MORNINGSTAR®

Secretariat of the Financial Stability Board
Basel, Switzerland
Email: fsb@bis.org

RE: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Sir or Madam:

Morningstar welcomes the opportunity to respond to the Financial Stability Board's proposed methodology for determining whether asset management firms are systemically important financial institutions. Morningstar is the world's largest rater of mutual funds and mutual fund firms, and therefore has special expertise in evaluating the asset management industry. We also have a long history of representing the interests of investors. With that perspective in mind, we believe that the FSB's SIFI proposals are unwarranted and, in fact, would impose costs on investors that vastly outweigh any perceived benefit to the stability of the global financial system.

First, we would note that in most fund markets around the world—and particularly in the United States, by far the world's largest mutual fund market—the use of leverage is very limited. In fact, by US law mutual funds must have three dollars of equity for each dollar of borrowings. By contrast, the large financial institutions at the heart of the global financial crisis had enormous leverage, with both Bear Stearns and Lehman Brothers having more than $30 of liabilities for each dollar of capital. Obviously, with that degree of leverage, fairly small changes in asset prices could (and did) wipe out the equity of these large investment banking firm—a risk that simply does not exist for Vanguard Total Stock Market or other large mutual funds. Indeed, most of the large funds that might be designated SIFIs, under the proposed methodology, have no leverage at all.

As former Fed Chairman Alan Greenspan has noted, it was leverage that fueled the 2008 financial crisis. Greenspan said that if mutual funds had owned most subprime mortgages, "we would not have seen the serial contagion we did. It is not the security that is critical, but the degree of leverage of the holders of the asset."

Nor do large asset management firms create systemic risk. For one thing, fund assets are segregated from fund firm assets—they belong to the fund shareholder, not to the firms—and fund firms tend to have low capital needs and little borrowing. Even if a

fund firm for some reason became unable to discharge its managerial duties, it is relatively easy for mutual funds—which have separate company structures and boards of directors—to find another advisor or merge with another fund. In fact, that sort of merger has occurred thousands of times in the United States over the past few decades.

In the 2008 financial crisis, fund firms showed that they could weather the financial difficulties of a parent company or even provide needed stability to a leveraged owner. For example, Neuberger Berman survived the 2008 bankruptcy of its parent, Lehman Brothers, with the fund firm and its client assets intact. Moreover, when Barclays needed to raise capital during the financial crisis, it was able to sell its highly successful iShares unit, which has continued to thrive under its current owner, BlackRock. Fund management is a very profitable business. To the extent that there are failures among the asset management companies that run the large funds that have attracted the interest of the FSB—those with perhaps hundreds of billions of dollars in assets—another asset manager will gladly step in to manage those assets at a profit.

Even if the fund firm is intact, might investor behavior drive a financial crisis? We are aware that the FSB and other regulators worry that in a time of market stress, a "waterfall scenario" might occur, in which shareholder redemptions prompt fund managers to sell their most liquid assets, leaving the funds with less-marketable, lower-quality securities. This, in turn, might prompt additional shareholders to redeem, according to this hypothesis, creating a sort of vicious cycle that would increase market dislocations.

It is impossible to know exactly what will happen in the future, but we do know that in the 2008 financial crisis—the largest since the Great Depression—nearly all funds easily met redemption requests, which by the way, were generally not massive. To take just one example, among US equity mutual funds, net redemptions in 2008 totaled approximately $130 billion, which was actually about $30 billion less cash than those funds had on hand, in the aggregate, at the beginning of the year. If the downturn in 2008—the worst in US equity markets since 1931—was not large enough to trigger the so-called waterfall scenario, is this really the right area for regulators to be focusing so much of their attention?

Moreover, even when funds do receive significant redemptions, managers do not necessarily need to resort to panicked selling. Fund managers have a number of sources of cash to meet redemptions, including ongoing investments by 401(k)

participants, dividends and interest payments on investments, and oftentimes, lines of credit. To take just one example, large firms like Vanguard and Fidelity have lines of credit with external institutions, as well as the authority to make short-term loans between their funds. Moreover, even in a fund category in which one might think the waterfall scenario would apply—high-yield bonds—there is no historical evidence showing that investor redemptions have led to massive amounts of selling.

With respect to applying the SIFI designation to funds, therefore, we quote Mercer Bullard, who established an investor advocacy group called Fund Democracy: "Mutual funds are the solution (to market instability), not the problem. 401(k)s were sources of stability during the financial crisis."

We also believe there is a logical inconsistency in the application of the SIFI designation to mutual funds. Under one of the FSB's proposed SIFI thresholds for mutual funds, a single S&P 500 Index fund with $101 billion in assets would be a SIFI. Yet six or eight $50 billion S&P 500 Index funds, spread across asset managers, would not be systemically important. In reality, individual investors' purchase and sale decisions—not fund manager decisions—will drive purchase and sale decisions within these fund portfolios. When a large S&P 500 Index fund receives significant redemptions, smaller index funds almost certainly will as well. Moreover, individuals with stock portfolios are likely to be sellers, too. Differentiating among all these types of sellers—subjecting some to heavy regulation, while others are free to operate as they have in the past—simply does not make sense.

To be sure, there are areas where it makes sense for local regulators to subject mutual funds and fund firms to greater scrutiny. In the United States, the SEC recently proposed rules that are intended to promote greater clarity around funds' derivative exposure. We welcome this initiative, though we also note that a large fund with an enormous amount of derivatives exposure—PIMCO Total Return—has recently sustained tens of billions of dollars of redemptions while still posting strong performance. Admittedly the market environment has been benign during the period when these redemptions occurred, but we note that in 2008, PIMCO also performed well, even though it also had heavy derivative exposure then.

In short, due to differences between the mutual fund and banking industries, we simply do not believe that subjecting funds to bank-style regulation is beneficial. Nor do we believe that mutual fund investors should pay a "tax" to support the banking industry the next time a number of large banks become insolvent. Viewed objectively,

the mutual fund industry simply does not pose a systemic risk to the global financial system—and the regulatory environment should reflect that.

If you have any questions about our submission, please feel free to contact me at +1 312 696 6559 or by email at scott.cooley@morningstar.com

Sincerely yours

Scott Cooley
Director of Policy Research