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Following the Evidence on Funds and Financial Stability

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Paul Schott Stevens

President and CEO

Investment Company Institute

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As prepared for delivery.

Thank you, Anthony [Hilton, director, CSFI], and thanks to all of you for attending this evening. Thanks also to Philip [Warland, Kreab] and Peter [Andrews, Oxera Consulting] for joining us tonight and for what should be a lively discussion. I'm very grateful for this opportunity to address this distinguished audience.

So—where asset management is concerned—where are we 10 years after the financial crisis?

Well, I'm pleased to report progress on one front: in October, the Financial Stability Board announced that it will no longer refer to asset management as "shadow banking."

A remarkable concession—after just seven years in which we argued that this misleading, inaccurate epithet had no place in the regulatory vocabulary.

But lest we get our hopes up too much—the next paragraph of the statement says: "This change in terminology…does not affect the substance."

And—indeed—there is no evidence that central bankers—particularly in Europe—have changed their views on asset management.

Lately we've heard from the Banque de France and the European Central Bank. Mark Carney, governor of the Bank of England and until this week chair of the FSB, singled out "open-ended funds" as a "potentially major new vulnerability" in "non-bank finance."

These central bankers all take a very similar approach when they address asset management:

- First, they celebrate improvements in the global banking system in the decade since the crisis.
- Then, they note the rapid growth of asset management. Indeed, it has grown. Regulated funds' assets under management rose from 22 trillion US dollars in 2008 globally to 50 trillion dollars now. That's a compound annual growth rate of 9 percent for the past decade. ICI's global membership accounts for 60 percent of that total—or 30 trillion US dollars.
- There follows a reluctant acknowledgement of asset management's financial and economic contribution. It's "a positive development," Governor Carney said, that "is bringing welcome diversity to the financial system."
- But the speakers quickly turn their attention to numerous risks that they assert may arise as finance moves away from the banks they regulate.
- And those supposed risks lead them to the heart of their argument—the need for bank-like regulation to rein in asset management. As ECB Vice President Luis de Guindos said, regulators "should aim at extending the macroprudential framework beyond banks to encompass the asset management sector."

Now, some here might assert that the action has moved away from the global FSB and toward the capital market experts at IOSCO, the International Organization of Securities Commissions. And the FSB has indeed tasked IOSCO with such initiatives as its recent consultation on measuring leverage in investment funds.

ICI and its member funds welcome IOSCO's engagement. We strongly believe that regulation of capital markets players—like regulated funds—belongs in the hands of experts, like IOSCO's members.

But the central bankers' recent rhetorical attention to funds conveys a different message. It tells me that they're not done with our funds yet.

The central bankers invariably call for better understanding of asset management. Governor Carney, for instance, calls upon the industry to "engage" in efforts to gather and share data on asset management.

The regulated fund industry has engaged—but there are few signs that central bankers have taken any account of the extensive data, evidence, and analysis that we already provided. Since the FSB and its US counterpart, the Financial Stability Oversight Council, were organized, ICI alone has filed more than 25 comment letters on systemic risk and regulated funds. That doesn't count almost 80 posts related to financial stability on ICI's blog—or more than a dozen speeches like this one—or countless meetings

with regulators and policymakers.

Our commentary has anticipated or addressed the very risks that central bankers continue to cite:

- We've shown, with data gathered over decades, that investors in stock and bond funds do not "run" or cause "fire sales" during market turmoil.
- We've explained why these patterns can be expected to continue.
- We've demonstrated that open-end funds manage liquidity to anticipate and meet redemption demands.
- We've shown that when individual funds need to wind down or close, there is no "contagion" to other funds or the broader financial system.
- We've provided data to show that neither mutual funds nor exchange-traded funds are driving volatility or prices—even in relatively thin markets, such as emerging economies.
- And we have explained how the comprehensive regulation of our funds tends to enhance the stability of markets.

Our evidence and analysis, however, contradicts bank regulators' many prior assumptions about open-end funds. Maybe this is why it has had so little impact on the growing financial stability bureaucracies—bodies which are, after all, in the business of postulating instabilities.

When we assert that funds have never caused the instabilities they posit, they often dismiss our evidence with the notion that this next time, things could be different. Where have we heard that before?

Two recent publications from the European Central Bank continue this pattern.

In its latest Financial Stability Review, the ECB acknowledges that outflows from bond funds "did not cause major disruptions in the underlying markets." Yet the ECB continues to insist that "going forward" such disruptions "could" occur and "may" unearth liquidity risks.

In response to these conjectured risks, the ECB proposes "macroprudential tools" such as allowing regulators to force funds to suspend redemptions—a suggestion that is contrary to the expectations of fund investors.

The ECB claims that, in a financial crisis, the benefits to the financial system of forced suspensions "would seem to outweigh" the costs in terms of investors' temporary loss of access to liquidity.

That "seem" assumes far too much.

It assumes the conjecture that fund investors run—and takes no account of evidence to the contrary.

And it assumes that forced suspensions would not make matters far worse—when in fact they could potentially trigger exactly the sort of runs that the ECB says it wants to prevent.

Unfortunately, this proposal, coming from the ECB, will carry weight with policymakers.

And the downside of following such proposals would be, I believe, potentially enormous— not only in added regulation and burdens on investors, but in lost opportunities to develop strong capital markets and the entrepreneurial new businesses they can foster. Those opportunity costs could be particularly high in jurisdictions which lack the well-developed capital markets and diverse financial systems we are accustomed to in Britain and the United States.

Note that I have referred several times to our products as "regulated funds." Our industry does not oppose regulation—to the contrary, we thrive on effective, balanced regulation.

Every major jurisdiction provides comprehensive rules for regulated funds—the Investment Company and Investment Adviser acts in the US; the OEIC Regulation here in Britain; the UCITS Directive in the EU; the Code on Unit Trusts and Mutual Funds in Hong Kong; and similar frameworks elsewhere. These codes are crucial to investor protection—and to sustaining investor trust.

These codes also enhance the resilience and stability of funds.

Recall that regulated funds were not a culprit in the global financial crisis. Yes, money market funds experienced turmoil—after more than a dozen major banking institutions had failed. But money market funds did not start the crisis, did not propagate it, and have since undergone major reforms.

More significantly, stock and bond funds were one of the most stable sectors in the financial system.

That's nothing new.

At your seats, we've provided a document summarizing dozens of market episodes, spanning more than 70 years. They cover the stock and bond markets; mutual funds and ETFs; the United States, Europe, and Canada—from 1944 right up to October 2018.

I can sum up the findings: throughout their history, regulated stock and bond funds have never threatened the financial system with the massive, destabilizing risks that central bankers like to speculate about. Our funds are not subject to contagious "run risk."

And when you look more closely at the structure of the regulated fund industry, these findings make perfect sense.

Start with the fact that fund managers are not banks. They are not the owners of fund portfolio assets—they are agents for the fund. Market gains and losses flow through to fund investors. Gains and losses are dispersed, and in real time, as assets are marked to market daily.

Another critical factor is fund regulation. Regulated funds face, among other things, long-standing limits on leverage—the essential fuel of financial crises. Open-end funds are required to invest primarily in liquid assets and to maintain liquidity necessary to meet anticipated redemptions. And securities regulators are sharpening standards for leverage and liquidity.

Perhaps most crucially, the majority of open-end fund shares globally are held by retail investors—and those investors, contrary to conventional wisdom, actually represent very patient capital.

ICI members report that 95 percent of the assets in US stock and bond mutual funds are held by households—not by institutions.

Roughly half of the assets in US long-term mutual funds are held in retirement accounts. Three out of every four US households that own mutual funds say that saving for retirement is their primary reason for investing in funds.

And those retirement savers take the long view. In December 2008—at the depths of the financial crisis—fewer than one in 25 participants in US retirement plans stopped contributing to their accounts. Fewer than one in seven even changed their asset allocation.

Just consider the irony. Regulated funds represent just a portion of the activity in the global capital markets—roughly one-quarter of assets, and a far smaller share of trading. They constitute the most highly regulated portion, because our funds must be suitable for retail investment. Yet it is our funds that seem to garner the most attention from the FSB and EU central bankers. It makes little sense.

We have outlined this data and analysis repeatedly. So why then do central bankers keep turning their focus back to asset management?

On this point, I can quote no less of an authority than Paul Volcker.

During the financial crisis, he invited me to join him for dinner in Washington. During our conversation, Chairman Volcker told me that regulated funds and asset management were “growing more important” in the financial system, while banking was “growing relatively less important.” “That,” he said, “is why we must regulate you.”

I understood his “we” to mean the Fed and central bankers—and his unspoken implication was that otherwise “we central bankers” would grow less important.

That conversation starkly illuminated the policy and bureaucratic stakes of this debate.

Giving central bankers such authority would have profound implications.

They come from a quite different regulatory culture—a culture in which protecting institutions from losses is key.

In the aftermath of the crisis, we often heard that their project is to eliminate any and all sources of risk to the financial system. That inevitably implicates capital markets—where gains and losses, risks and returns, are everyday occurrences.

As Mary Jo White, former chair of the US Securities and Exchange Commission, once said, investment risk is “the engine that gives life to new companies and provides opportunities to investors.” Regulation, she said, must strike a balance “between reducing undue risks and preserving the principle of ‘reward for risk’ that is at the center of our capital markets.”

That principle too often seems lost on stability regulators, who may misinterpret investment risk as systemic risk.

And while central bankers now pursue an overarching goal of “financial stability”—would it not be far wiser to concentrate on a goal of financial *robustness*?

What’s the difference?

On this question, insights from engineering, the sciences, and technology are instructive. These fields are all concerned with highly complex systems—and with “stability” versus “robustness.”

“Stability” is the capacity of a system to return to its original state after a shock. One author describes a stable system as one that maintains essentially all of its features “for all time.”

“Robustness” is different—because it reflects the ability of a system to cope with shocks. Robustness is the property of being strong and healthy in constitution. The concept is typically applied to complex systems subject to “multiple perturbations in multiple dimensions.”

Robust systems function better than stable systems in the face of uncertainty. When Nobel laureate economists Lars Peter Hansen and Thomas J. Sargent wanted to figure out how policymakers could make better decisions even when using uncertain models, they turned to robust control theory for answers.

Capital markets provide a model for a robust financial system.

A robust system offers *diversity*. Strong capital markets, operating alongside banks, provide diverse sources of funding for businesses, households, and governments.

A robust system encourages *innovation and experimentation*. We certainly see this in the fund industry, where dozens of new products—ranging from global stock funds to target date funds—have evolved to meet changing investor needs and market conditions.

And a robust system is *adaptable*. Rather than simply avoiding risks, capital market participants accept and manage risks. In our funds, investors willingly and knowingly accept investment risks, based on clear disclosure and the prospect of commensurate rewards.

Capital markets would be far different if they were overseen by prudential regulators setting stability as their overriding goal.

A stable, bank-centered system would narrow the sources of financing—making businesses and households more dependent on large, highly leveraged institutions.

A stable, bank-centered system would hamper innovation. Banks simply don't fund start-ups and entrepreneurial ventures—the wellsprings of creativity and vigor in our economies.

And a stable, bank-centered system would be rigid and inflexible—because banking regulation squeezes all institutions into a one-size-fits-all mold.

In short, if banishing risk in the name of stability is the central goal for financial regulation, it clearly threatens economic growth—because growth requires risk-taking.

To sum up, the current system of crisis prevention—dominated by central bankers and oriented toward stability—must take a new direction as it moves beyond banking.

Regulators need to take a more granular and nuanced look at the realities of the financial industries that they choose to examine.

They need to rely more on data and analysis—and less on speculation about risks that isn't supported by the empirical history or the institutional frameworks of our industry.

They need to depend more upon expert regulators who understand capital markets and don't instinctively turn to the banking toolkit.

And—most important of all—we need a renewed emphasis on the costs of financial stability regulation. In particular, we need to consider the economic costs of setting a goal of financial stability over the far preferable goal of financial robustness.

Thank you, and I look forward to our discussion.

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