The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
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ICI VIEWPOINTS

MAY 14, 2014

How SIFI Designation Could Lead to a New Taxpayer Bailout

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

We have spent the past several days discussing why efforts by international and domestic regulators to examine mutual funds as sources of systemic risk are unnecessary and inappropriate. Why are ICI and its members devoting such time and energy to this issue? The reason is simple: if regulators designate mutual funds as systemically important financial institutions (SIFIs), the consequences could include:

- Forcing fund investors to help shoulder the costs of bailing out a failing bank or other financial institution deemed systemically important;
- Imposing other new costs on investors;
- Impeding a fund's ability to serve investors; and
- Distorting the competitive marketplace and limiting investors' choices.

Putting Investors on the Hook for a "Bailout"

Under the Dodd-Frank Act's Orderly Liquidation Authority provisions, funds designated as SIFIs could be required, if needed, to help repay funds that the U.S. government spends to resolve distressed financial institutions deemed systemically important.

These costs would ultimately be borne by the designated fund's investors—essentially, a "taxpayer bailout" by another name. Given that the purpose of the Orderly Liquidation Authority provisions is to avoid having the costs of bailouts fall on taxpayers, it would be both ironic and extremely unfortunate if the end result were to burden U.S. mutual fund investors—many of whom are saving for retirement—with those costs.

Raising Costs for Fund Investors

If a fund is designated as a SIFI, that fund would face new regulatory fees and assessments, along with capital requirements.

Under Dodd-Frank, a designated fund would have to pay annual fees to defray the Federal Reserve's costs of overseeing the fund. In addition, designated funds would be assessed twice a year to cover the expenses of the Financial Stability Oversight Council (FSOC) and the Treasury's Office of Financial Research (OFR). As fund expenses, the costs of those fees and assessments ultimately would be borne by fund investors.

A designated fund also could be obligated to meet bank-level capital requirements of as much as 8 percent of fund assets. Unlike banks—which are highly leveraged and need capital to protect depositors and other creditors against losses—mutual funds have neither the need for capital nor the ability to meet capital requirements.

In addition, requiring funds to maintain capital to protect against losses is antithetical to the nature and purpose of regulated funds. Fund investors understand and accept the risks of their investment, including that it may lose value.

Harming a Fund's Ability to Serve Its Investors

Funds already are extensively regulated by the U.S. Securities and Exchange Commission (SEC), whose mission includes the protection of investors.

Yet funds designated as SIFIs would be subject to a second layer of regulatory oversight—in the form of "prudential supervision" by the Federal Reserve. This style of oversight could conflict with a fund manager's fiduciary duty to act in the best interests of the fund.

For example, the Federal Reserve could require a designated fund to hold more cash or cash-equivalent securities than contemplated by its investment objectives and policies. This obligation could make it challenging for the fund to deliver the investment strategy and performance that its investors expect.

In addition, the Federal Reserve could impel a designated fund to maintain its investment in a troubled institution—regardless of the potentially negative effect on the fund's investors.

This risk is not theoretical. During the Bear Stearns rescue in March 2008, the Lehman Brothers collapse in September 2008, and the European banking crisis of 2011, bank regulators criticized funds for withdrawing short-term financing from these institutions. Bank regulators apparently expected that these funds should ignore their fiduciary duty to their shareholders, ignore credit risks, and accept predictable losses.

Distorting the Marketplace

Investors are highly sensitive to fees and their effect on investment returns. The higher costs imposed on designated funds would make them less attractive to investors and thus could distort the competitive landscape.

As evidenced by declining fees of stock and bond funds over the past two decades, investors routinely benefit from competition in the fund marketplace. There's no reason to risk affecting those benefits through heavy-handed, unneeded regulation that distorts the marketplace.

Looking at the Big Picture

When one looks at all the different ways that investors could be affected, it's clear that the consequences of SIFI designation would harm investors and distort competition. Given the evidence that funds do not create systemic risk, it's hard to see how that damage would be justified.

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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