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Investment funds: neither banking nor in the shadow

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The question of the risks to financial stability posed by so-called non-bank financial intermediation (NBFI) - an expression that has prevailed internationally, as opposed to shadow banking - is now very much on the agenda in the debate on financial regulation. Some people are concerned that non-banking finance (according to them) is a sector that would be subject to less sophisticated and less stringent regulation and supervision, and about which supervisors would have insufficient information.

These types of considerations are usually made without distinguishing between the different segments of NBFI, among which asset management and, in particular, the investment fund industry, clearly stand out. In fact, it is usually made with a view to the latter, which worldwide represents 70% of NBFI, and which in turn represents 13.5% of the financial system, 85% and 7% in Spain respectively (it is important to clarify that neither the insurance activity nor pension funds are generally considered as NBFI). The idea conveyed, even explicitly, is that regulation should be equivalent to banking regulation; that fund management companies should be subject to high capital requirements; and that it could be a problem that funds do not have access to central bank liquidity.

But the reality is that NBFI and in particular the activity related to mutual funds is very different from banking activity. The latter, in its simplest form, consists of attracting deposits and granting loans by dissociating depositors from the risk associated with the loans, which makes it reasonable that regulation and supervision should be based on a model focused on controlling the solvency of institutions. The world of investment funds is different. Those who invest in them in search of a return are aware, or at least should be aware, that they are acquiring a stake in a pool of financial assets subject to price fluctuations and, consequently, that the value of their investment upon redemption may be different. And they know, or should know, that redemptions may require sales of the assets, which are not on the balance sheet of the management companies but are owned by the fund, i.e. the investors themselves. The risks, in this case, are associated with the overall market and therefore the supervision model must be based on the control of the activity rather than on the solvency of the management companies' assets.

Investment through mutual funds is therefore a very different activity from banking and the regulatory and supervisory approach to it should be different, but this does

not mean that it is not likewise heavily regulated and supervised. Its supervision, which is mainly aimed at investor protection, and essentially of the micro-prudential kind, also contributes to financial stability by addressing issues such as investment diversification, liquidity requirements and management, as well as limits on leverage. It is also a segment subject to rules and requirements that are harmonised at European level and that derive from the principles of international bodies such as IOSCO (the International Organization of Securities Commissions), which include a wide range of tools available to managers and supervisors to deal with different situations that may arise. In fact, conventional investment funds -UCITS and equivalent-, whose weight in the system has been very relevant for decades, have never posed any significant problem from the point of view of financial stability, not even at the most critical times of the last financial crisis; and, as far as alternative investment is concerned, the additional regulations implemented in recent years have undoubtedly generated transparency and more control.

We must never cease perfecting the rules and tools mentioned, but always taking into account the characteristics of the activity itself. Above all, it is important to persevere in our efforts to inform and educate so that all investors understand that an investment fund has little connection with a deposit and that, depending on the type of fund, daily or very short-term liquidity may be limited in certain scenarios to ensure equal treatment of unit-holders. I have to admit, incidentally, that the debate on which this article is centred has had the positive effect of making securities supervisors even more aware of the importance of information and education.

Furthermore, it is often suggested that the information available to supervisors in the field of investment funds, on transactions, positions, indebtedness, leverage, etc., should be greater, as should their ability to process and share it. Again, this is an area where there is room for improvement, but in which it is by no means necessary to start from scratch. In the European Union, the information available to supervisors is generally extensive, particularly with regard to UCITS funds (more than 60% of the total) and similar funds, and in some countries - Spain is undoubtedly at the forefront of this - we have a reporting and information processing system that allows us to effectively detect inaccurate valuations, breaches of investment limits, concentrations in less liquid assets and other incidents, and to carry on a supervisory activity that our management companies feel is active and intense.

The mutual funds industry is very different from the banking industry but it is not an opaque or poorly supervised industry. Improvements, which are undoubtedly possible, in its regulation and supervision must exploit the experience and wealth of information available to supervisors and - very importantly - take into account the specific characteristics of the activity and the specific challenges it poses from the perspective of financial stability. These are challenges that must be considered in relation to the benefits, in terms of stability and economic growth, gained through a more balanced mix of bank and market financing in the economy, one of the major objectives of the Capital Markets Union.

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