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Four Wrongs Don't Make a Right—A Financial Stability Proposal Falls Short

By Susan Olson

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After the global financial crisis, the Dodd-Frank Act of 2010 set up a regulatory framework to identify and mitigate threats to financial stability. Since then, regulators and industry have taken many actions to make financial markets and market participants more resilient. Yet a new proposal calling for further reform fails to take this progress into account, instead offering an action plan that's likely to create—not solve—problems in promoting financial stability.

The report published by the Center for American Progress (CAP) in July proposes to increase the federal government's grip on non-bank financial institutions—what CAP calls "shadow banks"—including mutual funds and exchange-traded funds (ETFs). Unfortunately, the paper runs counter to the progress made since Dodd-Frank toward effective, evidence-based approaches to mitigating financial stability risks.

The proposal contains many misconceptions. The four below stand out.

Misconception No. 1: All "shadow banks"—including registered funds—are insufficiently regulated.

The report starts with the flawed notion that non-bank financial institutions are "shadow banks" that pose big, hidden risks to the stability of the US financial system. It asserts that these institutions engage in bank-like activities with bank-like risks but without bank-like regulation.

The charge of insufficient regulation and the pejorative "shadow bank" moniker is clearly off point for registered funds. Registered funds do not operate like banks and therefore are not banks operating in the shadows. The Securities and Exchange Commission has exercised strong oversight over registered funds for nearly 80 years since passage of the Investment Company Act of 1940. The Act and SEC rules implementing the statute limit leverage, address liquidity risk, require disclosure, and provide other key protections.

Misconception No. 2: Primary regulators aren't up to the task.

The report proposes granting FSOC direct rulemaking authority and power, in many instances, to override primary regulators—the frontline agencies with expertise in the areas of the financial industry that they oversee. Underlying these recommendations is a misperception that primary regulators have been asleep at the switch.

Yet the SEC has been hard at work. After the passage of Dodd-Frank, the Commission has raised its high bar even higher by continuing to strengthen fund regulation. In 2010, for example, the SEC passed rules to reduce interest rate, credit, and liquidity risks of money market funds, and in 2014, implemented further reforms by requiring some money market funds to "float" their net asset value using daily share prices instead of a stable $1-a-share price, among other measures. Two years later, the SEC required open-

end funds to have formal liquidity risk management programs. New portfolio reporting requirements are giving the SEC deeper insights into funds' activities.

With these rules, the SEC has demonstrated that its deep, industry-specific knowledge enables it to craft regulations tailored to the unique characteristics of the industries it oversees. Other primary regulators have similar expertise. In contrast, FSOC serves best as a convener of regulators—its contributions should come from coordination, not from remaking the wheel.

Misconception No. 3: "Auto-designation" and bank-oriented prudential regulation are the solution.

Above all, CAP's proposal would go far beyond the powers that Congress contemplated in Dodd-Frank—giving FSOC power to automatically designate non-banks as "systemically important financial institutions" (SIFIs), subject to enhanced prudential standards and Federal Reserve supervision, based essentially on their size. Under the plan, any nonbank financial company with $50 billion in balance sheet assets ($50 billion in net assets for a registered fund) that meets one of five other quantitative criteria, such as $3.5 billion in derivatives liabilities, automatically becomes a SIFI.

The recommendation is troubling on two levels. First, designation should not be a first line of defense—much less automatic. It should be a regulatory tool of last resort for instances when an institution clearly poses significant risk that cannot be addressed by other means. It's worth noting that enhanced prudential standards do not automatically apply in the bank context unless the bank has at least $250 billion in balance sheets assets—a threshold set by Congress that is five times larger than CAP's proposed threshold for nonbanks.

In addition, Fed supervision and prudential standards are an ill-fitting solution for registered funds. The Fed's traditional use of capital and liquidity requirements address systemic risks posed by banks. Unlike banks, funds aren't heavily leveraged; their business doesn't involve the risks of making long-term loans based on short-term deposits. Stock and bond funds have never needed government bailouts, and their investment losses have never triggered system-wide runs. Indeed, fund shareholders, mostly long-term, household investors, aren't particularly prone to panic—having shown little inclination to redeem heavily during market turmoil over the past 75 years.

Misconception No. 4: The current administration is "defanging" FSOC

CAP faults the current FSOC for proposing reforms that would make less use of SIFI designation in favor of an "activities-based" regulatory approach. Again, CAP is out of step with the best thinking on how to enhance financial stability—because an activities-based approach addressing underlying sources of potential systemic risk can be more effective than focusing on risks at individual non-bank institutions. Under the approach, FSOC would evaluate products, activities, or practices that could pose risks to financial stability and then work with relevant regulators on measures to address identified risks. It could still use the designation tool, if needed.

Even a quartet of former government officials—Obama Administration Treasury secretaries Timothy Geithner and Jack Lew and Federal Reserve Board chairs Ben Bernanke and Janet Yellen—expressed support for such an approach in a comment letter on the FSOC reforms: "Activity-based rules, guidance, and supervision will often be the best choice to reduce risks in the system." As an example, they cite their experience with examining asset-management activities.

Solution in search of a problem?

Overall, CAP's plan is overkill. The current regulatory framework for identifying and mitigating potential risks to financial stability is not perfect, but it's becoming more effective and moving in the right direction. CAP's reboot risks introducing problems—not fixing them.

For more on financial stability, please visit ICI's *Financial Stability Resource Center*.

Susan Olson is General Counsel at ICI.

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