FINANCIAL TIMES

Asset managers' push into bonds prompts regulatory scrutiny

David Oakley in London and Barney Jopson in Washington

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One word goes a long way to explaining why regulators are now focusing on big asset managers as they try to make the financial system safer: bonds.

Since the financial crisis, the amount of bonds asset managers have on their books has grown dramatically, filling a void created by big dealer banks that have cut their exposure to fixed income.

This shift has triggered worries among regulators about what will happen if a rise in US interest rates sparks a rush for the exit in bond markets — and that prospect has fuelled debate on tougher regulation.

The Financial Stability Board, a global watchdog that has already designated some big banks and insurers as risks to financial stability, is now considering whether to slap the same "systemically important" label on asset managers.

The FSB is chaired by Mark Carney, governor of the Bank of England, who in April said: "Concerns arise about rising risks stemming from the overestimation by investors of the degree of liquidity [in] fixed income markets, as well as the growth of assets under management in funds that offer on-demand redemptions but invest in less liquid assets."

But another pillar of the UK regulatory establishment, Martin Wheatley, head of the Financial Conduct Authority, has now taken a different stance.

Mr Wheatley said global regulators faced "big questions" that needed to be answered before determining whether the world's largest asset managers should be deemed systemically important.

His intervention is a boon to the asset managers most likely to be designated as potential threats to the system — BlackRock, Vanguard and Fidelity.

The industry is broadly opposed to the FSB's moves because they do not want to be exposed to tough new regulations such as stress tests and capital requirements.

Bill McNabb, chief executive of Vanguard, which has the largest amount of mutual fund bonds on its books with $497bn, says it would be foolish to regulate asset managers in the same way as big banks.

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"We're not doing anything really fancy or sexy, it's really basic stuff," he says. "The fund business is so different than banking. One, it is an agency business so you as an investor in a fund take all the risk. We take no risk. Banks have a proprietary business model, they're taking client risk, which is completely different."

BlackRock has said there is a case for enhancing the regulation of some individual investment products and practices, just not whole companies.

The increase in fund managers' bond holdings has been remarkable. The 10 biggest asset management groups in the fixed income sector had $1,982bn, or $1.98tn, in mutual fund bond holdings as of January 31 compared with $921bn on January 31 2008, according to Morningstar.

In contrast, US primary dealer banks held $38bn in corporate bonds with more than one year maturities as of the end of April, a drop from $235bn in October 2007 that has been driven by stricter capital rules.

Some financial participants say the sheer size of groups such as Vanguard, BlackRock and Pimco, which have many billions of dollars of assets on their books, makes them "systemically important".

"It is difficult to argue that you are not systemically important when you in effect have so much of the financial system under management," says one trader at a European bank. He says bond market liquidity could become a problem as early as the summer if the Greek crisis worsens.

"Asset managers are not banks, but the very big ones still need some form of tighter regulation," he added.

Regulators are also looking at the potential risks stemming from securities lending by fund managers.

Asset managers stress that they manage other people's money, do not have big balance sheets, and could not go bankrupt as Lehman Brothers did in September 2008.

Barbara Novick, vice-chairman at BlackRock, told the Financial Times in March: “The market risk is with investors [because] an asset manager does not guarantee the funds. The idea that the asset manager creates risk or might fail and create risk is not the case.”

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And it is not just the asset managers that think they should be treated differently to banks.

Steve Grob, director of group strategy at Fidessa, a UK trading technology company, says the biggest asset managers have succeeded by taking a “cautious, conservative approach”.

He adds: “This is especially true if you contrast them with the more racy hedge fund end of the market that can leverage themselves proportionally way higher than any asset manager.”

Additional reporting by Stephen Foley and Philip Stafford