

Why Mutual Funds Do Not Pose Systemic Risk

“Why Mutual Funds Do Not Pose Systemic Risks”

16th Annual Investment Company Directors Conference

Paul Schott Stevens

President & CEO

Investment Company Institute

November 11, 2009

Amelia Island, FL

Thank you, Mike [Michael S. Scofield, chairman of the Independent Directors Council], and good evening to all of you. It is a great pleasure to be with you here tonight at IDC’s Investment Company Directors Conference.

The IDC is celebrating its fifth anniversary this year. I never have any trouble remembering how old the IDC is, because it was launched just a few weeks before I rejoined the Investment Company Institute as president and CEO in June 2004. So I have watched the IDC grow and blossom into a tremendous resource for fund directors, promoting education, advocating sound policies, and creating opportunities—like this conference—to build a stronger director community. All of us at ICI take great pride in the progress IDC has made, and in the outstanding work that all of you do, year in and year out, in your vital role on behalf of fund investors.

We’re glad that you could make it here tonight. I don’t have to tell you that the Florida Gulf Coast was threatened this week by Hurricane Ida. Of course, the chamber of commerce of Amelia Island will hasten to tell you that that’s the *other* side of Florida. On their web site, the city fathers boast that just

three storms of hurricane strength have come ashore near Amelia Island in the last 155 years. The National Hurricane Center says your risk of experiencing a hurricane is 25 percent higher in New York City or on Long Island than it is here. So you should all be feeling quite safe right now—particularly you New Yorkers!

I want to talk tonight about risk—specifically, systemic risk and how to manage it. Anticipating and limiting risks that threaten the stability of the entire financial system is a topic that's very much on the minds of policymakers in Washington after the financial hurricane that we've just weathered.

You may ask why mutual funds should be brought into that discussion. The debate over systemic risk generally has not focused on mutual funds—and quite correctly so, based on our experience of the past two years.

But I see three reasons why our industry needs to offer its own analysis and viewpoint on this issue.

The first reason is that the financial crisis has spurred policymakers to examine every aspect of the financial system—and that includes an effort to identify and preemptively address future major risks to the financial system. This prospective approach to regulation is a break with the past. Few experts were talking about banks being “too big to fail” until Continental Illinois’ insolvency in 1984 turned that concept into a regulatory catchphrase. Nor was there much attention paid to the risks posed by smaller but highly leveraged firms until Long Term Capital Management had to be rescued in 1998. And investment banks were not widely considered sources of financial instability until Bear Stearns was clawed back from the brink of bankruptcy—and Lehman Brothers was allowed to slide over the precipice. After that experience, Congress and the Obama administration want to establish mechanisms able to take a broad and searching look at today's and tomorrow's activities, products, and structures—with the objective of avoiding or mitigating major hazards to the financial system.

The second reason why we need to speak up is that the events of the past two years have highlighted sources of risk that extend well beyond traditional concerns with commercial banking. As Gerald Dwyer and Paula Tkac of the Federal Reserve Bank of Atlanta recently wrote, “securities based on subprime mortgages [were] less than 1 percent of [the estimated] \$138 trillion in assets traded in securities markets around the world” in late 2006. Yet problems in this relatively tiny sector spread to a wide array of other assets and took a toll on financial institutions around the world—banks and non-banks alike. As Federal Reserve Chairman Ben Bernanke has said, “strong and effective regulation and supervision of banking institutions, although necessary for reducing systemic risk, are not sufficient by themselves.”

A third reason we need to engage in this debate is that during the worst month of the crisis, some singled out money market mutual funds as a contributor to financial instability. That view is based on an incomplete narrative of the events of last fall, and the actual experience of money market funds requires a more careful analysis. We launched that discussion last March with the report and recommendations of ICI's Money Market Working Group. The SEC currently is considering extensive amendments to its regulations for money market funds. And this issue is before the President's

Working Group on Financial Markets as well. We will undoubtedly have opportunities to comment further on money market funds in the weeks ahead. But for tonight, I want to confine my remarks to the broader question of whether mutual funds generally are a source of systemic risk.

I should note at the outset that questions were raised before in our history about whether mutual funds could act as a destabilizing force. In the 1990s, with the rapid growth in stock and bond mutual funds, many commentators were concerned that individual investors, with their newfound access to these markets, would panic in a sharp market correction. If those individuals dumped their mutual fund shares, the argument went, they could turn a market downturn into a rout.

This proposition has been disproved, however, time and again.

In the mid-1990s, ICI conducted a number of studies on actual investor behavior, looking at every stock market break from 1944 through 1995. Our economists found that stock mutual fund investors never liquidated their holdings *en masse*. Even after 1987's Black Monday, outflows from stock funds over the next six weeks totaled only 5 percent of assets.

Since then, we have had two severe bear markets. But the same pattern of steady long-term investors persisted through the bursting of the tech stock bubble. And it has held true throughout the extraordinary market conditions that we have seen since the fall of 2007, with investors in long-term mutual funds standing fast in the face of the largest stock-market drop since the early 1930s. From the market's peak in October 2007 to the market low in March 2009, the Standard & Poor's 500-stock index fell 56 percent, yet stock mutual funds saw a net outflow amounting to just about 5 percent of their average assets during this period. And during September and October of 2008, when the S&P 500 fell 35 percent in just eight weeks, outflows totaled only 3 percent of stock fund assets. Fund shareholders consistently tell us that they are long-term investors—and they have been true to their objectives, even amidst the worst financial storm in generations.

So, back to the question at hand: Do mutual funds pose generalized risks to the financial system? Lest there be any suspense on this point, I would assert that they do not—and I expect most everyone here would agree. For even the strongest propositions in our policy debates, however, there is always a skeptic—so let me explain why I don't believe funds pose such risks. Doing so, I hope, will shed useful light on the nature of our industry and how it is regulated and conducted.

Let's admit at the outset that defining "systemic risk" is tricky, especially *ex ante*. In my testimony to the Senate Banking Committee in July, I called for a council of regulators who could identify "major hazards that can arise from financial activities, products, or structures, and that can spread rapidly and cause significant damage to our financial system." That working definition at least can serve as a starting place. It accepts the notion that such risk can emerge at numerous points. It focuses on "major hazards"—that is, truly out-sized risks—and on the contagion effect for the system at large as opposed to damage to individual entities.

But deciding what we mean by systemic risk is only the first step. As a practical matter, it's even more important to identify those activities, products, or structures that can create these major, system-threatening hazards.

It turns out that this, too, is no simple task. A number of factors have been suggested as key starting points for the analysis. The first is scale. As Treasury Secretary Timothy Geithner has said, "This financial crisis has shown that the largest financial institutions can pose special risks to the financial system as a whole. In addition to regulating these institutions differently we must give the federal government new tools for dealing with situations where their solvency is called into question."

But an institution need not be large to pose significant risks—nor does every large institution harbor the same risks. In both cases, it is the nature of the institution's activities that counts.

For this reason, a second factor being discussed is the "interconnectedness" of a financial institution. Presumably, an institution is more likely to introduce risks to the system at large when its activities are wide-ranging and complex, and it conducts its business with or through many other financial institutions. The activities of AIG Financial Products, which became the primary writer of credit default swap protection for mortgage-backed securities, illustrate those risks.

Other factors also are cited as potential indicators of systemic risk. Each of these loomed large in the context of the recent financial crisis. First is a specific form of interconnectedness—leverage. A second is illiquidity. A third is lack of transparency.

So, how do mutual funds appear when measured by those elements of systemic risk?

Let's start with size. The fund industry as a whole is very large and very pervasive. At the end of September, mutual funds managed \$10.8 trillion in assets on behalf of 87 million shareholders. And some fund complexes are sizable: ICI's three largest members all topped \$1 trillion in mutual fund assets, and 14 complexes managed more than \$200 billion apiece.

Impressive as they are, however, these figures can be a bit misleading. They represent the assets managed by complexes—not by individual funds. Each complex is composed of dozens, and in some cases, hundreds, of different funds. Typically, funds within a complex invest in a wide variety of different markets. And the vast majority of those funds are not large individually. At the end of 2008, 90 percent of equity funds had total net assets of \$1.3 billion or less; among bond funds, 90 percent held \$1.5 billion or less. On a systemic scale, these are not numbers that inspire concern.

More important, even the largest funds are not "interconnected"—they lack the web of relationships that is so crucial in launching and spreading risks throughout the financial system. Within a complex, each fund is a separate legal entity, organized as a corporation or business trust. Each fund has its own advisory relationship, shareholders, and assets held by an independent custodian. Each fund is subject to the control of its board of directors or trustees, the majority of whom are independent of the

fund's adviser. That adviser may manage many funds, but it owes a strict fiduciary duty to each fund: The adviser cannot sacrifice Fund A's returns to benefit Fund B. The adviser cannot mingle the various funds' assets; it cannot entwine funds in interlocking ownership of one another's shares; and with very limited exceptions it cannot set up business relationships with or between funds.

Of course, for efficiency, funds in a complex may depend on common operations and administrative support. Certainly they share a common brand and reputation. But within this structure, the XYZ Growth and Income fund is not liable for the failings of the XYZ World Equity Fund, or for those of any other fund in the XYZ family. Indeed, should the XYZ World Equity Fund falter, the other XYZ funds are prohibited from coming to its aid. The decline of one fund does not set off a domino effect within the family. We have seen notable examples during the financial crisis of high-yield or short-term bond funds suffering significant losses leading to heavy redemption pressure—without notable collateral damage to their sibling funds.

In fact, in our dynamic market, mutual funds are formed and go out of business routinely. In 2008, sponsors created 597 new mutual funds, while they liquidated 289 funds and merged 230 more. All of this activity transpired without causing a ripple in the broader financial markets, with no need for government intervention, and at no cost to the taxpayer. Contrast that to the failure of even a single bank—and so far in 2009, there have been 120 bank failures.

What about funds' relationships with their investors and other financial institutions? Do these connections create or spread systemic risks? To answer that question, we have to look closely at the other three factors—leverage, liquidity, and transparency. When we do, it's clear that mutual funds do not pose risks to the financial system as a whole.

First, as you know, investment companies face strict limits on leverage. For banks and other institutions, leverage provides the multiplier that makes our financial system such an efficient engine for economic growth. But in times of strain, leverage also can multiply small losses, creating risks that can shake the financial system.

Well before it failed, Bear Stearns was leveraged at 31-to-1—each dollar of capital was supporting \$31 in assets. When a firm is that highly leveraged, a 5 percent drop in asset values is more than enough to wipe out all of its equity. And when one highly leveraged firm holds the assets of another highly leveraged firm, losses can spread almost exponentially.

By contrast, the maximum leverage ratio allowed for mutual funds is 1.5-to-1—and most operate with less. Funds are strictly limited in the extent to which they can borrow, sell securities short, purchase securities on margin, or invest in certain derivatives. While those practices are common in hedge funds and other investment vehicles, their prohibition for mutual funds has an important benefit: A mutual fund cannot lose more than its shareholders' investment. Put differently, a fund's liabilities don't exceed its assets. And that, in turn, reduces mutual funds' systemic impact.

Lack of liquidity is another key element of systemic risk. Banking has always been regarded as risky because banks use highly liquid deposits to fund commercial, personal, and real estate loans. Deposits, for the most part, must be redeemed upon demand, while loans, for the most part, are neither callable nor readily tradable. So in the days before federal deposit insurance, when depositors lined up at the bank's door, the banker had no way to satisfy their demands for ready cash.

Mutual funds' liabilities are also highly liquid—a fund's shareholders have the right under almost any circumstances to redeem shares daily. But funds' assets are also liquid, consisting as they do of marketable securities. Mutual funds are required to maintain liquidity for ordinary redemptions, and no more than 15 percent of a fund's portfolio can be held in illiquid securities. Even those illiquid securities must be valued at their fair market value on a daily basis.

As a result, funds routinely handle large flows—purchases, exchanges, and redemptions—without any notable consequences to the broader financial system. Indeed, in a typical year, between 40 percent and 60 percent of long-term mutual funds are in net outflow. In the last 20 years, \$50 trillion have flowed in and out of long-term mutual funds—with nary a hiccup in the financial system traceable to those flows.

Lastly, let's consider transparency. Dwyer and Tkac, in their paper for the Atlanta Fed, say that “the underlying cause of the financial turmoil” was “the doubtful condition of financial institutions due to their ownership of difficult-to-value [...] assets.” That became quite evident in a number of market indicators, such as the spread between the effective federal funds rate, as measured by the overnight index swap rate, and the interbank lending rate, or LIBOR. On September 12, 2008, banks were paying a premium of just about 90 basis points to borrow overnight from one another; over the next month, that spread quadrupled, to more than 360 basis points. What that tells us is that sophisticated banking institutions lacked understanding and confidence in the assets and functioning of their banking counterparts.

Now, it is true that mutual funds, particularly fixed-income funds, owned some of those opaque assets. But funds, unlike other investors, were required to mark those assets to market on a daily basis. At the close of every day, each of the 7,000 long-term mutual funds operating in America must value its assets and reset the net asset value of its shares to match.

Transparency is built into every aspect of a mutual fund's structure. Those on the inside, whether at the adviser or on the board, do cope with many technicalities and fine points of law. But for an investor, a mutual fund is inherently simple and transparent. When investors buy shares in a fund, they know they are getting a piece of a professionally managed portfolio. They know that they have the same rights as every other shareholder, in a simple capital structure with no preferred shares or senior securities that will preempt their claims on fund assets. And they can know what their funds are holding, because funds must disclose their portfolios every quarter, and between disclosures are limited to buying and selling securities that fit their names, investment objectives, and other prospectus disclosures.

These valuable protections are no accident. They are the result of a comprehensive, well-developed regulatory regime rooted in the Investment Company Act of 1940. That Act was passed after the great crash of 1929, specifically to rein in the abuses that investment companies practiced when they were, in the words of economist John Kenneth Galbraith, “the most notable piece of speculative architecture of the late Twenties.” The valuable protections that were put in place by the '40 Act were not addressed directly to systemic risk, but they do bring added confidence that lends stability to funds' operations.

What can we conclude? If nothing else, perhaps I have convinced you tonight that it is extraordinarily difficult to define and identify systemic risk in the abstract. Our lawmakers are struggling with just that problem now, as they seek to craft legislation on avoiding and coping with these broad, unpredictable hazards.

I hope, however, that I've also convinced you of the necessity to approach these questions with a searching attitude. We cannot understand the risks that a specific financial activity, product, or structure poses unless we study it in detail.

In turning that lens on our industry, I hope I have made the case that mutual funds do not create broad risks for the financial system at large. No matter how many shareholders we serve, no matter how many assets we manage, the structures and protections that arise from the Investment Company Act of 1940 mitigate very substantially the risks that a fund industry like ours might pose if it were regulated and conducted differently. I believe that is the result, fundamentally, of the '40 Act's focus on putting the interests of shareholders first and foremost—a focus that our industry has adopted and made central to all of our operations.

Those of you here tonight are key to maintaining that focus. You represent our investors, and you do so diligently and with the highest fiduciary standards. You are here tonight because you want to advance your abilities to serve shareholders effectively.

Thank you for all of your efforts in that task, and thank you for your time and attention.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete.

Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.