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April 18, 2012

Eric S. Rosengren
President and Chief Executive Officer
Federal Reserve Bank of Boston
600 Atlantic Avenue # 100
Boston, MA 02210

Dear Mr. Rosengren:

I read with interest your speech entitled “Money Market Mutual Funds and Financial Stability” which you delivered on April 11, 2012 at the Financial Markets Conference sponsored by the Federal Reserve Bank of Atlanta.

I am a former Fed attorney who has been involved in regulatory matters affecting the banking industry as well as the mutual fund industry for three decades. I am the author of the leading treatises on *Federal Bank Holding Company Law*, *Securities Activities of Banks*, and *Mutual Fund Activities of Banks*. I also chaired a task force of the American Bar Association that studied the causes of the financial crisis and have taught banking and financial services regulation at Yale Law School, Boston University Law School, and Columbus School of Law. I have a longstanding interest in the evolution of the law governing the financial services industry. In private practice, I led the bank mutual fund practice of a major law firm. I have represented both banks and MMFs and thus have a client-related as well as academic interest in the outcome of the debate over whether structural changes are needed for MMFs.

I have been greatly troubled by statements made by Federal Reserve officials that I believe distort the facts concerning MMFs and their role in the financial system. In particular, I am concerned about proposals advocated by yourself and other Fed officials that do not appear to be supported by the level of economic analysis that is called for given what is at stake—the survival of MMFs as efficient investment vehicles valued by millions of individual and institutional investors and which play an important role in the financial system. Some of the proposals and public statements seem disingenuous and have an amateurish “shooting from the hip” quality that I feel is beneath the dignity of the nation’s central bank.

Eric S. Rosengren
April 18, 2012
Page 2

For example, the assertion in your speech that “prime funds played a critical role in the amplification of financial problems in recent years” is unsupported by any facts, analysis or elaboration whatsoever other than a reference to the Reserve Primary Fund’s “breaking the buck” which was an event that many believe was caused by the Fed itself. Statements by yourself and other Federal Reserve officials that MMFs are “fragile,” “susceptible to runs,” part of an “unregulated shadow banking system,” nonexistent in Europe, and generally a source of systemic risk similarly are unfounded and highly misleading.

I recently authored a paper entitled “Shooting the Messenger: The Fed and Money Market Funds.” The paper examines what appears to be a crusade by the Federal Reserve to regulate MMFs out of existence and finds it to be based on flawed assumptions and outright fallacies. My paper is available at <http://ssrn.com/abstract=2021652> or <http://www.sec.gov/comments/4-619/4-619.shtml>. I hope you and your staff will read my paper and find it useful as you consider this matter further.

In this letter, I would like to share with you my concerns about some of the statements in your recent speech.

Your Concerns About MMFs are Self-Contradictory and Misstate the True Source of Risk

Your speech reveals a concern not declared so openly before—namely, the dependency of banking organizations on MMFs for much of their short-term funding needs. You recognize the key role of MMFs as “important intermediaries” between investors and banks with short-term borrowing needs and state that “Given the importance of short-term credit markets to both investors and businesses, any disruptions to those credit markets represent a potential financial stability issue of both domestic and global significance.”

Yet, you argue that prime MMFs, whose portfolios consist of large amounts of short-term credit instruments issued or sponsored by banking organizations, are laden with risky assets and thereby amplify financial problems. Your argument is self-contradictory and fails to recognize that much of the “significant risk” of MMFs comes from banking organizations themselves, both as issuers of instruments held in MMF portfolios and as sponsors of MMFs.

Your speech notes that MMFs are a key buyer of short-term debt instruments issued by banks—commercial paper, certificates of deposit, and repurchase agreements—and points out that commercial paper and certificates of deposit made up 24 percent and 25 percent of prime MMF portfolios,

respectively, at the end of February. Repurchase agreements were 19 percent.¹ Treasury and government agency securities were 9 percent and 10 percent, respectively. Accordingly, a major portion of the assets of prime MMFs are bank-related. Thus, the primary source of “risk” in MMF portfolios which you seek to eliminate comes from the very organizations whose access to short-term funding you seek to preserve.

Notwithstanding this illogic, you argue that prime MMFs have taken on undue credit risk and therefore should be subject to capital requirements or other structural changes. As evidence of this risk, you point first to instances when sponsors of MMFs have provided support to their funds and, second, to credit default swap spreads on issuers or sponsors of securities in MMF portfolios. Both of these points are highly misleading and neither justifies your proposal to impose capital requirements or other structural changes on prime MMFs.

Your Statements Concerning Sponsor Support for MMFs Are Highly Misleading and Do Not Justify Structural Changes to MMFs

With respect to sponsor support for MMFs, you state that “a number of money market funds took significant credit risk that ultimately led to them needing sponsor support in the period from 2007 to 2010.” You refer to SEC Chairman Schapiro’s statement that the SEC allowed more than 100 MMFs to enter into capital support agreements with their sponsors during 2007-2008 and that 47 MMFs received direct cash contributions or had distressed assets purchased by their sponsors, resulting in losses of at least \$3.2 billion. You conjecture that, “in the absence of the support of sponsors, many of these money market funds would have been unable to maintain the fixed NAV.” Therefore, you conclude, a capital requirement or other structural changes should be imposed on prime MMFs.

Your conclusion is unwarranted by the facts, which are well-documented but ignored in your speech. In particular, you fail to mention that the majority of the sponsor support provided to MMFs in 2007-2008 was provided by banking organizations to their affiliated MMFs. You also fail to mention that the Basel capital rules likely required these banking organizations to hold additional capital to back their MMF support arrangements but that the banking regulators failed to require them to hold additional capital.

¹ Banking organizations are the main issuers of commercial paper and the main sponsors of asset-backed commercial paper conduits (“ABCP”). They also are the main counterparties of MMFs in repurchase agreements.

A well-publicized research paper by a senior Federal Reserve economist has shown that MMFs with bank-affiliated sponsors (which hold approximately one-half of all MMF assets) “were more likely both to hold troubled ABCP and to receive financial support to absorb losses.”² This Federal Reserve paper finds that MMFs with bank-affiliated sponsors were “significantly” more likely to hold distressed ABCP than other funds and that bank affiliation increased the probability that a fund held distressed paper “by between 26 and 41 percentage points.”³

The Federal Reserve paper concludes that these support arrangements for bank-affiliated MMFs created moral hazard and systemic risk:

The strength of this result aids in interpreting the link between bank affiliation and sponsor support—**bank-affiliated funds evidently were more likely to receive support because they were more likely to hold problematic ABCP**—and points to a potential **moral hazard problem for bank-affiliated MMF managers**. Moral hazard is not the only possible explanation, but some others are no more charitable.⁴

This paper’s findings also raise concerns about the systemic risks associated with sponsor support actions for MMFs and the expectations of safety that these actions have fostered among investors. Clearly, sponsor support of MMFs was critical in helping funds weather the ABCP crisis in 2007 and the run in 2008. But the extensive record of sponsor support has probably attracted many highly risk-averse investors who would not hold MMFs without the conviction that the funds are effectively (privately) insured. Hence, **sponsor support has likely increased investor risk for MMFs**. The fact that funds with bank sponsors were more likely to have held distressed ABCP and to have received sponsor bailouts in the wake of the ABCP crisis

² See Patrick E. McCabe, “The Cross Section of Money Market Fund Risks and Financial Crises,” Federal Reserve Board, Finance and Economics Discussion Series 2010-51 at 2. You cite to this paper in footnotes to your speech but make no mention of its key findings regarding sponsor support for bank-affiliated MMFs.

³ *Id.* at 32.

⁴ *Id.*

also suggests that the possibility of sponsor support may undermine incentives for prudent asset management.⁵

The history of sponsor support for MMFs suggests not that MMFs need to maintain capital but rather that banking organizations that provide support to their affiliated MMFs need to maintain capital and that the Federal Reserve should refocus its concerns about MMF risk-taking to risk-taking by bank-affiliated MMFs. It is appropriate to ask whether sponsor support for such funds is the cause of undue risk-taking, as indicated in the McCabe paper, and whether bank capital adequately takes into account such risk.⁶

The Federal Reserve has the ability to prohibit banking organizations from supporting their affiliated MMFs and to enforce capital requirements, and thereby address the moral hazard and systemic risk highlighted in the McCabe paper. Rather than recommending changes to rules under the jurisdiction of another agency (i.e., the SEC), perhaps the Federal Reserve should first consider potential changes to rules within its own jurisdiction.

Among other things, the Federal Reserve could strengthen its policy regarding sponsor support for bank-affiliated MMFs. In 2004, the Federal Reserve, along with other banking agencies, adopted a policy statement discouraging, but not prohibiting, banks from providing support to their affiliated MMFs.⁷ Bank holding companies, on the other hand, are not subject to any significant limitations under the Interagency Policy.

The President's Working Group, in its 2010 report on MMFs, noted that sponsor support for MMFs "may contribute to runs" and is a source of systemic risk.⁸ Chairman Bernanke in the past has expressed concern about sponsor

⁵ *Id.* at 35. In your speech, you note that a MMF sponsor recently provided support to a fund as a result of its holdings of downgraded Eksportfinans paper. Publicly available information indicates that the MMF in question was a bank-affiliated MMF.

⁶ At least one academic paper has shown that MMF sponsors with greater financial strength and non-fund business activities (such as banking organizations and their affiliates) were more likely to sponsor MMFs that took increased risk from 2007-2008 and more likely to provide support to such funds. See Marcin Kacperczyk and Philipp Schnabl, "How Safe Are Money Market Funds?" April 2012, electronic copy available at: <http://ssrn.com/abstract=1769025>.

⁷ See Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Interagency Policy Statement on Banks/Thriffs Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates (Jan. 5, 2004). See Federal Reserve Board, SR 04-1 (Jan. 5, 2004).

⁸ Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 3 and 10 ("uncertainty about the availability of such support during

support for MMFs and said that the Financial Stability Oversight Council will address sponsor support and consider options that could materially change the nature of such support.⁹ However, neither he nor other Federal Reserve officials have publicly discussed the sponsor support problem or proposals to deal with it.

The Federal Reserve also might consider whether banking organizations that have supported their affiliated MMFs should be required to consolidate the funds on their balance sheets for regulatory capital purposes. Under the Basel capital rules, such support appears to fall within the definition of a “direct credit substitute.”¹⁰ The capital rules require a bank to convert all of the assets supported by a direct credit substitute to an on-balance sheet credit equivalent amount and assign a credit conversion factor of 100 percent.¹¹

Thus, a banking organization that provides financial support to prevent an affiliated MMF from breaking a dollar may be required to convert all of the assets supported by the arrangement to an on-balance sheet credit equivalent in an amount equal to all of the assets being supported—i.e., potentially all of the assets in the fund.¹² In other words, the banking organization would be required to maintain capital as if the entire fund were on its balance sheet. Moreover, a banking organization that provides credit support to a MMF beyond the level of support it is legally obligated to provide may be deemed to be providing “implicit recourse.” When implicit recourse is found in the case of a securitization trust, for example, the regulators require the entire amount of securitized assets to be

crises may contribute to runs”; “the possibility that sponsors may become unwilling or unable to provide expected support during a crisis is itself a source of systemic risk.”).

⁹ See Letter dated Dec. 9, 2010 from Federal Reserve Board Chairman Ben S. Bernanke to Anthony J. Carfang, Treasury Strategies, Inc., attached to Letter dated Dec. 17, 2010 from Anthony J. Carfang to Securities and Exchange Commission Chairman Mary L. Schapiro, comments on SEC File No. 4-619, available at <http://www.sec.gov/comments/4-619/4-619.shtml>.

¹⁰ A “direct credit substitute” is defined to mean “an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance sheet asset or exposure that was not previously owned by the bank (third party asset) and the risk assumed by the bank exceeds the pro rate share of the bank’s interest in the third-party asset. If a bank has no claim on the third-party asset, then the bank’s assumption of any credit risk is a direct credit substitute. Direct credit substitutes include...guarantees, surety arrangements, credit derivatives and similar instruments backing financial claims that exceed a bank’s pro rata share in the financial claim...” See 12 C.F.R. Pt. 3, Appendix A, § 4(a)(4), 12 C.F.R. § 225, Appendix A.

¹¹ See 12 C.F.R. Pt. 3, Appendix A § 4(b)(1).

¹² This result is consistent with the treatment of bank recourse arrangements in connection with securitizations, such as when a bank agrees to assume losses in connection with loans sold to a securitization trust. See 66 Fed. Reg. 59614 (Nov. 29, 2001). Similarly, the banking regulators in 2010 amended their rules to require banking organizations to consolidate their ABCP conduits on their balance sheets. See 75 Fed. Reg. 4636 (Jan. 28, 2010).

put back onto the bank's balance sheet. The banking organization may be presumed to provide implicit recourse to any new securitization trust it sponsors as well.

It does not appear that the banking agencies have required banking organizations to maintain capital in the amounts required under the Basel capital rules to support their direct credit substitute or implicit support arrangements with MMFs. Before recommending capital requirements for all MMFs (including MMFs that do not receive sponsor support), perhaps the Federal Reserve should review its policies concerning capital requirements for banking organizations that support their affiliated MMFs.

The apparent disproportionate need for financial support by bank-affiliated MMFs suggests the possibility that some of these funds may have been managed with less rigorous credit standards than funds that were not bank-affiliated and did not need support. One plausible explanation for this disproportion is the moral hazard that arises when fund managers know that investment mistakes will be underwritten by an affiliate with deep pockets. This moral hazard is amplified when affiliate support has occurred in numerous instances in the past, and when regulators have allowed banking organizations to provide large amounts of support in order to avoid harm to their reputations. The moral hazard created by sponsor support for bank-affiliated MMFs potentially increases systemic risk in the financial system by allowing bank-affiliated MMFs to be managed with marginally greater risk to achieve marginally greater yields, creating competitive pressure on nonbank-affiliated MMFs to do the same.

Your Reliance on CDS Spreads as a Measure of MMF Risk is Highly Misleading and Does Not Justify Structural Changes to MMFs

As your second point of evidence that prime MMFs have taken on “excessive” risk, you refer to credit default swap spreads on securities held in their portfolios. You point out that as of September 30, 2011, 23 percent of the holdings in prime MMFs had an issuer, sponsor, or liquidity provider with a CDS spread of between 200 and 300 basis points.

Undoubtedly, a large number of the issuers, sponsors or liquidity providers in your sample are the very companies that you complain would suffer disruptions in credit availability if MMFs were to experience a “run” and withdraw from the market—namely, banking organizations and their affiliates that issue or sponsor short-term debt and asset-backed commercial paper. Some of these companies

had CDS spreads above 200 as of September 30, 2011, including Bank of America (422) and Citigroup (282), for example.¹³ The average U.S. bank CDS spread on September 30, 2011 was 306.¹⁴ Your data also may have included other issuers with CDS spreads above 200 such as General Electric (288) and Dow Chemical (226), for example.¹⁵ As an aside, it would be interesting to know whether, in your survey, bank-affiliated MMFs held disproportionately greater amounts of issuers with higher CDS spreads, as they did with ABCP as evidenced in the McCabe paper referred to above.

Your reliance on CDS spreads as a measure of the risk held by MMFs is highly misleading. Fitch Ratings has conducted several detailed studies of the accuracy and reliability of CDS spreads as a measure of default risk and found them to be inaccurate and unreliable for several reasons.¹⁶ Among other things, CDS spreads are particularly suspect during times of market stress when they generate “false positives.” Their volatility also makes them unreliable as a risk measure, according to Fitch.¹⁷

In one study, Fitch found that “CDS spreads did not appear to provide a leading signal of default risk for financial institutions.”¹⁸ In addition:

Prior Fitch studies have demonstrated the potential for “false positives” in CDS-implied PD [probability of default] estimates, particularly during periods of market distress, when pricing can be driven by factors not directly related to an entity’s fundamental creditworthiness, such as the high inherent leverage of CDS, liquidity conditions, counterparty risk, and risk aversion of market participants.¹⁹

¹³ Source: Bloomberg, 5-year CDS data.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See Fitch Ratings, “CDS Spreads and Default Risk: A Leading Indicator?” May 12, 2011; Fitch Ratings, “CDS Spreads and Default Risk, Interpreting the Signals,” Oct. 12, 2010; Fitch Special Report, “Credit Derivatives: A Case of Mixed Signals?” Dec. 2003.

¹⁷ *Id.* There has been significant volatility in CDS spreads for banking organizations in the past year. For example, CDS spreads oscillated in the following ranges for the following bank holding companies and their affiliates during the 52-week period beginning April 2011 to the present: Bank of America Corporation (129-499), Citigroup (119-368), Goldman Sachs (222-424), JP Morgan (72-190), Merrill Lynch (129-540), Morgan Stanley (140-594), and Wells Fargo (77-186). The average total U.S. bank CDS spread ranged from (110-361) during that period. Source: Bloomberg, 5-year CDS data.

¹⁸ Fitch Ratings, “CDS Spreads and Default Risk: A Leading Indicator?” May 12, 2011 at 1.

¹⁹ Thus, risk-aversion by MMF managers may be a cause of increased CDS spreads.

In another study, Fitch concluded:

As of August 2010. . . CDS spreads appeared to overstate the default risk for the REIT, homebuilder, bank, and insurance sectors.²⁰

Moreover, Fitch stated:

Indeed, volatility in CDS spreads over the cycle translated into dramatic shifts in implied PDs, reducing their usefulness as gauges of medium-term credit risk.²¹

Further:

Ultimately, CDS spreads can be a useful analytical tool. However, it is important to recognize the potential limitations caused by both their inherent volatility and incidence of false positives during stress periods, which can impose significant costs on market participants who rely on them as default risk indicators.²²

Fitch even has questioned the use of CDS spreads in the Basel capital rules for banking organizations and said they could create a channel for procyclicality that could increase systemic risk:

Additionally, for portfolio credit risk and economic capital models that rely on CDS-implied PDs as inputs, volatility and false positives could undermine both the stability and the robustness of the resulting risk capital estimates. For example, under the Basel III advanced internal ratings-based approaches, banks are able to estimate credit risk capital requirements using internal estimates of PD and loss severity. Based on the CDS-implied PDs generated in this study, the resulting Basel III capital charges, coupled with reserves to cover expected loss, would increase by a factor of approximately two (homebuilders), three (banks, insurance companies), and four (REIT), or five (monoclines) from trough to peak.

²⁰ Fitch Ratings, "CDS Spreads and Default Risk, Interpreting the Signals" Oct. 12, 2010, at 3.

²¹ *Id.* at 6.

²² *Id.* at 8.

From a systemic perspective, this variability in risk capital might create another channel for procyclicality. That is, as spreads widen, PD estimates increase, in turn weakening capital ratios and compelling deleveraging and forced selling, potentially driving further spread widening.²³

Several academic studies also have shown that CDS spreads are not a reliable indicator of the default risk of the issuer. Among other things, according to these studies, CDS spreads reflect liquidity provided by the CDS seller²⁴ and the probability of joint default of both the bond issuer and the CDS seller.²⁵

SEC Rule 2a-7 Substantially Limits MMF Risks

Given the unreliability of CDS spreads as a risk measure, and assuming that sponsor support for bank-affiliated MMFs is a risk can be addressed by banking regulators, I urge you to consider whether your concerns about the risks of prime MMFs may be overstated, or at least misdirected.

MMFs are not unregulated in the amount of risk they can incur. SEC regulations strictly limit MMF portfolio risks. SEC Rule 2a-7, as you know, limits MMF investments to short-term, high quality debt securities and other instruments. The rule requires a MMF to limit its investments to securities that pose a “minimal credit risk” as determined by the fund’s board independently of any credit rating. In addition, the rule limits “second tier securities” (securities with other than the highest rating) to no more than three percent of a MMF’s assets and holdings of second tier securities of any one issuer to no more than one-half of one percent of the fund’s assets. MMFs may not acquire any second tier security with a remaining maturity in excess of 45 days. The rule requires

²³ *Id.* at 8.

²⁴ See Dragon Yongjun Tangy and Hon Yanz, “Liquidity and Credit Default Swap Spreads,” Sept. 4, 2007, available at SSRN.com (“We find that both liquidity level and liquidity risk are significant factors in determining CDS spreads....On average, liquidity and liquidity risk together could account for about 20% of CDS spreads....[T]he supply curve for CDS contracts may be a function of order flows. The demand-supply dynamics are affected by search frictions, the market maker's pricing power, hedging costs and the risk of adverse selection that endogenously determine the liquidity of the securities and, in turn, their prices.”).

²⁵ See Stefano Giglio, “Credit Default Swap Spreads and Systemic Financial Risk,” March 2011, available at SSRN.com. See also Jennie Bai and Liuren Wu “Anchoring Credit Default Swap Spreads to Firm Fundamentals,” available at www.newyorkfed.org/research/economists/bai/fundamental.pdf.

MMF portfolios to have a weighted average maturity of 60 days or less.²⁶ The SEC has said that a fund with a WAM of 60 days could withstand a 50 basis point increase in credit spreads across its portfolio, 10 percent redemptions, and an increase in interest rates of over 150 basis points before breaking the buck, assuming a weighted average life limitation of 120 days.²⁷ Rule 2a-7 also requires each MMF to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions. The rule requires MMFs to hold at least 10 percent of their total assets in daily liquid assets and at least 30 percent of their total assets in weekly liquid assets.²⁸ The rule requires MMFs to disclose their portfolio holdings and imposes stress testing and other safety requirements.

I am not aware of any allegations that prime MMFs have not been complying with Rule 2a-7. Nor am I aware of any economic analyses or studies showing that Rule 2a-7, particularly as amended by the SEC in 2010, has permitted prime MMFs to assume “large” or “excessive” credit risks, as you allege.

The President’s Working Group report on MMFs concluded that the amendments to Rule 2a-7 adopted by the SEC in 2010 sufficiently address credit risk exposure in MMF portfolios.²⁹

Making MMFs Risk-Free Is Not a Sound Policy Aim

The President’s Working Group report on MMFs rejected the idea of making MMFs risk-free as a policy objective. The report bears quoting at length on this point:

Importantly, preventing any individual MMF from ever breaking the buck is not a practical policy objective—

²⁶ The actual WAM of prime institutional MMFs was 39 days at the end of December 2011 and 44 days at the end of March 2012. Fitch Ratings, “U.S. Money Market Funds Sector Update: First Quarter 2012” (April 16, 2012) at 5, citing iMoneyNet data.

²⁷ 75 Fed. Reg. 10060, 10071 (March 4, 2010).

²⁸ Fitch Ratings reported that prime MMFs rated by it held approximately 30 percent of their portfolios in daily liquid assets in the first quarter of 2012. Fitch Ratings, “U.S. Money Market Funds Sector Update: First Quarter 2012” (April 16, 2012) at 1.

²⁹ Report of the President’s Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 16 (amendments to Rule 2a-7 “should substantially reduce” the “liquidity risks associated with maturity transformation and MMF portfolios’ exposures to credit and interest-rate risks”).

though the new SEC rules for MMFs should help ensure that such events remain rare. . . .³⁰ * * * *

Notwithstanding the need for reform, the significance of MMFs in the U.S. financial system suggests that changes must be considered carefully. Tighter restrictions on MMFs might, for example, lead to a reduction in the supply of short-term credit, a shift in assets to substitute investment vehicles that are subject to less regulation than MMFs, and significant impairment of an important cash-management tool for investors. Moreover, the economic importance of risk-taking by MMFs—as lenders in private debt markets and as investments that appeal to shareholders’ preferences for risk and return—suggests that **the appropriate objective for reform should not be to eliminate all risks posed by MMFs**. Attempting to prevent any fund from *ever* breaking the buck would be an impractical goal that might lead, for example, to draconian and—from a broad economic perspective—counterproductive measures, such as outright prohibitions on purchases of private debt instruments and securities with maturities of more than one day. Instead, policymakers should balance the benefits of allowing individual MMFs to take some risks and facilitating private and public borrowers’ access to term financing in money markets with the broader objective of mitigating systemic risks—in particular, the risk that one fund’s problems may cause serious harm to other MMFs, their shareholders, short-term funding markets, the financial system, and the economy.³¹ * * * *

Making each individual MMF robust enough to survive a crisis of the size of that experienced in 2008 may not be an appropriate policy objective because it would unduly limit risk taking. Indeed, although the SEC’s tightening of restrictions on the liquidity, interest-rate, and credit risks borne by individual MMFs will be helpful in making MMFs more resilient to future strains, there are practical limits to the degree of systemic risk mitigation

³⁰ Report of the President’s Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 4.

³¹ *Id.* at 13-14.

that can be achieved through further restrictions of this type. For example, an objective of preventing any MMF from breaking the buck probably would not be feasible for funds that invest in private debt markets. Changes that would prevent funds from breaking the buck due to a single Lehman Brothers-like exposure would have to be severe: Only limiting funds' exposures to each issuer to less than one-half of 1 percent of assets would prevent a precipitous drop in the value of any single issuer's debt from causing a MMF to break the buck. But even such a limit on exposure to a single issuer would not address the risk that MMFs may accumulate exposures to distinct but highly correlated issuers, and that funds would remain vulnerable to events that cause the debt of multiple issuers to lose value.

Beyond diversification limits, new rules to protect MMFs from material credit losses would be difficult to craft unless regulators take **the extreme step of eliminating funds' ability to hold any risky assets. But that approach would be clearly undesirable, as it would adversely affect many firms that obtain short-term financing through commercial paper and similar instruments.** In addition, such an extreme approach would deny many retail investors any opportunity to obtain exposure to private money market instruments and most likely would motivate some institutional investors to shift assets from MMFs to less regulated vehicles.

Similarly, liquidity requirements sufficient to cover all redemption scenarios for MMFs probably would be impractical and inefficient. The SEC's new liquidity requirements help mitigate liquidity risks borne by the funds, and if MMFs had held enough liquid assets in September 2008 to meet the new liquidity requirements, each MMF would have had adequate daily liquidity to meet redemption requests on most individual days during the run. Even so, the cumulative effect of severe outflows on *consecutive* days would have exceeded many funds' liquidity buffers. . . .

Raising the liquidity requirements enough so that each MMF would hold adequate daily liquidity to withstand a

large-scale run would be a severe constraint and would fail to take advantage of risk-pooling opportunities that might be exploited by external sources of liquidity. During the run in 2008, individual MMFs experienced large variations in the timing and magnitude of their redemptions. Liquidity requirements stringent enough to ensure that every individual MMF could have met redemptions without selling assets would have left most of the industry with far too much liquidity, even during the run, and would have created additional liquidity risks for issuers of short-term securities, since these issuers would have had to roll over paper more frequently. . . .³²

A Floating NAV for MMFs Similarly is Not a Viable Option

In your speech, you recommend that policymakers consider eliminating the stable \$1.00 NAV that is the defining characteristic of MMFs. You state that a floating NAV “would more accurately reflect the fundamental nature of the product actually offered, rather than making implicit promises to investors that cannot always be kept during stressful times.”

The concept of a floating NAV was considered by the President’s Working Group and largely rejected for the following reasons:

To be sure, a floating NAV itself would not eliminate entirely MMFs’ susceptibility to runs. Rational investors still would have an incentive to redeem as fast as possible the shares of any MMF that is at risk of depleting its liquidity buffer before that buffer is exhausted, because subsequent redemptions may force the fund to dispose of less-liquid assets and incur losses. However, investors would have less of an incentive to run from MMFs with floating NAVs than from those with stable, rounded NAVs.

Notwithstanding the advantages of a floating NAV, elimination of the stable NAV for MMFs would be a dramatic change for a nearly \$3 trillion asset-management sector that has been built around the stable \$1 share price. Indeed, a switch to floating NAVs for MMFs raises several concerns.

³² *Id.* at 17-18.

First, such a change might reduce investor demand for MMFs and thus diminish their capacity to supply credit to businesses, financial institutions, state and local governments, and other borrowers who obtain financing in short-term debt markets. MMFs are the dominant providers of some types of credit, such as commercial paper and short-term municipal debt, so a significant contraction of MMFs might cause particular difficulties for borrowers who rely on these instruments for financing. If the contraction were abrupt, redemptions might cause severe disruptions for MMFs, the markets for the instruments the funds hold, and borrowers who tap those markets.

While there is no direct evidence on the likely effect of a floating NAV on the demand for MMFs, the risk of a substantial shift of assets away from MMFs and into other vehicles should be weighed carefully. Assets under management in MMFs dwarf those of their nearest substitutes, such as, for example, ultra-short bond funds, most likely because ultra-short bond funds are not viewed as cash substitutes. To the extent that demand for stable NAV funds is boosted by investors who hold MMFs because they perceive them to be risk-free, a reduction in demand for these funds might be desirable. However, some investors face functional obstacles to placing certain assets in floating NAV funds. For example, internal investment guidelines may prevent corporate cash managers from investing in floating NAV funds, some state laws allow municipalities to invest only in stable-value funds, and fiduciary obligations may prevent institutional investors from investing client money in floating NAV funds. In addition, some investors may not tolerate the loss of accounting convenience and tax efficiencies that would result from a shift to a floating NAV, although these problems might be mitigated somewhat through regulatory or legislative actions.

Second, a related concern is that elimination of MMFs' stable NAVs may cause investors to shift assets to stable NAV substitutes that are vulnerable to runs but subject to less regulation than MMFs. In particular, many institutional investors might move assets to less regulated or

unregulated cash management vehicles, such as offshore MMFs, enhanced cash funds, and other stable value vehicles that hold portfolios similar to those of MMFs but are not subject to the ICA's restrictions on MMFs. These unregistered funds can take on more risks than MMFs, but such risks are not necessarily transparent to investors. Accordingly, unregistered funds may pose even greater systemic risks than MMFs, particularly if new restrictions on MMFs prompt substantial growth in unregistered funds. **Thus, changes to MMF rules might displace or even increase systemic risks, rather than mitigate them, and make such risks more difficult to monitor and control.**

. . . . Elimination of MMFs' stable NAVs may also prompt some investors—particularly retail investors—to shift assets from MMFs to banks. Such asset shifts would have potential benefits and drawbacks, which are discussed in some detail in section 3(g).

Third, MMFs' transition from stable to floating NAVs might itself be systemically risky. . . .

Fourth, risk management practices in a floating NAV MMF industry might deteriorate without the discipline required to maintain a \$1 share price. MMFs comply with rule 2a-7 because doing so gives them the ability to use amortized-cost accounting to maintain a stable NAV. Without this reward, the incentive to follow 2a-7 restrictions is less clear. Moreover, the stable, rounded NAV creates a bright line for fund advisers: Losses in excess of ½ of 1 percent would be catastrophic because they would cause a fund to break the buck. **With a floating NAV, funds would not have as clear a tipping point, so fund advisers might face reduced incentives for prudent risk management.**

The fifth and final concern is that a floating NAV that accomplishes its proponents' objectives of reducing systemic risks may be difficult to implement. Under normal market conditions, even a floating NAV would likely move very little because of the nature of MMF assets. For example, although a requirement that MMFs move to a \$10

NAV and round to the nearest cent would force funds to reprice shares for as little as a 5 basis point change in portfolio value, NAV fluctuations might still remain relatively rare. Enhanced precision for NAVs (for example, NAVs with five significant figures) could bring more regular, incremental fluctuations, but precise pricing of many money market securities is challenging given the absence of active secondary markets. In addition, if fund sponsors decided to provide support to offset any small deviations from the usual NAV, deviations from that NAV might remain rare.

Thus, a floating NAV may not substantially improve investors' understanding of the riskiness of MMFs or reduce the stigma and systemic risks associated with breaking the buck. Investors' perceptions that MMFs are virtually riskless may change slowly and unpredictably if NAV fluctuations remain small and rare. MMFs with floating NAVs, at least temporarily, might even be more prone to runs if investors who continue to see shares as essentially risk-free react to small or temporary changes in the value of their shares.³³

A Capital Buffer Is Not Appropriate for MMFs

Your proposal to require MMFs to maintain a capital buffer, along with a redemption penalty on investors, seems particularly inappropriate, for reasons discussed in my paper "Shooting the Messenger: The Fed and Money Market Funds." Capital may be appropriate as a loss-absorbing mechanism for banks, which are in the business of assuming credit risk on long-term loans and other assets. Unlike banks, MMFs operate subject to the strict limitations of Rule 2a-7 and are permitted to incur only minimal credit risk.

Experience shows that capital is a weak guard against risk-taking, in any case. The bank capital rules actually encouraged excessive risk-taking by banks and contributed to the build-up of toxic assets in the financial system that ultimately caused the financial crisis, as pointed out in my paper.

The idea that MMFs should maintain capital is not supported by any economic analysis that I am aware of. The President's Working Group report on

³³ *Id.* at 20-22 (footnotes omitted).

MMFs pointed out significant difficulties with such an approach that would involve converting MMFs into special purpose banks:

[T]he capital needed to reorganize MMFs as SPBs [special purpose banks] may be a significant hurdle to successful implementation of this option. Access to the Federal Reserve discount window and deposit insurance coverage most likely would require that the new SPBs hold reservable deposits and meet specific capitalization standards. Given the scale of assets under management in the MMF industry, MMF sponsors (or banks) that wish to keep funds operating would have to raise substantial equity—probably at least tens of billions of dollars—to meet regulatory capital requirements. Raising such sums would be a considerable challenge. The asset management business typically is not capital intensive, so many asset managers—and several of the largest sponsors of MMFs—are lightly capitalized and probably could not provide such amounts of capital. **If asset managers or other firms were unwilling or unable to raise the capital needed to operate the new SPBs, a sharp reduction in assets in stable NAV MMFs might diminish their capacity to supply short-term credit, curtail the availability of an attractive investment option (particularly for retail investors), and motivate institutional investors to shift assets to unregulated vehicles.**

An additional hurdle to converting MMFs to SPBs would be the substantial increase in explicit government guarantees that would result from the creation of new insured deposits. The potential liability to the government probably would far exceed any premiums that could be collected for some time.

Uncertainties about the reaction of institutional investors to MMFs reorganized as SPBs raise some important concerns about whether such reorganizations would provide a substantial degree of systemic-risk mitigation. Coverage limits on deposit insurance would leave many large investors unprotected in case of a significant capital loss. Thus, even with the protections afforded to banks, MMFs would still be vulnerable to runs by institutional investors,

unless much higher deposit insurance limits were allowed for the newly created SPBs. Moreover, even in the absence of runs, institutional MMFs often experience volatile cash flows, and the potential effects of large and high-frequency flows into and out of the banking system (if MMFs become SPBs) would need to be analyzed carefully.

. . . . [A] substantial mandatory capital buffer for MMFs would reduce their net yields and possibly motivate institutional investors to move assets from MMFs to unregulated alternatives (particularly if regulatory reform does not include new constraints on such vehicles). The effect of these competing incentives on institutional investors' cash management practices is uncertain, but it is at least plausible that a reorganization of MMFs as SPBs may lead to a net shift of assets to unregulated investment vehicles.³⁴

Thus, as the President's Working Group report recognizes, your proposal to impose a capital requirement on MMFs likely would cause the very problem you aim to prevent—disruption of the credit markets on which banking organizations and other corporations depend—and otherwise increase systemic risk.

MMFs Do Not Implicitly Promise a \$1.00 NAV

In your speech, you incorrectly state that MMFs “implicitly promise” to maintain a fixed net asset value of \$1.00 per share. MMFs do not implicitly promise to maintain a fixed net asset value. It is true that they seek to do so, and historically they have been successful in doing so.³⁵ But they make no promise or guarantee to that effect. Indeed, MMFs are required by SEC regulations to disclose in their prospectuses and marketing literature that MMF shares are not guaranteed by any government agency and that investors may lose money.

³⁴ *Id.* at 33-35 (footnotes omitted).

³⁵ As the Federal Reserve research paper on MMFs stated: “Money market funds . . . have an impressive record of price stability. From the introduction of the rules specifically governing these funds in 1983 until the Lehman bankruptcy in September 2008, only one small MMF lost money for investors, and that loss, in 1994, had little broader impact on the industry. Although MMF prospectuses and advertisements must warn that ‘it is possible to lose money by investing in the Fund’ . . . investors virtually never lost anything.” McCabe, *supra*, at 1. Notwithstanding its breaking a dollar, the Reserve Primary Fund ultimately paid its investors 99 cents on the dollar.

Your concern that MMFs are subject to runs suggests that you do not really believe there is such an “implicit promise” or that investors take it seriously—otherwise there would be no potential for runs.

The President’s Working Group has stated that sponsor support for MMFs has helped to foster the false impression that MMFs are guaranteed:

MMFs are under no legal or regulatory requirement to redeem shares at \$1; rule 2a-7 only requires that MMFs be managed to maintain a stable NAV. Yet sponsor-supported stable, rounded NAVs and the typical \$1 MMF share price foster investors’ impressions that MMFs are extremely safe investments.³⁶

The President’s Working Group has posited that, if MMF sponsors had not been permitted to support their funds in recent years, MMF investors might have had more realistic expectations and been less inclined to run:

If MMFs with rounded NAVs had lacked sponsor support over the past few decades, many might have broken the buck and diminished the expectation of a stable \$1 share price. In that case, investors who nonetheless elected to hold shares in such funds might have become more tolerant of risk and less inclined to run.³⁷

Thus, a remedy to the problem of sponsor-support for bank-affiliated MMFs might go far in eliminating the perception of an “implied promise.”

* * * *

Mr. Rosengren, although I have been critical of your statements and proposals concerning MMFs, I hope you will not take my comments personally or as an attack on the Federal Reserve itself. I am proud to have served in the Legal Division of the Board of Governors and have long been a strong supporter of the Fed’s role in banking supervision and regulation. On the whole, I believe the Federal Reserve System acted admirably during the financial crisis.

³⁶ Report of the President’s Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 10-11.

³⁷ *Id.* at 11.

Eric S. Rosengren
April 18, 2012
Page 21

I firmly believe, however, that it is unnecessary and potentially dangerous for the Fed to become involved in regulating an industry with which it has little regulatory experience or expertise, especially one that is well-regulated by another independent federal agency and that historically has operated with little risk to investors or the financial system. The Federal Reserve obviously has a systemic oversight role as a member of FSOC, but in the case of MMFs, that role should not be one that encourages additional regulation where none is needed and which could prove deleterious to the functioning of the financial markets and investors who rely on MMFs.

Because of the relevance of your speech to the SEC's current deliberations on MMFs, I am submitting this letter to the SEC and the Financial Stability Oversight Council for their consideration also.

Sincerely,

Melanie L. Fein

Melanie L. Fein

cc: Securities and Exchange Commission
Financial Stability Oversight Council