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Financial Stability and Asset Management: What's at Stake?

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Dinner Remarks
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on Financial Stability and Asset Management

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Thank you, Con, for hosting us here tonight, and for the outstanding work you do through the Center for Finance, Law & Policy. The Center does an exceptional job in helping advance public understanding of the vital role that finance plays in our economy and the best ways to make our financial system more resilient, more efficient, and better able to serve the needs of businesses and households.

The dialogue that we are kicking off tonight certainly fits that mission. Together, our two organizations have assembled a wide array of experts with deep knowledge of the debate over whether asset management poses any threat to financial stability. We're grateful to all of our speakers for lending their expertise and perspective, and we hope that all of our attendees will join in to make this a robust discussion.

On behalf of regulated funds from jurisdictions around the world, the Investment Company Institute has been deeply engaged with the question of whether funds or their managers pose super-size risks to the U.S. or global financial systems—risks that require regulating them as "SIFIs," or systemically important financial institutions.

Our voluminous submissions to the Office of Financial Research, the Financial Stability Oversight Council, and the Financial Stability Board, as well as our extensive public commentary, have aimed to achieve several purposes.

First, we have sought to educate central bank and finance ministry officials about the nature, experience, and regulation of a part of the financial system largely unknown to them—that is, asset management generally and regulated funds in particular.

Second, we have sought to fill a striking void of empirical information, and thus to ensure that policy making is well-informed.

Finally, we aim to deflect the imposition of bank-style regulation on institutions for which it is unnecessary—indeed, for which it would be extremely harmful.

In our judgment, neither regulated funds nor their managers pose threats to financial stability. The existing regulation and defining characteristics of regulated stock and bond funds, as well as their historical experience, render designation as SIFIs unnecessary and inappropriate.

Now, that conclusion is not universally shared—in Washington, in London, in Basel, or even in this room. We can look forward to a robust debate tomorrow, from all points of view, on whether and how funds and asset managers do or do not jeopardize the stability

of the financial system at large.

So rather than preview or pre-empt tomorrow's discussions, I'd like to step back and ask a fundamental question:

What's at stake in this debate?

In other words—what do we stand to lose if we get this issue wrong, in the case of America's regulated funds?

As it happens, this year marks the 75th anniversary of the birth of the modern fund industry in the United States. For 75 years, closed-end funds, mutual funds, unit investment trusts, and, more recently, exchange-traded funds have operated under a comprehensive framework of laws and regulations based in the Investment Company Act of 1940.

The history of the past 75 years is a remarkable story of orderly growth and evolution. Over this period, regulated funds have emerged as the most efficient and effective aggregators and deployers of capital in the history of finance. The assets managed by U.S. regulated funds have grown from $1.1 billion in 1940 to almost $18 trillion today—an increase of 1.6 million percent.

And that's without any form of "prudential oversight."

Those assets are the tangible expression of the thrift and long-term financial aspirations of millions of ordinary Americans. Our data show that 95 percent of the assets in U.S. stock and bond funds are owned by households—and 49 percent, just short of half, are held in retirement accounts. More than 90 million Americans own shares in mutual funds.

In short, the 75-year history of modern regulated funds has witnessed a historic democratization of investing.

This era has also fostered great innovation—in types of funds, in investment strategies, in managers, and in personal investment objectives. ICI data show that some 800 U.S. fund complexes offered more than 16,000 funds as of January—a wealth of choices and strategies in a highly competitive landscape.

Those funds respond to the particular investment objectives and risk tolerances of millions of shareholders and their financial advisers—a vast and diverse array of individual decisionmakers who ultimately determine how their respective financial assets will be deployed.

The growth and democratization of U.S. mutual funds is also a reflection of a key strength of the American financial system—its robust capital markets.

Now, I'm a student of history, so I'm going to take you back even further than 1940—back another 150 years, to 1790.

In that year, under the newly ratified Constitution of the United States, the federal government took two crucial steps: it assumed the debts of the states, creating the U.S. bond market, and it formed the First Bank of the United States. In that one year, both pillars of the American financial system were created.

Since then, capital markets and banking have existed side-by-side in this country—not always comfortably, perhaps. But the healthy competition between these two forms of finance has spurred growth and innovation for both savers and users of capital—and it's an important reason why America's financial system is so dynamic and efficient.

This system is also the envy of the world.

ICI is a global organization. In the past three and a half years, we have opened offices in London and Hong Kong and have gained new fund members from four continents. We are pursuing a global policy agenda that includes promotion of capital-market development and investment-based defined contribution retirement plans in jurisdictions around the world.

And one common theme that I hear in country after country is: how do we develop stronger capital markets? How do we:

- diversify our sources of financing;
- move money out of bank deposits and into equity;
- encourage our savers to become investors who take reasonable risks for better returns; and
- foster a culture that encourages entrepreneurship and ownership?

In Europe, the latest theme is the development of a Capital Markets Union to "further develop and integrate capital markets," to "help reduce [Europe's] very high dependence on bank funding," and to "increase the attractiveness of Europe as a place to invest." The European Commission views development of the CMU as a key part of its jobs and growth agenda.

In Japan, the government has created the Panel for Vitalizing Financial and Capital Markets to help strengthen its economy. An explicit goal is to develop "a society where individuals build wealth with risk asset allocation appropriate to stage of life cycle." To advance that end, the Panel aims to foster the development of asset management and investment funds.

And from the United Kingdom to Hong Kong, the evolution of retirement systems is elevating the key role of capital-market investment as the key to workers' retirement security.

Meanwhile, back in the United States, we have … the FSOC.

That's a group of regulators, mostly from banking agencies, with the Federal Reserve effectively in the lead, driving to bring SIFI designation to funds, asset managers, or asset management products, carrying with it capital requirements and "enhanced prudential supervision"—by the Fed, of course.

In short, we have a dedicated effort, targeting large, highly regulated U.S. funds, to bring bank-style regulation to asset management and thus to the capital markets.

That's a strong statement—so let me address each of its three elements.

First, a "dedicated effort." We see that in the approach that regulators have taken, in the U.S. and globally, to advance their push toward designation of asset management.

From the start—from the OFR Report of September 2013—this push has been based on academic theory—to the exclusion of empirical data and historical experience. Indeed—in resistance to data and experience.

In their consultations and requests for information, the FSOC and the FSB do not point to any actual events in which regulated stock and bond funds raised systemic threats, even in the greatest financial crisis since the Great Depression.

Some of you are thinking, "What about money market funds?" Yes, money market funds were caught up in the crisis, but the experience of long-term stock and bond funds was strikingly different. Unlike money market funds, their net asset value per share fluctuates daily. They are not designed as transactional vehicles. They did not experience redemptions of the kind that threatened prime money market funds in 2008. And of course the regulation of U.S. money market funds has been comprehensively addressed—not once, but twice—since the crisis. Money market funds are not relevant to the current debate, which concerns long-term funds.

Rather than demonstrate the market failure or structural weakness that rises to a systemic threat, the FSOC and the FSB repeatedly assume hypothetical situations that have never arisen in the 75-year history of U.S. regulated stock and bond funds.

They posit an extraordinary level of "herding," when the factual record suggests nothing of the kind, and the data demonstrate the heterogeneity of 90 million fund investors and their advisers.

They assume exceptional degrees of "run risk," when the data show that fund outflows are muted even in times of greatest financial stress.

They assume "first-mover advantage," when forward pricing and other standard practices of funds render any such advantage meaningless.

And these regulators simply dismiss any data or analysis that demonstrates that their conjectures are baseless. Indeed, in its latest consultation, the Financial Stability Board states that it has no interest in the probability or likelihood that any of its hypothetical risks could occur. Apparently, if you can imagine that a systemic event might happen, then you must assume that it will happen—and regulate accordingly.

Imagine that the city of Boston had a mandate that its bridges, its tunnels, and its trains had to be built to accommodate a mass exodus of the entire population—every man, woman, and child, with all their belongings—on a single day. That has never happened—nothing remotely like it. But it might happen—so the FSB's logic would argue that you should pave over the Charles River, drive a superhighway through Harvard Square, and stack triple-decker train tracks above the Mass Pike.

Boston would not be Boston anymore. Nor would mutual funds remain mutual funds if regulated on the premise, for example, that a $100 billion bond fund must be able to sell off its entire portfolio on any given day.

Let me just add that in the United States, regulatory policy may not be based on conjecture, surmise, or caprice. Our laws require regulators to act reasonably; to consider the balance of costs and benefits; to amass and consider an empirical record in support of their policy judgments. These are standards set to protect our citizens—in this case, the retirement savers of America—against arbitrary rulemaking.

Second—I said that this effort is targeted at large, successful, well-regulated U.S. funds. In its latest consultation, the FSB returns to the same size threshold—$100 billion in assets under management—that it used in its earlier work. That is a number simply pulled out of the air.

The only difference is that $100 billion is now presented as one “option” among a mares' nest of equally arbitrary ratios and exposure measures.

The $100 billion threshold singles out 14 large regulated U.S. mutual funds and ETFs for evaluation as global SIFIs.

I've stated that the second FSB consultation paper represents “a giant step backward.” In part, that's because the FSB has decided to add criteria for evaluating asset managers to the structure that it created in its first consultation, which focused just on investment funds.

They call this their “dual approach.” To me, it looks like double jeopardy.

Lastly, I stated that the goal of this effort is to bring bank-style regulation to asset management and thus to the capital markets.

You won't find evidence for that in the statements of the FSOC, the FSB, or the Federal Reserve. On all fronts, these systemic regulators maintain that it's too early to say how they would remedy the alleged risks that they assume could arise from funds or asset managers.

In a way, that's fitting—the regulators can't name the problems, nor can they tell us what they propose to do about them. It adds to the disembodied, theoretical nature of the whole discussion.

What we do know is that we have a law in the United States that specifies how a SIFI must be regulated. Under the Dodd-Frank Act, a designated fund could be obligated to meet bank-level capital requirements—that's 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—regulated funds have neither the need for capital nor the ability to meet capital requirements. But Dodd-Frank nonetheless would require a designated fund to set aside capital—and an independent study by the American Action Forum calculates that capital requirements could cost a young investor saving for retirement up to one-quarter of his or her lifetime returns in such a fund.

The rhetoric we've been hearing lately from central bankers about “macroprudential” regulation also raises concerns.

Their emphasis on liquidity standards and redemption restrictions for funds suggests that a SIFI regime in asset management could result in highly prescriptive regulations that push funds and their managers toward a common set of “approved” investments—just as the Basel standards pushed banks toward a standard portfolio of “lower-risk” assets, and thus helped usher in the financial crisis of 2008. This is the model that central bankers would bring to asset management.

Let's be clear—to the degree that the central banks impose prescriptive regulation on funds or other asset managers, they run a significant risk of

- diminishing diversification in financial services and financing for economic activity;
- increasing correlation and herding;
- exacerbating volatility;
- increasing the probability of shocks to the financial system; and
- amplifying—rather than muting—the impact of such shocks.

And with banking regulators setting the rules, it's not hard to believe that the same set of assets could end up on the “approved” lists for both funds and banks. In that case—well, let me quote a recent article by Hester Peirce: “Imagine the scene as banks and asset managers all fight during a crisis for the safe assets that their common regulatory frameworks permit.”

So let me go back to my original question: What's at stake as we debate the role of asset management in the financial system?

One answer is: the resiliency of the financial system. Every corner of finance needs to be examined for potential threats to financial stability, and mitigating systemic risk needs to take a higher priority in regulation.

The regulated fund industry has never said, “Don't look at us.” We'll bear the examination; we'll welcome any inquiry based on empirical evidence and data; and we at ICI will respond to questions in great detail—as will many of our members. We'll even help sponsor conferences where both sides can air their points of view!

What we ask—what common sense and good governance require—is that regulators listen; that they pay attention to the analysis, the data, and the historical record; and that they weigh the costs of their remedies against actual benefits in realistic—not conjectured—scenarios.

Because the other answer to “What’s at stake” is this: the vibrancy and health of our capital markets—the capital markets that are the envy of the world, and the engine of growth for our economy.

I look forward to a lively discussion tomorrow. Thank you again to Con and his team, our hosts here at Boston University, and good night.

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