

## A Strong Footing: The Critical Role of Capital Markets in the Post-Crisis World

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### Luncheon Keynote

### American Chamber of Commerce of Japan

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Thank you for that warm welcome, and thanks to all of you for coming today. I am deeply honored to have this opportunity to address you and to share my perspective on some of the critical issues facing our global financial system.

Personally, I am truly delighted to be in Tokyo once again.

It was my honor, in the middle of my career, following my time in government service at the White House and the Pentagon, to be chosen by the Japan Society as a US-Japan Leadership Fellow.

I was resident for several months in Tokyo in 1990, living at the International House and working out of the Research Institute for Peace and Security.

As you may recall, this was at the time of the first Gulf Crisis, following Iraq's invasion of Kuwait, when Japan was wrestling with the role of its armed forces in international peace cooperation. I had the opportunity not only to get to know this great city but also travel through much of Japan. I cherish those memories as I do the Japanese friends I made in those days, and I am glad of the many subsequent opportunities I have had to visit here.

Looking back, I could not have predicted that twenty-five years later I would be returning to Tokyo once again as head of the Investment Company Institute.

For those of you who do not know of ICI, we are a leading global trade association for funds that are closely regulated and offered to the public in jurisdictions worldwide. We seek to encourage adherence to high ethical standards in the fund business; promote public understanding of funds and fund investing; and otherwise to advance the interests of funds, their shareholders, directors, and advisers.

Because of the many advantages they offer to investors, funds have emerged as key financial intermediaries in countries all around the world. And it is from that perspective today that I want to discuss the state of capital markets.

My remarks will focus on why so many countries—with Japan at the forefront—are working to develop and strengthen their capital markets.

I want to discuss the three important advantages that strong capital markets offer to economies—efficiency, stability, and flexibility.

And that discussion will lead us into possible regulatory developments that could compromise the role of capital markets in building more robust economies.

As it happens, this year marks the 75th anniversary of the modern fund industry in the United States and also the 75th birthday of ICI. Since 1940, mutual funds and other regulated funds have operated and prospered under a comprehensive framework of laws and regulations established by the last of the so-called New Deal legislation.

The history of the past 75 years is a remarkable story of orderly growth and evolution.

Our US funds have over time become the primary vehicle for Americans who want to participate in stock and bond markets.

Today, more than 90 million Americans own shares in mutual funds. Those investors enjoy a wealth of choices and strategies in a highly competitive landscape—some 800 US fund sponsors offering more than 16,000 funds. As a result, the assets managed by US regulated funds have grown from 1.1 billion dollars in 1940 to almost 18 *trillion* dollars today—an increase of 1.6 *million* percent.

This is a record that we take pride in. Many factors have contributed to the growth of US mutual funds, and the democratization of investing that they represent. Surely, one critical factor reflects a key strength of the American financial system—its robust capital markets.

Now, ICI is also a global organization. In the past three and a half years, we have opened offices in London and Hong Kong and have gained new fund members from four continents, including here in Japan. We are pursuing a global policy agenda that includes promotion of capital markets and increased use of regulated funds in retirement systems in jurisdictions around the world.

And one common theme that I hear in country after country is this: How can we develop stronger capital markets? How do we –

- allocate capital more efficiently to promote economic growth ...
- diversify our sources of financing ...
- move money out of bank deposits and into equity ...
- encourage savers to become investors who take reasonable risks for better returns ...
- improve our population's prospects for retirement security ... and
- foster a culture that encourages entrepreneurship and ownership?

As leaders around the world seek to revive or strengthen their economies, they recognize that their financial systems must include robust alternatives to banks as a source of financing.

Here in Japan, the government has created the Panel for Vitalizing Financial and Capital Markets to help strengthen the economy. An explicit goal is to develop “a society where individuals build wealth with risk asset allocation appropriate to [the] stage of [their] life cycle.”

To advance that end, the Panel aims to foster the development of asset management and investment funds.

In Europe, the latest theme is the development of a Capital Markets Union, or “CMU,” to “further develop and integrate capital markets,” to “help reduce [Europe's] very high dependence on bank funding,” and to “increase the attractiveness of Europe as a place to invest.” The European Commission views development of the CMU as a key part of its jobs and growth agenda.

In Latin American and Southeast Asian nations, in China, India and Brazil, governments are pursuing policies to develop stock exchanges, enhance market-based debt financing, and encourage investment. Even in sub-Saharan Africa, 16 new stock exchanges have opened in the last quarter century.

Why?

Why are leaders from so wide a range of countries placing so much emphasis on diversifying their financial systems? Why do they want to supplement deposit-based banking with investment and ownership through equity and fixed-income markets?

Economists and policymakers who have studied these questions have identified many advantages gained through developed capital markets. I will concentrate on three—efficiency; economic stability; and economic flexibility.

For many purposes, capital markets are *more efficient* than banks in matching savers—the providers of capital—with borrowers—the enterprises or households that need funding. As technology has improved, the information advantages that banks rely upon to

underwrite borrowers have eroded. So borrowers have found it costs less to eliminate or minimize the role of the middleman by raising funds more directly with stock investors or bond buyers.

Capital markets also help distribute risk more efficiently.

Each issuer of stock or bonds presents a unique set of risks, based on its products, its business strategy, and its financing model.

Each investor gets to decide which of those risks it is best able to assume—because an investor is more or less tolerant of risk, or because it holds other assets with offsetting risks.

You can see this through a personal example: younger savers tend to invest more heavily in stocks than older savers, because young people have a longer time horizon and more working years to recover from any downturn in the market. Investors can voluntarily assume the risk that best fits their circumstances—and that helps create a more efficient financial system.

Developed capital markets also help enhance *economic stability*.

Think about it—securities that trade in markets offer immediate feedback. Frequent trading provides a readily updated scorecard on the value of assets. Every trade is a reflection of the myriad economic factors that can affect the value or creditworthiness of a company or a country. Unlike bank lenders, owners of stocks and bonds can't carry their assets on their books for months or years without reflecting these changing values.

That might seem to make capital markets more volatile—and policymakers sometimes dislike markets for just that reason.

But in a landmark 2004 study of the financial markets, Glenn Hubbard, the dean of the Columbia University Graduate School of Business, and William Dudley, then the chief US economist of Goldman Sachs, argued that this mark-to-market approach *enhances* economic stability. Capital markets make it more difficult to avoid recognizing economic or financial problems, they wrote. Thus, “As a result, pain is borne in real time.”

They contrast that to the regulatory forbearance that troubled banks all too often receive—regulators look the other way, and allow problems to grow.

Usually, they write, “this forbearance just creates a much bigger problem that poses a greater threat to macroeconomic stability.” There are many examples of this pattern, including the savings and loan debacle in my country and Japan's decade-long banking crisis.

Even without a crisis, the frequent feedback from capital markets rewards good policies and punishes bad decisions. All else being equal, when tax, spending, and regulatory policies are harmonized for economic growth, asset prices rise, investors are happier, and policymakers are rewarded. Thus, developed capital markets support economic stability.

The third factor is *economic flexibility*. Put simply, capital markets encourage entrepreneurship. As Ross Levine, an economist at the University of California, Berkeley, said, “[O]ne way to define a better financial system is that it does a superior job ... allocating capital to those with the best projects, ideas, and entrepreneurial energy.”

Risk-tolerant equity investors are better equipped than risk-averse banks to finance ground-breaking new ideas. Robust capital markets can finance new companies earlier in their development, speeding their growth.

Authorities in Europe have recognized this potential benefit from deeper capital markets.

In a speech last month, Jonathan Hill, the member of the European Commission responsible for financial services, noted that if European venture capital markets were on the same scale as America's, “companies would have been able to tap into an extra 90 billion euro of funding between 2008 and 2013”—funding more than 4,000 venture capital deals. Imagine the new ideas and new industries that might have grown.

Greater efficiency ... economic stability ... and economic flexibility. Those are the advantages that can come from developing better capital markets—and, as I have noted, they are widely recognized.

The next question is—how? How can policymakers foster changes in systems and in culture to encourage investment?

Jurisdictions with successful capital markets share a number of common elements. Let me mention a few.

First, a sound legal system with strong property rights is essential.

Corporate governance in particular must be oriented toward protecting investors—the owners of companies—rather than the

interests of managers.

Similarly, governments must not try to pick winners and losers – that is, they must avoid tax or credit policies that favor certain interests and thus distort investment decisions. Capital markets allow investors to send their cash to the ideas and businesses where it can be used most effectively. Governments seeking economic efficiency need to respect that process.

Sound regulation is crucial. Exchanges and clearing and settlement systems must be organized and supervised to help markets run efficiently and to provide liquidity for trading. Issuers of stock and bonds must be subject to well-accepted accounting rules and high standards for reporting and transparency. Regulators, too, must follow transparent procedures. Markets can thrive under a wide range of rules—but they do not do well when no one knows what the rules are.

Capital market regulation works best when it is based more on principles, and less on prescriptions. Financial market participants tend to have great skill in finding and exploiting gaps in a prescriptive system.

Broader principles aimed at managing risks and conflicts tend to work more effectively.

In that regard, there is one key principle that has served the mutual fund industry well—the principle of fiduciary duty that an asset manager owes to the funds and investors that it serves.

Essentially, a fiduciary is one who takes it upon himself to act for or advise another, thus inviting the other's confidence and trust. The distinguishing obligations of a fiduciary are the twin duties of loyalty and care. For a fund adviser, loyalty to the interests of fund shareholders and due care in managing their assets are essential. Investors must trust that their adviser is looking out for them.

Strong laws, fair tax and credit policies, and sound, principle-based regulation—these are among the key ingredients for strong capital markets.

As an aside, let me just say that, based on my limited knowledge of the Government of Japan's program for vitalizing capital markets, it appears that Japan is moving in the right direction on these and other measures. I hesitate to comment in depth, because I am no expert on the latest Japanese developments! But I believe the Panel is making good progress.

As I've said, governments from Addis Ababa to Singapore are trying to nurture stronger capital markets, because they want the benefits of efficiency, economic stability, and economic flexibility that such markets can bring.

Yet in the wake of the financial crisis, we are seeing a concerted movement by banking regulators to assert unprecedented authority over asset managers and thus over the capital markets in which they participate. This is evident in the work of two councils of regulators that were recently created to guard against "systemic risk"—financial institutions or activities that could trigger or accelerate the next financial crisis.

These councils—the multinational Financial Stability Board in Basel and, in the US, the Financial Stability Oversight Council—are pursuing the notion that funds and asset managers are merely "shadow banks," that they pose super-sized threats to financial stability, and that they should be subject to bank-style regulation.

What would that mean exactly? Likely it would mean capital requirements that have never been applied to funds and that do not fit the business model of funds. It also would mean a regime of "enhanced prudential supervision" designed around protecting the banking system—not serving the interests of investors.

And this conflicted model of regulation could reach far into the mutual fund business. Under the latest proposal by the Financial Stability Board, *more than half* of the assets that Americans hold in mutual funds—almost 10 trillion dollars—could be swept into this new framework.

This would be ironic—if it were not so worrisome. After all, the financial crisis was first and foremost a *banking* problem, fueled by the collapse of major banking institutions. *Banking* regulators failed to anticipate the risks from the US housing market and subprime mortgages that *banks* had issued and sold.

The carnage in the banking system did create problems for US money market funds. But those issues have been comprehensively addressed through two sets of reforms passed by the US Securities and Exchange Commission.

Other types of regulated funds—stock and bond funds—came through the crisis without incident. In fact, America's regulated stock and bond funds proved to be among the most stable parts of the financial system during the 2008 crisis.

Indeed, former Federal Reserve Chairman Alan Greenspan has suggested that the financial crisis would have caused much less damage if the US financial system had relied more on capital markets—mutual funds in particular.

Writing after the crisis, Greenspan noted that subprime mortgages were the “toxic asset” of the financial crisis. But if those mortgages had been held by mutual funds, he wrote, “we would not have seen the serial contagion we did.”

Chairman Greenspan recognized that the impact of losses at banks are concentrated and multiplied by the leverage that banks use to swell their balance sheets. But mutual funds use little to no leverage, and fund shareholders accept that they will share any gains or losses on the assets that their funds hold.

ICI and its members have amassed a weighty record of data and analysis on the question of funds and systemic risk, a record that draws on 75 years of experience with stock and bonds through one market crisis after another. The conclusion is clear: there is no basis for the proposition that regulated stock or bond funds, or their managers, pose outsized risks to the financial system.

Moreover, regulating funds like banks would be extremely harmful. It would penalize investors, distort the fund marketplace, and compromise regulated funds’ important role in financing a growing economy.

Indeed, if central banks impose highly prescriptive regulations on funds and their managers, they will run a significant risk of diminishing the diversification in financial services that capital markets provide. Their actions could exacerbate volatility in markets, increase the probability of shocks to the financial system—and make those shocks more harmful, not less.

I am not saying that our funds, or capital market participants generally, are opposed to regulation. Remember, earlier I said that “sound regulation is crucial” to the development and operation of robust capital markets.

Mutual funds in particular have prospered under a comprehensive and effective framework of regulation that has withstood the test of time.

But the advantages that capital markets bring—in promoting efficiency, economic stability, and economic flexibility—rest in the fact that funds and other capital market participants are *not* banks, and are not regulated like banks. Undermining that financial diversity by imposing bank-style regulation on capital market participants will not serve our economies well.

When I came to Japan 25 years ago, I was at something of a crossroads in my career. For five years, I had been deeply engaged in issues of foreign policy and defense at senior levels of the United States government. After my experience in Japan, I had various opportunities to continue to work in that field. I decided, however, to return to my previous path in the practice of law, becoming over time more and more involved with financial services regulation as counsel to mutual funds, their boards, and their advisers.

I’m sometimes asked if I miss the grand issues on which I worked while on the staff of the National Security Council. In some ways I do—and I certainly have maintained a keen interest in such matters to this day.

But I have never felt that matters of finance—particularly on the scale that we are discussing today—should be regarded as secondary. As historian Niall Ferguson has written:

“The evolution of credit and debt was as important as *any* technological innovation in the rise of civilization ... without the foundation of borrowing and lending, the economic history of our world would scarcely have gotten off the ground.”

Today, the health of our economies depend no less on the strength of our financial systems—and the role that capital markets can play.

That is why it is so vital for us to pay close attention to these issues, and to make sure that policymakers get them right.

Thank you for your time and attention.