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Presentation on FSB Proposed NBNI G-SIFI Methodology for Investment Funds (pdf)

Preliminary Observations: FSB Proposed NBNI G-SIFI Methodology for Investment Funds Dan Waters Managing Director ICI Global March 2014 Overview • Observations About Systemic Risk Regulation • Comments on Proposed Methodology for Investment Funds • Size • Leverage • “Failure” • Existing Regulation Observations About Systemic Risk Regulation • Consultation rightly acknowledges that potential disruption to global financial system and economic activity can arise in different ways: • Distress of a particular institution • Markets • Products • Instruments • Financial activities • Regulators should use the appropriate tool to mitigate specific, identified risks 2 Observations About Systemic Risk Regulation (cont’d) • Consultation appropriately recognizes the “very different nature of [investment] funds’ risk profiles” in contrast to those of banks, insurance companies and other financial entities* • Contrasts are numerous and consequential: • Size • Leverage • Risk transmission • Structure 3 • Regulation • Substitutability • Orderly liquidations without government intervention * FSB, Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (8 Jan. 2014) at 29 Observations About Systemic Risk Regulation (cont’d) • In light of these differences, activities-based regulation would be the most effective approach for addressing systemic risk concerns (if any) related to investment funds • Much of this regulation is already underway • Money market funds and functioning of money markets • Repurchase agreements • Securities lending • Derivatives and counterparty risk • Length of settlement cycle 4 Comments on Proposed Methodology for Investment Funds • Threshold for determining the assessment pool should not be based on size alone • Size reveals very little about whether an investment fund could pose risk to the global financial system • For this reason, U.S. nonbank SIFI framework* envisions an assessment pool based on size plus a second quantitative measure (e.g., leverage ratio) 5 * Pursuant to Title I of the Dodd-Frank Act (2010). Comments on Proposed Methodology for Investment Funds (cont’d) • Under the proposed size threshold ($US 100 billion for non-hedge funds), 14 US registered investment companies (“US RICs”) would be the only funds automatically subject to further review • As the next two slides demonstrate, those US RICs pale in comparison to the size of the banks designated as G-SIBs 6 Assets of Largest US RICs’ Balance Sheets Are Dwarfed by Assets of G-SIBs 7 $47.9 $2.1 Total of G-SIBs Total of 14 US RICs with assets > $100 billion Trillions of dollars, September 2013 1Data as of December 31, 2013. Sources: Investment Company Institute, Lipper, Financial Stability Board “2013 Update of Group of Global Systemically Important Banks (G-SIBs)” for names of G-SIBs, Relbanks for total assets of G-SIBs 1 Assets of Largest US RICs’ Balance Sheets Are Dwarfed by Assets of G-

SIBs 8 $3.1 $1.7 $0.2 $0.152 Largest G-SIB: Industrial and Commercial Bank of China Ltd Average of G-SIBs Smallest G-SIB: State Street Average of 14 US RICs with assets > $100 billion Trillions of dollars, September 2013 1Data as of December 31, 2013. Sources: Investment Company Institute, Lipper, Financial Stability Board “2013 Update of Group of Global Systemically Important Banks (G-SIBs)” for names of G-SIBs, Relbanks for total assets of G-SIBs 1 Comments on Proposed Methodology for Investment Funds (cont’d) • All financial crises have involved debt that has become dangerously out of scale • “[I]t is vital that we understand the fundamental importance of leverage to financial stability risks … The fundamental cause of the financial crisis of 2007–08 was the build-up of excessive leverage ….”* 9 *Adair Turner, “Debt, Money, and Mephistopheles: How Do We Get Out of This Mess?” Group of Thirty, Occasional Paper, no. 87 (May 2013) Comments on Proposed Methodology for Investment Funds (cont’d) • Leverage should be a high-level “impact factor” • Central to systemic risk inquiry, so insufficient to consider leverage simply as an “indicator” • Leverage is the key differentiator among types of financial institutions (e.g., banks and insurance companies vs. US RICs and similarly regulated funds) • By any comparison, the largest US RICs are unleveraged (consultation defines leverage as “Gross AUM of the fund/NAV of the fund”) 10 Leverage of US RICs with Net Assets > $100 billion Fund Name Net Assets, Dec 20131 Leverage Ratio2 Open-end Funds Vanguard Total Stock Market Index $307.3 1.01 PIMCO Total Return Fund $237.3 1.18 Vanguard Inst Index Fund $162.8 1.00 Vanguard 500 Index Fund $159.8 1.00 American Funds Growth Fund of America $138.9 1.00 CREF Stock Account $126.5 1.05 Vanguard Total Intl Stock Index $113.5 1.06 American Funds EuroPacific Growth Fund $112.4 1.01 Fidelity Contra Fund $111.1 1.01 Vanguard Total Bond Market Index $108.1 1.08 Average 1.04 ETFs SSgA SPDR S&P 500 ETF Trust $174.9 1.00 Money Market Funds Vanguard Prime Money Market Fund $131.8 1.01 Fidelity Cash Reserves $119.2 1.01 JP Morgan Prime Money Market Fund $117.8 1.01 11 1Lipper data as of December 31, 2013. 2Data comes from each fund's most recent financial statements. Leverage ratio is measured as gross AUM of the fund/NAV of the fund. Note: Dollars are in billions. Sources: Fund documents; Lipper Balance Sheet Leverage 9:1 ≈2.5:1 1.04:1 US Commercial Banks Average: Sept. 2013 Hedge Funds Average: June 2013 Average of Long-Term US RICs with Assets > $100 Billion 12 1Measured as total balance sheet assets relative to book value of equity. 2Credit Suisse, US Monthly Chart Book, August 8, 2013. 3As of each fund’s latest reporting date. Measured as gross AUM of the fund/NAV of the fund. Sources: Investment Company Institute, FDIC, Credit Suisse, fund documents 3 1 2 Comments on Proposed Methodology for Investment Funds (cont’d) • Funds with so little leverage are unlikely to have any substantial impact on counterparties (“counterparty channel”) or markets (“market channel”) in the event of their liquidation* • US RICs simply do not “fail” the way banks and insurance companies do • In fact, US RICs and their sponsors exit the market regularly in an orderly manner without any systemic impact or any need for government intervention * FSB, Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (8 Jan. 2014) at 34 13 Number of US Mutual Funds Merged/Liquidated* Number of Fund Sponsors Exiting Business 14 *Data include mutual funds that invest primarily in other mutual funds. Source: Investment Company Institute 16 43 64 55 44 47 46 40 62 53 53 37 39 287 113 145 190 261 340 355 286 286 251 207 221 332 507 237 210 296 46 138 234 282 237 397 310 394 248 336 231 315 257 362 258 300 197 333 251 379 472 498 737 665 680 534 587 438 536 589 869 495 510 493 19 96 19 97 19 98 19 99 20 00 20 01 20 02 20 03 20 04 20 05 20 06 20 07 20 08 20 09 20 10 20 11 20 12 Fund sponsors leaving Merged mutual funds Liquidated mutual funds Comments on Proposed Methodology for Investment Funds (cont’d) • US RICs differ fundamentally from banks and insurers in their structure and regulation—in ways that limit any possible systemic effect • In addition to having little or no leverage, US RICs: • Mark assets to market daily • Disclose portfolio holdings quarterly • Maintain very high portfolio liquidity • Have simple capital structures • Etc. (more detail provided in Appendix) 15 16 APPENDIX Structural Characteristics of US RICs Mitigate Systemic Risk • Each fund is a separate legal entity, the assets of which are owned pro rata by fund shareholders • Fund assets are held with eligible custodian and no party other than the fund has a claim to the assets • Economic exposures are created at the fund level, and investment gains and losses belong to the fund • Fund shareholders are “shock absorbers” for any negative effects caused by fund distress/default • A fund’s investment adviser serves in an agency capacity and does not take on balance sheet risk 17 Regulation of US RICs Protects Investors and Addresses Systemic Risk • Leverage and borrowing: strictly limited. Future obligations must be “covered” by unencumbered, liquid assets that are marked-to- market daily. No borrowing unless total assets less liabilities other than borrowing is three times greater than total borrowings • Liquidity: at least 85% of fund portfolio in liquid securities to support redemptions • Daily valuation: at current market prices • Simple, transparent structure: no debt or preferred stock; no off- balance sheet financing • Extensive disclosures: evergreen prospectus, robust public periodic reporting (including quarterly portfolio holdings) and audited financials 18 Regulation of US RICs Protects Investors and Addresses Systemic Risk (cont’d) • Diversification: all mutual funds meet tax law standard; most adhere to higher standard in securities law • Affiliated transactions: prohibited or subject to strict conditions imposed by SEC • Custody: mandated arrangements with eligible custodians; no party other than fund has claim to assets • Independent board: oversight of fund’s investment program, risk management, compliance, portfolio valuation. Ability to terminate investment adviser 19