

Preserving the Unique Role of Asset Management

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Fourth Annual Malta Conference

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As prepared for delivery.

Thank you, for those kind words of welcome and introduction.

I am pleased to join you here today for the Fourth Annual Malta Conference, and I want to thank our hosts, the Malta Financial Service Authority and ESAFON.

They have assembled a strong program in support of Malta's investment fund sector, and I'm honored to participate.

I've long wanted to visit Malta. I am especially pleased that my first visit falls in 2014—a momentous year for this island nation. In just a few days, you will be marking the 50th anniversary of your independence from the United Kingdom.

Just four months ago, you observed the 10th anniversary of Malta's admission into the European Union.

That step, in turn, came 10 years after Malta's leaders adopted a national strategy of developing a major international financial center here to serve the investors and markets of Europe, the Middle East, and Africa. We can see the fruits of that strategy here today. May you grow into an ever-more vibrant and successful center for fund investing!

Due to its central location, Malta has long served as a crossroads of the Mediterranean, both in war and in peace.

Its history has been shaped by the interplay and the clash of civilizations, north and south, east and west, that have met here—Phoenician, Carthaginian, Roman, Byzantine, Moorish, Norman, Spanish, British, and more.

Now, the French skeptic Voltaire warned us that, "All the ancient histories ... are just fables that have been agreed upon." And he observed, "[A]t their origin [the fables] are at the very most probable, ... and they lose one degree of probability in each generation."

But Malta's history is so rich—and written so clearly on the landscape of this island—that even Voltaire might agree: the most colorful account can hardly do it justice.

Maltese history is popularly associated with the Knights of Malta—or, more properly, the Sovereign Military Hospitaller Order of St. John of Jerusalem, of Rhodes, and of Malta.

The Order came to Malta in 1530, at the invitation of the Holy Roman Emperor, after the Turks expelled the Knights from the Greek island of Rhodes. What they found here, they described as little more than "a rock," sustained mainly by fishing. What they built here was one of Europe's strongest outposts, on both land and sea, and a crucial center for maritime traffic, military and commercial, through the Mediterranean.

That strength was frequently tested—most notably in 1565, when Sulieman the Magnificent launched a fleet of almost 200 ships and more than 20,000 men to take Malta. Opposing them were just 500 Knights and perhaps 6,000 other soldiers drawn from Malta and Spain. Under the leadership of the Order's Grand Master Jean de Vallette, this small force held off the invaders, despite incessant bombardment.

After four months and more than 10,000 Ottoman casualties, the invasion was repulsed—and the Knights and their leader became renowned throughout Europe. To quote Voltaire again, “Nothing is better known than the siege of Malta.” With the support that poured in, Vallette reconstructed Malta's forts and built the city of Valletta—now the capital.

The Knights left Malta during the Napoleonic Wars, but modern Maltese are no less resilient—as they demonstrated during World War II. Their valor under punishing German and Italian bombing was recognized by the British with an Order of George, the highest civilian honor, awarded to the entire populace.

A remarkable history, ancient and modern. But if the spirit of Vallette lives in Malta's leaders today, I have no doubt of the success of your continuing mission to build an international financial center with a thriving fund sector.

I was reminded of Voltaire's dictum—“All the ancient histories ... are just fables that have been agreed upon”—as I thought about my subject today.

As we consider how to preserve and foster the unique role of asset management in today's financial markets, we are confronted with the effects of fables—fables of recent, not ancient, vintage.

It's only been six years since the bankruptcy of Lehman Brothers ignited the worst firestorm of the financial crisis. Yet in those six years, the varied sources of that crisis have been clouded and confused. Major actors have sought to establish their own narratives of the crisis, narratives designed to play up the responsibility of others.

Banking regulators in particular have agreed upon emphasizing the role of what they like to call “shadow banks.”

The Financial Stability Board of the Group of 20 nations offered a definition of “shadow banks” that could be applied to almost any financial activity done without a banking charter—and implied that all such activities are—one—inappropriate, and—two—motivated primarily by the desire to avoid banking regulation. The FSB's broad definition would sweep investment funds—even regulated funds like UCITS and US mutual funds—into that shady category.

We reject that idea.

As [we told the FSB](#), the term “shadow banking” is a pejorative term that misstates the activities, the importance, and—in the case of regulated funds—the strong regulation that governs our practices.

Yet this concept — as applied to asset management — is having a significant impact on our industry in this post-crisis environment.

We are currently engaged in a [global debate over financial stability](#), “systemic risk,” and how the financial system can be made more resilient. With their emphasis on the role of “shadow banks,” regulators have turned their attention on whether asset managers and their funds pose potential threats to the stability of the financial system.

The Financial Stability Board, for example, is trying to define the terms under which large investment funds could be designated as “global systemically important financial institutions,” or “global SIFIs.” In the United States, the Financial Stability Oversight Council has been [examining asset managers](#), their funds, and their activities to see whether SIFI designation is warranted.

What is a SIFI? It is an institution whose distress or disorderly failure could place at risk the stability of the financial system as a whole. It is, in short, an institution that may occasion “systemic risk”—and thus must be subjected to heightened regulation and oversight.

But what is “systemic risk”? Given all the attention that policymakers have focused on stopping it, you might expect the term to be well understood. In fact, it's not. A recent report from a bipartisan think tank in Washington offered not one definition, but 10—each different from the other in some significant way.

Here's a definition that didn't make that list: one economist says that systemic risk seems to be a “grab bag of scenarios,” however improbable they may be, “that are supposed to rationalize” more and more intervention by banking regulators in capital markets.

No matter what the definition—we are vigorously opposing this notion that funds or managers should be subject to SIFI designation—particularly with regard to regulated funds, such as US mutual funds or UCITS.

Before I get into the details of our case, let me make two overarching points.

First, this is not a debate about “regulation” versus “no regulation.” The fund sector around the world has thrived under sound regulation that addresses risks to investors and the capital markets. In particular, in the past six years ICI and its regulated fund members around the world actively have supported efforts to address abuses and close regulatory gaps exposed by the global financial crisis.

This is instead a debate over where and how risks to the financial system at large may occur—and what the most effective tools are to address such risks, out of the many tools that regulators have at hand.

My second point is that the stakes in this debate are high—for our investors, for our funds, and for our economies.

Designation of regulated funds could [raise costs for investors](#), distort the marketplace for funds, and damage one of the best mechanisms for saving for retirement, financing business development, and stimulating economic growth.

Here in Malta, where you are working hard to develop the fund sector and the capital markets, you can appreciate that inappropriate regulation of investment funds could impede development of those markets and the diversified sources of financing that European leaders and businesses have long sought to supplement traditional bank funding.

This is why ICI and many of its members have worked hard to assemble [a large, growing body of hard data and analysis](#), and to educate policymakers about the structure and experience of regulated funds both in the US and abroad. Our emphasis, based on ICI’s mission, has been on regulated funds—US mutual funds and similarly regulated funds, like UCITs, in other markets. Yet many of the principles we discuss apply to other funds and their managers as well.

The results of that work are clear:

- Regulated funds and their managers [do not pose risks](#) to the financial system at large;
- designation of regulated funds or their managers as SIFIs is unnecessary;
- and applying the framework of bank-style regulation to regulated funds or their managers would be harmful to these funds, their investors, and the capital markets.

How can I state so emphatically that regulated funds and their managers do not pose risks to the financial system at large? Let’s go back to that term “shadow banks.”

Clearly, asset managers do not operate in “the shadows.” Regulated funds in particular are the most well-lit and transparent of all financial products.

And asset managers and their funds are not banks.

As the FSB recognized in its own consultation on investment funds earlier this year, regulated funds have a very different risk profile from the banks and other financial institutions that are the focus of systemic risk considerations.

These funds typically make [little use of leverage](#)—and leverage has proved to be the essential fuel of financial crises. Virtually all major financial crises have involved debt that has grown dangerously out of scale. That most certainly includes the great financial crisis we all just experienced.

In this respect, regulated funds are quite unlike banks.

For example, the largest US banks—those that have been designated as global SIFIs—carry about \$10 in debt for every \$1 dollar of their own equity. For the world’s 11 largest stock and bond funds—all US funds—the comparable figures are about 4 cents in debt for every \$1 of their own equity.

There are many other features that distinguish regulated funds from banks—starting with their very nature.

Banks invest for their own accounts, as principals, and put their own money at risk. That’s why banks need to have capital on hand, to absorb losses that could bankrupt them.

In contrast, fund managers invest for their funds, as agents. The gains or losses in the fund belong to the fund’s investors. In short—banks tend to centralize risks, while fund managers leave risk-taking to their end investors. That’s why fund managers do not need capital as banks do.

And regulated funds operate under strict regulatory regimes that limit their potential to cause broad systemic effects.

Under many fund regimes—including Europe’s UCITS directives and US regulations under the Investment Company Act of 1940—funds are subject to rules ensuring transparency; diversification of their portfolios; liquidity to meet demands for redemptions; and frequent, if not daily, valuation of their holdings. Their use of derivatives is also limited. A custodian holds all the assets of the fund—and neither the fund’s manager nor its creditors has any claim on those assets.

This [comprehensive regulation of funds](#) protects shareholders –but it also serves to limit risk that could have broader effects on the financial system.

As a result of these structural differences, regulated funds differ from banks in another key way: these [funds do not fail](#) in the same way as banks. Regulators’ fears about “disorderly failure” are based on their experience with banks and other highly leveraged institutions—and don’t apply to regulated funds.

Banks guarantee customers that they will get their money back plus interest. Funds have investors—and make no such promise. They don’t promise any gain on investments. They do not even guarantee that investors will get their principal back. If a fund’s investments prosper, fund investors share the gains, on a pro rata basis.

And if the fund’s investments lose value, shareholders know and expect that the losses are theirs. In most regimes, regulated funds keep score on the ups and downs of their portfolios frequently—even daily—calculating the market value of all their holdings and reporting to all their investors.

With little or no debt and frequent mark-to-market valuation, funds aren’t likely to become insolvent. And when a fund does close, those same features mean that it is relatively easy to unwind. In the US, funds that do close follow a tried and true process.

Literally hundreds of mutual funds and dozens of fund managers exit the US market every year. Not one requires government intervention or taxpayer assistance. Contrast that to banks.

Even when confronted with all these reasons why regulated funds do not create systemic risk, banking regulators cling to one notion—the idea that fund investors are subject to panics and destabilizing “runs” that can create “fire sales,” drive down markets, and spread damage to other investors and institutions. They fear that the ability of investors to redeem fund shares quickly could create severe liquidity pressures on markets.

[These concerns are misplaced](#), for two reasons.

First, because regulated funds that offer investors liquidity also have tools to manage that liquidity. US mutual funds, for example, must maintain 85 percent of their assets in liquid securities; must mark their portfolios to market every day; and can manage redemptions by paying out over seven days or providing redemptions in kind. UCITS and other non-US funds have other tools, including gates on redemptions, to manage liquidity.

Second, the notion that investors in regulated funds are prone to flight simply does not withstand closer scrutiny—certainly not for long-term funds.

For example, modern US mutual funds have been through a lot of what bank regulators call “stress testing”—in the real world of markets—during their 75-year history.

The evidence is consistent and compelling: US stock and bond funds have never faced the destabilizing “runs” that regulators and the media imagine. In every period of market turmoil since World War II, stock and bond mutual fund investors did not “run”; fund sales of stocks or bonds accounted for a modest share of total trading; and fund sales had a minimal impact on asset prices.

Take 2008. It was the second-worst year for the US stock markets since 1825. From October 2007 to February 2009, the Standard & Poor’s 500-Stock Index fell by more than 50 percent. Did US stock fund investors pull out? Yes—they withdrew, on net, a grand total of 3.6 percent of assets. That’s right—less than 1 dollar in 25.

Proponents of the myth of the flighty investor are persistent—they keep trying out new theories. In every case they raise—high-yield bond funds, emerging market funds, you name it—we have tested the data for US funds. And we have never found evidence to support their speculations that long-term funds destabilize markets.

Not at all like banks ... little to no leverage ... agents not principals ... comprehensive regulation ... no disorderly failure ... and stable investors. On all these counts I can say confidently that regulated funds and their managers don’t occasion systemic risk.

ICI has been driving that message into the public debate on every possible occasion—because the stakes for our funds, their managers, and their investors are so high.

On the global scene, the Financial Stability Board has not discussed what additional regulations it would recommend that national authorities adopt if investment funds were designated as global SIFIs.

We know, however, that the model that some regulators have in mind is banking regulation—or, in the term that's in vogue with central bankers, "macro prudential regulation."

That could mean applying bank-like capital standards to regulated funds—a change in the basic model of fund investing. Funds don't need capital buffers because, as I've described, funds pass gains and losses through to their investors.

Setting aside, for example, 8 percent of a fund's assets for capital could severely undercut that fund's performance and competitive standing. The costs would fall on the fund's investors—at least, until those investors saw the harm and took their assets elsewhere.

Designated funds could also face higher fees and taxes to pay for their own regulation. And in the US, a designated fund could be subject to assessments to help bail out other financial institutions. Under the Dodd-Frank Act, if a big bank fails and its assets won't cover its debts, the government can assess all other SIFIs—including any designated mutual funds—to make up the difference.

While the law was intended to keep the costs of bank bailouts from falling on taxpayers, dropping that burden on shareholders in large mutual funds is just a taxpayer bailout by another name.

SIFI designation would also be likely to render regulated funds subject to "prudential supervision" by central banks or other banking regulators. That could give regulators broad power that would even reach to the fund's portfolio management.

In the US, the Federal Reserve could substitute its "prudence" for the fiduciary judgments of a SIFI-designated fund's investment adviser.

All of these costs and burdens would fall uniquely on those funds designated as SIFIs—likely to be the largest and most successful funds or fund families. In the competitive markets in which regulated funds operate, designation would not make a fund "too big to fail"—it would render it too burdened to succeed.

Fortunately, [there is a better way](#) to approach any risks that regulators might perceive in funds and asset management. That approach is to regulate activities or practices that authorities perceive as risks to financial stability—and to regulate them across markets and participants.

When they focus solely on designation of specific financial entities—for example, specific funds or managers—regulators are using only one of the tools in their kits. But they have many other tools to address activities and practices, and those tools—I would submit—are better-suited to the job of making the financial system more resilient.

Why?

Well, an activity-based approach is more comprehensive—it is more likely to address all of the market participants engaged in an activity that could pose threats to stability, in a way that singling out one or a few large firms or funds for designation would not.

We know that regulated funds tend to draw attention from policymakers and the press because our funds are the most easily observed and readily measured participants in the markets. Our transparency and openness make us highly visible.

In our research, however, ICI has found that regulated funds represent a relatively small portion of assets, both in the overall capital markets and in specific asset classes.

For example, in 2012 regulated funds held 14.5 percent—that's right, less than 15 percent—of worldwide stock and bond market assets.

They owned [just over 8 percent](#) of the market capitalization of emerging market stocks.

Funds' share of market activity is even less: In the US, domestic equity funds account on average for just 8 percent of stock market trading. Bond funds' share of overall trading is even smaller.

Now, this might seem like a stretch, but [we see a parallel](#) here between finance and astrophysics. Yes, astrophysics.

Just as scientists have learned that they cannot account for the composition and behavior of the universe without including "dark matter," we believe that it's impossible to understand the functioning and risks of the capital markets without looking beyond the well-lit regulated fund sector and considering the other players who account for the vast majority of holdings and trading.

Activity-based regulation will cover a far greater share of the universe than will regulations focused just on funds—or on the even

narrower slice represented by funds targeted for SIFI designation.

Just as important, activity-based regulation starts with identified activities and practices that pose demonstrable risks. That's in stark contrast to the hypothetical and improbable scenarios that have dominated much of the discussion of systemic risk and asset management.

Finally, targeting activities and practices will engage primary regulators who have deep experience and expertise with specific industries and markets. For regulated funds, those would be capital market regulators—rather than the banking regulators who have dominated and largely driven systemic risk discussions. To us, given the vast differences between banks and regulated funds, that just makes sense.

I've emphasized the arguments that we have advanced in this debate—but [we have not been alone](#). Former regulators, academics, business groups, and even some long-time critics of our industry have spoken out against designating regulated funds or their managers as systemically important. In the US, many members of our Congress from both parties have expressed their concern about regulators' efforts.

We hope that our advocacy is having some effect.

The Financial Stability Board is planning a second consultation on financial stability and investment funds. Its first consultation, in January, focused on standards that would, on the [basis of their size alone](#), single out certain funds for designation as SIFIs. Reportedly, this new round will consider the merits of activity-based regulation, although it may still discuss designation of individual funds or firms.

In the US, the Financial Services Oversight Council has directed its staff to turn its efforts on asset management toward “a more focused analysis of industry-wide products and activities.”

More recently, the primary regulator of US regulated funds, the Securities and Exchange Commission, created an Office of Risk Assessment to develop tools to spot and measure risks, including risks to the financial system as a whole. We welcome greater engagement by the SEC, which has a successful record of regulating mutual funds for almost 75 years, in examining practices and activities.

Still, the ultimate resolution of this issue remains in doubt — and much hangs in the balance.

According to the International Investment Funds Association, regulated funds worldwide manage almost \$31 trillion in assets. They are a large and growing source of finance for economies around the world.

They are a key mechanism for investors to save for retirement and other long-term goals. They have thrived under a regulatory regime administered by those who know our capital markets best, and just as surely will wither if regulated like banks.

To be clear, our industry welcomes scrutiny. Through our research, we constantly strive to increase understanding of our funds and their role.

But we will do our utmost to dispel any fables—ancient or modern—that could stand in the way of their continued success.

Thank you for your time and attention, and I wish you a most successful conference.