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Promoting Excellence in Fund Governance

ICI Provides Detailed Empirical Analysis to Rebut FSOC's 'Systemic Risk' Theories for Regulated Funds

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Washington, DC, March 26, 2015—In a detailed response to the Financial Stability Oversight Council (FSOC), ICI addressed questions about the operations of regulated stock and bond funds, rebutted the FSOC's misconceptions about potential liquidity risks, and stated that "an objective review of the record will lead the Council to conclude that these funds do not present risks to U.S. financial stability."

The ICI comment letter, filed in response to the FSOC's request for information on asset management products and activities, offers original empirical research on the historical behavior of stock and bond funds and their investors, as well as on the liquidity management practices of fund managers. The letter details how those practices, combined with the comprehensive regulation of funds and their managers, serve to rebut the FSOC's hypothetical concerns that fund investors have incentives to increase selling or add to liquidity pressures during periods of market stress.

ICI's letter also warns that any "solutions the Council may ultimately propose" to perceived risks around stock and bond funds should not exacerbate risks or introduce excessive new costs. Any fund or manager that the FSOC might designate as a "systemically important financial institution" (SIFI) would be subject to oversight by the Federal Reserve and bank-like regulation, including possible capital requirements. Inappropriately applying these or other highly prescriptive "remedies" to regulated funds or their managers would have the negative effect of:

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

“Many of the concerns that the FSOC and other regulatory bodies raise about funds are based on hypothetical assumptions about risk, with no support from empirical data, the historical record, or industry experience,” said ICI President and CEO Paul Schott Stevens. “We hope the FSOC’s request for information signals the Council’s determination to increase its reliance on evidence and experience, and to take full account of current regulation. If so, we are confident that the FSOC will agree that there is no basis for SIFI designation of a regulated fund or its manager.”

The SEC’s regulatory framework promotes financial stability

The FSOC request sought information in four areas—liquidity and redemptions, leverage, operational risk, and resolution of funds or managers through closure or merger. As ICI’s letter explains, all four areas “have been subject to extensive regulatory oversight . . . throughout the 75-year history of U.S. regulated funds.” Securities and Exchange Commission Chair Mary Jo White has announced a robust rulemaking agenda to make potential enhancements in all four areas as early as the third quarter of 2015. The SEC’s regulatory framework promotes financial stability, and the SEC is best positioned to address any regulatory concerns relating to the asset management industry.

Data rebut FSOC hypotheses on investor incentives, liquidity management

One central theme raised by the FSOC and bank-oriented regulatory bodies has been the hypothesis that fund managers’ approach to accommodating investor redemptions creates significant incentives for investors to redeem quickly during periods of market stress and thus accelerate market declines or exacerbate liquidity pressures.

In a detailed, data-based analysis, the ICI letter shows that this theory does not match actual fund behavior. Mutual fund cash flows and portfolio managers’ ongoing liquidity management are effective in allowing funds to meet redemption demands and maintain liquidity. Contrary to the FSOC theory that shareholder redemptions make funds less liquid, the letter notes, data demonstrate that “funds’ holdings of cash as a percent of their assets tend to remain relatively stable, even during periods of redemption.” This is consistent with ICI’s earlier findings that outflows from stock and bond funds are muted even in times of market turmoil.

Further findings demonstrate that regulated funds don’t pose risks to financial stability

Similar analyses of the FSOC’s other concerns show that:

- On leverage, “the very largest regulated funds barely are leveraged,” and “it is frankly puzzling how the FSOC or [Financial Stability Board] believes a regulated fund could ever be the source, or transmitter,” of risk to lenders or counterparties. [ICI comment letter, page 55]
- On operational risks, “the regulated fund industry is well positioned to respond” to unanticipated business interruptions, due to “robust business continuity planning by funds and their key service providers, technology and processing improvements … and involvement by the SEC and FINRA.” [page 8]

- On resolution, “mutual funds do not experience ‘disorderly failure.’ … Without leverage, it is virtually impossible for a fund to become insolvent—i.e., for its liabilities to exceed its assets.” The letter provides data showing that large numbers of stock and bond mutual funds and fund sponsors have left the business each year without “broadly affecting the investing public, market participants, or financial markets”—and without government assistance. [page 75]

For more information on ICI’s positions and research, please visit our Financial Stability page.

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