IDC Independent Directors Council
Promoting Excellence in Fund Governance

Financial Stability: A Conversation with Investors

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As prepared for delivery.

Thank you, Marie [Chandoha], for those kind words, for your inspiring message, and most of all for chairing this year's General Membership Meeting. You have challenged us to think harder and reach higher, and with your volunteer committee you shaped the powerful program we now have before us. We all owe you a debt of gratitude.

Good afternoon, and welcome to all of you. We do indeed have a great three days ahead of us, and I too invite you to make the most of every opportunity to gain and share insights.

As Marie mentioned, my topic today is the ongoing debate about asset management and financial stability. Both U.S. and global regulators now are examining whether asset managers and investment funds—including U.S. mutual funds—should be treated like the largest banks and designated "systemically important financial institutions," or SIFIs.

This is not a debate about “regulation” versus “no regulation.” ICI and all of its members, both U.S. and global funds, favor sound regulation to address risks to investors and the capital markets. In the past six years, we actively have supported efforts to address abuses and close regulatory gaps exposed by the global financial crisis.

No—this is instead a debate over where and how risks to the financial system at large may occur—and what the most effective tools are to address such risks, out of the many tools that regulators have at hand. On that score, our position is clear:

- regulated funds and their managers do not pose risks to the financial system at large;
- designation of funds or asset managers as SIFIs is unnecessary;
- and cramming our funds into a framework of bank-style regulation will be deeply harmful to funds, their investors, and the capital markets.

If you have followed this debate at all, you may have noticed that this concept of “systemic risk” is pretty slippery—those bent on finding it seem to detect it everywhere. That is why ICI and many of its members have worked hard to assemble a large, growing body of hard data and analysis; to describe industry norms and practices; and to educate policymakers about the structure and experience of regulated funds both in the U.S. and abroad—all to bring some rigor to the dialogue.

Ultimately, the critical voices in this debate will be the voices of fund investors—the 90 million Americans who seek to meet their financial goals by investing in our diversified, well-regulated, and relatively low-cost funds. It is important that we make sure our investors understand what’s at stake—the consequences they will suffer if regulators insist on regulating mutual funds as if they were banks.

I have worked in Washington for almost my entire career. When I travel to other parts of the country, many people draw me out about developments in the capital. Often these conversations start with expressions of puzzlement, even amazement—like, “What are they thinking back there?”

So, consider my remarks today as an imagined conversation with a mutual fund shareholder, an investor who is also a concerned citizen. I want to explain in clear terms why the funds they have entrusted with their savings and their financial dreams do not pose a threat to the stability of the financial system. I want to spell out the costs of treating a mutual fund as a SIFI, both in added expenses and in the distortions such regulations would bring to the competitive marketplace of funds. And I want to describe what the prospect of central bank regulation of our capital markets means—to the financial system and to the funding that fuels new businesses and job creation, especially in the United States.

That’s a tall order—especially in the few minutes I have. So let’s plunge in.

How can we say with such certainty that U.S. mutual funds do not threaten financial stability? After all, isn’t investing risky by its nature?

There's no question that investing in the stock or bond markets entails risks. For mutual funds, those risks are thoroughly disclosed under comprehensive regulation administered for almost 75 years by the Securities and Exchange Commission. Fund shareholders accept those risks in exchange for the prospect of returns.

But the debate over financial stability should focus on systemic risk—risk that can spread rapidly from one institution to another and then another, threatening the health of the financial world at large—and damaging the economy. It's the kind of risk that forces governments to step in with bailouts and rescues. It's that kind of risk that Congress, in the Dodd-Frank Act of 2010, told a new council of regulators, the Financial Stability Oversight Council or "FSOC," to focus on.

There are four reasons why U.S. mutual funds do not create super-sized risks like that.

First, mutual funds do not borrow significant amounts to make their investments.

That is, they make little use of what's called leverage—and leverage has proved to be the essential fuel of financial crises. Virtually all major financial crises have involved debt that has grown dangerously out of scale. That most certainly includes the great financial crisis we all just experienced.

As former Federal Reserve Chairman Alan Greenspan said: "It is not the toxic security that is critical, but the degree of leverage of the holders of the asset."

In the latest crisis, the "toxic security" was sub-prime mortgages—but Greenspan went on to say that if these securities had been held by mutual funds, we would not have seen contagion across the financial system. [1] Why? Because mutual funds do not invest with borrowed money.

In this respect, funds are quite unlike banks. For example, the largest U.S. banks—those that have been designated as risky to the global financial system—carry almost $10 in debt for every $1 dollar of equity. For the 11 largest U.S. stock and bond funds, the comparable figures are about 4 cents in debt for every $1 of shareholder capital.

The second—and related—reason why mutual funds do not create systemic risk is that these funds do not fail in the same way as banks. Regulators' fears about "disorderly failure" are based on their experience with banks—and don't apply to funds.

Banks guarantee customers that they will get their money back plus interest. Mutual funds have investors—and make no such promise. They don't promise any gain on investments. They do not even guarantee that investors will get their principal back.

If a fund's investments prosper, fund investors share the gains, on a pro rata basis. And if the fund's investments fizzle, shareholders know and expect that the losses are theirs.

Funds keep score on the ups and downs of their portfolios daily, calculating the current value of all their holdings.

Banks become insolvent with remarkable frequency, and every single one that fails requires the government to step in. With little or no debt and daily mark-to-market valuation, funds aren't likely to become insolvent. And when funds do close, they have a tried and true process for winding up their affairs. With no fanfare, literally hundreds of mutual funds and dozens of fund managers exit the business every year. Not one requires government intervention or taxpayer assistance.

But what about the risks of a fund's investment activity? The Office of Financial Research, the research arm of the FSOC, speculates that bad turns in the market make stock and bond fund investors take flight: they redeem their fund shares, and fund managers accordingly must sell the fund's investments—at "fire sale" prices that drive down markets and spread the damage to other investors and institutions.

This is a colorful story. We've been hearing it for a long time—since 1929, in fact. And every time stock prices falter or interest rates rise, the media comes searching for evidence that fund investors are panicking.

Well, my journalist friends tell me they have a saying in newsrooms—"Great story, if true." But this one isn't. That's point number three.

Modern U.S. mutual funds have been around for almost 75 years. During that time, we've been through a lot of what bank regulators call "stress-testing"—not their tabletop exercises, but real-world crises. The historical evidence is consistent and compelling: stock and bond funds have never faced the destabilizing "runs" that regulators and reporters imagine. In every period of market turmoil since World War II, stock and bond mutual fund investors did not "run"; fund sales of stocks and bonds accounted for a modest share of total trading; and funds' sales had a minimal impact on asset prices.

2008 was the second-worst year for the U.S. stock markets since 1825. From October 2007 to February 2009, the Standard & Poor's 500-Stock Index fell by more than 50 percent. Did stock fund investors pull out? Yes—they withdrew, on net, a grand total of 3.6 percent of assets. That's right—less than $1 in 25.

Proponents of the myth of the flighty fund investor are persistent—they keep trying out new theories. In every case they raise—high-yield bond funds, emerging-market funds, you name it—we have tested the data. And we have never found evidence to support their speculations that long-term funds destabilize markets.

What explains this? Well, U.S. households own the vast majority of our stock and bond mutual funds. At the end of last year, these funds had more than $12 trillion in assets, and 95 percent of that belonged to America's households. And contrary to the standard media line that individual investors

are “dumb” [2] and flighty, these investors have proved to be squarely focused on the long term. Years and years of ICI surveys confirm that virtually all of America’s 90 million mutual fund investors have saving for retirement as one of their goals—and three-quarters of them say that retirement saving is their primary goal.

In fact, half of stock and bond fund assets are held for retirement, in 401(k)s, individual retirement accounts, and similar plans.

What about the other half? Well, 80 percent of Americans who own funds outside of retirement plans rely upon professional financial advisers, who help investors stay the course through proper diversification and asset allocation, especially at times when markets are in turmoil.

There’s another reason for this stability—and it’s the fourth reason why funds do not create or transmit systemic risk. It has to do with the structure and regulation of mutual funds and their managers.

Banks invest for their own accounts, as principals, and they’re at risk for the money. That’s why they need to have capital on hand, to absorb losses that could bankrupt them.

Fund managers invest for their funds, as agents. Fund managers do not put their own money at risk—the gains or losses in the fund belong to the fund’s investors. That’s why fund managers do not need capital as banks do.

The very structure of funds limits the spread of risk. Each fund stands on its own—a legal entity separate from its manager and from the manager’s other funds. Gains or losses in one fund do not affect the investment results of any other fund.

A custodian, almost always a bank, holds all the assets of the fund—and neither the fund’s manager nor its creditors has any claim on those assets.

The comprehensive regulation of funds protects shareholders—but it also serves to limit risk. For example, mutual funds must have a simple capital structure. At least 85 percent of their assets must be liquid. Together with diversification and daily mark-to-market valuation, that liquidity helps mutual funds meet redemptions in a fair and orderly manner. And all aspects of the manager’s work for the fund are overseen by independent fund directors, there to help safeguard the interests of fund shareholders.

Not at all like banks ... little to no leverage ... no disorderly failure or need for government intervention ... a stable investor base ... agents, not principals ... and comprehensive regulation. On all these counts I can say confidently that mutual funds and their managers don’t occasion systemic risk.

ICI has been driving that message into the public debate on every possible occasion. Why? Because despite all these differences, there is every indication that the FSOC is proceeding down a path to regulate mutual funds like they were banks. The implications of this are very worrisome.

By designating mutual funds as SIFIs, FSOC would impair the single best tool available to average Americans for retirement saving and individual investment—as well as a key source of financing in our economy.

What does designation as a SIFI mean? Under the Dodd-Frank Act, the Federal Reserve conducts “enhanced supervision” of all SIFIs. A designated fund would need to meet bank-level capital requirements of 8 percent—purportedly for “loss absorption”—with the costs falling to investors. A designated fund would have to cover other costs as well—the costs of its Federal Reserve supervision, and a share of the costs of the FSOC and its research arm. All of these costs would flow through to fund investors.

These costs would fall uniquely on those designated as SIFIs—likely to be the largest U.S. funds or fund families. As a group, the largest U.S. funds are highly efficient and relatively low-cost within their asset classes. They have an average expense ratio of just 31 basis points.

So it would not take much of a “SIFI premium” to increase the fees of these funds significantly. That would make it hard for them to compete against the many similar funds that are not designated SIFIs. In our wildly competitive fund marketplace, designation won’t make a fund “too big to fail”—it will render it too burdened to succeed.

The Fed would become the “prudential supervisor” of any fund designated as a SIFI—broad power that would even reach to the fund’s portfolio management. The Fed could substitute its “prudence” for the fiduciary judgments of a SIFI-designated fund’s investment adviser. During times of market turmoil, for example, the Fed might impel a fund to maintain financing for a troubled bank, even if the fund’s manager were to conclude that holding that position is not in the best interests of the fund’s shareholders.

This concern is not theoretical. When Bear Stearns was rescued in March 2008 ... when Lehman Brothers collapsed in September 2008 ... when European banks were under stress in 2011—each time, regulators criticized funds for pulling back financing from those troubled institutions.

Bank regulators apparently expected that funds would ignore credit risk, accept avoidable losses, and “take one for the team”—in short, that the interests of the banking system, and of bank regulators, would trump those of the fund’s investors.

And then there is the prospect of a bailout. Under Dodd-Frank, if a big bank fails and its assets won’t cover its debts, the government can assess all other SIFIs—including any designated mutual funds—to make up the difference. The law was intended to keep the costs of bank bailouts from falling on taxpayers. Dropping that burden on retirement savers and other shareholders in large mutual funds is just a taxpayer bailout by another name.

I ask you: How long could fund investing—rooted in the trust of investors—continue to thrive under such conditions?

So far, I've been talking to my imaginary mutual fund shareholder as one investor to another.

Now, I need to shift gears and speak as one citizen to another.

Because there are two other aspects of this issue that ought to give all of us—as citizens—added concern.

The first is the very process by which these decisions are being made. As I said, both U.S. and global regulators are pursuing SIFI designation for large U.S. mutual funds. Unfortunately, neither forum provides the kind of transparency and accountability that so serious an issue merits—and that we as citizens have a right to expect from government.

The Dodd-Frank Act and rules adopted by the FSOC do establish some rudimentary standards for considering how the FSOC will assess non-bank institutions for SIFI designation. But the FSOC can change its rules at any time, and with no public notice. It operates largely in secret, with closed meetings that are never fully reported on the public record. U.S. law guarantees mutual funds and other SEC-regulated entities a wide variety of procedural protections—but most of those are simply absent with the FSOC.

Watching the smoke that's emerged from the FSOC's chimney, there's reason for concern that many of the Council's decisions are pre-judged. A research report prepared for the FSOC last September reflected a poor understanding of the asset management industry—at best—while cataloging imagined risks that the industry poses.

Just yesterday, the FSOC held a conference at the Treasury Department to help educate members of its various agencies about asset management. Yet weeks ago, the media were reporting that the Council was hustling two large mutual fund managers toward designation. In the face of such news, it's understandable that questions have surfaced about the fairness of this whole process.

Indeed, numerous members of Congress—from both sides of the Capitol and both sides of the aisle—are asking just those questions. More than 43 House members and nine Senators have written to Treasury Secretary Jack Lew to express concerns with the FSOC's proceedings.

And House Financial Services Committee Chairman Jeb Hensarling [R-TX] has called upon the FSOC to "cease and desist" all designation activities until Congress has an opportunity to understand the Council's activities. We agree.

There is another reason we should be concerned, as citizens, about granting bank regulators—specifically, the Federal Reserve—power over funds.

Doing so could erode one of the great strengths of America's economy—the dual system of financing through banking and capital markets that has been characteristic of the United States from its earliest days.

Yet that is precisely what will happen if the concept of systemic risk becomes, as one economist describes it, simply a "grab bag of scenarios," however improbable they may be, "that are supposed to rationalize" more and more intervention in our financial markets. [3]

Nothing in the Dodd-Frank Act suggests that Congress envisioned turning the Fed into a powerhouse regulator of our capital markets, much less an uber-manager of the savings America's households have put away for their retirement through mutual funds.

* * *

I suspect my imaginary fund shareholder is quite overwhelmed by now. Let me just leave him or her with one more thought.

As I said, this debate is not about regulation versus no regulation. Mutual funds already are one of the most highly regulated financial products available.

Fund regulation in the U.S. has been around for almost 75 years, and has proven to be highly successful—supporting the orderly growth and development of an industry that manages some $17 trillion in assets and serves half the nation's households. The Securities and Exchange Commission, as primary regulator of funds and their managers, can take pride in that record.

We need to continue to improve on that regulation, as our industry grows and its activities and practices evolve. Regulators always should be attentive to that need, and we welcome opportunities to work with them to protect our investors and strengthen financial markets further.

The FSOC can play a constructive role in this process—if it chooses to. That role is not as a stalking-horse for aggrandizing bank regulators at the expense of capital markets regulators. It is as a forum for serious, informed, and objective consideration of where and how risks arise for the financial system as a whole.

Such consideration, we are confident, would make clear that neither regulated funds nor their managers are a source of such risks.

Thank you for your time and attention.

endnotes

[1] Alan Greenspan, "How to Avoid Another Global Financial Crisis," *The American*, March 6, 2014. Emphases added.

[2] See, for example, Jason Zweig, “Investors, How Dumb Are You?” page B1, *Wall Street Journal*, May 10-11, 2014.

[3] Lars Peter Hansen, “Challenges in Identifying and Measuring Systemic Risk,” *University of Chicago, Becker Friedman Institute Working Paper 2012-012*, February 2013, pp. 4-5.

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