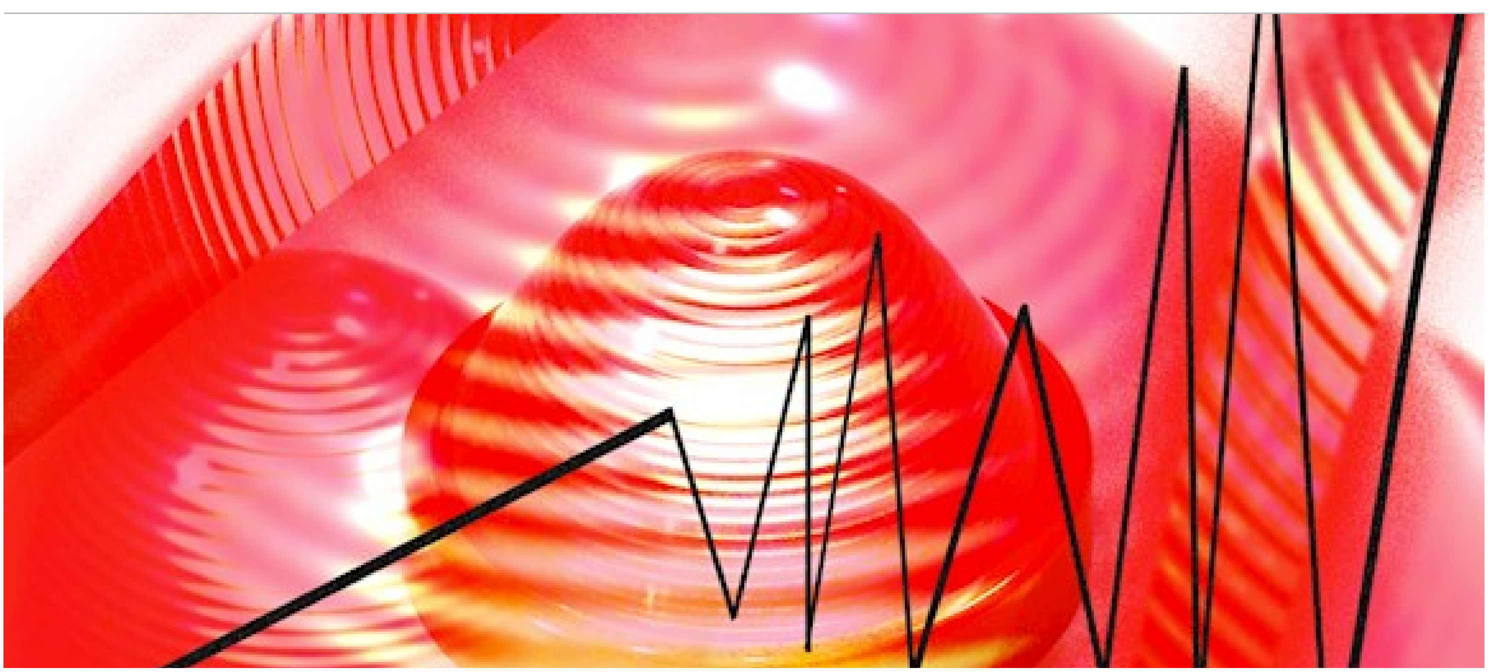
Institutional Investor

CULTURE

Angst Spreads Over Credit Fund Dangers

Jamie Dimon, the Financial Stability Board, and now Fitch are ringing the alarm on shadow banking.

By Julie Segal May 21, 2019



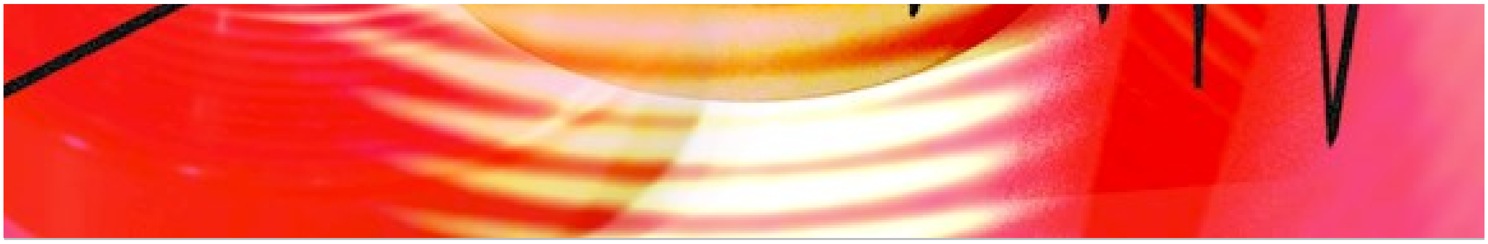


Illustration by II

Credit products will unleash volatility during the next market downturn, Fitch has warned, and pension funds and insurance companies better brace themselves to ride it out.

Since the financial crisis, asset managers have replaced banks as corporate lenders, launching funds for both institutional and retail investors. But the effect of these new-fangled products on market stability has yet to be tested.

Investors and others should plan for redemption pressures on funds and volatile prices, according to a report released Tuesday by ratings agency Fitch. Still, the long-term nature of both pension funds and insurance companies should allow them to hold fast and avoid losses from forced selling.

Collective investment vehicles — such as open-end fixed income funds, money market funds, and credit hedge funds —represented $36.7 trillion or 71 percent of total shadow banking assets as of the end of 2017, according to the Financial Stability Board's definition and Fitch figures.

This is a marked rise since the end of 2008, when only 43.6 percent of these activities came from funds. Shadow banks are the financial firms that now lend to corporations and others, in addition to banks.

[*II* Deep Dive: Shadow Banking Needs Careful Monitoring, Jamie Dimon Warns]

Pensions and insurers have been among the biggest buyers of these products, and their exposure to shadow banks have increased in turn. More than a quarter (28.2 percent) of pension fund assets and 19.8 percent of insurance assets were exposed to "other financial intermediaries" as of the end of 2017, according to the Financial Stability Board.

But that's only direct exposure. "Pension funds and insurance companies remain exposed to broader asset price volatility that may be triggered by forced selling of similarly-held collateral by open-end funds," according to Fitch.

Regulators essentially pushed lending out of banks after the financial crisis, and asset managers and others moved in to pick up the slack. As a result, pension funds, sovereign wealth funds, and insurance companies, shoulder lending risks that previously belonged to banks. Like all financial experiments, this shift produced plenty of unintended consequences. Asset managers have eagerly launched fixed income exchange-traded funds, for instance, that invest in illiquid securities like leveraged loans. But ETFs offer investors immediate liquidity, even when the manager can't sell the underlying assets in such a timeframe. That mismatch could cascade through markets.

The effects on the financial system can't be tested in a lab. Only the next market downturn will do that. "How shadow banking entities perform through the next credit cycle will determine whether this more diffuse but less transparent and more lightly regulated construct is more beneficial for the overall financial system versus the prior, more bank-concentrated model."

Related Content

PORTFOLIO

Private Credit Managers Flex New Muscles

Julie Segal November 06, 2018

PORTFOLIO

Shadow Banking and the Likelihood of U.S. Recession

Scott Pence December 07. 2015