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Applying Evidence to Theories on Regulated Funds

By Sean Collins

Late last month, the Financial Stability Oversight Council (FSOC) voted to rescind its designation of American International Group (AIG). After requiring a bailout during the financial crisis, the insurer was designated as a non-bank "systemically important financial institution," or SIFI, in 2013. When FSOC conducted its most recent annual review, it decided AIG no longer warranted "systemic" status.

At first blush, this news wouldn't seem to have much import for regulated funds. A closer look at FSOC's reasoning, however, may suggest a more fundamental change in the way it plans to approach future work on systemic risk.

In its 68-page notice explaining the basis for its decision, FSOC makes it clear that it has re-examined one of its key theories—the so-called asset liquidation transmission channel. When FSOC designated AIG as a SIFI, one of the arguments it used was that if AIG ever came under financial distress, "there could be a forced, rapid liquidation of a significant portion of AIG's assets as a result of [insurance] policyholder surrenders or withdrawals that could cause significant disruptions to key markets, including corporate debt and asset-backed securities markets."

What does this mean? Stated simply, FSOC conjectured during the designation process that if AIG experienced financial distress, its policyholders *could* behave like depositors at a bank, causing a "run" on AIG that would cascade through the financial markets.

But in removing AIG's designation, FSOC has reconsidered that view. It now states that "additional consideration of incentives and disincentives for retail policyholders to surrender policies, including analysis of historical evidence of retail and institutional investor behavior, indicate that there is not a significant risk that asset liquidation by AIG would disrupt trading in key markets or cause significant losses or funding problems for other firms with similar holdings."

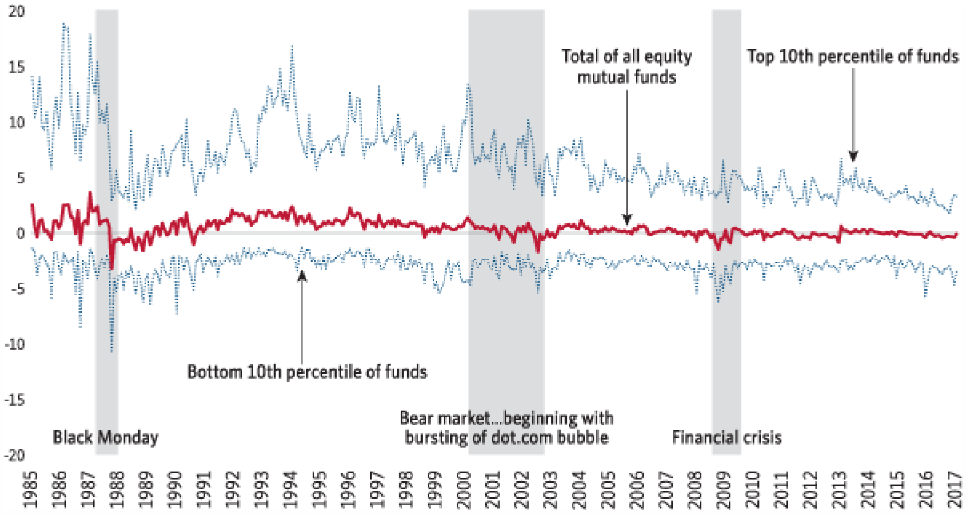
In other words, FSOC has decided to go beyond conjecture to see whether there is historical*evidence* that insurance policyholders tend to "run." It didn't find that.

We find this noteworthy because FSOC has engaged in the same sort of conjecture with respect to regulated stock and bond funds. In an April 2016 statement, FSOC posited that investors in regulated stock and bond funds might be similarly inclined to run from their investments in the face of market declines, forcing funds to sell their assets at fire-sale prices, and resulting in "spillover effects" to other market participants and the broader markets that would threaten financial stability.

FSOC failed to substantiate those contentions with evidence. Nor could it. As ICI has long pointed out, the theory of "forced, rapid liquidation" of fund assets caused by rapid, widespread, redemptions by shareholders in regulated stock and bond funds has never stood up to the test of historical evidence. For example, aggregate shareholder redemptions from equity mutual funds throughout history have been modest, even when markets are stressed—as the figure below shows.

Outflows from Equity Mutual Funds Are Modest, Even During Market Turmoil

Flows as a percent of equity mutual funds' previous month's assets; January 1985–August 2017



Source: Investment Company Institute

Consider what happened from August 2008 to March 2009—in the depths of the financial crisis—when outflows from regulated equity funds totaled just 3.6 percent of those funds' assets as of August 2008. These relatively minor outflows occurred despite the fact that equity prices, as measured by the Standard & Poor's 500-stock index, fell by 47 percent from their August 2008 peak to the March 2009 trough.

The reasons for this steady and consistent behavior are simple: regulated stock and bond fund shareholders invest to meet longer-term goals. They view their funds as part of a diversified portfolio intended for retirement, college, homeownership, or some other major objective. Rather than panic when prices fall, they keep their focus on the longer term and ride out the market gyrations.

The asset liquidation transmission theory is not the only tenuous notion that FSOC and others—often looking at the world through a banking lens—have misapplied to regulated funds. For example, contrary to persistent misconceptions:

- *Regulated funds are not unregulated "shadow banks."* Simply put, they aren't banks, and they aren't in the shadows. The business model for regulated funds is fundamentally different from that of banks. A bank's depositors are creditors of the bank. Thus, if the bank fails, depositors could lose their money or their money could be tied up in bankruptcy proceedings. This is what creates the possibility of bank runs. To prevent runs, banks are required to hold capital and, in the United States, the vast majority of bank deposits are insured by the Federal Deposit Insurance Corporation for up to $250,000. In contrast, investors are not creditors of a fund, but owners of the fund's assets. Fund investors know that they will reap the rewards of fund gains—and absorb the impact of fund losses—on a pro rata basis.

  And the notion that regulated funds operate in the shadows couldn't be further from the truth. These funds are thoroughly regulated and highly transparent, due most notably to the extensive regulatory and reporting requirements under the Investment Company Act of 1940 and other federal securities laws, as administered by the Securities and Exchange Commission. This comprehensive, capital markets–based regulation, along with structural and other characteristics of regulated funds, limits risk transmission from funds to the financial system at large.

- *For regulated funds, size does not equate to risk.* In the case of banks, the size of a bank's balance sheet and the amount of its debt go hand in hand. In other words, size equates to risk. In contrast, regulated funds—regardless of size—generally employ little to no balance-sheet leverage, due to regulatory limits and as a matter of normal industry practice.

- *Regulated funds don't "fail" like banks do.* Again, unlike banks, regulated funds do not guarantee returns to investors and have little to no balance sheet leverage. Funds have exit strategies—including liquidation or merger with another fund—that can be executed within the existing regulatory framework. In fact, regulated funds come and go with some regularity with no noticeable effect on the broader financial system.

Such bank-centric theories about regulated funds don't match up with the facts. And misapplying them to regulated funds—for example, as the basis for designating a fund as a SIFI—would do real damage. SIFI designation would carry with it bank-style regulation, including capital requirements and prudential supervision by the Federal Reserve Board. The result would be conflicting, inappropriate regulatory oversight that could harm fund investors without providing any offsetting gain in financial stability.

By re-examining the asset liquidation transmission channel theory as applied to AIG, FSOC appears to be putting greater weight on evidence and less on conjecture. That's a development we welcome and encourage.

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