

Keynote Address, 2021 Mutual Funds and Investment Management Conference

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Please let me express my sincere gratitude to everyone who has been part of putting this conference together, as well as everyone in attendance today. This conference is the premier event in the United States for legal and compliance professionals working in the regulated fund industry, and it is an honor to speak before you today as the Investment Company Institute's new president and chief executive officer.

Since I came onboard four months ago, I have met with our Board of Governors as well as numerous other leaders of member firms to identify their priorities and concerns amid the challenges posed by this pandemic. It is abundantly clear that ICI must always be a strong and productive voice for the regulated fund industry with respect to the development of the rules, regulations, and policies that govern our financial system. All of you are key partners with ICI in carrying out our mission to promote and protect the interests of fund investors.

In that context, I would like to speak with you today about the discussions that US and international policymakers are having about the March 2020 market turmoil and their work to make the financial markets more resilient in the face of a similar liquidity shock. Such work is taking place in international bodies such as the Financial Stability Board (FSB) and International Organization of Securities Commissions, with the active participation of US financial regulators.

For those familiar with the regulatory debates following the 2007–2009 global financial crisis, these discussions should give you a sense of déjà vu. Regulated funds, including money market funds and long-term open-end funds, such as bond funds, are being closely scrutinized for systemic

vulnerabilities. Indeed, some commentators have gone as far as to argue that the market events of March 2020 indicate that the business models of these funds should fundamentally change because they contend that these funds are unsafe for the global financial system in the absence of a central bank liquidity backstop.

Before I go any further, please allow me to emphasize a few points.

As the association representing the *regulated* fund industry, ICI wholeheartedly supports smart regulatory reforms to make our funds—and, more broadly, the financial system—more resilient.

We endorse reforms developed by assessing accurate data and information to fix identified problems. This approach should produce targeted reforms that respect the critical role regulated funds play in market-based financing, which supports economic growth.

We always will question, however, any proposals that seek significant changes to regulated funds if those proposals are not based on accurate data or seek to improperly equate marketwide problems with shortcomings in fund regulation. I do have concerns that this may be happening in the current debate.

In my remarks today, I would like to:

- recount and comment on the market events last March;
- outline some considerations that I believe policymakers should keep in mind in their pursuit of reforms; and
- share my views on the current policy discussions about money market funds and bond mutual funds.

Observations About the Events of March 2020

Let us not forget March 2020 and how the financial turmoil unfolded.

Although US Treasury securities are usually a safe haven for market participants during times of market stress, data indicate that investors were selling Treasury bonds in early March 2020, signaling that the Treasury market was becoming dislocated. This dislocation began in advance of redemption pressure on money market funds. Numerous factors appear to have contributed to this aberrant behavior, ranging from market participants rebalancing positions to account for changing market conditions to capital requirements for banks.

Strains in the Treasury market quickly spilled over into short- and long-term credit markets, including the markets for municipal debt securities, commercial paper, bank certificates of deposit, and corporate bonds. In light of the uncertainty around the virus and the economy amid strict government lockdowns, investors became extremely risk averse and sought to preserve or bolster their cash positions. As a result, the demand for liquidity far outstripped the supply of it. These dynamics affected all market participants.

Eventually, liquidity in the short- and long-term credit markets—and the flow of credit through them—fell precipitously, risking damage to households, governments, and businesses, including financial institutions. With the demand for liquidity overwhelming the supply from the private sector, there was little choice but for central banks to carry out their traditional role as lenders of last resort. The combination of the Federal Reserve, European Central Bank, and other central banks' wide-ranging actions—which were appropriate, timely, and flexible—helped restore liquidity and the flow of credit.

From these events, I offer three observations.

First, the events of March 2020 should not be branded as a financial crisis in the same vein as the 2007–2009 global financial crisis. In March 2020, the markets suffered a liquidity crisis associated with an epic economic shock, which itself stemmed from drastic measures taken to control a fast-spreading pandemic. How many of us do not recall the fear and anxiety of a year ago when we left the office and were told to stay home?

Expectations of an economic collapse led to a sharp and fast decline in financial markets and a vast, immediate demand for liquidity. All sectors of the financial system subject to this “dash for cash”—both banking and nonbanking sectors—faced difficulty, *in a few short weeks*.

Compare that against the global financial crisis, which was, at its heart, a credit crisis caused by a housing bubble—leading to failures of dealers and banks, spilling over into the real economy, and playing out *over two long years*.

Why does this matter? Those who refer to March 2020 as the “second time in just over a decade” that there has been a global financial crisis are misdiagnosing the problems we need to address with any regulatory reforms.

This leads to my second observation. Money market funds and bond mutual funds are, of course, inextricable components of the financial system. However, they did not trigger the stresses in the financial markets. This observation is important because, as regulators consider what reforms may be needed, they should prioritize examining the factors that created the stresses and, only after identifying and addressing those factors, consider necessary policy reforms for regulated funds.

One of those factors was the extraordinary foreign demand for US dollar liquidity. Foreign central banks sold large amounts of US Treasury debt and borrowed nearly \$500 billion from the Federal Reserve through its foreign exchange swap facilities.

Policymakers and regulators also should be looking for ways to improve the fixed-income markets themselves. It was the structure of fixed-income markets—not the actions of funds—that was at the heart of the ensuing challenges of March 2020.

Third, the fact that central banks stepped in to provide liquidity support to the financial markets does not mean that the current financial regulatory framework somehow failed or that fund managers and financial firms were engaging in risky market behavior. It would be impossible to design a financial system that is foolproof against every circumstance—especially for a crisis, such as the global pandemic, which originates outside the financial system. In such extraordinary times, central banks serve as lenders of last resort to support affected parts of the economy. And indeed, we saw last March that even just the announcement of central bank actions—especially those of the Federal Reserve—quickly helped calm the markets, restore liquidity, and reignite the flow of credit to the economy.

As we consider the future of our markets in the wake of this pandemic, I question those who say that regulated funds must be regulated so aggressively that central bank intervention would never again be needed to provide liquidity support in the face of great economic shock. Such views claim that eliminating any future possibility of central bank support would avoid moral hazard. But that thinking seems oversimplistic and dangerously rash. Of course, funds should be responsible for robust liquidity risk management and should be subject to appropriate rules and regulations. But can we hold funds at fault for central bank intervention intended to calm financial markets during a time of extreme uncertainty around a global catastrophe? Respectfully, that should not be the starting point for any discussion of new reforms.

Considerations for Policymakers and Regulators

In developing smart reforms, policymakers and regulators should weigh a number of key considerations. Three in particular stand out as the most salient.

Importance of Nonbank Financial Intermediation to the Global Financial System

First, policymakers and regulators should acknowledge the importance of nonbank financial intermediation to the global financial system. This includes the vital role of money market funds, long-term open-end funds, and other regulated funds—particularly in jurisdictions with robust capital markets. Capital markets are powerful engines of economic growth and innovation, especially today as the world looks to the capital markets to finance a more sustainable future.

This is why, when considering the merits of reforms, regulators should work to preserve the benefits of regulated funds and pursue policies to permit jurisdictions to diversify beyond bank financing to market-based financing.

Money market funds especially are a liquid and diversified cash management tool for investors and a key source of funding for governments and the private sector. At the end of last year, US-regulated money market funds held \$3.9 trillion in short-term Treasury and agency securities and repurchase agreements, along with \$414 billion in short-term municipal debt, bank certificates of deposit, and commercial paper. Money market funds accounted for 17 percent of the commercial paper market,

which is an important source of short-term funding for banks and other financial institutions that provide funding for US households and businesses.

Long-term funds, in turn, are indispensable tools for retail investors saving for their most important financial goals, reaching a wide variety of households across diverse demographic and financial characteristics. In 2020, more than 58 million US households, or nearly 46 percent, owned mutual funds. Of those 58 million, 90 percent owned equity funds, 43 percent owned bond funds, and 35 percent owned “balanced funds,” such as target date and target risk funds. All ages and income groups own mutual funds, including nearly half of US households younger than 35. Forty-three percent of mutual fund–owning households have annual household income of less than \$100,000.

Nonbank financial intermediation, including through regulated funds, can reduce the cost of capital and improve allocation of capital to companies and households. Whatever medicine policymakers decide to administer in their efforts to strengthen our industry, it must not be so strong that it inadvertently kills the patient it is attempting to make healthier.

Efficient Resiliency

Second, we should not ignore the lessons of the financial stability reforms adopted in response to the 2007–2009 global financial crisis. Indeed, we must recall the discussions that international policymakers were having only four years ago in evaluating the reforms’ effectiveness.

Mark Carney, then governor of the Bank of England and chair of the FSB, spoke of the need for “efficient resiliency” in regulatory reform. The concept of efficient resiliency suggests three goals for regulators:

- First, a dynamic implementation of reforms that is based on constant learning and adjustment to ensure that reforms are achieving intended outcomes. I think it is important here to point out that outcomes for the capital markets are different from those for banking. The capital markets are intended to be places where people go to choose and take risks.
- Second, an admonition that the pursuit of resilience cannot be at the expense of delivering a financial system that supports economic growth. For the capital markets, that includes considering the impact on fund investors and on funds’ role in supporting capital formation.
- Third, an understanding of the interaction of reforms across regulatory areas. It is essential that policymakers ensure that reforms are not producing unintended consequences and that interference among reforms is not undermining the broader goal of a more resilient global financial system.

Here, I applaud the FSB’s holistic review of the events of March 2020, issued last November. As the FSB moves forward with its work plan to consider policy recommendations, I hope that policymakers can avoid looking at financial sectors in isolation from each other and instead look closely at the interaction of reforms across financial sectors.

For example, the FSB should investigate whether regulatory requirements on key market players, such as particular elements of the capital requirements on banks, may have contributed to, or were a driving

force in, the significant liquidity shortfall last March.

Likewise, regulators should consider whether mandated capital and liquidity requirements, which were meant to serve as buffers, actually served as hard floors—what some have described as “concrete air bags”—constraining market participants’ ability to respond to liquidity stress. Such a discussion should look closely at the regulatory disincentives imposed on fund boards, as well as bank boards, to use such buffers in times of stress.

Above all, regulators must always evaluate the potential benefits of proposed reforms against the risk that they could reduce the ability of capital markets to support short-, medium-, and long-term economic growth. Here, the benefits of nonbank financial intermediation should be acknowledged.

Questions like these were openly discussed in international regulatory fora just a few years ago and should not be forgotten today. An approach to regulation based on efficient resiliency is the genesis of smart reforms.

Jurisdictional Solutions—No One-Size-Fits-All Answers

The last of my three considerations is for policymakers and regulators to recognize that there are significant differences across jurisdictions—in terms of size, operation, the types of participants, the laws and regulations of funds and the markets, and the needs of investors. Any discussion of policy recommendations, especially by international policymakers, should avoid the trap of one-size-fits-all regulation.

While international bodies can contribute greatly to the discussion, policy recommendations should be developed with the recognition that regulators in each jurisdiction must choose the right regulations for their markets. To this end, international regulatory bodies should avoid prescriptive standards that limit the ability of national regulators to consider what is most suitable for their markets.

Direction of Policy

Having laid out what I hope policymakers and regulators will keep in mind when they consider new regulatory reforms, I would like to offer some thoughts on the policy options being discussed for money market funds and the developing discussion about bond funds.

Money Market Funds

Last fall, the FSB began the important process of reviewing and assessing the market events of March 2020, with specific focus on money market funds as significant participants in the short-term funding markets. In December, the President’s Working Group on Financial Markets issued a report discussing 10 reform measures that policymakers could consider to improve the resilience of money market funds and the broader short-term funding markets.

In recognition of the importance of money market funds to investors and the economy, ICI and its members have devoted significant time and effort over the years to considering how to make these funds more robust under even the most adverse market conditions—goals we share with the Securities and Exchange Commission (SEC) and other policymakers.

Three principles have always guided our analysis of money market fund reform proposals:

- First, given the tremendous benefits that money market funds provide to investors and the economy, it is imperative to preserve this product's essential characteristics.
- Second, in devising a solution, we need to stay focused on the objective that policymakers are seeking to achieve. This objective is to strengthen money market funds even further against adverse market conditions and to enable them to meet extraordinarily high levels of redemption requests.
- Finally, any solution must be designed to promote this important policy goal while minimizing the potential for unintended negative consequences.

With these principles in mind, we have found that a number of the reform options that have been proposed suffer from significant drawbacks—ranging from potential detrimental impacts on money market funds, their investors, and the markets, to complicated regulatory, structural, and operational hurdles.

For example, one proposal would be to introduce swing pricing to money market funds. To make swing pricing work, however, funds would have to eliminate popular features such as same-day settlement and multiple NAV strikes, reducing the utility of the product to investors without necessarily reducing the incentives for investors to redeem during times of stress.

Another example is the use of capital buffers. Capital buffers would negatively affect money market fund yields, making such funds not commercially viable, while they are unlikely to offer any substantial protection during a liquidity crisis, such as the one we had last March.

For those who remember the debate about money market funds between 2012 and 2014, the potential policy options should evoke some strong memories. Many were considered back then and, in several cases, rejected by the SEC itself. Therefore, it should not surprise regulators that some of these options remain problematic even today.

On the other hand, at least one option could prove useful. Removing the tie between money market fund liquidity and fee and gate thresholds could address policymakers' concerns with the least negative impact. The run risk that regulators appropriately worry about is exacerbated by these bright lines in regulation where market participants find themselves trying to stay on one side of the line.

ICI's analysis indicates that, as the weekly liquid assets of particular prime money market funds fell toward 30 percent, investors were increasingly likely to redeem. Investors apparently reacted to the mere *possibility* that funds had the legal authority to impose fees and gates rather than the *probability*

that they would do so. Thus, the 30 percent weekly liquid asset requirement, combined with the possibility of fees and gates, created a bright line that investors sought to avoid despite the fact that these funds still had *plentiful weekly liquidity*.

Bond Mutual Funds

There is also a spotlight on long-term open-end funds, particularly bond funds, and their experiences in March. Now, concerns about so-called liquidity mismatch in funds are not new—after all, the SEC’s liquidity risk management rule emerged directly from those earlier policy debates. However, there is a renewed momentum in suggesting that bond mutual funds amplified stresses in financial markets and asserting that structural reforms may be necessary.

So how should we help the policy community understand that it’s important to look before they leap?

Just as with money market reforms, accurate data are critical to being able to assess how these funds really performed. Earlier this month, ICI published an empirical analysis regarding some important questions: what caused the record redemptions from US bond mutual funds in March 2020? And was it heightened sensitivity by bond fund investors, or were the redemptions simply proportional to the size of the financial market shock?

ICI’s analysis indicates that investors in US bond mutual funds behaved in March 2020 much as they always have—moderate redemptions in proportion to the size of the market shock. It’s just that this time, the shock was massive and unprecedented.

ICI will be issuing more commentary on a range of issues relating to the experience of bond mutual funds and their investors in March 2020. A theme that will emerge is that the evidence is still far too mixed and preliminary to conclude that regulatory intervention is indicated for bond mutual funds.

As I mentioned earlier, one area that should be considered is improving the fixed-income markets themselves. Although the financial market turmoil last March was caused by a public health crisis, it was the structure of the fixed-income markets—not the actions of funds—that was at the *heart* of the ensuing challenges.

Conclusion

In closing, policymakers must take great care to adopt reforms that meaningfully reduce systemic risks, but are not so sweeping that they overcorrect, cleansing the system of the everyday risk-taking that is central to financial markets and has proved so vital for the real economy. The stakes of getting this right are enormous.

Like the public health officials who are guiding our societies during this pandemic, we need financial policymakers to be clear-eyed in their assessment of the market events of March 2020. They need to follow the evidence. They should recognize the extraordinary nature of these events and consider the

long-term implications for financial markets and how they function.

The market turmoil in March 2020 reflected a severe liquidity crisis caused by a global health crisis, which caused the shutdown of the global economy in a matter of weeks. It is neither necessary, nor appropriate, to place ex ante measures on regulated funds to make them completely immune to extreme economic and financial conditions—such as another liquidity dislocation on the same scale as the one sparked by the pandemic. Reforms that try to do so will inevitably harm regulated funds, to the detriment of their investors and the broader economy.

Thank you for your time and attention.

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