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FACT SHEET: ICI LETTERS TO FSB AND KEY U.S. REGULATORS DETAIL FATAL FLAWS WITH G-SIFI DESIGNATION METHODOLOGY AND CONSEQUENCES FOR FUNDS AND INVESTORS

The Financial Stability Board (FSB) is currently undertaking its second consultation period related to methodologies for evaluating investment funds and asset managers for designation as global systemically important financial institutions (G-SIFIs).

ICI asserted the following critical points on G-SIFI designation methodology and consequences in a comment letter to the FSB and a separate letter to U.S. Treasury Secretary Jack Lew, Federal Reserve Chair Janet Yellen, and Securities and Exchange Commission Chair Mary Jo White:

- The funds and managers that the FSB's "methodologies" would single out for potential designation are almost solely U.S. firms.
- Designation of U.S. regulated funds or their managers would harm investors and U.S. markets.
- The FSB is following "a foolish consistency" in a fundamentally flawed process.
- The FSB incorrectly focuses on size, then contradicts its own standards by proposing to carve out sovereign wealth funds and pension funds—including some exceptionally large investment pools—without sound reasons.
- The FSB ignores critical data—including comments on its first consultation—relying instead on conjecture.

The FSB Singles Out Many U.S. Regulated Funds and Managers for Potential Designation

- The current FSB consultation continues to place undue emphasis on the size of a fund, thus singling out many large, highly regulated U.S. stock and bond funds as candidates for potential designation.
- The latest consultation adds criteria to sweep large asset managers into the designation net, possibly based entirely on the amount of assets under management. This approach would also result in identification of candidates for potential designation that are almost solely U.S. firms—in this case, asset managers.
- The group of U.S. stock and bond funds that stand to be identified for possible designation demonstrated a remarkable degree of stability during the financial crisis.

- These funds are among the most comprehensively regulated and highly transparent parts of the global financial system.

- These funds do not have the riskiness of banks and make little use of leverage (in many cases, none at all). All attendant investment losses or gains are incurred by fund shareholders.

- Focusing on these funds and their managers appears misguided for a process designed to identify lurking risks of global dimension.

Designation of U.S. Regulated Funds or Their Managers Would Harm Investors and U.S. Markets

- The process set in motion by the FSB consultation could ultimately be used to exert multinational influence on the Financial Stability Oversight Council (FSOC) to expand regulatory reach of the Federal Reserve to include U.S. funds, managers, and capital markets.

- In the United States, under the Dodd-Frank Act, designated funds could face prescriptive, bank-like "remedies" in the form of capital requirements, added fees, additional regulation by the Federal Reserve. Examples include (1) additional "loss absorption" capacity (*i.e.*, capital) requirements; (2) enhanced "prudential supervision"; and (3) resolution planning requirements.

- Stock and bond funds and their investors could also be assessed to bail out failing large financial institutions in the future.

- These "remedies" are ill-suited to mutual funds and are harmful to fund investors, who would face higher costs and lower returns.

- The resulting competitive imbalances would distort the fund marketplace, potentially leading to regulatory arbitrage and reducing investor choice.

- Designation also could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. This could pit the banking regulators' interest in protecting the banking system against funds' interest in serving millions of investors.

- ICI questions why the standards emerging from this multilateral process, which has no formal status or sanction under U.S. law, should target almost exclusively U.S. firms and capital markets.

- The harmful consequences of applying these ill-suited policy measures to U.S. mutual funds underscores ICI's strong conviction that designation would be inappropriate for regulated funds or their managers and would ultimately harm tens of millions of investors.

FSB Is Following "a Foolish Consistency" in Fundamentally Flawed Process

- The FSB has continued to insist that methodologies for funds and managers should achieve "broad consistency" with standards applied to global systemically important banks and insurers.

- This goal does not appear to stem from directions from the G20 but rather is a choice made by FSB that utterly discounts the fundamental distinctions between the agency business of asset management and the principal businesses of banking and insurance.

- Aligning standards and remedies for regulated funds and their managers with those for banking is "a foolish consistency," because it leads down an unproductive path.

- ICI asserts that "true mitigation of identified risks in the asset management sector can only come from activity-based regulation."

- ICI urges U.S. regulators to use their influence to "redirect" the FSB toward a market-wide, activity-based approach to regulation.

FSB Incorrectly Focuses on Size; Then Carves Out Other Exceptionally Large Investment Pools

- The FSB methodology continues to place undue emphasis on the size of a fund while ignoring the substantial body of evidence from its first consultation showing that regulated funds have not been and are not expected to be sources of risk to global financial stability.

- Indeed, under the proposed methodology, the FSB would continue to zero in on the most highly regulated, transparent, and *unleveraged* funds for possible G-SIFI designation.

- These funds have not been—and are not expected to be—sources of risk to global financial stability. In fact, as demonstrated by the data, the largest regulated U.S. funds belong to the part of the financial system that was most stable during the global financial crisis.

- ICI rejects the idea that size is a primary driver of systemic risk. If size is truly a concern, however, it is inappropriate for the FSB to exclude from consideration other, larger investment pools such as pension funds and sovereign wealth funds.

- Indeed, nine sovereign wealth and pension funds are larger than the world's largest regulated fund. And another 26 sovereign wealth and pension funds exceed $100 billion in assets, one of FSB's size-based evaluation thresholds.

- ICI does not advocate designating these investment pools as G-SIFIs, but questions the FSB's "hollow" reasons for exempting them.

ICI Provides Data; FSB Ignores Data and Relies On Conjecture Instead

- For regulated funds, there is simply no historical or empirical basis for the FSB's concerns that a fund's investment losses, fully borne by its shareholders, could be transmitted to other market participants in such a manner and magnitude as to destabilize the global financial system.

- Nor has the FSB provided any empirical data or reasoned analysis for concluding that these concerns will materialize in the future when, for example, the U.S. Federal Reserve raises interest rates after years of keeping them at historically low levels.

- Indeed, there are many reasons why U.S. regulated funds will *not* pose threats to financial security:

    - Regulated funds are subject to regulatory limits on leverage and typically have little to no leverage.
    - Structural features of regulated funds have the effect of limiting risk and the transmission of risk. Most notably, each regulated fund is a separate legal entity and the losses of one regulated fund are not absorbed by other funds or the fund manager.
    - Regulated funds must adhere to comprehensive regulatory requirements that protect investors and serve to mitigate risk to the financial system.
    - Regulated funds and their managers are highly substitutable.
    - Regulated funds do not "fail" like banks do, but instead routinely exit the business in an orderly fashion through mergers or liquidations. A liquidation follows an established, orderly process for distributing remaining assets to the fund's investors and winding up the fund. These events do not give rise to disorder in the markets or otherwise "transmit distress" to other market participants.

For more information on why funds do not pose a systemic risk, see pages 15–36 of ICI's comment letter to the FSB.

To read ICI's comments to the FSB and U.S. regulators and to follow ICI's work G-SIFI issues, visit ICI's financial stability resource page.