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Promoting and Preserving Vibrant Capital Markets

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Thank you for that warm welcome, and thanks to all of you for coming today. I am deeply honoured to have this opportunity to address you and to share my perspective on some of the critical issues facing our global financial system.

I am honoured to be here with the Confederation of Indian Industry as you celebrate your 120th year of service to your nation. I know that CII has a long and distinguished record of bringing together industry, government, and the institutions of civil society to support and sustain development of the Indian economy. Events like this—your 11th Mutual Fund Summit—showcase CII's crucial role.

I want to thank Leo Puri, chairman of today's summit and managing director of UTI, for inviting me to participate in this program.

In addition, I would like to recognise my friend Hoshang Sinor, chief executive of the Association of Mutual Funds in India and my colleague in the International Investment Funds Association. Over the years, Sinor many times has encouraged me to come to India. This is my first visit, and I am happy to finally be here.

For those of you who do not know of ICI, we are a leading global trade association for funds that are highly regulated and offered to the public in jurisdictions worldwide.

Because of the many advantages they offer to investors, regulated funds have emerged as key financial intermediaries in countries all around the world. And it is from that perspective today that I want to discuss the state of capital markets.

My remarks will focus on why so many countries—including India—are striving to develop and strengthen their capital markets. In line with the theme of this plenary session, this is a crucial global trend, with major implications for markets in India and elsewhere.

I want to discuss the three important advantages that strong capital markets offer to economies—efficiency, stability, and flexibility.

I also want to share our industry's concerns about possible regulatory developments that could compromise the role of capital markets in building more robust economies. I'm afraid that this too may be a global trend—and one that is much less positive.

As it happens, this year marks the 75th anniversary of the modern fund industry in the United States—and also the 75th birthday of ICI. Since 1940, mutual funds and other regulated funds in my country have operated and prospered under a comprehensive framework of laws and regulations established by the last of the so-called New Deal legislation that followed the Great Depression.

The history of the past 75 years is a remarkable story of orderly growth and evolution.

Over time, regulated funds in the United States have become the primary vehicle for Americans who want to participate in stock and bond markets.

Today, more than 90 million Americans own shares in mutual funds. Those investors enjoy a wealth of choices and strategies in a highly competitive landscape—for example, some 800 US fund sponsors currently offer more than 16,000 funds. As a result, the assets managed by US regulated funds have grown from $1.1 billion in 1940 to almost $18 trillion today—an increase of 1.6 million percent.

Many factors have contributed to the growth of US mutual funds, and to the democratisation of investing that they represent. Surely, one critical factor involves a key strength of the American financial system—its robust capital markets.

Now, ICI is also a global organisation. In the past three-and-a-half years, we have opened offices in London and Hong Kong, and have gained new fund members from four continents, including Asia. We are pursuing a global policy agenda that includes promotion of capital markets around the world, and the important role that regulated funds play in developing and deepening these markets.

And one common theme that I hear in country after country is this: How can we cultivate stronger capital markets? How do we:

- allocate capital more efficiently to promote economic growth …
- diversify our sources of financing …
- encourage savers to become investors who take reasonable risks for better returns …
- improve our population's prospects for retirement security … and
- foster a culture that encourages entrepreneurship and ownership?

As leaders around the world seek to revive or strengthen their economies, they recognise that their financial systems must include robust alternatives to banks as a source of financing.

In Japan, for example, the government has created the Panel for Vitalizing Financial and Capital Markets to help strengthen the economy. An explicit goal is to develop “a society where individuals build wealth with risk asset allocation appropriate to [the] stage of [their] life cycle.” I was fortunate to have the opportunity in April to speak with the Panel about their work toward achieving this goal.

Similarly, both ICI and ICI Global are working with European policymakers as they develop concepts for their Capital Markets Union, or CMU.

The objective of this initiative is to “further develop and integrate capital markets,” to “help reduce [Europe’s] very high dependence on bank funding,” and to “increase the attractiveness of Europe as a place to invest.” The European Commission views development of the CMU as a key part of its jobs-and-growth agenda.

From Latin America to East Asia, governments are pursuing policies to develop stock exchanges, enhance market-based financing, and encourage investment. Even in sub-Saharan Africa, 16 new stock exchanges have opened in the last quarter-century.

India is no exception to this trend. As you know well, India has a well-developed equity market, as well as a healthy market in exchange-traded derivatives. And Indian regulators are making strides in bringing debt markets—particularly the market for corporate bonds—up to the same standard.

By strengthening its capital markets India has attracted a growing amount of foreign institutional investment. At the end of 2014, US and European regulated funds held more than $132 billion in equity holdings in India, and more than $9 billion in Indian bonds. Regulated funds in many other jurisdictions—including Canada, Japan, Hong Kong, and Australia—also are investing in Indian equity and bonds.

These are not mere statistics. Rather, they are a testament to the notable progress that India has made in cultivating and deepening its capital markets.

This global trend to develop and strengthen capital markets invites a question—*why*?

Why are leaders from so wide a range of countries placing so much emphasis on diversifying their financial systems? Why do they want to supplement deposit-based banking with investment and ownership through equity and fixed-income markets?

The answer to these questions may seem obvious to all here, but it is worth going back to first principles.

Greg Medcraft, chair of the International Organization of Securities Commissions, or IOSCO, put it well during a speech in Washington, DC, last week, when he said that well-developed capital markets foster economic growth, wealth, and jobs.

Key to cultivating this prosperity are the many advantages that deep capital markets offer. They include *efficiency*, *economic stability*, and *economic flexibility*.

For many purposes, capital markets are *more efficient* than banks in matching savers (the providers of capital) with borrowers (the enterprises or households that need funding). As technology has improved, the information advantages that banks rely upon to underwrite borrowers have eroded. Borrowers have found that directly raising funds with stock investors or bond buyers, and eliminating or minimising the role of the middleman, simply costs less.

Capital markets also help distribute risk more efficiently. Here's why.

Each issuer of stock or bonds presents a unique set of risks—based on its products, its business strategy, and its financing model. At the same time, each investor gets to decide which of those risks it is best able to assume—because the investor may be more or less tolerant of risk, for instance, or it may hold other assets with offsetting risks.

For example, younger savers may tend to invest more heavily in stocks than older savers, because young people have a longer time horizon to invest and more working years to recover from any downturn in the market. Because investors can voluntarily assume the risk that best fits their circumstances, we gain the benefit of a more efficient financial system.

The second advantage that developed capital markets offer is enhanced *economic stability*.

Think about it—securities that trade in markets offer immediate feedback. Liquid markets provide a real-time scorecard on the value of assets. Every trade is a reflection of myriad economic factors that can affect the value or creditworthiness of a company or a country.

That might seem to make capital markets more volatile—and policymakers sometimes are wary of markets for just that reason.

But in a landmark 2004 study of the financial markets, Glenn Hubbard, the dean of the Columbia University Graduate School of Business, and William Dudley, then the chief US economist of Goldman Sachs, argued that this mark-to-market approach *enhances* economic stability. Capital markets make it more difficult to avoid recognising economic or financial problems, they wrote. "As a result," they said, "pain is borne in real time."

They contrast that to the regulatory forbearance that troubled banks receive all too often—regulators look the other way, and allow problems to grow.

Usually, they write, "this forbearance just creates a much bigger problem that poses a greater threat to macroeconomic stability." There are many examples of this pattern, including the savings-and-loan debacle in my country, and Japan's decade-long banking crisis.

The frequent feedback from capital markets routinely rewards good policies and punishes bad decisions. All else being equal, when tax, spending, and regulatory policies are harmonised for economic growth, asset prices rise, investors are happier, and policymakers are rewarded. Thus, developed capital markets support economic stability.

The third factor is economic *flexibility*. Put simply, capital markets encourage entrepreneurship. As Ross Levine, an economist at the University of California, Berkeley, said, "[O]ne way to define a better financial system is that it does a superior job … allocating capital to those with the best projects, ideas, and entrepreneurial energy."

Risk-tolerant equity investors are better equipped than risk-averse banks to finance groundbreaking new ideas. Robust capital markets can help finance new companies earlier in their development, speeding their growth.

Authorities in Europe have recognised this potential benefit. In a speech in the spring, Jonathan Hill, the member of the European Commission responsible for financial services, noted that if European venture-capital markets were on the same scale as America's, "companies would have been able to tap into an extra 90 billion euros of funding between 2008 and 2013"—funding more than 4,000 venture capital deals. Imagine the new ideas and new industries that might have grown!

Greater efficiency … economic stability … and economic flexibility. Those are the advantages that can come from developing better capital markets—and, as I have noted, they are widely recognised.

The next question is—*how*? How can policymakers foster changes in systems, and in cultures, to encourage investment?

Jurisdictions that have successful capital markets share a number of common elements. Let me mention a few.

A sound legal system with strong property rights is essential. Corporate governance in particular must be oriented toward protecting investors—the owners of companies—rather than the interests of managers.

Governments also must not try to pick winners and losers—that is, they must avoid tax or credit policies that favor certain interests and thus distort investment decisions. Indeed, fair and consistent policymaking is crucial—and, thus, tax obligations should be clear and predictable.

Capital markets enable investors to send their cash to the ideas and businesses where it can be used most effectively. Governments seeking economic efficiency need to respect that process.

Sound regulation also is crucial. Exchanges, as well as clearing and settlement systems, must be organised and supervised to help markets run efficiently and to provide liquidity for trading. Issuers of stock and bonds must be subject to well-accepted accounting rules, and high standards for reporting and transparency. Regulators, too, must follow transparent procedures. Markets can thrive under a wide range of rules—but they do not do well when no one knows what the rules are.

In this regard, India is fortunate. In a 2013 survey of Indian capital markets, the financial consultants at Celent noted that "India has a good regulatory climate … which shielded the economy, to some extent, from larger negative impacts of the global financial crisis and helped it regain its mark quickly afterward."

Strong laws ... fair tax and credit policies ... and sound, principle-based regulation—these are among the key ingredients for strong capital markets.

As I've said, governments from Addis Ababa to Singapore are trying to nurture stronger capital markets, because they want the benefits of efficiency, economic stability, and economic flexibility that such markets can bring.

Yet in the wake of the financial crisis, as international regulators have worked to identify and mitigate risks to the global financial system, these benefits have not been as clearly and consistently recognised as they should be.

In particular, there has been a strong inclination by banking regulators to view the broader financial system—including the asset management sector—through a banking prism.

We have seen this inclination most clearly in the work of the international Financial Stability Board, or FSB.

For some time, the FSB has been working on designing methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector. An overarching goal of the FSB has been to make these methodologies consistent with the methodology used to identify G-SIFI banks.

I'm sure you would agree that this goal of consistency makes little sense. Funds and asset managers are not banks. They do not "fail" like banks do. Investment funds are highly substitutable, and the funds that ICI represents—regulated funds—generally use little to no leverage. Fund managers act as agents, not principals. They invest on behalf of their clients, leaving the risks—and rewards—to the end investors, who knowingly accept this tradeoff.

Yet the FSB has put the "cart before the horse," so to speak, by proposing ways to address potential systemic risks in the asset management sector before determining whether asset managers and their funds even present those risks.

They are proceeding on the idea—rooted in the experience of banks—that size alone can indicate the potential to pose risks to financial stability. The FSB is proposing two possible "materiality thresholds" that would single out the largest regulated funds for possible designation. Yet these funds have not been—nor are they expected to be—sources of risk to global financial stability.

In response to the FSB's consultations and other similar policy initiatives, ICI has assembled a large and growing body of research and analysis on the regulation, structure, and historical experience of regulated funds.

Our findings illustrate why these funds should not be designated as SIFIs, and why imposing bank-type regulation on them would harm funds, investors, markets, and the economy.

We have encouraged regulators to shift their focus from funds and managers, to an examination of *activities* or *practices* across the asset management sector. If they identify any potential risks to financial stability, regulators should address those risks through industry-wide or activity-based regulation.

We are encouraged by recent signs that this message has begun to resonate with global regulators. Earlier this month, a communique issued by the board of IOSCO said that a review of asset management activities and practices should "take precedence" over consideration of how to designate funds or asset managers as "systemically important."

More recently, in a speech in Washington, IOSCO Chairman Medcraft cautioned that conclusions about the nature of asset management, and any potential risks posed by the sector, should not be "theoretical and drawn from academic papers based on what might have happened in distant past. [Instead, they] should be based on what we're currently seeing and what we might think will happen in real markets."

His remarks also underscored some of the fundamental flaws in the FSB's work to date on asset management. "I'm not convinced," he said, that "there is evidence that asset managers put financial stability at risk simply because they're large. As yet we do not have concrete evidence that this has been or might be the case."

We look forward to working with IOSCO as it conducts its review of activities and products. And we are encouraged that the US Securities and Exchange Commission is moving in a similar direction, by considering a number of targeted reforms in the asset management sector.

Getting all this right is greatly important. It is essential not to confuse investment risk with systemic risk. Every day, investors around the world work to meet their financial goals by making decisions based upon the risks associated with investment returns. That risk-taking—that risk/return calculus—is essential to the health and dynamism of our capital markets, which in turn are essential to creating jobs, wealth and economic growth.

To quote Chairman Medcraft one last time, "[Regulators] need to ensure that our work [involves] not just ensuring the stability of the financial system, but recognising the role that markets have to play in funding economic growth and creating jobs, and facilitating that role."

If the international regulatory reform agenda for asset management needs to be recast in this fashion, there also is a need to fashion a better international mechanism than today's FSB by which to coordinate it.

Currently, representatives of central banks by and large make up the membership of—and lead—the FSB. Banking and bank regulation are the organisation's core competencies, and color its culture and worldview. Perhaps it is no wonder that the FSB has seemed to struggle in addressing the highly diverse and unfamiliar enterprise that asset management represents.

By contrast, capital markets regulators have longstanding, hands-on experience with asset management. Their success as regulators underpins the extraordinary growth of funds and fund investing—one of the most important innovations in modern finance. They understand the tools that fund managers use to manage a wide range of market conditions and risks. And they have the necessary expertise to adapt regulations to new activities or products as they emerge.

No one questions the desirability of a high-level international forum focused on promoting rigorous regulatory standards across the global financial system. I would submit, however, that the best body by which to achieve this objective is one in which capital markets regulators have an equal role with their banking colleagues—where their collaboration advances the objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.

Surely, these two objectives are not at odds with each other. I believe it is imperative that we create regulatory mechanisms that will be able to pursue them in tandem, for the benefit of all.

Thank you for your time and attention.