Preliminary Observations: FSB Proposed NBNI G-SIFI Methodology for Investment Funds

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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
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
  • 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
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)

* 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.
Assets of Largest US RICs’ Balance Sheets Are Dwarfed by Assets of G-SIBs

Trillions of dollars, September 2013

- Total of G-SIBs: $47.9 trillion
- Total of 14 US RICs with assets > $100 billion: $2.1 trillion

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
Assets of Largest US RICs’ Balance Sheets Are Dwarfed by Assets of G-SIBs

Trillions of dollars, September 2013

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

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
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 ….”*

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

Comments on Proposed Methodology for Investment Funds (cont’d)
Leverage of US RICs with Net Assets > $100 billion

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Net Assets, Dec 2013</th>
<th>Leverage Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Open-end Funds</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vanguard Total Stock Market Index</td>
<td>$307.3</td>
<td>1.01</td>
</tr>
<tr>
<td>PIMCO Total Return Fund</td>
<td>$237.3</td>
<td>1.18</td>
</tr>
<tr>
<td>Vanguard Inst Index Fund</td>
<td>$162.8</td>
<td>1.00</td>
</tr>
<tr>
<td>Vanguard 500 Index Fund</td>
<td>$159.8</td>
<td>1.00</td>
</tr>
<tr>
<td>American Funds Growth Fund of America</td>
<td>$138.9</td>
<td>1.00</td>
</tr>
<tr>
<td>CREF Stock Account</td>
<td>$126.5</td>
<td>1.05</td>
</tr>
<tr>
<td>Vanguard Total Intl Stock Index</td>
<td>$113.5</td>
<td>1.06</td>
</tr>
<tr>
<td>American Funds EuroPacific Growth Fund</td>
<td>$112.4</td>
<td>1.01</td>
</tr>
<tr>
<td>Fidelity Contra Fund</td>
<td>$111.1</td>
<td>1.01</td>
</tr>
<tr>
<td>Vanguard Total Bond Market Index</td>
<td>$108.1</td>
<td>1.08</td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>1.04</td>
</tr>
<tr>
<td><strong>ETFs</strong></td>
<td></td>
<td></td>
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<tr>
<td>SSgA SPDR S&amp;P 500 ETF Trust</td>
<td>$174.9</td>
<td>1.00</td>
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<tr>
<td><strong>Money Market Funds</strong></td>
<td></td>
<td></td>
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<tr>
<td>Vanguard Prime Money Market Fund</td>
<td>$131.8</td>
<td>1.01</td>
</tr>
<tr>
<td>Fidelity Cash Reserves</td>
<td>$119.2</td>
<td>1.01</td>
</tr>
<tr>
<td>JP Morgan Prime Money Market Fund</td>
<td>$117.8</td>
<td>1.01</td>
</tr>
</tbody>
</table>

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
Balance Sheet Leverage

<table>
<thead>
<tr>
<th>Category</th>
<th>Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Commercial Banks, Average: Sept. 2013¹</td>
<td>9:1</td>
</tr>
<tr>
<td>Hedge Funds, Average: June 2013²</td>
<td>≈2.5:1</td>
</tr>
<tr>
<td>Average of Long-Term US RICs with Assets &gt; $100 Billion³</td>
<td>1.04:1</td>
</tr>
</tbody>
</table>

¹Measured as total balance sheet assets relative to book value of equity.
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
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
Number of US Mutual Funds Merged/Liqudicated*  
Number of Fund Sponsors Exiting Business

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