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One Year Later: Some Lessons from the Financial Crisis

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President's Address, ICI Capital Markets Conference

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Good morning. I'm Paul Stevens, President and CEO of the Investment Company Institute and it is my great pleasure to welcome you to ICI's 11th annual conference on capital markets.

When we met a year ago, the financial crisis was raging. The failure of Lehman Brothers was still fresh, and events were unfolding rapidly, with the passage of the TARP legislation, roll-out of the Treasury Guarantee Program for money market funds, and other measures. The financial markets were exceptionally fragile: During the week when we held our conference, the Dow Jones Industrial Average lost 18 percent of its value and fell below 10,000—a level it has yet to reach again.

One year later, millions of Americans are still feeling the effects of the financial crisis—in unemployment, lost income, lost homes, and the damage done to their financial aspirations, including retirement savings. Yes, the credit crisis has eased, and equity markets are up from their low points last spring, softening the blow to investors' accounts. The worst of the crisis is past. But we cannot think—as many in the press seem to believe—that a partial recovery in the stock indexes and renewed profitability for some financial institutions mark the end of that episode. Nor should a dawning recovery remove the impetus for changes in how we do business.

Instead, we need to review those events and learn from them, so that we can work together to strengthen our financial system and make it more resistant to crises—and more resilient when the next crisis comes.

What are these lessons? Here are a few that I have drawn.

First, we've all seen how complicated and interdependent our financial system has become, both in the U.S. and globally. We've seen rising foreclosure rates in Phoenix, the failure of storied investment banks on Wall Street, and a near-collapse of the banking system in Iceland—all linked to a quiet, almost unnoticed growth in U.S. mortgage lending to subprime borrowers.

Clearly, we need to create structures that look across borders, across business lines, and across jurisdictional fiefdoms to anticipate and address serious threats to the stability of the financial system. No existing regulator has the breadth of vision or detailed knowledge to cope with these complex and multi-faceted risks. That is why ICI has urged Congress to establish a Systemic Risk Council, including the core federal financial regulators, charged with identifying risks and directing the regulatory actions needed to mitigate them. Enlisting diverse perspectives and expertise will improve our odds of spotting the risks that could trigger the next crisis.

The second lesson I've drawn is that financial markets depend vitally on public understanding, public confidence, and trust. I'm not saying that the average saver or investor has to be conversant with derivatives or even able to read a balance sheet. But the public has to have confidence in the basic character of financial markets and financial leaders.

In the aftermath of the panic of 1907, J.P. Morgan was called to testify at a Congressional hearing. Asked about the basis of the financial system, he replied, "The first thing is character." He added, "[A] man I do not trust could not get money from me on all the bonds in Christendom."

Character, with respect to markets, depends on features like orderliness, transparency, effective oversight, and the assurance that all participants are treated fairly. If those features in fact are absent—or simply appear to be so—confidence can ebb quickly. Confidence must be earned, it cannot be compelled. Confidence begets confidence, but the reverse is also true. When distrust reaches a critical level, financial markets can shut down entirely. And rebuilding or regaining trust—what William Pitt described as a "plant of slow growth" —is difficult.

Obviously, those of us in the mutual fund industry have long known that investor confidence is crucial. Our regulatory framework dates from 1940. It was designed to regain confidence in investment trusts, something that had been lost as a result of abusive practices in the late 1920s and the stock market crash of 1929. Our regulation was built around some key principles: disclosure, simple capital structures, strict limits on leverage, prohibitions against self-dealing, and strong custodial arrangements to protect fund assets. And over the years these principles have served to enlist the confidence and to protect the interests of millions of American households as fund investors.

Even with all these proven regulatory safeguards, however, the turmoil of the last two years—and especially the volatility in equity markets—has colored many investors' views on mutual funds. We have been tracking shareholder sentiment about mutual funds for many years. In our May 2009 survey, 64 percent of fund shareholders said they had favorable impressions of fund companies, down from 73 percent in 2008. If the mutual fund industry, which had so small a hand in creating the crisis, could suffer such a hard knock, that to me is proof that financial debacles have a high cost that all market participants pay in some form or other.

The third lesson, for me, concerns the important role that government plays in our markets. As the events that unfolded last September showed, sometimes only government has the firepower needed to stop a crisis. We saw this firsthand, when the bankruptcy of Lehman Brothers caused a money market fund to write down its net asset value below the $1.00-per-share that such funds try to maintain. After this fund broke the dollar, many other money market funds faced severe redemption pressure, even as the markets in commercial paper and municipal debt faced serious strains. As you all know, the Treasury Department and the Federal Reserve stepped up, constructed a series of fire lines, and helped restore liquidity in these markets and confidence in money market funds. This was effective crisis management.

It's important, however, that programs created to halt a crisis don't take on a life of their own and outlast the need. That's why we are glad that the Treasury Guaranty Program for Money Market Funds had a strict one-year time limit, and expired without incident last week. No claims were filed or paid under the Guaranty Program, and Treasury collected a tidy $1.2 billion in premiums along the way. The Fed's credit facilities for the money markets will also roll off in due course.

Government's other role, of course, is to make sure that the rules by which financial institutions operate day-to-day are fair, efficient, and followed. As the crisis eases, Washington is conducting a broad review of the line-up of agencies that oversee financial institutions and considering a wide-range of substantive reforms. One aspect, as I've mentioned, is the regulation of systemic risk. Another that is central to our business is capital markets regulation. ICI is pleased that the Administration reaffirmed the Securities and Exchange Commission's authority over capital markets, including investment companies, and we urge Congress to strengthen the SEC in that role.

Going forward, one great challenge is to strike the right balance between the role of government and that of the private sector. A fourth lesson of the crisis is that regulation is necessary—but it can be far more effective when it is backed by industry leadership on best practices.

Here, too, our experience with money market funds is instructive. As the immediate crisis of last fall eased, the leadership of ICI recognized that new rules would be needed to make money market funds even more resilient. So we took the lead, creating a Money Market Working Group to identify a comprehensive set of regulatory changes. The Group recommended, among many other things, tough new standards on liquidity, to improve money market funds' ability to respond to heavy demand for redemptions. Members of the Working Group pledged to abide by these new standards even before the SEC adopts final rules in this area. I'm pleased to note that the rules the SEC has proposed reflect many of our Working Group's recommendations. As a result of all this effort, perhaps more progress has been made on strengthening money market funds than on any other issue raised by the financial crisis.

The list of issues still to be resolved is long and growing. Take, for example, a topic that we will be focusing on today—market structure and trading. As you all know, since the SEC undertook to enact Regulation NMS, our securities markets have seen an explosion of new trading venues and practices. This burst into public attention in August, when the issue of "flash orders" moved to the center of the SEC's agenda. Suddenly, the financial pages—and the editorial pages—were full of discussions of high-frequency trading, rebate-driven order flow, algorithmic trading, dark pools, co-location, and market fragmentation.

Our fund members take a keen interest in market structure. That's because we are, more than ever, the conduit through which ordinary Americans deal with the capital markets. From 2004 to 2008, U.S. households sold, on net, $2.5 trillion worth of directly held stock. At the same time, they purchased, on net, $2.4 trillion worth of registered investment company assets. When we discuss market structure, we often hold a mental image of the "retail" investor as the round-lot trader placing an order to buy one hundred shares of IBM. I would suggest to you that today's "retail" investor is far more likely to be represented in the market by a mutual fund adviser who trades IBM in blocks of tens of thousands of shares.

Fund advisers provide their 87 million individual shareholders not just professional portfolio management but also liquidity, as they daily sell and redeem fund shares. As a result, controlling trading costs is central to their ability to deliver performance and fulfill their fiduciary duty. The changes in market structure in recent years have brought down the direct, easily measured costs of trading, as commission rates have fallen. It is no less important to control other costs—including market impact, or the amount by which the price of a stock moves against the trader during the time it takes to execute a trade. The larger the trade, the greater is the risk of such adverse price movement—a risk that can be compounded if other market participants, legitimately or not, have information about the trade. Our members go to great lengths to maintain the confidentiality of their trading activities, limit market impact, and thereby control their trading costs and better serve the interests of fund shareholders.

From that standpoint, Reg NMS has been a success for funds and their shareholders. A variety of new trading venues have evolved in which mutual funds and other institutional investors can move large blocks of securities in an efficient and confidential manner, with less market impact. The development of these venues has helped funds reduce their trading costs, to the direct advantage of their investors.

So we find it disturbing when some of these venues are singled out for criticism by those who don't fully understand the function that they fill or the investors that they serve. It is more disturbing still when the media or policymakers lump these innovations, even those that clearly benefit investors, in with other practices that are at best unproven—and with some that may be just plain abusive.

This is an area where regulators should tread with caution. SEC Chairman Mary Schapiro has called for a broad review of market structure issues, and we welcome that examination. We would urge the Commission to gather as much research and insight as it can, from a wide array of market participants, on how these changes in trading are actually working and on their impact.

So I began by talking about crisis response, and I am concluding by urging caution and care. Is this a contradiction? I don't think so, and I can draw on history to make my case.

We have just been through the worst financial crisis since the Great Depression. Mutual funds experienced significant declines in asset values, but otherwise fared reasonably well—thanks to a regulatory foundation laid decades ago, in 1940. But building that foundation after the Great Crash took several years and a great deal of deliberation by the SEC, Congress, and the fund industry. The results of their work—the Investment Company Act and Investment Advisers Act—have stood the test of time.

So, one more lesson learned from the financial crisis is this: Sometimes, speed is of the essence; sometimes, deliberateness is a virtue. Wisdom lies in recognizing the difference. Let us hope our response to this financial crisis will prove as wise.

And now, it is my distinct pleasure to bring you our first keynote speaker, Commissioner Jill Sommers of the Commodity Futures Trading Commission.

Commissioner Sommers was sworn in just two years ago, but clearly those have been busy years. Last year, the Commission had to contend with the furor around the spike in energy prices, investigating whether market manipulation was responsible. And then came the broader financial crisis, where the Commission has been deeply engaged in efforts to establish a comprehensive framework to regulate over-the-counter derivatives.

Commissioner Sommers brings a wide range of experience to bear on these and other matters on the agenda of the CFTC. She knows Capitol Hill from the inside, having worked for Senator Bob Dole for five years. She knows markets, having overseen regulatory and legislative matters for the Chicago Mercantile Exchange. And she has a broad industry perspective, from her work at the International Swaps and Derivatives Association, where she was head of government affairs.

But Commissioner Sommers knows Main Street as well. Her family has owned a hardware store in Fort Scott, Kansas, for 40 years. She tells us that that's where she learned the value of a dollar and the importance of good business decisions. In Washington, learning like that is invaluable. Ladies and gentlemen, please join me welcoming Commissioner Jill Sommers.
