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Key policymakers across the globe, including those here in Europe, have acknowledged the need to enhance the resilience of the financial system and to provide a diverse basis for funding national, regional, and global economies.

In a speech last December, EU Commissioner Michael Barnier highlighted the importance of ‘mak[ing] the financial system safer while diversifying funding sources.’ Sharon Bowles, Chair of the European Parliament’s ECON Committee elaborated on the need for diversified funding, saying that ‘Asset managers are going to be the new front line in funding our economies, as well as recipients of regulation. We won’t get the former if we get it wrong with the latter.’

As regulators move to implement post-financial crisis reforms, it is essential that their analysis and regulatory measures reflect a comprehensive understanding not only of traditional banking models and regulatory approaches, but also of capital markets: specifically, their structure, institutional business models, investment propositions and, crucially, their regulation.

Failure to appreciate the fundamental differences between these two distinct dimensions of our financial system risks yielding inappropriate regulatory reforms that could hinder the development of economies with sufficiently diversified funding sources.

The regulatory approaches mooted in the United States and in Europe on money market funds are a case in point. The debate on these investment products has raged for years. At present, we await the Securities and Exchange Commission's answer, while, happily, a skeptical European Parliament has quite sensibly delayed the European Commission's deeply flawed proposed Regulation.

I do not propose to say more at this point about the money market fund debate, because the more urgent issue for global funds and their managers is the Financial Stability Board (FSB) consultation on its proposed methodology for identifying global systemically important financial institutions, or G-SIFIs.

The FSB's consultation in January came hard on the heels of a report from the US Treasury's Office of Financial Research (OFR) that strongly suggested that asset management poses systemic risk.

For three reasons, however, I am going to focus today on the FSB consultation.

The first is that the FSB approach has significantly greater potential to affect the regulation of funds on a global basis. The FSB's methodology, if pursued, will give national regulators a great deal of discretion to look at their own countries' investment funds and make a judgment about their potentially systemic nature.

The second reason to concentrate on the FSB consultation is that it more precisely focuses on funds. While the OFR report speaks of funds in very general terms—and does not even specify whether funds or their managers are its focus—the FSB consultation explains that its concern is investment funds of a certain size—funds with assets in excess of 100 billion US dollars.

And the third reason—speaking quite frankly—is that the FSB's report is a better, more substantive product. It does not take a myopic view of investment funds through a banking lens; instead, it acknowledges key characteristics of regulated funds that the OFR report does not.

The FSB consultation appropriately recognises the 'very different nature of [investment] funds' risk profiles' in contrast to those of banks, insurance companies, and other financial entities [1].

It outlines four fundamental differences:

- First, fund investors knowingly expose their money to the potential gains and losses in a fund's investment portfolio.
- Second, fund investors are the 'shock absorber' for systemic risk, meaning that any losses are absorbed by the investors and not magnified across the economy.
- Third, funds have various liquidity management tools to manage high levels of redemptions.
- Fourth, asset managers act as agents for investors.

The FSB consultation also notes that funds are highly substitutable—that in most asset classes, investors have many choices among funds. And it addresses the fact that funds do not fail in a disorderly manner, using data from the United States.

Yet while the FSB acknowledges these important differences, it does not recognise their full implication: that is, these differences support the argument that funds are not systemically risky.

My colleagues at ICI and ICI Global have devoted a considerable amount of effort and research to substantiating that statement—work that I will summarise, and try to do justice to, today.

Given the time constraints, however, I will not be able to discuss all of our work, or indeed, the entire scope of the FSB's methodology. We are, however, filing a lengthy and detailed comment letter on April 7, which will address each of the points the FSB has raised.

ICI and ICI Global's analysis has focused on those mutual funds that meet the FSB's 'materiality threshold' for consideration as G-SIFIs—funds that have assets in excess of 100 billion US dollars.

As it happens, there are only 14 funds in the world that meet that threshold—all of which are US mutual funds. These 14 funds are not hedge funds or private equity funds. Rather, they are funds similar to UCITS in that they invest in securities and are already substantively regulated.

The FSB's threshold creates a sample on which my colleagues in Washington have a great deal of data. That means my presentation may seem somewhat US-centric—but we are only following the FSB's lead.

What does that data tell us about these 14 funds in terms of systemic risk analysis? That these funds—the largest investment funds in the world—are not SIFIs. There are four reasons in support of this conclusion:

- First, regulated funds make little use of leverage—the essential fuel of financial crises.
- Second, these funds simply do not 'fail' the way banks and insurance companies do.
- Third, concerns about 'herding,' runs, and contagion—the investor behavior that would create and transmit risks from the fund sector to the broader financial system—are not supported by historical evidence.
- And finally, the structure and comprehensive regulation of mutual funds and their managers not only protect investors, but limit systemic risks and the transmission of risk.

Let us start with leverage first.

Leverage is the key differentiator among types of financial institutions, and is the fuel that can turn a financial spark into a bonfire. Indeed, all major financial crises have involved debt that has grown dangerously out of scale.

As former Financial Services Authority Chair Adair Turner has written: '[I]t is vital that we understand the fundamental importance of leverage to financial stability risks….The fundamental cause of the financial crisis of 2007–2008 was the build-up of excessive leverage.' [2]

Well, how levered are these 14 US funds?

The average leverage ratio for those 14 funds is 1.04 to 1. Contrast that to the average leverage ratio for US commercial banks, which is 9 to 1.

The simple fact is that US mutual funds—and similarly regulated funds in other jurisdictions—make little or no use of leverage. Therefore, their assets are almost entirely supported by investors' equity—money that fund investors have knowingly put at risk. As a fund's assets gain or lose value, those investment returns are entirely borne by fund investors.

The banking regulators who dominate the FSB process may miss the significance of these points, because their worldview is shaped by a lifetime of experience with highly levered institutions.

That worldview is also colored by their oversight of failing institutions—another area where banking experience has little useful application to funds.

Funds do not 'fail' in the same way that banks or operating businesses do. With limited borrowing, and with daily valuation of assets reflected in a fund's net asset value, it's highly unlikely that a fund would get to a point where its liabilities exceed its assets.

That does not mean that funds never close. In fact, in the United States, managers routinely close or merge funds for a variety of reasons.

In the decade from 2003 through 2012, more than 5,700 US funds were liquidated or merged—and 476 fund sponsors left the business. None of these required government or taxpayer assistance. To its credit, the FSB's consultation cites similar US data.

What about 'runs' on a stock or bond fund? If investors were to panic and run from such a fund, wouldn't that destabilise the market?

The FSB is concerned that if investors lose confidence in a specific asset class because a fund is in distress, their rapid movements could lead to runs on other funds that have similar features or investment strategies.

Let me be blunt—there is no evidence in US history to support that speculation about stock and bond funds.

ICI economists have scoured every period of market stress since World War II. The data show no evidence that US stock and bond mutual fund investors panicked and stampeded in any of those episodes.

The economists also looked at flows out of individual US stock and bond funds for every month since 1985 — well over 1 million data points. The herding and contagion hypothesis would suggest a large shift toward outflows in periods of market turmoil.

In fact, the data show only small shifts in such periods—and virtually no increase in the share of US mutual funds experiencing large outflows.

There is a fourth important reason why funds and asset managers do not create or transmit systemic risk—and that lies in the structure and regulation of funds and their managers.

Here, the principles I cite generally apply to regulated funds in a jurisdictions and regulatory regimes around the world.

Unlike banks and insurers, asset managers are agents, not principals. Asset managers do not put their own money at risk—and they do not need capital to absorb investment losses.

The structure of funds limits the spread of risk. In most jurisdictions, fund assets are held separately by an eligible custodian, and are not available to satisfy claims by the manager’s creditors.

The comprehensive regulation of funds also serves to limit risk—even as it protects investors. Standards for diversification, liquidity, and valuation help assure that funds can meet redemptions in a fair and orderly manner.

I’ve discussed four reasons why even the largest regulated funds are not SIFIs. To recap: they lack leverage; they do not fail in a disorderly manner; they have never been subject to runs; and their structure and regulation limit risks.

What does this analysis of the key characteristics of funds tell us?

It shows us that mutual funds and other funds with similar regulatory constraints and structures are highly unlikely to be the source of systemic risk transmission and therefore cannot sensibly be designated as G-SIFIs.

Therefore, while we recognise that every regulatory regime is different, we think regulators in Europe, Asia, Australia, or any other major fund market would be hard pressed to designate regulated funds as systemically important financial institutions.

To return to the broader questions facing this panel, I must also say a few words about the consequences of SIFI designation for large regulated funds.

The FSB has not specified exactly what additional regulations it would expect national regulators to apply to designated funds. What we do know, however, is that any additional regulation will impose additional costs and burdens on funds—and their investors.

We also know that new regulations and new costs applied selectively will distort the competitive landscape of our industry, in ways that are both numerous and unpredictable.

The consequences of designation could thus undermine an important source of funding for governments, businesses, and individuals worldwide.

So if we are to respond to the challenge that Sharon Bowles and others have articulated—that of asset management providing important diversification of finance—how will we get the regulation right?

There is a better way to address systemic risk concerns—if any—related to investment funds, and that is through activities-based regulation.

If regulators believe that specific activities or practices could pose risks to the financial system, they should use their existing authorities—augmented in many jurisdictions by post-crisis reforms—to address them.

Substantial efforts are already underway to address regulators' systemic risk concerns in specific areas—including money markets, repurchase agreements, securities lending, and derivatives trading.

None of these issues is simple. But while coping with discrete activities and practices may be challenging, this approach offers several advantages over the sweeping resort to SIFI designation. It starts with demonstrable risks. It addresses risks that can arise in small institutions as well as large ones. And it employs the skills and experience of primary regulators, rather than drawing only from the bank-centric views that dominate discussions of systemic risk.

The latter factor is of particular concern to those of us who operate in the capital markets. It should be of concern, too, to all who want to foster diversity—and greater strength—in the financing upon which our economies depend.

Thank you for your kind attention, and I look forward to our discussion.

endnotes

[1] FSB, Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (8 Jan. 2014) at 29.

[2] Adair Turner, 'Debt, Money, and Mephistopheles: How Do We Get Out of This Mess?' Group of Thirty, Occasional Paper, no. 87 (May 2013)
