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ICI VIEWPOINTS

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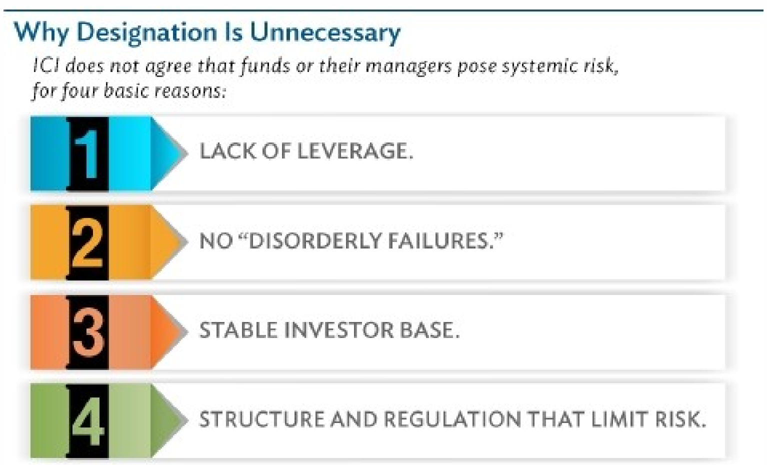
SIFI Designation for Funds: Unnecessary and Harmful

By Mike McNamee

First in a series of Viewpoints *postings on funds and financial stability.*

U.S. and international regulators are examining whether asset managers or the investment funds that they offer could be sources of risk to the overall financial system and should thus be designated as systemically important financial institutions (SIFIs). This could be the beginning of a move toward new, bank-style prudential regulation of the asset management industry—which could significantly affect mutual funds and the investors who use them.



The U.S. Financial Stability Oversight Council (FSOC), which includes the heads of various regulatory bodies and has a mandate to identify and monitor potential risks to the U.S. financial system, is holding a conference on May 19 to examine the asset management industry and its activities. With this in mind, ICI will run a series of *Viewpoints* posts addressing the facts—and busting a few myths—about the issues surrounding designation. Here's an overview of those issues and a glimpse at what we'll cover.

Why Designation Is Unnecessary

ICI does not agree that funds or their managers pose systemic risk, for four basic reasons:

1. *Lack of leverage.* Unlike banks and other financial institutions, mutual funds make little or no use of leverage—the essential fuel of financial crises. For example, the average balance-sheet leverage ratio of U.S. banks designated as global SIFIs is 10 times higher than that of the 11 largest U.S. stock and bond funds.
2. *No "disorderly failures."* Mutual funds simply do not "fail" the way that banks and insurance companies do. Hundreds of stock and bond mutual funds and dozens of fund managers exit the business each year—and none of them require government intervention or taxpayer assistance.
3. *Stable investor base.* Claims that mutual funds have the potential to significantly move markets have no basis in history. Fund

holdings make up a small share of the overall stock and bond market, and many investors use funds for long-term investment, such as saving for retirement. ICI Research has scoured every period of market stress since World War II, looking at flows of individual stock and bond funds, and found virtually no increase in the share of funds experiencing large outflows during times of market stress.

4. *Structure and regulation that limit risk.* The regulation and structure of mutual funds not only protect investors, but also limit systemic risk. Fund activities are highly regulated under the Investment Company Act of 1940 and other laws. In addition, funds are overseen by boards composed largely of independent directors; as of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes, while two-thirds of fund complexes report having an independent board chair. Finally, under funds' business model, fund investors absorb any investment gains and losses, rather than the fund manager.

The Harmful Costs and Consequences of Designation

Though there are uncertainties about what lies in store if funds or their managers are designated as SIFIs, we do know that designated funds would be subject to bank-like regulation by the Federal Reserve Board, which could harm fund investors and distort the competitive market for funds.

For example, investors in a designated fund could—under requirements prescribed for non-bank SIFIs by the Dodd-Frank Act—face new fees, bank-level capital requirements, and additional, inappropriate regulation. Given the high degree of competition in the fund industry and investors' sensitivity to fees and their effect on returns, it wouldn't take much in added fees or capital costs to distort the competitive landscape for funds.

Assessments to prop up a failing bank or other systemically important institution could be imposed on designated funds. If applied to U.S. mutual funds, such charges would be tantamount to taxes on millions of fund investors—many of whom would have entrusted the designated funds with their retirement savings—and could create a "taxpayer bailout" by another name.

Finally, as a systemic-risk regulator the Fed would practice "prudential supervision," which focuses primarily on preserving the banking system rather than on fiduciary duty—the unwavering responsibility of fund managers always to act in the best interests of funds or clients. For example, under prudential supervision, the Fed could require a designated fund to hold more cash (or cash-equivalent securities) than the fund's goals call for, regardless of the fund's stated approach to investing—undercutting the fund's ability to deliver the strategy and returns its investors expect. And in times of market turmoil, the Fed could decide that it is necessary for a fund to help maintain financing for a troubled company or financial institution, regardless of whether such actions serve the best interests of the fund's shareholders.

Overseas Overreach

As part of an effort led by Federal Reserve Board Governor Daniel Tarullo, the Financial Stability Board (FSB)—composed of financial regulators and central bankers from around the globe—recently issued a consultation saying that investment funds with more than $100 billion in assets should be examined as possible sources of systemic risk. Only 14 funds meet this threshold—and all are U.S.-registered investment companies. If FSB decides these funds should be treated as "global SIFIs," FSOC will have a pretext for designating some or all of them—even though the U.S. Congress has never granted FSB the authority to drive increased regulation on U.S. mutual funds.

Rather than providing the transparency and accountability that are hallmarks of a good regulatory process, the FSOC follows processes that are opaque, to say the least. For example, the standards for when the Council must seek and consider public comment—as the Securities and Exchange Commission and rulemaking agencies must—are unclear. It regularly holds closed meetings, with minimal public notice before or reporting after, and is not required to conduct cost-benefit analysis on its decisions. And FSOC can change its standards for designating financial institutions as SIFIs without disclosing those changes. The changes to FSOC procedures announced May 7 don't solve all of these problems.

A Better Way Forward

ICI supports an activity-based approach as a better way to protect investors and address regulators' concerns about potential systemic risks. This approach targets specific practices that pose demonstrable risk, rather than singling out individual funds or firms for additional, inappropriate regulation.

Under the activity-based model, regulators that already have expertise with specific industries and markets follow regular rulemaking procedures—with public meetings, notice and comment, and requirements to follow the record and apply cost-benefit analysis.

This approach is already at work. For example, the SEC is following it as it examines the need for further regulation of money market funds. The fund industry also is working to address activities that may create risks, such as participating in a voluntary initiative to shorten settlement cycles from trade date plus three days (T+3) to T+2.

Providing Clarity

Misguided efforts to fix a part of the financial system that's not broken could cause real harm to the fund industry and the more than 90 million investors it serves. ICI will continue to work with policymakers and the public, at home and abroad, to foster greater understanding about mutual funds and their managers, how they operate, how they're regulated, and how they play an essential role in creating vibrant financial markets worldwide.

For more information on ICI's views and research on financial stability, please visit our Financial Stability Resource Center or read the other entries in this Viewpoints *series:*

- SIFI Designation for Funds: Unnecessary and Harmful
- Size by Itself Doesn't Matter—Leverage Does
- The Market Crash That Never Came
- Who Are the FSB 14?
- How SIFI Designation Could Lead to a New Taxpayer Bailout
- Overseas Overreach
- For Concerns About Risk, a Better Way Forward

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