The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

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ICI VIEWPOINTS

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Why Asset Management Is Not a Source of Systemic Risk

This Viewpoints post is a summary of a speech given by ICI President and CEO Paul Schott Stevens at the Mutual Funds and Investment Management Conference. The entire speech is now available.

Since September, U.S. and international regulators have released reports suggesting that asset managers or the funds that they offer may be sources of risk to the overall financial system. ICI does not agree that the asset management sector poses systemic risk. Nonetheless, these reports could be the predicate for new, bank-style prudential regulation of the asset management industry—which could significantly harm funds and the investors who use them.

Far-reaching Concern

In the United States, the financial crisis of 2008–2009 led to passage of the Dodd-Frank Act, which requires heightened regulation for all bank holding companies with assets of $50 billion or more. It also established the Financial Stability Oversight Council (FSOC), giving it a powerful tool—the ability to identify non-bank systemically important financial institutions (SIFIs) that could pose threats to financial stability. So far, FSOC has designated three non-bank SIFIs—two insurers and a finance company.

FSOC's focus on SIFIs has been mirrored by the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system.

If regulators decide that certain funds or asset managers should face additional regulation, the consequences will reach far beyond the 20 largest managers listed in a report released last September by the U.S. Treasury Department's Office of Financial Research (OFR), or the 14 U.S.-registered investment companies singled out in a January consultation paper from the FSB. These two efforts—U.S. and global—are mutually reinforcing, leading to concern that this issue could reach to every corner of the fund industry.

No Threat to Financial Stability

ICI is assembling the data and the arguments to demonstrate why even the largest U.S. mutual funds do not threaten financial stability. Our argument can be summed up in four points:

- First, unlike banks and other financial institutions, mutual funds make little or no use of leverage—the essential fuel of financial crises.

- Second, mutual funds simply do not “fail” the way banks and insurance companies do. Hundreds of mutual funds and dozens of fund managers exit the business each year—and none of them require government intervention or taxpayer assistance.
- Third, the specific systemic risks that the OFR Report hypothesizes—such as “herding” behavior by asset managers and their investors—have no basis in history. ICI Research has scoured every period of market stress since World War II, looking at flows out of individual stock and bond funds, and found virtually no increase in the share of funds experiencing large outflows during times of market stress.
- Finally, the structure and comprehensive regulation of mutual funds and their managers not only protect investors, but limit systemic risk and the transmission of risk.

ICI is working hard to share our analysis with FSOC members, international regulators, Congress, scholars, the media, and others. Why have we made this issue such a priority? The reason is simple: the implications for our industry—and ultimately our shareholders—are vast.

Costs and Consequences

There are significant uncertainties about what lies in store if funds or their managers are designated as SIFIs. The Federal Reserve Board—the agency charged with supervising non-bank SIFIs—has not specified what its “remedies” for systemic risk may be, and the remedies suggested by Dodd-Frank are unclear. We do know that capital comes at a cost, and that it wouldn’t take much in added fees, assessments, and capital costs to increase significantly what designated funds would have to charge investors—distorting the competitive landscape for funds and investors.

Most significantly, as a systemic-risk regulator the Fed would practice “prudential supervision,” which focuses primarily on preserving the banking system, rather than fiduciary duty—the unwavering responsibility always to act in the best interests of your funds or clients. In times of market turmoil, the Fed might well decide that it is necessary for a fund to maintain financing for a troubled company or financial institution, irrespective of the best interests of the fund’s shareholders.

This risk is not purely theoretical. Amidst the rescue of Bear Stearns in March 2008, the collapse of Lehman Brothers in September 2008, and the European banking crisis of 2011, U.S. and other bank regulators harshly criticized funds for pulling back from funding dodgy institutions. Apparently, bank regulators expected that, in the interests of “the system,” funds would ignore credit risks and accept predictable losses—in short, “take one for the team”—with no regard for the interests of their own shareholders.

A Better Way Forward

The consequences of SIFI designation could significantly impair fund investing. For our economy, they could undermine a key source of financing. And for individual Americans, these new regulations could harm severely the single best vehicle for retirement saving and investment.

We believe that there’s a better way forward: an activities-based approach that would involve the regulators that already have expertise with specific industries and markets. Instead of assuming that an entire industry is risky and then looking for remedies to address undefined problems, these regulators would address specific activities or practices that pose demonstrable risks to the financial system, then follow regular rulemaking procedures—with public meetings, notice, and comment, and requirements to follow the record and apply cost-benefit analysis.

Substantial efforts already are underway to address regulators’ systemic risk concerns in such areas as money markets, repurchase agreements, securities lending, and derivatives trading. For example, ICI recently endorsed a voluntary, industry-led initiative to shorten settlement cycles for a range of securities from three days or longer after the trade date to trade date-plus-two. This initiative could significantly reduce operational risks and make financial markets more resilient.

Yes, the financial crisis revealed some significant weaknesses in the system—but asset managers were not a source of risk, nor are they likely to be. Misguided efforts to fix a part of the financial system that’s not broken could cause real harm to the fund industry and the more than 90 million investors we serve. ICI will continue to work with policymakers and the public, at home and abroad, to ensure that people know the truth about asset managers, how they operate, how they’re regulated, and how they play an essential role in creating vibrant financial markets worldwide.

- Read Paul Schott Stevens’ entire speech: “Financial Stability and U.S. Mutual Funds”
- Read a speech on the global SIFI issue by ICI Global Managing Director Dan Waters: “Financial Stability and Regulated Funds”
