

ICI: G-SIFI Designation of Regulated Funds Unnecessary and Inappropriate, Would Harm Investors

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FSB Focus on Size Alone Misplaced; Leverage Is Critical in Determining Risk

Washington, DC, April 8, 2014 - Designation of regulated funds like US mutual funds as “global systemically important financial institutions” (G-SIFIs) is neither necessary nor appropriate, ICI says in a [comment letter](#) to the Financial Stability Board. The consequences of designating such funds “would be highly adverse to the designated fund, its investors, the overall fund marketplace and fund investing at large,” ICI says.

The ICI letter explains that the [methodology proposed by the FSB](#) for assessing investment funds, based on a per se threshold of US\$100 billion in assets, would lead to 14 regulated US funds being ultimately put on the path for designation by the US Financial Stability Oversight Council (FSOC) as “systemically important financial institutions” (SIFIs). National authorities in other jurisdictions could set their own thresholds and sweep in more funds for enhanced regulation.

The ICI letter explains how the existing regulation and defining characteristics, as well as the historical experience, of regulated US stock and bond funds make designation inappropriate. ICI President and CEO Paul Schott Stevens submitted the letter on behalf of the Institute’s entire fund membership, including US and global funds.

“The FSB’s consultation seems to reflect an inclination on the part of some regulators to paint the entire canvas of the financial system with a single broad brush and to dramatically expand bank regulatory standards to other types of financial institutions, regardless of how they are structured,

operated, and currently regulated,” says ICI President and CEO Paul Schott Stevens. “We urge the FSB, as well as the FSOC, to adopt procedures that assure greater transparency and that promote greater public and industry confidence.”

ICI suggests that a better way to protect investors and address regulators’ concerns about potential risks is through an activity-based approach to regulation. The approach that US and European Union regulators currently are taking on money market funds is an example of an activity-based approach to risk-mitigating regulation, the letter says.

FSB Proposes Fundamentally Flawed Materiality Standard; Size Alone Is Immaterial

The letter explains that, in isolation, the size of an investment fund—in contrast to the size of a bank—reveals very little about whether that fund could pose risk to the financial system. ICI urges that any initial threshold used by the FSB for evaluating investment funds should include a measure of leverage—the essential fuel for financial crises.

The FSB’s proposed “materiality threshold” of US\$100 billion in assets is at odds with the FSB’s stated goal of consistent treatment for different types of financial institutions. The 14 regulated US funds that meet the threshold are “orders of magnitude smaller than global systemically important banks (G-SIBs),” the letter states. “Far from promoting consistency, the consultation in fact proposes to apply a unique and more sweeping standard to investment funds, without any justification for this difference in treatment.”

Regulated funds also contrast sharply with banks in their use of leverage. The balance sheet leverage ratio of the 14 regulated US funds averages 1.04, as compared to an average of 10.7 for US G-SIBs. At this rate, for a regulated US fund to achieve the same dollar amount of indebtedness as the smallest US G-SIB, the fund would have to hold US\$5.4 trillion in assets under management—17 times greater than the world’s largest regulated fund.

Funds’ Existing Regulation, Features Render Designation Unnecessary, Inappropriate

In the letter, ICI explains other defining characteristics of regulated funds and their regulation that set them apart from banks and make designation inappropriate for these funds:

- The FSB consultation’s concepts of “distress” and “disorderly failure” have little relevance to investment funds. Investment losses do not constitute “distress” for a fund. Unlike bank depositors, fund investors are not promised either a gain on their investment or a return of their principal. The ability to redeem shares on a daily basis is a defining feature of US mutual funds and underlies many of these funds’ regulatory requirements and operational practices—including daily valuation of fund assets and liquidity requirements.
- The concept of public “bailouts” likewise has little relevance to investment funds. Literally hundreds of regulated US funds exit the business through liquidation and merger each year, without any

government intervention or taxpayer assistance. As the consultation recognizes, “even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact” for the period from 2000 through 2012.

- The FSB’s concerns about “systemic risk transmission” through rapid liquidation of fund assets are not warranted. Since the inception of regulated fund investing in the United States almost 75 years ago, the historical evidence is consistent and compelling: stock and bond funds have never faced such a scenario, not even during the global financial crisis of 2007–2008. Even in adverse market conditions, trading by regulated US funds represents a modest share of overall market activity, which reflects the largely retail investor base of these funds and the long-term financial goals of most fund investors.

FSB Approach Would Harm Investors

While the FSB consultation does not specify what policy measures would apply to investment funds designated as G-SIFIs, the letter notes that the Dodd-Frank Act in the United States prescribes a set of requirements for nonbank SIFIS, including the likely imposition of capital requirements (perhaps as high as 8 percent) and supervision by the US Federal Reserve Board.

Unlike banks, regulated funds simply have neither the need nor the ability to meet capital requirements, ICI states. Their “capital” comes from investors who fully accept that they will absorb investment gains and losses. Capital requirements imposed on regulated funds would introduce moral hazard and would lessen market discipline.

The costs of capital and new fees imposed on a designated fund would be borne by fund investors. It would not take much of an increase in costs, the letter notes, to drive investors—who have demonstrated their sensitivity to fund costs—away from designated funds to their many competitors.

In addition, designation of a fund would put its investors on the hook to help pay for the resolution of a failing financial institution—contrary to the goal of Congress to end US taxpayer bailouts of financial institutions. “It would be both ironic and most unfortunate if the end result were to burden US mutual fund investors—many of whom are saving for retirement—with those costs,” the letter states.

Supervision by the Federal Reserve also could affect a designated fund’s investment management and service to its investors. ICI explains that under US law, fund managers have a fiduciary duty to always act in the best interests of their funds. If, however, a fund is subject to bank-style prudential supervision by the Federal Reserve, regulators could impel the fund manager take certain actions to maintain financing for banks or other counterparties, regardless of whether such actions serve the interests of the fund and its investors.

ICI Supports “Activity-Based” Approach to Regulation

As an alternative to designation of individual regulated funds, ICI urges regulators to focus instead on identifying specific activities or practices that they believe pose risks and address those concerns through “activity-based” regulation. The FSB consultation appropriately acknowledges that this could

be an alternative to the designation approach. Capital markets regulators should take the lead with respect to regulation of capital markets activities and practices.

Regulators already are making notable use of both new and existing authorities to address risks where they arise. For example, in addition to money market fund reform efforts by US and international regulators, US regulators are also continuing to address specific concerns with securities lending, repurchase agreements, and swaps trading, clearing, and settlement. The US Securities and Exchange Commission is working to strengthen its oversight of US asset managers and regulated funds—an effort that ICI welcomes and is supporting. In addition, ICI's Board of Governors has endorsed a voluntary industry initiative to shorten settlement cycles for a range of securities. ICI and its members in many jurisdictions are engaging across this range of initiatives to help advance efforts to make markets and market participants more resilient to future shocks, without imposing undue costs and burdens on regulated funds and their investors.

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