

MEMO# 8393

November 13, 1996

THE NEW FINANCE BY PROFESSOR EDWARDS OF COLUMBIA UNIVERSITY

November 13, 1996 TO: BOARD OF GOVERNORS No. 60-96 RE: THE NEW FINANCE BY PROFESSOR EDWARDS OF COLUMBIA UNIVERSITY

Enclosed is a copy of *The New Finance, Regulation and Financial Stability*, a recently- published book by Columbia University business professor Franklin R. Edwards. In his book, Professor Edwards concludes that the growth of mutual funds and other nonbank financial institutions benefits the U.S. economy. Professor Edwards observes that the structure and characteristics of funds, e.g., asset transparency, liquidity, and the requirement to mark to market, make it unlikely that shareholders will engage in runs on mutual funds. Edwards points to the existence of "regulatory safeguards and industry practices [that would] cushion the effects on asset prices of widespread mutual fund redemptions, should they occur." He also counters speculations that fund managers themselves will trigger a widespread selloff in the event of a market downturn, or that short-term credit market defaults will force money market funds to break a dollar and precipitate a shareholder run. Examining shareholder behavior during past market crises, Edwards finds that shareholders are not subject to a "mob psychology." He concludes that "Mutual fund shareholders do not appear to be easily spooked by unanticipated economic reversals. Rather, they appear to behave as investors with long time horizons." Edwards concludes that it would be ill-advised to impose bank-like regulation, such as reserve and capital requirements, on mutual funds. According to Edwards, "...Extending government guarantees and safeguards to mutual funds may ultimately increase financial fragility by undermining market incentives." Matthew P. Fink
President Enclosure

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