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ICI Responds to the FSB Consultation on Systemic Risk and Investment Funds

By null

In early January, the Financial Stability Board (FSB)—an international group of financial authorities—published a consultation paper on the issue of systemic risk and investment funds. Though the consultation recognizes several factors that distinguish investment funds from banks, it uses a flawed methodology that focuses on fund size and singles out only 14 funds—all regulated U.S. funds—as candidates for further investigation. This post is a lightly edited version of the executive summary that accompanied ICI's detailed comment letter on the consultation, submitted April 7.

ICI and its members, both in the United States and globally, long have favored sound regulation to address risks to investors and the capital markets. We actively have supported U.S. and global efforts to address the abuses and excessive risk-taking highlighted by the global financial crisis and to bolster areas of insufficient regulation.

It is important, however, to think critically about where and how risks appear—and to choose the right tool, out of the many that regulators have at their disposal—to address risks appropriately and effectively. As the consultation by the FSB recognizes, the risk profile of investment funds—and certainly of regulated funds—is starkly different from that of banks or insurance companies. Designation of regulated funds as "systemically important financial institutions" (SIFIs), whether in the United States or other jurisdictions, is neither necessary nor appropriate as a means to address concerns about stability of the global financial markets. The consequences of designating regulated funds would be highly adverse to the designated fund, its investors, the overall fund marketplace, and fund investing at large.

Serious Concerns

The FSB has defined non-bank, non-insurer global SIFIs (G-SIFIs) as entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions." Application of these concepts outside the world of banking and insurance requires a more robust and informed understanding of investment funds than is reflected in the consultation. Our detailed comments, including our empirical research, seek to help fill that gap by examining each element of the FSB consultation in the context of the structure, regulation, and historical experience of regulated funds in the United States and other jurisdictions. (Our comments generally address regulated stock and bond funds, but SIFI or G-SIFI designation also would not be appropriate or effective for money market funds, which currently are subject to separate regulatory actions.)

We sincerely appreciate the opportunity to comment on the consultation, as we do previous opportunities to comment on the work of the FSB. That said, we continue to have serious concerns about many aspects of the assessment process, a process that is not expressly sanctioned by any provisions of U.S. or other law and that lacks sufficient transparency. The process appears designed to permit the FSB, other international regulatory bodies, and central bank representatives to exercise maximum discretion over matters with very serious potential consequences for regulated funds and other affected entities, without specific authorization in law or requirements for "due process." We would urge the FSB, as well as the Financial Stability Oversight Council (FSOC) in the United States, to adopt procedures that assure greater transparency and accountability, and that promote greater public and industry confidence.

Size Is Not an Indicator of Risk

As for the substance of the consultation and the proposed methodology for investment funds, we submit that size is not a*per se* indicator of risk. The consultation proposes a "materiality threshold"—set at $100 billion in assets under management—to define a "practical and manageable number" of investment funds to be analyzed under the proposed methodology. It incorrectly theorizes a linear relationship between size and risk in this context.

The size of an investment fund—in contrast to a bank—by itself reveals very little about whether that fund could pose risk to the global financial system. Based on their investment objectives and policies and their portfolios, two funds of the same size can present sharply different risk profiles. ICI believes that any initial threshold for evaluating investment funds should include balance-sheet leverage—the "interconnection"' that speeds the transmission and heightens the impact of risk among institutions, and the essential fuel for financial crisis.

The proposed *per se* materiality threshold does not serve to filter the universe of investment funds in any way that would usefully advance the stated objectives of the Group of 20 (G20) and the FSB. It produces an assessment pool of 14 funds—all regulated U.S. funds—as the only funds worldwide that automatically would be subjected to further examination. Moreover, the proposed threshold clearly is at odds with the FSB's stated goal of maximizing the consistency of treatment of different types of financial entities, producing a pool of investment funds that are orders of magnitude smaller than global systemically important banks (G-SIBs). Far from promoting consistency, the consultation proposes to apply a unique and more sweeping standard to investment funds, without any justification for this difference in treatment.

Fundamental Differences Between Regulated Funds and Banks

In sharp contrast to banks, these 14 funds have virtually no leverage. Calculated under the FSB's definition, their balance-sheet leverage ratio averages 1.04, as compared to an average of 10.7 for U.S. G-SIBs. At this rate, for a regulated U.S. fund to achieve the same dollar amount of indebtedness as the smallest U.S. G-SIB, the fund would have to hold $5.4 trillion in assets under management.

As former Federal Reserve Chairman Alan Greenspan recognized in analyzing the global financial crisis, mutual funds do not serve to fuel "serial contagion"—in other words, systemic risk—precisely because of their lack of leverage.

In addition, the 14 large regulated U.S. funds pursue investment strategies that are comparable to literally hundreds of competing funds in the U.S. market. As is typical for regulated U.S. funds, their portfolio holdings are highly diversified. These funds are, in short, highly "substitutable." All of them have simple capital structures, and their business and operations are straightforward and transparent. Thus, they lack the "complexity" that the FSB offers as a crucial element of its G-SIFI definition.

The concepts of "distress" and "disorderly failure"—stemming directly from the FSB's concern with "too-big-to-fail" institutions—are derived from experience with banks and have little relevance to investment funds. Investment losses do not constitute "distress": unlike bank depositors, fund investors are not promised either a gain on their investment or a return of their principal. Some investors may react to losses by selling their fund shares. The ability to redeem shares on a daily basis, however, is a defining feature of U.S. mutual funds and underlies many of these funds' regulatory requirements and operational practices—notably including daily valuation of fund assets and liquidity requirements.

No Need for Resolution Planning

The concept of public "bailouts" likewise has little relevance to investment funds. Literally hundreds of regulated U.S. funds exit the business through liquidation and merger each year, without any government intervention or taxpayer assistance. As the consultation recognizes, "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact" for the period from 2000 through 2012. When a mutual fund liquidates, it follows an established and orderly process to distribute its remaining assets *pro rata* to its investors and wind up its affairs, in accordance with provisions of federal and state law and under the oversight of the fund's board of directors or trustees. Thus, such funds have no need for bank-like "resolution planning," and regulators have no need for additional authority to cope with "disorderly failures" of these funds.

The FSB posits circumstances under which an investment fund "has to liquidate its assets quickly, [which] may impact asset prices and thereby significantly disrupt trading or funding in key markets." Since the inception of regulated fund investing in the U.S. almost 75 years ago, the historical evidence is consistent and compelling: stock and bond funds have never faced such a scenario, not even during the global financial crisis of 2007–2008. Indeed, across a range of adverse market events and conditions, sales of stocks and bonds by regulated U.S. funds represent a modest share of overall market activity—a fact that reflects the nature today of their largely retail investor base and the long-term financial goals of most fund investors.

Market Distortions

Though the FSB consultation does not specify what policy measures would apply to investment funds designated as G-SIFIs, the

U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act prescribes a comprehensive set of requirements for non-bank SIFIs. Most troubling is the prospect of capital requirements (perhaps as high as 8 percent) for "loss absorption." Unlike banks, regulated funds simply have neither the need nor the ability to meet capital requirements. Their "capital" comes from investors who own fund shares and who fully accept that they will absorb investment gains and losses on a *pro rata* basis. Mechanisms for "loss absorption" would be antithetical to funds' basic nature and purpose, would introduce moral hazard, and would lessen market discipline.

Capital requirements and assorted fees assessable to nonbank SIFIs under the Dodd-Frank Act would put a designated fund at a distinct competitive disadvantage and distort the market. The 14 regulated U.S. funds singled out by the FSB's materiality threshold are highly efficient, relatively low-cost funds within their asset classes: they have an asset-weighted average expense ratio of just 31 basis points. Investors in regulated U.S. funds are highly sensitive to fund costs and their impact over time on fund returns. It would not take much in added regulatory costs to condition the investors in these funds to avail themselves of one of the many competing funds not subject to these costs.

The Dodd-Frank Act also authorizes, under its Orderly Liquidation Authority, assessments of nonbank SIFIs to reimburse the U.S. government for the costs of resolving a distressed financial institution—for example, a large bank holding company. Though the purpose of the Orderly Liquidation Authority provisions was to avoid having the costs of "bailouts" fall on U.S. taxpayers, designation of a regulated U.S. fund raises the prospect that this burden would fall on individual investors, many of whom would have entrusted the fund with their retirement savings—in substance, a taxpayer bailout.

Prudential supervision by the U.S. Federal Reserve also could affect the management of a designated fund's portfolio and how the fund serves its investors. It sets up the potential—arguably, the likelihood—for a clash between the goals of prudential supervision and the fiduciary duty that the fund's manager and board of directors owe to the fund.

For example, in the interest of mitigating risks to the financial system at large, the Federal Reserve could impel a fund's manager to maintain financing for banks or other counterparties, to remain exposed to certain markets, to avoid exposure to certain issuers, or to maintain excess levels of cash or cash equivalents in the fund's portfolio—regardless of whether such actions, in the judgment of the fund's manager, serve the interests of the fund and its investors.

Activity-Based Regulation Is a Better Alternative

It is ICI's view that regulators who believe that specific activities or practices pose risks to the market or to the financial system should use their considerable rulemaking authority to address those risks through activity-based regulation, rather than designating individual regulated funds.

In the United States and other jurisdictions, post-crisis legislation has augmented regulators' broad authority by adding many new tools to address abuses and excessive risk-taking. Regulators already are making notable use of these authorities. The approach currently being taken with respect to money market funds is an example of an activity-based focus on risk mitigation. Other U.S. efforts include regulatory reform for securities lending and repurchase agreement transactions, and changes in the way swaps are traded, cleared and settled. The U.S. Securities and Exchange Commission is working to strengthen its oversight of U.S. asset managers and regulated funds—an effort that ICI welcomes. In addition, ICI's Board of Governors has endorsed a voluntary industry initiative to shorten settlement cycles for a range of securities from trade date plus three days (T+3) to T+2. Globally, the FSB itself, along with other global bodies, is playing an active role in efforts to mitigate risk in the financial system.

Together with our members, ICI is engaging across this range of initiatives to help advance efforts to make markets and market participants more resilient to future shocks, without imposing undue costs and burdens on regulated funds and their investors