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Why Designating Funds as SIFIs Could Hurt Retirees

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By Paul Schott Stevens

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The regulatory drive to designate mutual funds or their managers as systemically important financial institutions increasingly looks like a campaign to extend the power of central banks and other banking regulators over global capital markets. As the Financial Stability Oversight Council sets the agenda for its May 19 conference on asset management, media leaks suggest that the Council is forging ahead in considering mutual funds or their managers for designation—despite the fact that they pose no threat to the stability of the financial system.

Former regulators, academics, and U.S. lawmakers agree that mutual funds and their managers are fundamentally different from the highly leveraged institutions at the center of the financial crisis and the focus of postcrisis reforms. Yet the FSOC and its global counterpart, the Financial Stability Board, seem determined to treat mutual funds and advisers as if they pose the same risks to the financial system as banks—and to subject them to bank-style capital requirements and supervision.

If FSOC designates mutual funds as SIFIs, it will impair the single best tool for individual investors—used by 90 million Americans saving for such financial goals as retirement and education—and harm capital markets. Designated funds and their investors would bear higher, unnecessary costs and could be put on the hook to bail out failing institutions in the next financial crisis.

Moves to designate mutual funds or their managers as SIFIs ignore the fact that mutual funds do not cause systemic risk. In fact, mutual funds are structured in a way that prevents shocks to the financial system. Unlike banks, mutual funds use little to no leverage—the fuel for all major financial crises. Without leverage, the closely regulated interactions between funds and other market participants do not accelerate or intensify risks.

Nor do funds “fail” in the same calamitous way as banks. If a fund’s assets gain or lose value, those results belong to the investors. Every year, hundreds of stock and bond funds enter and exit the marketplace—but not one has triggered a crisis or required government intervention. Funds don’t need “resolution planning” or taxpayer bailouts.

History also shows that regulators’ speculations about the behavior of funds and their investors have no basis in fact. Since the modern mutual fund industry emerged after World War II, stock and bond funds have not experienced large-scale redemptions during any episode of market stress. Funds are primarily long-term investments: households own 95 percent of stock and bond fund assets, and 70 percent of those households report that saving for retirement is their primary financial goal. The notion that funds create systemic risk through bank-style “runs” is simply wrong.

A fund designated as a SIFI will face significant additional regulatory costs, including capital requirements—costs that will fall on shareholders. The Federal Reserve, in the name of "prudential supervision," could force a fund's manager to maintain financing for troubled banks or to hold excessive levels of cash—regardless of the impact on the interests of the fund or its shareholders.

Further, any designated fund could be subject to assessments for the Orderly Liquidation Authority—the mechanism for bailing out too-big-to-fail financial institutions. Despite Congress' express desire to prevent future taxpayer bailouts, designation of mutual funds could put the burden of a future financial crisis on the backs of fund investors—many of whom are retirement savers.

Members of Congress are taking note of the disconnect between the facts and the FSOC’s actions. On April 9, 41 members of the House Financial Services Committee—17 Democrats and 24 Republicans—sent a bipartisan letter to Treasury Secretary Jacob Lew urging the FSOC to recognize that “asset managers have a fundamentally different risk profile—one that is much lower” than banks. The signers urged the FSOC to ensure that its action “does not limit access to [funds’] services or cause them to become cost-prohibitive.” On May 8, Committee Chairman Jeb Hensarling (R-TX) called upon the FSOC to “cease and desist” all pending designations until Congress finds out more about how the council is making decisions.

Designating funds as SIFIs would drive up shareholder costs, distort the fund marketplace, and expose retirement savers and other fund investors to the liability of paying for bank bailouts. If regulators have specific risks they want to address, they have plenty of tools to do so. And if the FSOC persists in this regulatory overreach, it should expect Congress’ interest and concern only to grow.

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