Financial Stability and U.S. Mutual Funds

March 5, 2014

Overview

- U.S. and Global Examination of Asset Management, Mutual Funds
- Concerns About the FSOC Process
- Why Even Large Funds Are Not SIFIs
    1. Lack of Leverage
    2. No Disorderly Failure
    3. No Evidence of “Herding,” Fire Sales
    4. Funds’ Structure and Regulation Mitigate Risks
- Adverse Consequences of SIFI Designation
- A Better Way to Address Any Risks That May Arise

In the U.S., Dodd-Frank Creates FSOC

- Dodd-Frank Act established Financial Stability Oversight Council (FSOC)
  - 10 voting members—heads of federal financial regulators (Fed, SEC, CFTC, FDIC, etc.), chaired by Treasury Secretary
  - Charged with:
    - Identifying risks to U.S. financial stability
    - Promoting market discipline
    - Responding to emerging threats to stability

A Key FSOC Tool: SIFI Designation

- FSOC can designate non-bank “systemically important financial institutions” (SIFIs)
  - SIFIs subject to enhanced prudential regulation and consolidated supervision by the Federal Reserve
- Standard is whether an institution could pose threat to U.S. financial stability, due to:
  - Material financial distress at the company, or
  - The nature, scope, scale, concentration, interconnectedness, or mix of its activities

FSOC Process for Designating SIFIs

- Must consider 10 Dodd-Frank factors, plus other appropriate risk-related factors
- Adopted analytical framework & three-stage process
  - Called for additional analysis on what stability risks, if any, are posed by asset management
  - Ordered Office of Financial Research (OFR) study
- SIFIs designated to date include two insurers, one finance company
  - Dodd-Frank specified SIFI treatment for all bank holding companies with assets > $50 billion

FSOC Turns to Asset Management

- OFR published *Asset Management and Financial Stability* in September 2013
- Report suggested that asset managers or funds could create or transmit systemic risk through:
  - "Reaching for yield" and "herding" into particular assets or asset classes
  - Redemption risks triggering "fire sales"
  - Leverage
  - Firms as a source of risk

What Was the Intent of Congress?

"I have not seen the argument made yet to cover" the "very plain-vanilla asset managers."

- Former House Financial Services Chairman Barney Frank (D-MA) at The Clearing House, Nov. 22, 2013

"I was frankly surprised to see suggestions that the asset managers that are diversified and fairly stolid in their approach would be considered."

- Chairman Frank to the *Financial Times*, Dec. 8, 2013

Concerns About FSOC Process

- FSOC faces few administrative checks
  - Closed meetings with minimal public reporting
  - No assurances it will seek, consider public comment
  - No required disclosure of changes to SIFI designation standards
  - No required cost-benefit analysis
- OFR, FSOC appear to lack full understanding of how asset management differs from banking
- OFR report appears to be results-driven

Globally, FSB Focuses on Funds

- G-20's Financial Stability Board (FSB) has designated 29 banks, nine insurers as G-SIFIs
- Now considering how to identify non-bank, non-insurer G-SIFIs
- January 2014 consultation discusses evaluating investment funds as G-SIFIs
  - Proposes a "materiality threshold" of U.S.$100 billion for investment funds
  - 14 U.S. funds are *only* funds captured
- FSB decision could pressure U.S. SIFI designation

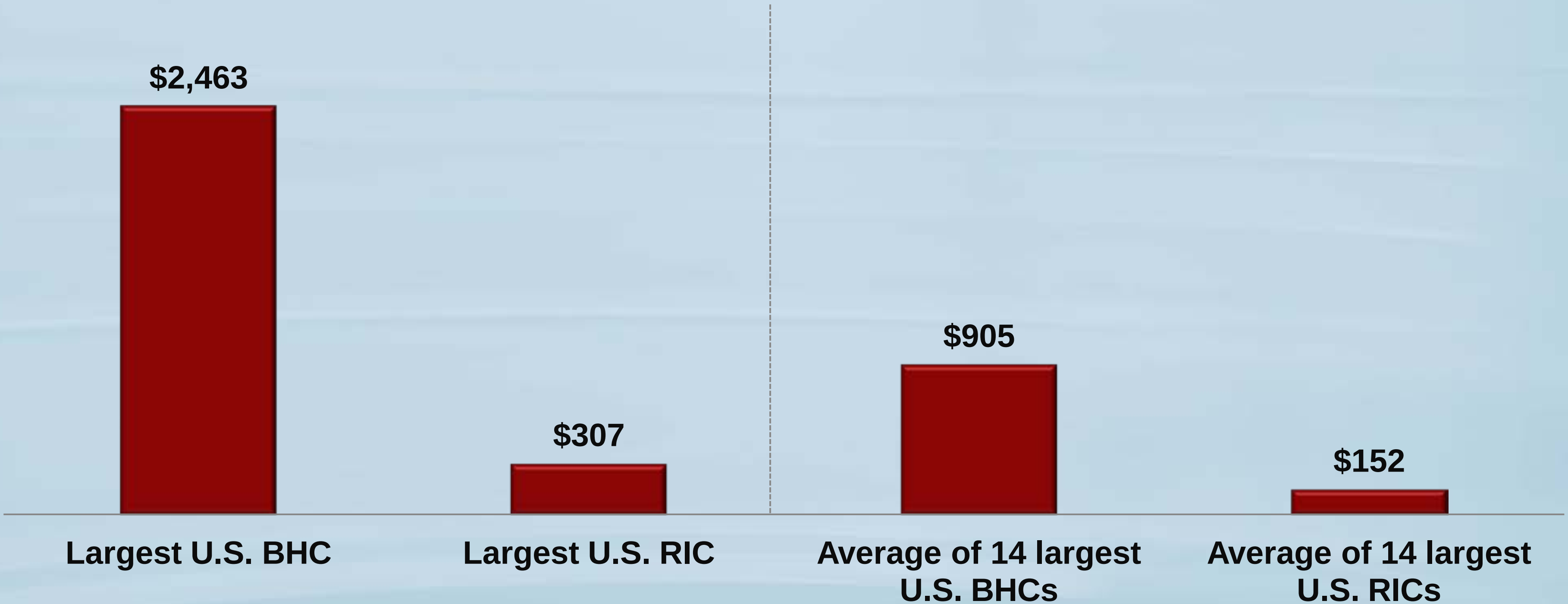
14 U.S. Funds Are *Only* Funds to Meet FSB's $100B Threshold

Fund Name	Net Assets, Dec 2013[1]	Leverage Ratio[2]
Long-Term Mutual 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
Exchange-Traded Funds		
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

[1]Lipper data as of December 31, 2013.
[2]Data 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

Large U.S. Funds Are Dwarfed by Large U.S. Bank Holding Companies

*Balance sheet assets, billions of dollars**



*Data for BHCs as of September 30, 2013; data for RICs as of December 31, 2013.
Sources: Investment Company Institute, Lipper, and the Federal Financial Institutions Examination Council (FFIEC)

Why Even the Largest U.S. Funds Are Not SIFIs

1. Funds use little to no leverage
2. Funds don’t have disorderly failures—and don’t rely on government intervention
3. Funds don’t exhibit “herding,” heavy redemptions leading to fire sales
   - No support in historical experience for concerns
4. Funds’ structure and regulation limit risks and transmission of risks

Why Even Large Funds Are Not SIFIs: *Lack of Leverage*

- Leverage is key differentiator among financial institutions, and central to systemic risk inquiry
- Funds use little to no leverage
  - Investment losses, gains flow to shareholders
  - Shareholders act as “shock absorber”
- Liquidation of a fund unlikely to have any substantial impact on counterparties or markets

Leverage Is Key in Systemic Risk

- *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..."
  - Adair Turner, "Debt, Money, and Mephistopheles: How Do We Get Out of This Mess?" Group of Thirty, Occasional Paper, no. 87 (May 2013)

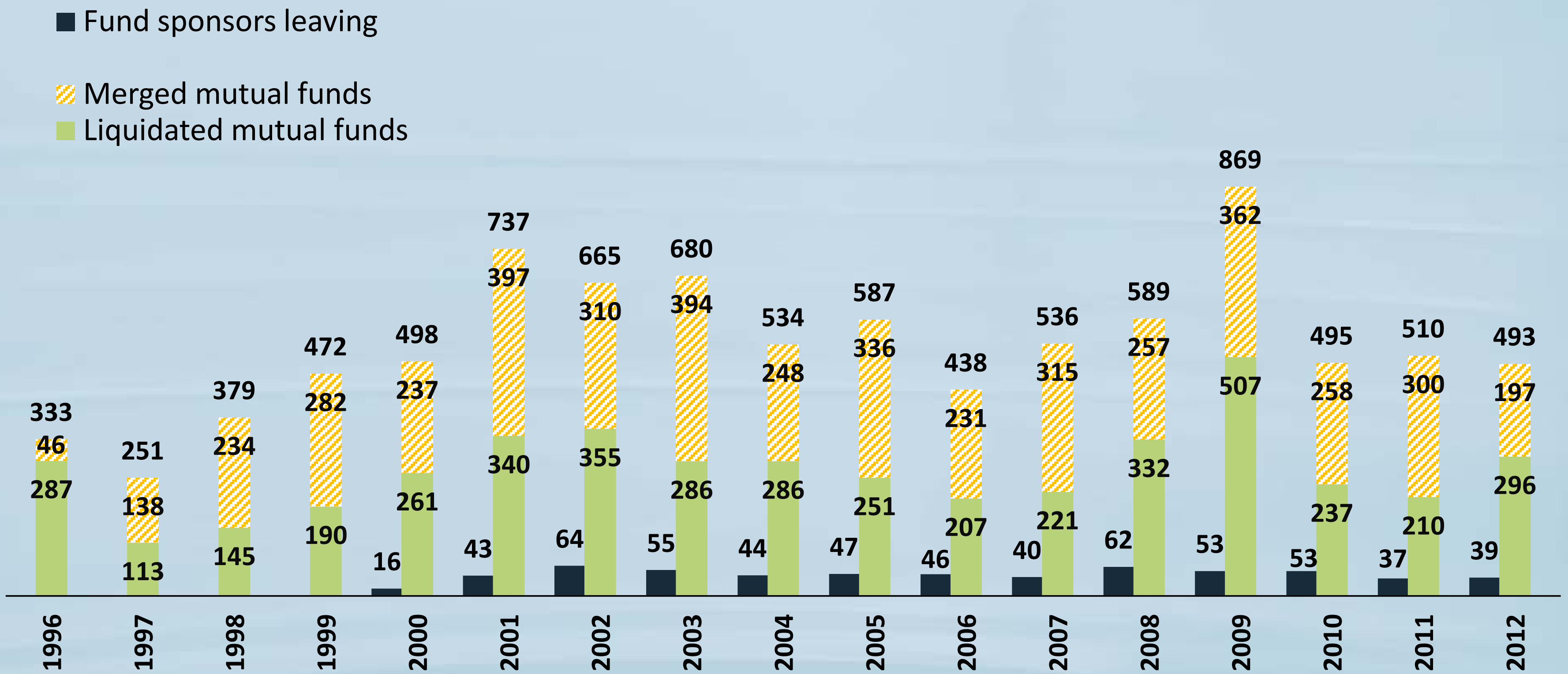
Large Funds Do Not Use Leverage, in Contrast to Banks or Hedge Funds

[1] *Measured as total balance sheet assets relative to book value of equity.*
[2] *Credit Suisse,* US Monthly Chart Book, *August 8, 2013.*
[3] *As 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

Why Even Large Funds Are Not SIFIs: *No Disorderly Failure*

- Mutual funds and their managers simply do not “fail” the way banks and insurance companies do
- In fact, funds and their sponsors routinely exit the market in an orderly manner
- Fund mergers and liquidations have no systemic impact
- Fund mergers and liquidations occur with no need for government intervention

Unlike Banks, U.S. Funds and Sponsors Routinely Exit with No Government Aid



*Data include mutual funds that invest primarily in other mutual funds.
Source: Investment Company Institute

Why Even Large Funds Are Not SIFIs: *No Evidence of "Herding," Fire Sales*

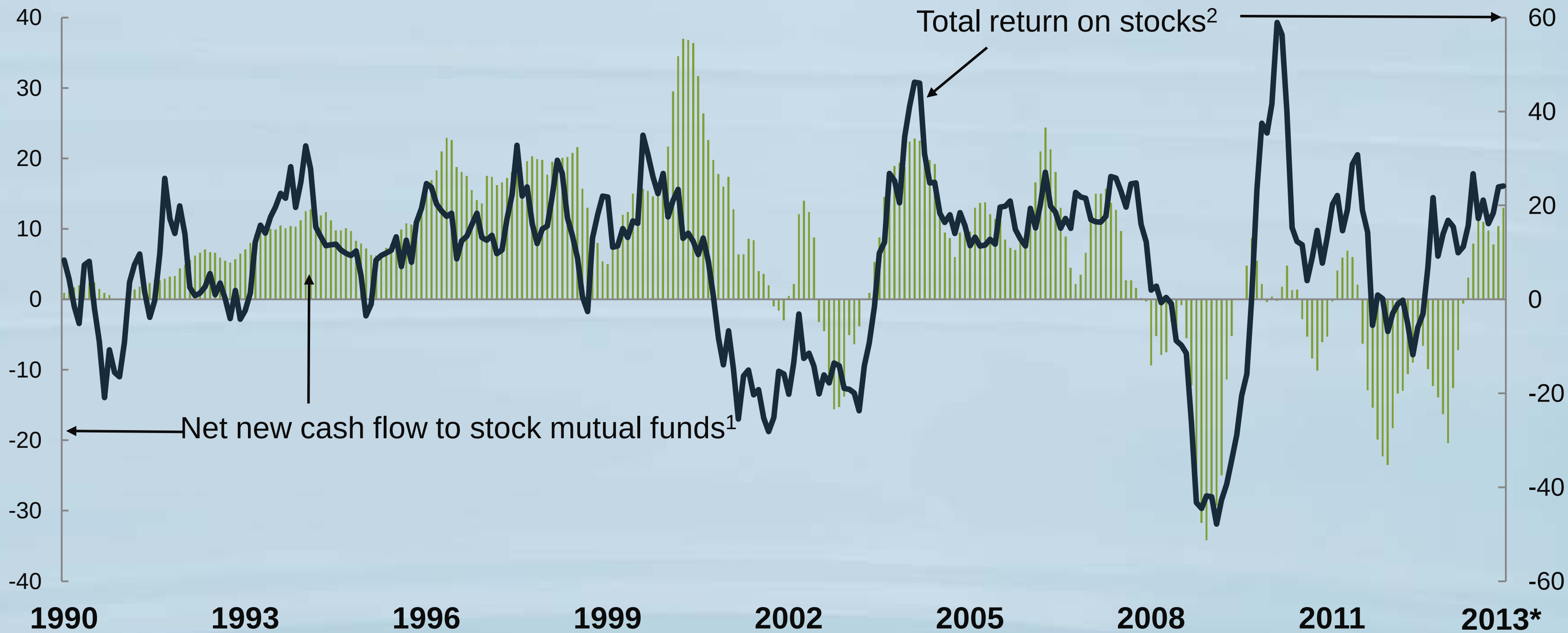
- OFR report's core argument: investors and asset managers "crowd or 'herd' into popular asset classes or securities ... contribute to increases in asset prices ... and magnify market volatility"
- Then, stock and bond funds "face the risk of large redemption requests in stressed markets"—forcing sales of securities at "fire sale" prices and transmitting risks across the financial system
- Neither the historical record nor academic research support this thesis

Fund Flows: What the Data Show

- Flows to stock funds closely track stock market performance—but that isn't systemic risk
- Flows in and out of stock mutual funds are small:
  - Relative to the size of funds (fund assets)
  - Relative to the size of markets (market cap)
- Even gross sales (ignoring offsetting inflows) are a small share of market trading
- Market crises have not caused large-scale or disruptive flight from stock mutual funds
- The same facts apply to bond funds

Flows to Stock Mutual Funds Closely Track Stock Returns

*1990–2013**



Data are through November 26, 2013.

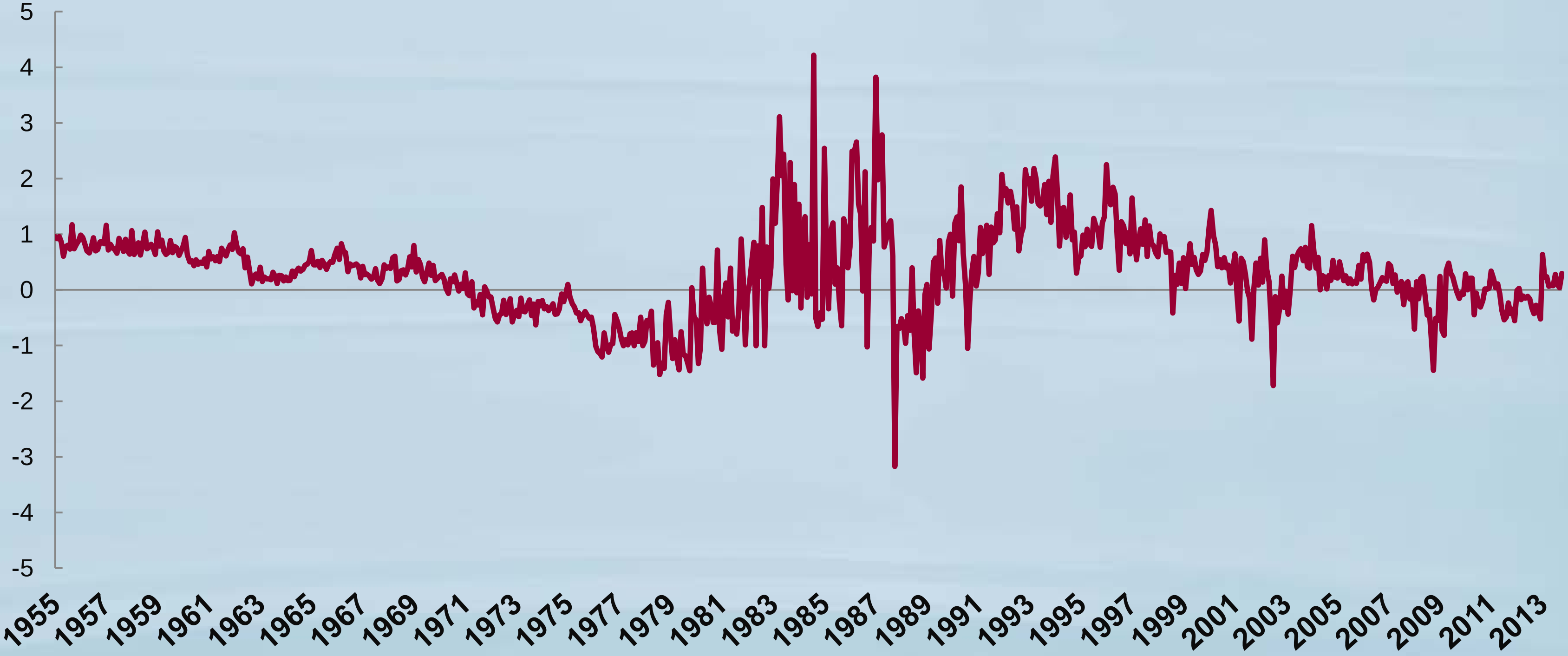
[1]Net new cash flow to equity funds is plotted as a six-month moving average.

[2]The return on equities is measured as the year-over-year change in the MSCI All Country World Total Return Index.

Sources: Investment Company Institute and Morgan Stanley Capital International

Flows to Stock Mutual Funds Are Small Share of Stock Fund Assets

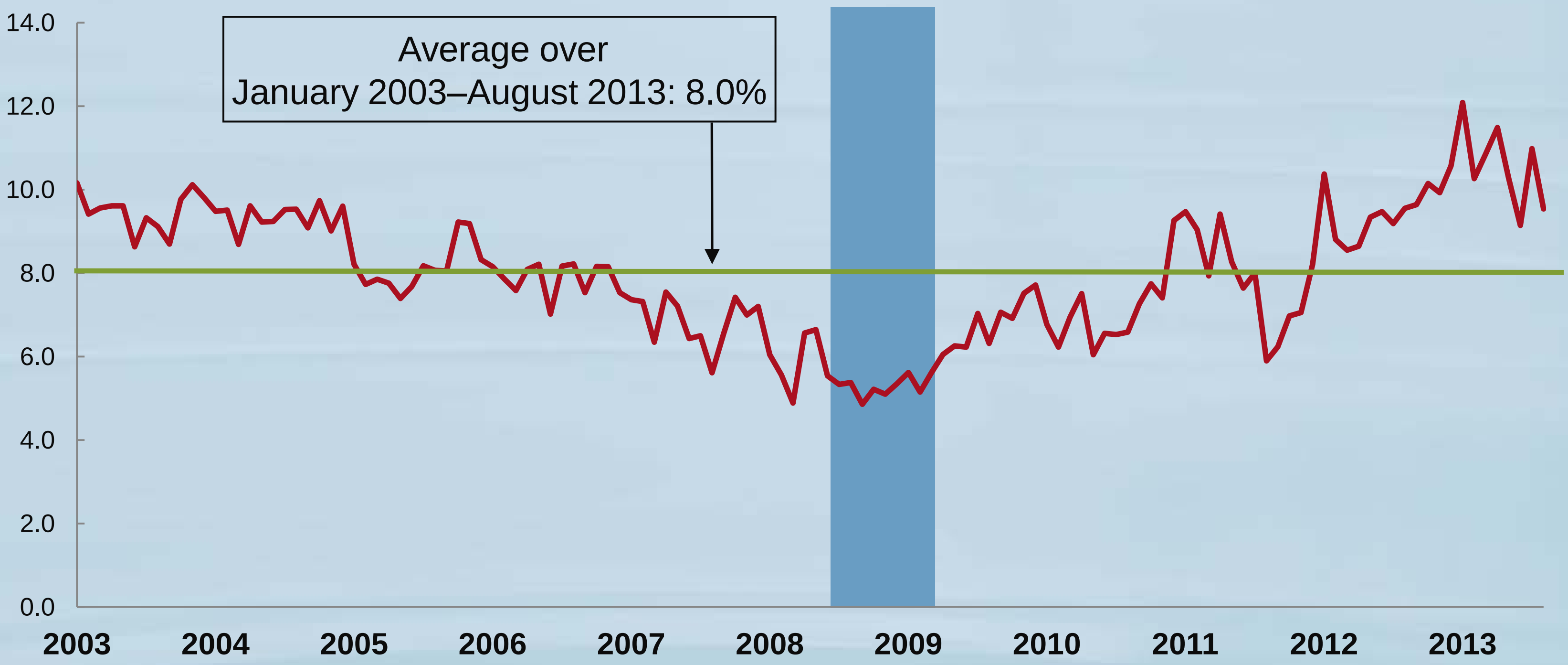
*Monthly, percent, 1955–2013**



**Data are through October 2013.*
Source: Investment Company Institute

Gross Sales by Domestic Stock Funds Are Small Share of NYSE+NASDAQ Trading*

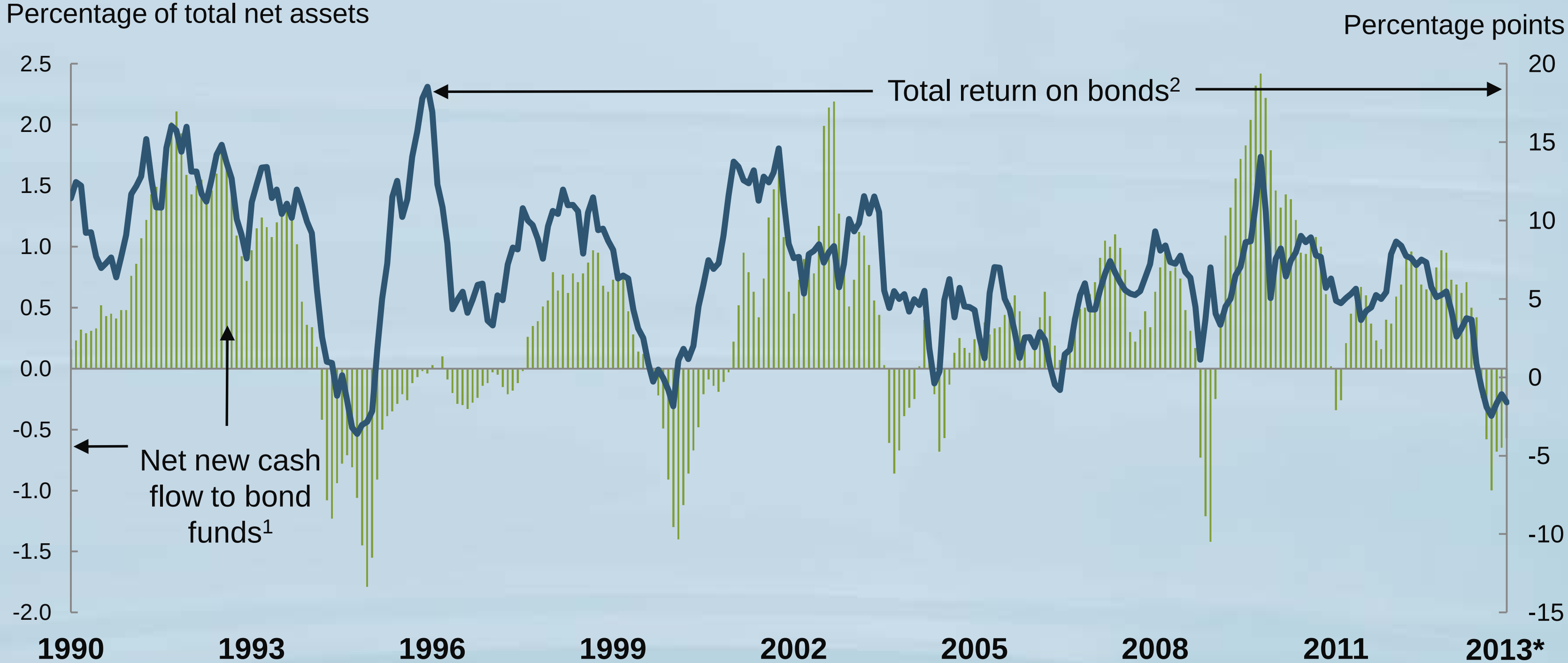
Monthly, percent



**Total value of domestic electronic order book stock trades on NYSE and NASDAQ stock exchanges, as reported by the World Federation of Exchanges; does not include trades from negotiated deals because these data are available only from January 2008 forward.*
Sources: Investment Company Institute and World Federation of Exchanges

Flows to Bond Mutual Funds Also Closely Track Returns

*1990–2013**



**Data are through November 26, 2013.*

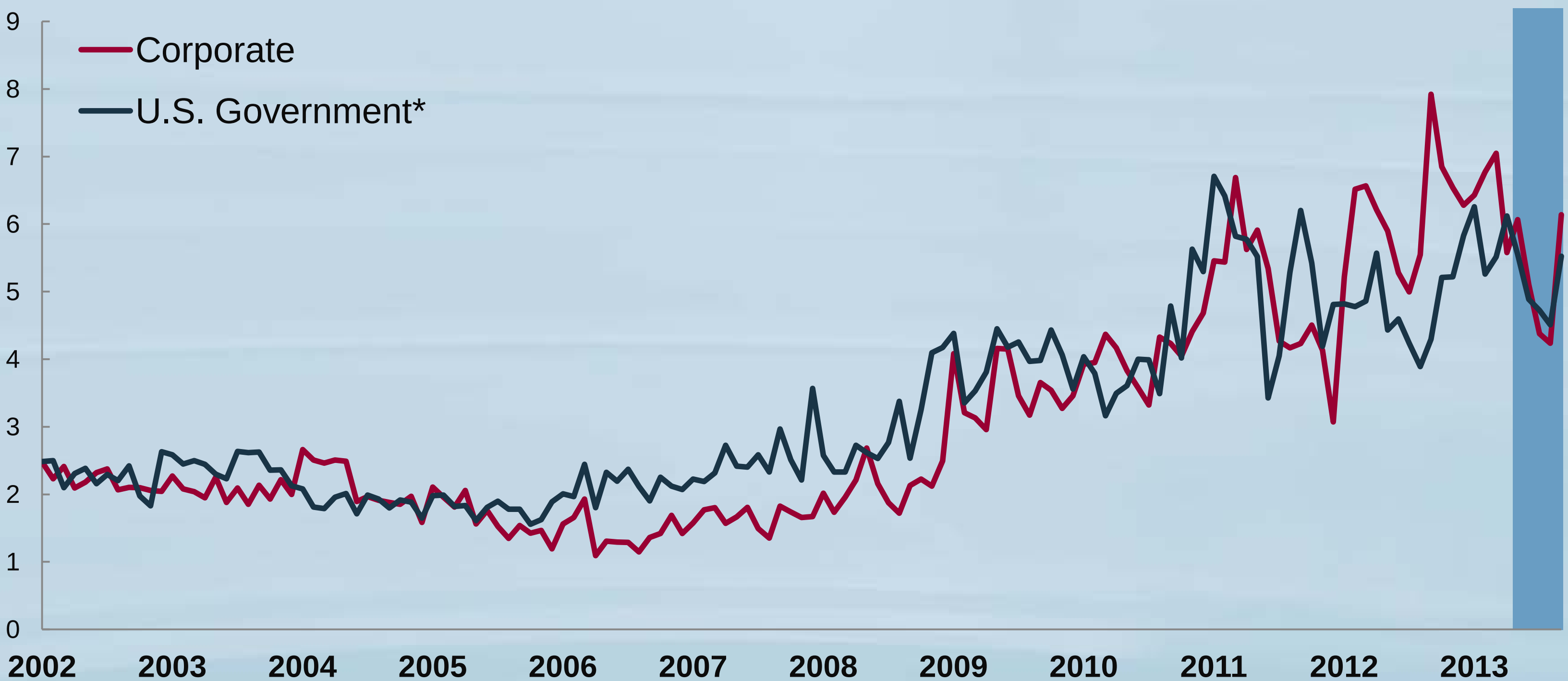
[1]Net new cash flow to bond funds plotted as a 3-month moving average of the share of NNCF in previous month assets. The data exclude flows to high-yield bond funds.

[2]Year-over-year change in the Citigroup Broad Investment Grade Bond Index.

Sources: Investment Company Institute and Citigroup

Mutual Funds' Bond Trading Is Small Share of Primary Dealer Transactions

Monthly purchases and sales by mutual funds as percent of primary dealer transactions



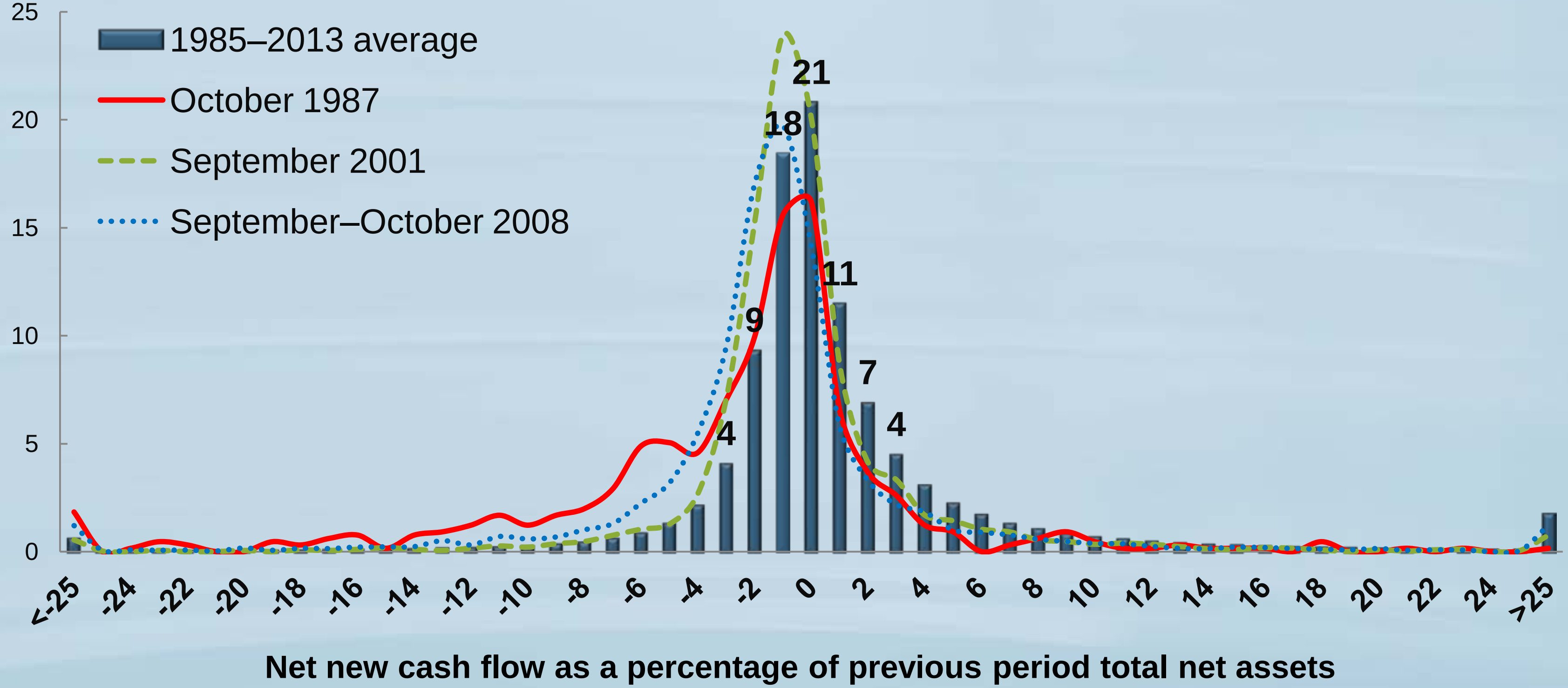
**U.S. Government primary dealer transactions consist of U.S. Government, federal agency, and mortgage-backed securities.*
Sources: Investment Company Institute and the Federal Reserve Bank of New York

Market Crises Have Not Spurred Large-Scale Flight from Equity or Bond Funds

- ICI calculated flows for individual stock, bond funds for every month since 1985—1 million+ data points
- Over the period, monthly flows as percent of fund assets cluster around 0 (half between +/- 1%)
- “Herding” thesis predicts sharp shift to outflows, spike in large outflows during market turmoil
- But data for stock and bond market crises (*e.g.*, October 1987, June 2013) show only minor shifts
- Neither industry nor individual funds show “herding”

Market Crises Have Not Spurred Large-Scale Flight from Equity Mutual Funds*

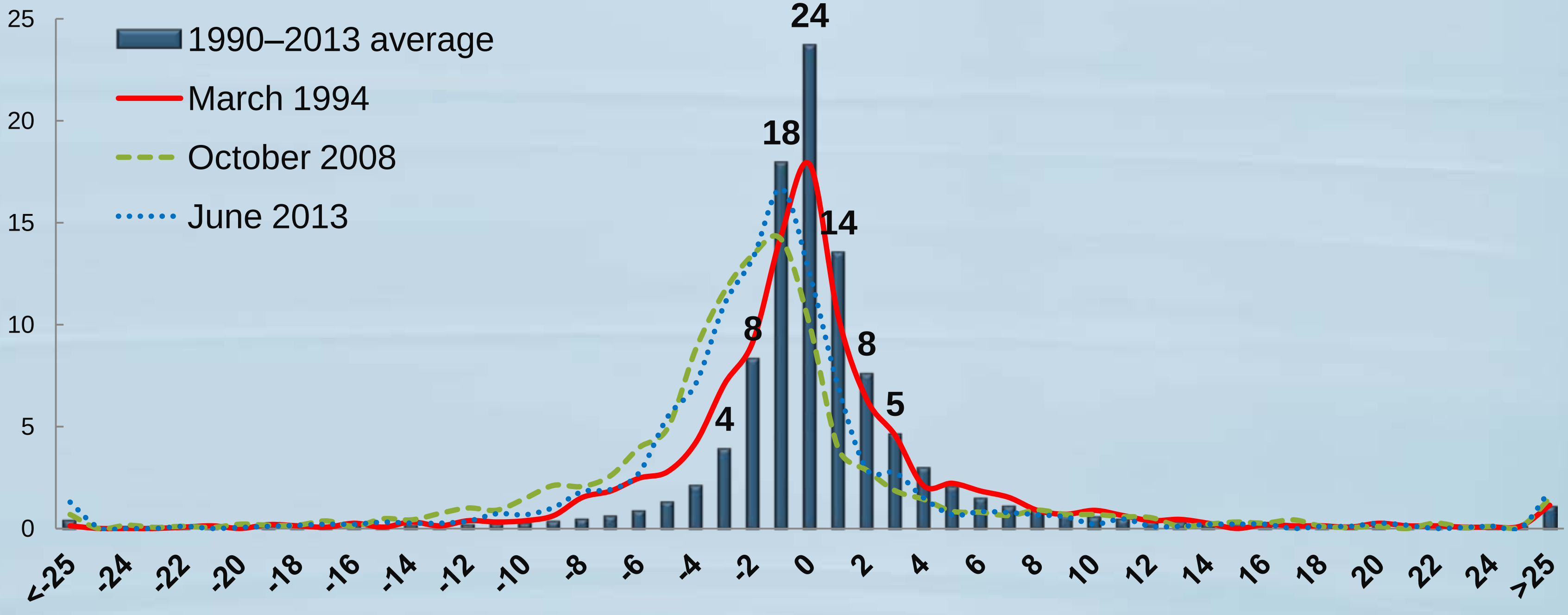
Distribution of monthly flows as percentage of total number of funds



**Net percentage flow is calculated as mutual fund net new cash flow as a percentage of previous period total net assets.*
Note: Data exclude funds with less than $10 million in average assets.
Source: Investment Company Institute

Bond Mutual Funds* Also Have Not Shown Large-Scale Flight in Market Crises

Distribution of monthly flows as percentage of total number of funds



Net new cash flow as a percentage of previous period total net assets

*Net percentage flow is calculated as mutual fund net new cash flow as a percentage of previous period total net assets.
Note: Data exclude funds with less than $10 million in average assets.
Source: Investment Company Institute

Why Even Large Funds Are Not SIFIs: *Structure and Regulation Limit Risks*

- Asset managers' role as agents limits systemic risk and risk transmission
- Legal separation of funds, managers prevents spread of risks
- Funds' comprehensive regulation protects shareholders *and* reduces potential for systemic risk

Asset Managers' Agency Role Limits Systemic Risk, Risk Transmission

- Unlike banks and insurers, asset managers are agents, not principals—a key risk distinction
- Asset managers do not put their own money at risk; they do not need capital to absorb investment losses
- This agency role and structure mandated by regulation limit risk and transmission of risk
  - Each fund is legally separate from manager, other funds
  - Fund assets are held by custodian; failure of fund manager wouldn't impair assets

Funds' Comprehensive Regulation Reduces Risks

- Funds are regulated under all major securities laws—in particular, Investment Company Act
- Fund regulation protects shareholders—*and* reduces potential for systemic risk
  - Funds' borrowing and leverage are strictly limited
  - Funds are required to have a simple capital structure
  - Liquidity, daily mark-to-market valuation, diversification help funds meet redemptions in orderly and fair manner

Consequences of SIFI Designation

- Dodd-Frank imposes costs on non-bank SIFIs
  - Fees to cover Fed's supervisory costs for SIFIs
  - Assessments to fund OFR
  - Possible assessments for Orderly Liquidation Fund
- Fed has created uncertainty on other "remedies" for non-bank SIFIs
  - Will assess how enhanced capital requirements and prudential supervision should apply and tailor "if appropriate"
  - Designate first, figure out remedies later?

SIFI "Remedies" Would Harm Funds and Fund Shareholders

- If Federal Reserve imposes capital requirements on designated funds:
  - Fundamentally incompatible with the business model of funds, managers
  - Fund investors could face enormous added costs to carry capital
- Fees, costs of added regulation would drive up costs ultimately borne by shareholders
  - Shareholders might move from designated funds or managers to lower-cost, less-restricted competitors

The Ultimate Conflict: Fiduciary Duty

- Prudential regulation could conflict directly with fund managers' fiduciary duty to funds, clients
  - Fed could direct investments by funds "for the good of the system"—regardless of shareholder impact
  - Contrary to managers' exclusive duty of loyalty to interests of fund shareholders
- If SIFI funds or managers are assessed for bailout pool:
  - Fund shareholders at risk for "TBTF" banks
  - Retirement savers would substitute for taxpayers
  - Retirement fiduciaries would shun SIFI funds

A Better Way to Address Any Potential Risks: Activities

- Regulators should target any specific, identified risks with powers to regulate activities, practices
- Dodd-Frank powers and existing authorities give wide scope for mitigating risks
- Substantial efforts are already underway
  - Money market funds, functioning of money markets
  - Repurchase agreements
  - Securities lending
  - Derivatives and counterparty risks
  - Shortening settlement cycles

Financial Stability and U.S. Mutual Funds

Appendix: Structural Characteristics and Regulation of U.S. Mutual Funds

Structural Characteristics of U.S. 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 or default
- A fund’s investment adviser serves in an agency capacity and does not take on balance sheet risk

Regulation of U.S. 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 percent of fund portfolio in liquid securities to support redemptions
- **Daily valuation**: at current market prices
- **Extensive disclosures**: evergreen prospectus, robust public periodic reporting (including quarterly portfolio holdings), and audited financials

Regulation Protects Investors *and* Addresses Systemic Risk (cont'd)

- **Simple, transparent structure**: no debt or preferred stock; no off-balance sheet financing
- **Diversification**: all mutual funds meet tax law standard; most adhere to higher securities law standard
- **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