. Thus a 10% change in China’s FX holdings generates $360 billion of sales - and another 360 billion of purchases. A 5 % rise in US interest rates will add (over time) 900 billion to the US budget deficit – annually. A 3% shift in global asset preferences triggers over $4 trillion in securities transactions. And a mere 1 percent of derivative contracts gone wrong could cause some $7 trillion in losses. Yes, the numbers are big.

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[1] “Asset Management and Financial Stability,” The Office of Financial Research, 30 September, 2013

[2] “Assessment methodologies for identifying non-bank non-insurer global systemically important financial institutions,” 8 January 2014

[3] “The Age of Asset Management?” speech by Andrew Haldane, Executive Director, Financial Stability, Bank of England, 4 April, 2014, http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf

But the numbers are not only big in *absolute* terms they are big *relative* to the size of the economies they are meant to support. Indeed, the business of finance has soared as a percentage of total economic activity. In 1980 the financial sector in the OECD represented less than 10 pct of Gross Domestic Product. By 2007 it had reached over 30%. During this time transaction volumes exploded. The total within the US economy alone – that is, the total turnover of equity trading, government and corporate debt, FX and exchange traded derivatives was 2.6 times GDP in 1970, 6.4 times by 1980 and some 52 times by the year 2000.[4] Today, the value of currency traded in FX markets is 100 times that of world trade in goods and services. [John Kay, *Other People's Money*]

Beyond this general "*financialization*" of western economies there exists an unprecedented degree of complexity and interconnectivity. Thus subprime problems in Pittsburg popped up as write-downs in Dusseldorf. The mere prospect of "Grexit" once threatened Europe and beyond. More recently, taper tantrums at the Fed triggered tremors in Turkey – and elsewhere.

Finally, we must add leverage to the mix. At the center of our financial universe is the banking system – creator of credit; counterparty to trading; generator, manager and transmitter of both risk and liquidity. When the banking system freezes, our financial system fractures. The banking system freezes when losses threaten to overwhelm banks' loss-taking ability. And their loss-taking ability is determined by the degree to which their risk-taking is funded with equity versus debt. In other words, financial stability hinges on the amount of capital in bank balance sheets. Going into the recent crisis most of the world's largest, complex and interconnected banks were excessively leveraged. Loss-absorbing capital was wafer thin. Not surprisingly, market confidence evaporated quickly.

What *is* surprising is that policy makers have failed to embrace the lessons of the debacle. Leverage remains excessive. Yes, new global standards have been agreed in Basel. They tighten definitions of banking risk and place an overall cap on leverage. Bankers say the rules are too tough. Well, you be the judge. Basel boasts two ways of limiting leverage. The first is to assign different minimum capital requirements to different categories of risk assets. The second is to cap overall banking assets at some multiple of loss absorbing equity. *Risk Weighted Assets* is the technical term for the one; *leverage ratio* for the other.

So let us take an example of the first. Remember "CDOs squared" – that mini masterpiece of financial innovation that helped spread panic throughout the market place and finally ended in tears? How much loss absorbing capital do you think that the "tough" new rules require for a bank to carry an investment in a debt obligation, backed by a debt obligation, backed by a pool of loans made to US sub-prime residential home owners? Oh, and assume that these easy-to-understand securities are deemed AAA by the world's leading credit rating agencies. What do you think? 20% of face value? 10%? 5%? Well for your info the *new* Basel rules demand 135 pence of equity funding for every 100 pounds of the stuff. That is a loss absorbing capital ratio of less than 1.4% - and this for a risk that most bankers, rating agencies, regulators and investors completely misjudged. Such is the sophistication and reliability of the new, improved system for Risk Weighted Assets.

[4] "Too much finance," IMF Working Paper, Jean-Louis Arcand, Enrico Berkes, and Ugo Panizza, June 2013

Fortunately, Basel III introduces a backstop. A bank's total leverage will be capped. And what does that look like? Well, as currently set the rules permit the balance sheets of banks to balloon to 33 times their equity. At 33 times leverage a bank's asset values need fall only 3 per cent to wipe out 100 percent of capital. A tiny 1 percent drop leaves the institutions geared 50 times; a 2 percent fall, 100 times. How confidence-inspiring is that? It is true that next time around bank bond holders are supposed to take a hit. But at the next sign of stress how long do you suppose bank creditors will wait around to find out? How long will *you* wait? Now consider that some banks' balance sheets are equal in size to their home nation's GDP and you will grasp the challenge of "too big to fail." Add in the fact that the aggregate of bank risk assets can exceed 4 times their country's economic output, and you will also understand the term "too big to bail."

Lessons in lobbying

How can this be? Look to bank lobbying to explain it. It has certainly been a marvel to watch – and carries lessons for the investment industry.

Think back to 2009. Remember the banks' first response to the crisis? It was to deny the very need for reform. How dumb was that? They quickly regrouped.

The next phase was to acknowledge that reforms were in fact necessary - but only if such rules could be agreed on a global basis. Level playing field was the rallying cry. "We will if they will." This approach was less dumb – even clever. The lobby reasoned rightly that global standards would be difficult to achieve and if achieved, would be set to the lowest common denominator of international consensus. Indeed, new standards were agreed but watered down considerably from initial proposals.

Next they pushed back the deadline for implementation of even these modest reforms – to 2019, a date so distant as to be irrelevant to any banker's career and so extended as to be vulnerable to lots more lobbying. Incidentally, when the Glass-Steagall act (actually the Banking Act) was passed in 1933, authorities gave the banks 12 months to divest their securities businesses. They met the deadline.

Throughout bank lobbyists have worked to persuade politicians, pundits and public that society has to choose between safer banks and economic growth; between safer banks and shareholder returns; and between a safer financial system and one that is competitive. Let's examine these assertions.

Start with the first – that society must choose between safer banks and economic growth. You have all heard the arguments. "Raise our capital requirements and we will have to cut back on lending. This will retard the recovery and damage economic growth." Really? Take a moment to do the math. Assume that a bank has a trillion pound balance sheet funded by 50 billion of equity and 950 billion of debt. Now double the equity to 100 and retire 50 of debt. Has the balance sheet shrunk? No. Has the bank had to cut credit? No. Does more capital necessarily lead to less lending? No. Has society had to choose between safety and growth? No. This is what I call "myth number one."

“Ah but how dumb can you be!” comes the banker’s retort. “Equity is expensive. Double our equity and you will lower our Return on Equity (RoE), damage shareholder value and discourage the supply of bank capital.” This is myth number two. Let me take it in two parts.

First, RoE may well be an appropriate measure of *long term* bank profitability but as a short term target it is flawed and dangerous. Just ask yourself: did the big banks’ focus on double digit RoE achieve it over time? No. Did the annual emphasis on RoE produce attractive and sustainable shareholder returns? No. So does a short term focus on RoE equate to shareholder value? No. Why? Because it does not adjust for risk. The returns (and EPS-linked bonuses) may come short term but the risks come later. “Later” came in 2008 - and the related fines keep on coming.

Second, the most successful investors are not interested in short term RoE; they are interested in achieving attractive risk-adjusted returns. The higher the perceived risk the higher the return required. The lower the perceived risk the lower the return expected. Capital will flow in either combination but its price will be different. Banks with little equity but lots of leverage and complexity are more risky than those with less leverage and more equity. Investors in equity and debt will charge accordingly. That “charge” is the bank’s cost of capital. And given that markets tend to reward more predictable earnings with higher multiples, even lower nominal earnings need not lower market cap, dividends or shareholder returns.

So safer banks can be competitive. It follows that a competitive financial sector can boast banks that are adequately safe.

In short, higher capital requirements are compatible with economic growth, shareholder value and financial competitiveness. (They are just not compatible with non-risk adjusted banker pay.)

During the darkest days of the financial crisis, these myths held sway. Politicians were simply unwilling to take the risk that our titans of finance might be wrong - twice in a row. And in the US at least, such legislative caution was rewarded with bank funded campaign contributions.

Now back from the brink, regulators are revisiting the issue of capital adequacy. You won’t hear them admit it but they recognize that Basel III is a busted flush. How else to explain the increased reliance on balance sheet “stress testing” plus attempts to take loss absorbing requirements beyond the Basel minimums? But the fact is that leverage is excessive and looks likely to remain so. Britain’s authorities are battling to lower gearing to – wait for it, 20 to 25 times. US regulators are pushing America’s banking behemoths towards something equivalent. Comforted? Don’t be. By comparison you may wish to know that the average hedge fund operates at less than 3 times leverage. So ladies and gentlemen, the even tougher new rules target a banking system levered 7 to 10 times more than the hedge fund sector.

What regulators and policy makers do admit is that despite all the hub-bub they have yet to address the issue of “too big to fail.” Barring an unlikely break-up of the banks, many remain “too to bail.” And we all know that they are “too big to jail.” Despite revelations of scandal after scandal no bank has lost its overall license to operate and not a single senior banking executive has faced prison for wrong-doings on his watch. They have kept the bonuses. Many have retired on handsome pensions. Some have gone on to start new financial ventures. Few if any have been barred from the financial sector.

Government's response? In the UK for example a *Banking Standards Board* will work to change banking culture – though one senior there warned that it may take a decade to do so. And then there are the new rules on senior persons' accountability.

True to form, the banking lobby is advancing another myth to muddy the waters. "Holding seniors to account for the actions of subordinates will deter talent from the leadership ranks and undermine the competitiveness of the sector." Society, they seem to be saying must also choose between a banking system that is law abiding and ethical and one that is competitive. The British Government promptly rejected that view - and then ousted its most ardent campaigner against financial misconduct.[5]

Oh, and worthy of mention is the latest bank lobby canard to wit: "higher capital requirements are damaging market liquidity." The argument conveniently ignores the fact that in 2008 capital requirements were all but non-existent and did little to prevent liquidity from drying up in 2009. Indeed, most practitioners would acknowledge that fear of banking failure was the principle cause of illiquid markets. And by the way, since when do market makers have a God-given right to risk free market making? Liquidity has a price. Illiquidity has a premium. It was ever thus.

Systemic risk and the investment professional

Now what does all this have to do with the investment management industry? Well, four things. First, we have a big stake in sound banking reform - for the ultimate object of *banking* reform is to restore and enhance financial stability. And I can think of no segment of the financial sector that has a greater stake in stability than the investment management industry. Alas, no one has been less vocal on the subject. Just ask yourself: What was our industry's public position on too big to fail? What is our stance on too big to bail? What have we said about too big to jail? Is it possible that some institutions are just too big to manage? These are key questions of our time. For six years the reform debate has raged. For six years, with very few exceptions, we have kept our heads down and kept our mouths shut. In their struggle with the banking lobby, politicians and regulators needed help. We might have made a difference. We would have made some friends.

Second, although we don't always pocket the same pay we are tarred with the same brush. Even at the very best of times, the niceties of "buy side" versus "sell side" are lost on the layman. But our continued reluctance to comment on the recklessness and fecklessness of investment banking has meant that neither public nor politician adequately distinguish between investment *banking* and investment *management*. We missed a golden opportunity not only to secure a seat at the reform table but to

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[5] In a major address, Chancellor George Osborne asserted that: "There is no trade-off between high standards of conduct and competitiveness." *Mansion House, London 10 June, 2015*. Shortly thereafter, it became public that Martin Wheatley, Chief Executive Officer of the UK's Financial Conduct Authority would not be reappointed to his position.

better differentiate ourselves in the process. To the man in the street, we are all investment bankers now.

Third, as you can see, we are next on the list. Why? Well, excessive leverage in the banking system leaves it vulnerable to collapse. Authorities understand this. Western governments cannot afford a re-run. Treasuries know this. The public would not tolerate a repeat performance. Politicians fear this. So, the failure to resolve the issue of "too big to fail" risks spawning a regulatory campaign to spot and control any and all threats that might lead to bank failures. And so regulators look for threats. And when one starts looking one soon discovers that the world of capital flows is big, complex and could well overwhelm the meager capital buffers of our creators of credit. "Gosh, we had better try and control the investment flows as well." BlackRock is big! Therefore it must be systemically important. If it is systemically important it should be subject to regulation." Well, regulators already do control the investment *firms*. But neither we nor they can control the investment *flows*. They might as well try to hold back the tides or abolish greed and fear.[6]

Fourth, financial repression is fed by the failure of financial reform. It is distorting capital flows and making it ever more difficult for the industry to meet client expectations. Rates remain low because our financial system remains fragile. These policies translate to ever greater challenges for the savers we seek to serve, the pension funds we manage and the insurance payouts we promise. Some may enjoy the ride. Many more are being forced to take more risk for less return. Veterans worry how it will all end.

What's to be done?

So what is to be done? Well we need to stand up and we need to speak out. We have begun to do so. The CFA Institute has launched a "Future of Finance" initiative and is mobilising its membership to take a more active part in key financial issues of our day. And a small handful of industry CEOs have begun to express a view. But as an *industry* we are off to a bad start. Yes, we work behind the scenes. But the first time the public saw us get involved in financial reform was when we fought the extension of European bank bonus rules to our own investment industry. Although it was the right thing to do it was an unseemly debut.

Our industry's next foray into the fray was to pick a fight with the US authorities over the issue of Constant Net Asset Value money market funds. Reasonable regulators argued that if investors were led to believe that a fund would never break the buck, then the vendor had better have the wherewithal to pony up when it did. Alternatively they said; "Call it a floating NAV product. They do in Europe; why not in the US?" US firms fought it and "won." Bad move.

More recently those in the firing line are leading a campaign to persuade regulators that neither they nor the investment industry should be designated systemically important institutions. They are correct

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[6] *Regulators' attempts to hold back the financial tide are futile*, Robert Jenkins, **Financial Times**, 17 April, 2014.

in their argument but a bit late to the party. The message this sends is that the largest, most important members of the global investment fraternity had little interest in the global system and its regulation until the spotlight threatened their own short term self interest.

Indeed, our industry's policy response has been self-centered, reactive and unconvincing to wit:

- We did not cause the problem so why should we be concerned?
- Banking reform is important but what does it have to do with us?
- A regulatory review is warranted but be careful you do not impair our ability to attract talent and compete.
- If you regulate us more severely, then savers we serve will suffer.

It is not too late to make a difference

Fortunately, it is not too late to make a difference. Our opportunity lies in doing now what our industry failed to do for the last six years. We need to show we are part of the solution and not part of the problem. We need to demonstrate that we are different. We do not deploy excess leverage. We do not act as principals. We are not subsidized by the taxpayer. We are not too big to fail, bail or jail. When our clients supply funding or credit, it is most often 100 pct equity-backed.

And in order to drive home the distinction we must be prepared to point fingers at the excessive leverage that regulators continue to permit in the *banking* system. We can both make our case *and* a major contribution by highlighting the job left undone. But we have to speak up. The OFR has raised the issue. The Bank of England has tabled the question. The FSB has passed us the podium. We need to grab it and offer a series of sound and hard hitting lessons in leverage. Money management firms – both large and small alike must send the same message. For unless authorities are to deny investors access to their money, those huge flows that we intermediate will most assuredly move in unexpected and at times exaggerated ways. In the case of money managers the clients will take the losses that result. But the authorities must ensure that the equity requirements protecting the banking system are sufficient so that the banks can take theirs – without taking down the system and without recourse to the taxpayer.

Still other issues await our input. Accountability for financial wrong-doing; fiduciary duty; the moral and market implications of High Frequency Trading are three issues that spring to mind. There are many more. True, our trade bodies respond on our behalf to regulatory invitations to comment. But this discreet approach won't get it done. The public, the body politic and our clients need to know where we stand. Until we call for jail terms for wrong doers; unless we start putting customers first and until we call time on the electronic front running of HFT, little will appear to have changed. Bankers took the lead in taking morals out of finance and policy makers have failed to put moral hazard back in. The investment industry can and must try to reverse the trend. It may not succeed. But it will earn plaudits if it tries - and condemnation if it doesn't.

Our industry is far from perfect but it *is* crucial to finance. We convert streams of savings into the rivers of capital that fuel economic growth. We offer investors the opportunity to diversify their assets into areas and at a cost that few could achieve on their own. Are we important to the financial system? Yes. Are we a threat in any major way? No. But we must make the case and we must help regulators understand where the real threats lie. To date we have done neither. As agents for our clients we must not only demonstrate a duty of care for the funds in our charge but also that we care about the financial system within which we operate and on which our clients ultimately depend. Globally managed assets are on track to reach $100 trillion. How can we possibly remain silent?

Reinventing the Investment Industry

Ladies and gentlemen, the theme of this conference is "Reinventing the Investment Industry." No doubt other speakers will explain that this will require demonstrating a compelling value proposition. It will involve better understanding client needs and delivering solutions and outcomes rather than products. But it must also entail recognition of the importance of capital markets to society and financial stability to capital markets. Today we expect manufacturers and mining to actively guard the environment within which they operate. For the investment industry the *environment* is the global financial system. And that means taking an active part in the financial reform – not just to parry short term regulatory attacks but to contribute to a healthier system in which we can achieve better our clients' objectives as well as our own. Please, please do so.

Thank you.

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