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June 26, 2012

Hon. Daniel K. Tarullo
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Tarullo:

Your speech entitled "Shadow Banking After the Financial Crisis" delivered on June 12, 2012 continues the Federal Reserve's campaign of misinformation and misguided proposals concerning the role of money market funds ("MMFs") in the financial system.

You attempt to fit MMFs into a description of the "shadow banking system" that simply does not reflect their activities and operations. MMFs are not shadow banks. They lack the attributes of either banks or shadow banks. The institutions that are most heavily engaged in "shadow banking" activities are banks themselves and their affiliates, as I show in my paper "Shooting the Messenger: The Fed and Money Market Funds," a copy of which I have enclosed.

A key feature of a "shadow bank" as that term has been used is the use of leverage. Your speech highlights leverage as a key characteristic of a shadow bank. MMFs are almost completely unleveraged. Banks and bank holding companies leverage their capital approximately ten to one. Every dollar of MMF capital supports $1.00 of assets whereas every dollar of bank and bank holding company capital supports roughly ten times that amount. It is highly misleading to put MMFs in a category with other institutions that leverage their capital. Because MMFs do not leverage their capital, they do not "create money" in the way that banks do and they thus do not create systemic risk the way banks do.

You point to a historically isolated event affecting MMFs during the financial crisis as a justification for drastic reforms that industry experts say would incapacitate MMFs—namely, the breaking of a dollar by the Reserve Primary Fund. You assert that "the most acute phase of the crisis" was precipitated by a "disastrous run" on MMFs. You fail to mention the devastating runs on over-leveraged bank-sponsored asset-backed commercial paper

("ABCP") in 2007 that left the banking system effectively insolvent and marked the beginning of the crisis, without any run on MMFs. You point to a "general run on money funds" after a single MMF broke a dollar in 2008 but nowhere do you mention the word "Lehman" or allude to the Fed's disastrous decision to allow a systemically important financial institution fail contrary to expectations it created.

Also missing from your account is the over-reliance of banking organizations on short-term credit to fund their activities and the failure of regulators to require banks to maintain adequate capital to absorb losses on guarantees they made on commercial paper—much like AIG's issuance of billions of dollars of credit default swaps with insufficient capital. A critical moment occurred in 2004 when the Fed and other banking regulators exempted bank ABCP from consolidated capital treatment, thereby leading to a ballooning of ABCP fed by subprime mortgages and excessive credit card debt. You mention that the "general run" on MMFs "contributed to severe funding pressures for issuers of commercial paper," but you fail to mention that the vast majority of the commercial paper issuers were (or are now) banks and their affiliates relying excessively on the short-term funding markets to leverage their ABCP and other "shadow banking" activities.

In your speech, you suggest as a "second best" reform alternative that banking regulators consider limiting the reliance of banks on funding provided by MMFs. It is curious, however, that you single out MMFs and do not suggest limiting the over-reliance of banks on all sources of short-term funding other than insured deposits, including uninsured deposits. It also is curious that this reform alternative, which would directly address the problem and can be directly implemented by the Fed, is "second best" to solutions that have nothing to do with the real problem, would disable entities that are not part of the real problem (i.e., MMFs), and require action by a government agency other than the Fed (i.e., the SEC).

The causes of the financial crisis are many and implicate Fed monetary policy, regulatory and supervisory policy, and broader government economic and social policies. But MMFs are not among the causes of the crisis. The run on MMFs was part of the system-wide response to the crisis, but not its cause. The Fed's insistence on twisting the facts suggest that the Fed either still does not understand what occurred or is manipulating the facts to hide its own culpability or serve some purpose not warranted by the facts. In any case, the Fed's obfuscations are inimical to sound public policy.

Your speech effectively acknowledges that the Fed still does not have a complete understanding of the forces that destabilized the financial system in 2007 and 2008. Yet, the Fed is pursuing major structural changes that will have far-reaching implications for systemic stability in the future.

I find particularly troubling your assertion that immediate action is needed to cripple the highly successful $2.6 trillion MMF industry. You state that there are significant ongoing policy debates and disagreements concerning the growth of the shadow banking system, the events of 2007 and 2008, and the social utility of "some elements" of the shadow banking system, including MMFs. You acknowledge that conclusions drawn from these debates will be important in framing a broadly directed regulatory plan and that a regulatory response to the shadow banking system should be grounded in a "full understanding of the dynamics that drove its rapid growth, the social utility of its intermediation activities, and the risks they create." Among other policy issues needing consensus, you cite "the implications of private money creation and of intermediaries behaving like banks but without bank-like regulation," which you state are "potentially quite profound."

Yet, you assert that it is "neither necessary nor wise" for regulators to await a full resolution of these issues or the development of comprehensive alternatives before pursuing measures that "reform" MMFs. Incredibly, you state, "nor would it be prudent for them to do so." Your remarks affirm fears that the Fed is shooting from the hip in pushing for regulatory changes that would fatally damage MMFs and eliminate them from the financial system. Your remarks validate complaints that the Fed's proposals for MMFs lack a rational or sound policy basis. I daresay your remarks might even call into question the soundness of some of the Fed's other regulatory reform initiatives.

A key focus of your stated concern regarding MMFs is that historically some MMF sponsors have voluntarily supported their funds to prevent them from breaking a dollar, thereby fostering a false sense of security among MMF investors. You refer to this as a "pathology" and "risk illusion" that led to "pervasive underpricing" of risks that made them an "artificially cheap source of funding" subject to "destabilizing runs." Despite your inflated terminology, your concern about sponsor support for MMFs is valid.

A 2010 Federal Reserve research paper highlighted the moral hazard and potential systemic risks that may result from sponsor support of MMFs.[1] Interestingly, the Fed research paper found that the majority of sponsor support occurrences during 2007-2008 involved banking organizations that purchased ABCP from their own affiliated MMFs. The report found that bank-affiliated MMFs were "significantly more likely to hold distressed ABCP than other funds" and required more support than non-bank-affiliated MMFs. The report suggests that sponsor support by banking organizations created moral hazard that led to the funds' holding of such assets:

> Although sponsor risk was not a significant factor in the cross-section of net flows during the ABCP crisis, one proxy for sponsor risk—whether an MMF was affiliated with a bank—was a significant predictor of poor outcomes during this episode. **Bank-affiliated money funds were more likely to receive sponsor support and to hold distressed ABCP in their portfolios**.[2] * * *
>
> 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 also suggests that the possibility of **sponsor support may undermine incentives for prudent asset management**.[3]
>
> * * * Furthermore, during the run in 2008, concerns about the ability of sponsors to support their MMFs evidently prompted heavier redemptions from money funds with weaker sponsors, and thus transmitted the sponsors' strains to off-balance-sheet MMFs and into short-term funding markets. Thus, **by fostering expectations of implicit recourse to sponsors, past support actions had created a channel for the transmission during crises of strains** between entities that should not have been related.

[1] Patrick E. McCabe, Senior Economist, Federal Reserve Board, "The Cross Section of Money Market Fund Risks and Financial Crises," Finance and Economics Discussion Series 2010-51 (2010).
[2] McCabe, at 34.
[3] McCabe, at 35.

> **Whether or not such support was actually delivered, it may have contributed to financial strains.** Bailouts of MMFs during the run required scarce capital from sponsors at a time when liquidity was in short supply and worsened some sponsors' financial condition (Standard & Poor's, 2008a). But Reserve's failure to provide support that investors had come to expect was catastrophic for the Reserve franchise and destabilizing for the financial system. Moreover, **despite the apparent importance of sponsor support for MMFs, the practice is discretionary, unregulated, and opaque, and it is probably most unreliable when systemic risks are most salient**.[4]

The Fed research paper did not conclude that draconian measures need to be taken to prevent any MMF ever from breaking the dollar again. Rather, it concluded that regulators should consider the systemic risks posed by sponsor support of MMFs—particularly support by banking organizations of their affiliated MMFs. The research paper suggests that MMFs—particularly bank-affiliated MMFs—might not have needed sponsor support had stricter controls been imposed on sponsor support earlier.

Policymakers have concurred that the sponsor support problem needs to be addressed. The President's Working Group, in a 2010 report on MMFs, stated that sponsor support for MMFs has helped foster the idea that MMFs are guaranteed.[5] This misimpression "may contribute to runs" and is a source of

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[4] McCabe at 35. The SEC has suggested the reason for the higher incidence of sponsor support for bank-affiliated MMFs is that bank-affiliated MMFs held more risky ABCP than non-bank-affiliated MMFs and were managed less prudently. Money Market Fund Reform, Securities and Exchange Commission Release No. IC-28807; File No. S7-11-09, at 41. The SEC granted approximately 44 exceptions from the Investment Company Act to allow fund sponsors to provide various forms of financial support to their affiliated funds during 2007-2008. By far, the majority of these fund sponsors were affiliated with banks. Public company filings by bank holding companies with the SEC show that nearly all of the substantial MMF support arrangements involved bank-affiliated funds and nearly all banking organizations with affiliated MMFs funds supported one or more of their funds.

[5] Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 3 and 10-11 ("uncertainty about the availability of such support during 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.").

systemic risk, according to the report. Chairman Bernanke has expressed concern about sponsor 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.[6] SEC Chairman Schapiro in recent testimony noted that over 300 instances of sponsor support have occurred since the 1970s.[7] Yet, in all of the public pronouncements and proposals regarding MMFs emanating from the Federal Reserve and Chairman Schapiro during the last year and a half, there has been no mention of any reform to address the sponsor support problem.

The SEC has taken action that makes the sponsor support problem worse. The SEC in 2010 made it easier for banking organizations and other sponsors to provide implicit and explicit support to their affiliated MMFs. The SEC amended its rules to allow sponsors to purchase defaulted as well as other portfolio securities from affiliated funds, subject to certain conditions. The SEC acknowledged that such support "might also give a competitive advantage to funds that receive it because they may be more willing to invest in securities with higher risk and higher yields"[8]—i.e., create moral hazard and systemic risk.

The Fed and other banking regulators also have exacerbated the sponsor support problem, for reasons cited in letters from me to the Board's general counsel in 2009 and 2010, which I have enclosed. Among other things, the banking regulators have adopted a policy statement regarding bank support for affiliated MMFs that creates a supervisory framework for such support and imposes virtually no restraints on such support by bank holding companies.

A requirement that MMFs maintain a mandatory capital buffer to absorb commercial paper and other losses is a form of sponsor support that also seems contrary to the conclusions in the Fed research paper. Among other things, a

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[6] 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, 2910 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.

[7] Testimony of Mary L. Schapiro, Chairman, Securities and Exchange Commission, before the Senate Committee on Banking, Housing and Urban Affairs, June 21, 2012.

[8] 75 Fed. Reg. 10060, 10105 (March 4, 2010). In addition, during the financial crisis, the SEC's Chief Accountant issued an advisory stating that bank support for affiliated MMFs would not require consolidation for accounting purposes. See "SEC Issues Clarification on Accounting Issues Relating to Bank Support for Money Market Mutual Funds," Securities and Exchange Commission Press Release 2008-205, Sept. 17, 2008.

capital buffer might increase moral hazard and systemic risk in the same way that sponsor support does by creating the misimpression that MMFs are guaranteed and by encouraging fund managers to invest in incrementally riskier commercial paper knowing a backstop is available if the paper defaults.

The sponsor support problem might be substantially eliminated if the Fed prohibits or severely limits the ability of bank holding companies to support their affiliated MMFs. 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 during the crisis:

> 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.[9]

Thus, remedying the problem of sponsor support for bank-affiliated MMFs might go far in eliminating the perception of an "implied guarantee" and moral hazard.

Yet, instead of pursuing the obvious solution, the Fed has advocated measures that either have nothing to do with sponsor support for MMFs, such as prohibiting MMFs from offering their shares at $1.00 per share or restricting the ability of shareholders to redeem their shares, or that encourage it, such as by imposing inappropriate capital requirements. These proposals would harm MMFs and deprive the financial system of the safety, liquidity, efficiency, transparency, diversity, and competition that MMFs provide.

In 2009, a client and I met with senior members of the Board's staff for the express purpose of urging regulatory action to address the sponsor support problem. At the meeting and in follow-up correspondence, we recommended changes in the Board's policy statement concerning sponsor support for MMFs which, as noted, imposes virtually no restrictions on bank holding company

[9] Report of the President's Working Group on Financial Markets, Money Market Fund Reform Options, Oct. 2010, at 11.

support for affiliated MMFs. Copies of my letters are enclosed. Now that you and other Board members, the President's Working Group, and Chairman Schapiro have recognized sponsor support as a problem, it may be hoped that you will focus on ways to address the problem directly instead of attempting to eliminate the key characteristics of MMFs that make them so highly valued and useful to millions of investors.

I am enclosing my recent papers entitled "Money Market Funds, Systemic Risk, and the Dodd-Frank Act," "How to Reduce the Risk of Runs on Money Market Funds," and "Shooting the Messenger: The Fed and Money Market Funds." These papers describe numerous benefits that MMFs provide to the financial system and discuss reasons why it is erroneous to regard MMFs as shadow banks and a source of systemic risk. I hope you will find this material informative and useful as you consider these matters further.

Because this matter is of current interest to the Securities and Exchange Commission, I am sharing a copy of this letter with the Commission.

Sincerely,

Melanie L. Fein

Melanie L. Fein

Enclosures

cc: Hon. Ben S. Bernanke
Securities and Exchange Commission

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July 22, 2009

Scott G. Alvarez
General Counsel
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Re: **Perceived Guarantee of Bank-Affiliated Money Market Funds**

Dear Scott:

As you know, [redacted] I met with Board staff on June 30 to discuss our concerns regarding the growing investor perception that banking organizations are effectively guaranteeing their affiliated money market funds. We greatly appreciated the opportunity to discuss this matter with the staff.

In the enclosed letter, we explain in greater detail the basis for our concerns that this perception is creating a source of moral hazard and systemic risk in the financial system. We also suggest ways that the banking agencies' Interagency Policy Statement on this subject might be clarified to discourage such a perception.

Thank you for your attention to this matter and please let me know if I can provide you with additional information or answer any questions you may have.

Best regards and

Sincerely,

Melanie L. Fein

Melanie L. Fein

Enclosures

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July 22, 2009

Scott G. Alvarez
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Re: **Perceived Guarantee of Bank-Affiliated Money Market Funds**

Dear Mr. Alvarez:

As you know, [redacted] I recently met with the Board's staff to discuss our concerns regarding the growing investor perception that banking organizations are effectively guaranteeing their affiliated money market funds. We greatly appreciated the opportunity to present our concerns to the staff.

In this letter, we explain in greater detail the basis for our concerns that this perception is creating a source of moral hazard and systemic risk in the financial system. In an appendix hereto, we suggest ways that the banking agencies' Interagency Policy Statement on this subject might be clarified to discourage such a perception.[1]

The Interagency Policy Strongly Supports the Perception of a Guarantee for Bank-Affiliated Money Market Funds by Creating a Supervisory Framework for Such Support

We understand that the Interagency Policy is not intended to encourage banks to act as guarantors of affiliated money market funds. Indeed, it highlights the legal impediments and safety and soundness concerns regarding such support by banks and instructs banks to adopt policies and procedures designed to avoid creating an expectation that a bank will prop up an affiliated fund.

[1] *See* Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Interagency Policy Statement on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates (Jan. 5, 2004), available at http://www.federalreserve.gov/boarddocs/srletters/2004/SR0401a1.pdf.

Nevertheless, the Interagency Policy creates a supervisory framework for banking organizations to support their affiliated funds and strongly supports the perception of both an explicit and implicit guarantee. Notably, ***the Policy imposes no significant limitations on bank holding company support for bank-affiliated funds***.

The Policy states that banks may be motivated to support their affiliated funds "for reasons of reputation risk and liability mitigation" and that, to avoid engaging in unsafe and unsound banking practices, "banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank-advised investment funds." The Policy thus condones support transactions that occur within a framework of policies and procedures. The Interagency Policy states:

> The banking agencies "<u>expect</u>" banking organizations to establish alternative emergency support from the parent bank holding company or other affiliates. Such action is to be taken prior to seeking support from the bank.
>
> The banking agencies "<u>expect</u>" a banking organization to institute policies and procedures for identifying circumstances triggering the need for financial support and the process for obtaining it.
>
> In the limited instances when a **bank** (as opposed to bank holding company) provides financial support, the banking agencies "<u>expect</u>" a **bank's** procedures to include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board designated committee, independent of the investment advisory function.
>
> The banking agencies "<u>expect</u>" a banking organization to implement policies and procedures to mitigate the need for significant **bank** (as opposed to bank holding company) support.
>
> The banking agencies "<u>expect</u>" a banking organization to ensure proper regulatory reporting of contingent liabilities (such as support agreements) arising from its investment advisory activities in accordance with FAS 5.
>
> Bank management should notify and consult with the appropriate banking agency prior to (or immediately after, in the event of an emergency) the provision of material

> financial support by a **bank** (but not a bank holding company) to its advised funds. The banking agency will closely scrutinize the circumstances and address situations that raise supervisory concerns.

These supervisory expectations create a framework under which banking organizations may support their affiliated money market funds on both a routine and emergency basis. The framework for bank involvement in providing such support is more limited than for bank holding companies or nonbank affiliates. Indeed, ***bank holding companies appear to be subject to no significant limitations under the Interagency Policy***.[2]

Investors often do not distinguish between a bank and its nonbank affiliates and are unable to ascertain which entity within a banking organization provides support to a bank-affiliated fund. This confusion is not surprising in light of the public reports filed by bank holding companies with the Securities and Exchange Commission that obscure the regulatory distinctions between banks and their affiliates. In those reports, banking organizations do not specifically address which entity within the consolidated organization has provided financial support to an affiliated fund. Nor is such information clearly provided in SEC no-action letters approving such support or otherwise readily available.

In any event, support for an affiliated fund can be substantial regardless of whether it comes from a bank or nonbank affiliate within a banking organization. From an investor's perception, it is immaterial which entity within a banking organization provides the support.

The Perception of a Guarantee is Affirmed by Numerous Financial Support Arrangements by Banking Organizations with Bank-Affiliated Money Market Funds

The perception that the federal banking agencies readily allow banking organizations to support their affiliated money market funds may arise from the numerous financial support arrangements that banking organizations have entered into with their affiliated money market funds during the past 18 months.

The SEC granted approximately 25 exceptions from the Investment Company Act to allow fund sponsors to provide various forms of financial support to their affiliated funds during this time. By far, the majority of these fund sponsors were affiliated with banks—mostly national banks. I am enclosing an

[2] The title of the Interagency Policy Statement even suggests that it does not apply to bank holding companies.

appendix showing the amounts involved in these support arrangements as reported in public company filings with the SEC. What the data show is that:

> ***Nearly all of the substantial money market fund support arrangements involved bank-affiliated funds.***
>
> ***Nearly all banking organizations that advise money market funds supported one or more of their funds.***

Data is not available to show the total amount of fund assets that were supported by bank-affiliated fund advisers, but the number likely is in excess of $1.0 trillion. Based on the data we do have, it appears that banking organizations incurred losses in excess of $6.0 billion in providing this support.[3]

The Perception of a Guarantee is Affirmed by Banking Organization Support Agreements for SIVs and Other Investment Vehicles

The perception that banking organizations are guaranteeing their affiliated money market funds also may arise from arrangements by which banking organizations have supported other types of investment vehicles. These include structured investment vehicles or "SIVs" and special purpose entities or "SPEs."

Major banking organizations have purchased assets from their sponsored SIVs and SPEs and in some cases actually have consolidated the SIVs onto their own balance sheets.[4] These support arrangements have involved substantial billions of dollars.[5] In some cases, these arrangements may have threatened the solvency of the institution involved, absent federal assistance.

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[3] It is impossible to know the total amount of support that has been provided to bank-affiliated money market funds or the related losses because this information is not always required to be disclosed, or disclosed clearly.

[4] *See, e.g.,* Citigroup 10-K Annual Report for FY 2007, p. 8:

"On December 13, 2007, Citigroup announced its decision to commit, not legally required, to provide a support facility that would resolve uncertainties regarding senior debt repayment facing the Citi-advised Structured Investment Vehicles (SIVs). As a result of the Company's commitment, Citigroup included the SIVs' assets and liabilities in its Consolidated Balance Sheet as of December 31, 2007. This resulted in an increase of assets of **$59 billion**. (emphasis added) On February 12, 2008, Citigroup finalized the terms of the support facility, which takes the form of a commitment to provide mezzanine capital to the SIV vehicles in the event the market value of their capital notes approaches zero."

[5] *See* Bank of America Corporation 10-K Annual Report for FY 2007. Bank of America reported that its total liquidity exposure to off-balance sheet SPEs was **$104.1 billion** as of December 31, 2007.

Assuming that the organizations providing this support followed the Interagency Policy, they would have consulted with the OCC and/or Federal Reserve and obtained supervisory approval for these arrangements.

In each case, it appears that the justification for allowing these bailout arrangements was to mitigate "reputation risk" and potential legal liability to the banking organization, even though the organization's solvency was in question.

The Perception of a Guarantee is Affirmed by OCC Interpretive Letters and Regulations Authorizing National Banks To Guarantee Mutual Funds and Affiliates

The OCC in 2004 issued an interpretive letter authorizing a national bank to provide financial warranties on the investment advice and asset allocation services provided by the bank in the creation and operation of a mutual fund.[6] The OCC conditioned its approval on the bank's adoption of satisfactory risk management procedures and internal controls designed to ensure that the activities were conducted safely and soundly.[7] Again, the OCC allowed a national bank to guarantee an affiliated fund within a framework of policies and procedures.

In April of 2008, the OCC amended its regulations to expand the authority of national banks to issue guarantees to their customers and affiliates. The regulation, which would cover affiliated money market mutual funds, states as follows:

> a national bank may guarantee obligations of a customer, subsidiary or affiliate that are financial in character, provided the amount of the bank's financial obligation is reasonably ascertainable and otherwise consistent with applicable law.[8]

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[6] OCC Interpretive Letter No. 1010 (Sept. 7, 2004). The financial warranties were designed to guarantee that investment structuring advice and asset allocation monitoring services provided by the bank to the fund would perform as designed. The financial warranty guaranteed that the bank would make up any shortfall between the "guaranteed amount" to investors on the maturity date and the fund's then current net asset value.

[7] The OCC stated that "the nature of this complex financial transaction requires sophisticated risk measurement and management capacities on the part of the bank and qualified personnel in order for the activity to actually function as described and to operate in a safe and sound manner." An effective risk measurement and management process, the OCC said, would include appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective and independent risk control function that oversees and ensures the appropriateness of the risk management process. The OCC also required the bank to seek a regulatory capital opinion concerning treatment of the financial warranties for capital purposes.

[8] 12 C.F.R. § 7.1017(b).

The OCC stated that the issuing bank must be able to determine the extent of its exposure and engage in the activity in a safe and sound manner. A bank also must comply with other applicable laws, such as sections 23A and 23B of the Federal Reserve Act. In adopting the regulation, the OCC stated:

> The OCC has emphasized that banks must be able to respond to the evolving needs of their customers, provided always that such guarantees be issued and managed in a safe and sound manner. Permitting national banks to exercise their broad authority to act as guarantor or surety benefits customers by giving banks greater ability to facilitate customers' financial transactions and by providing banks with greater flexibility to provide financial services in evolving markets.[9]

In response to one commenter's suggestion that the OCC require national banks to conduct financial guarantee activities through separately capitalized subsidiaries, the OCC stated:

> The OCC declines to adopt this approach. As indicated above, acting as a guarantor involves the core banking powers of both lending and acting as financial intermediary and is therefore a permissible banking activity that need not be conducted only in a separate legal entity. OCC rules prescribe the appropriate regulatory capital treatment for guarantor activities. Moreover, the circumstances under which the revised provision authorizes guarantor activities—the financial guaranty is reasonably ascertainable in amount and complies with applicable law—are safeguards promoting the conduct of these transactions in a safe and sound manner. Accordingly, it is

[9] 73 Fed. Reg. 22215, 22226 (April 24, 2008). The OCC noted that a bank must adopt appropriate risk management processes in connection with its guarantee activities: "[A]dequate risk measurement and management processes tailored to manage and control the risks of financial guaranty activities are necessary to ensure that a bank is conducting its financial guaranty activity in a safe and sound manner. These include appropriate standards set by the board of directors, managerial and staff expertise, policies and operating procedures, risk identification and measurement, and ongoing evaluation of the specific guarantees issued; management information systems; and an effective risk control function that oversees and ensures the appropriateness of the risk management process. Such risk measurement and risk management processes should be of a scope and scale appropriate for the nature and complexity of the bank's financial guaranty activities." *Id.*

> not necessary to require national banks to conduct this activity in a separately capitalized affiliate.[10]

The Capital Implications of Banking Organization Support for Money Market Funds Are Profound

The capital implications of banking organization support for affiliated money market funds are potentially profound. Under the Basel I capital rules that currently apply to all banks, such support may fall within the definition of a "direct credit substitute."[11] 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.[12]

Thus, a banking organization that provides financial support to prevent an affiliated money market fund from breaking a dollar would 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 supported being supported—i.e., all of the assets in the fund.[13] In other words, the banking organization would be required to maintain capital as if the entire fund were on its balance sheet.

The underlying assets in the fund then would be risk-weighted according to the risk-based capital rules. Commercial paper held by the fund would be risk weighted at 100 percent. Mortgage-backed securities would be risk weighted at 50 percent. Obligations of government sponsored entities would be risk weighted at 20 percent, and direct U.S. obligations would be risk weighted at zero.

Moreover, a banking organization that provides credit support to a money market fund beyond the level of support it is legally obligated to provide under an explicit agreement 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 put back onto the

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[10] *Id.*

[11] 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. . . ." 12 C.F.R. Pt. 3, Appendix A, § 4(a)(4).

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

[13] 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. The banking agencies amended the capital rules in 2001 to address this kind of risk. 66 Fed. Reg. 59614 (Nov. 29, 2001).

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

Accordingly, even though a banking organization may assume direct liability for a small percentage of a money market fund's assets, the capital rules treat the bank as supporting the *entire fund* for capital purposes. If the banking organization assumes liability beyond that which it is legally obligated to provide, the capital rules may treat the organization as supporting *all of its other affiliated funds as well*.

Of the nearly $4 trillion in assets currently held in money market funds, a significant portion is held in bank-affiliated funds. Thus, banking organizations that lend credit support to their affiliated money market funds are incurring very substantial capital liabilities under the capital rules.

It does not appear that the banking agencies have required banking organizations to maintain capital in the amounts required under the capital rules to support their direct credit substitute arrangements with money market funds. In view of emergency conditions during the past 18 months, supervisory forbearance in this regard may be understandable. Going forward, however, it would seem appropriate for the banking agencies to remind banks of the applicability of the direct credit substitute rules (and also the implicit recourse rules) and to enforce those rules if banking organizations provide credit support for their affiliated money market funds in the future.

Banking Organization Support of Money Market Funds Creates Moral Hazard and Potential Systemic Risk

Bank-affiliated funds appear to have had a disproportionate need for support relative to the rest of the money market fund industry during the past 18 months. This disproportion raises questions concerning the quality of the credit standards and review processes at bank-affiliated funds, as well as other funds that required financial support.

The support typically was necessitated by credit downgrades of assets in the funds' portfolios and was needed to prevent a fund's net asset value from falling below $1.00 (i.e., breaking a dollar). In many cases, the credit-impaired assets were SIVs sponsored by large banks whose assets included residential mortgages.

The SEC has noted that "some money market funds invested more significantly in SIV securities while other money market funds avoided such investments entirely."[14] The SEC has suggested that the credit analysis performed by managers of funds that invested in SIVs was less rigorous than at funds that did not invest in SIVs and did not need support:

> The staff's recent examinations of money market funds indicate that credit analysts for money market funds that invested in SIVs that subsequently defaulted appear to have had access to the same basic set of information on SIVs as did analysts at money market funds that did not and that the judgment of these credit analysts regarding minimal creditworthiness of the SIVs that subsequently defaulted appeared to have been different. The staff's exams also appear to indicate that credit analysts for money market funds that invested in SIVs that subsequently defaulted placed less emphasis on the length of time that payment experience was available on assets in the collateral pool and they were willing to accept sub-prime mortgage credits as a seasoned asset class. In addition, their decision, in part, may have been influenced by the greater amount of over-collateralization of the collateral pools and the high yields paid by notes supported by sub-prime credits.[15]

A money market fund is permitted to invest only in securities that the fund's board of directors or credit review committee determines present minimal credit risks.[16] The SEC previously had cautioned that SIVs and other asset-backed securities require careful credit review.[17]

The apparent disproportionate need for financial support by bank-affiliated money market funds 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 bad investment decisions will be underwritten by an affiliate with deep pockets.[18]

This moral hazard is amplified when a regulatory process exists for affiliate support, when affiliate support has occurred in numerous instances in the past, and

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[14] Money Market Fund Reform, SEC Release No. IC-28807; File No. S7-11-09, at 41.

[15] Money Market Fund Reform, SEC Release No. IC-28807; File No. S7-11-09, at 41 n. 138.

[16] SEC Rule 2a-7(c)(3)(i).

[17] *See* Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959 (Dec. 17, 1993), 58 Fed. Reg. 68585 (Dec. 28, 1993), text accompanying n.108-109.

[18] The Reserve Primary Fund broke a dollar in September of 2008, for example, because its portfolio managers held onto commercial paper of Lehman Brothers in the mistaken belief that the government would rescue Lehman, as it did Bear Stearns—a clear manifestation of moral hazard.

when regulators have allowed banking organizations to provide large amounts of support in order to avoid harm to their reputations, even at the potential risk of the organization's solvency.[19]

This moral hazard creates the potential for systemic risk in the financial system. It creates the possibility that bank-affiliated money market funds will be managed with marginally greater risk to achieve marginally greater yields, creating competitive pressure on nonbank-affiliated money market funds to do the same. If that occurs, the result will be an overall lowering of credit standards in the money market fund industry with the potential for some future event to destabilize the industry, as occurred last year. Any destabilization of the money market fund industry could have potentially serious consequences for the commercial paper market and the economy as a whole, as we have seen.

Banking Organization Support of Money Market Funds Expands the Federal Safety Net Outside the Banking System

The expectation that banking organizations will effectively guarantee their affiliated money market funds in the future raises serious questions concerning the scope of the federal safety net that protects the banking system. The federal "safety net" traditionally has been thought of as the system of implicit and explicit government guarantees that stand behind the banking system.[20]

Banking supervisors in the past have sought to limit the scope of the safety net as a matter of policy and voiced concerns about the expansion of the safety net to cover nonbank affiliates of banks and risks from non-traditional activities.[21] These concerns have focused on the potential for increased taxpayer costs stemming from large bank failures and demands on supervisory resources as well as complaints that the safety net effectively subsidizes nonbank affiliates, giving them an unfair competitive advantage over nonbank competitors that do not enjoy deposit insurance and other safety net benefits. Concerns also have been raised that the implicit federal safety net guarantee creates "moral hazard" by inducing excessive risk-taking and uneconomic market behavior, resulting in artificial distortions in the marketplace. These concerns seem even more relevant now.

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[19] It also is known that regulators exerted significant pressure on banking organizations to bailout their affiliated money market funds in 1993 and 1994 when many of them experienced credit quality problems due to investments in "inverse floaters" related to government securities.

[20] Historically, the federal safety net has included federal deposit insurance, access to the Federal Reserve discount window for liquidity purposes, access to Fedwire and daylight overdrafts, and prudential supervision designed to ensure banking safety and soundness.

[21] *See generally* Statement of Federal Reserve Board Chairman Alan Greenspan before the Senate Committee on Banking, Housing and Urban Affairs (June 17, 1998); Lehnert and Passmore, "The Banking Industry and the Safety Net Subsidy," Federal Reserve Board, Finance and Economics Discussion Series 99-34.

* * * *

Based on the foregoing, we remain concerned by the growing perception that banking organizations are guarantors of bank-affiliated money market funds.

In the enclosed document, we suggest revisions to the Interagency Policy Statement to help minimize this perception and thereby minimize moral hazard and systemic risk.

Thank you for your attention to this matter.

Sincerely,

Melanie L. Fein

Melanie L. Fein

Enclosures

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October 12, 2010

Scott G. Alvarez
General Counsel
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

RE: Money Market Funds

Dear Scott:

Last year, I wrote to you [redacted] concerning the growing perception that banking organizations are effectively guaranteeing their affiliated money market funds. We met with the Board's staff and explained in detail the basis for our concerns that this perception creates moral hazard and systemic risk in the financial system. We also suggested ways that the banking agencies' Interagency Policy Statement on this subject might be clarified to discourage such a perception.

Since our meeting with the Board's staff last year, several developments have occurred that I would like to bring to your attention:

First, the Board's economic research staff has released a study finding that sponsor support of money market funds—particularly by banking organizations—is a potential source of moral hazard and systemic risk in the financial system and may have exacerbated the recent financial crisis.[1] Excerpts from the report are attached hereto.

Second, the Task Force on Regulatory Reform of the American Bar Association's Banking Law Committee has adopted a statement of recommendations for actions that the Board and other banking agencies should take to address the

[1] Federal Reserve Board, Finance and Economics Discussion Series, The Cross Section of Money Market Fund Risks and Financial Crises, Patrick E. McCabe, 2010-51. Available at: http://www.federalreserve.gov/Pubs/feds/2010/201051/201051pap.pdf.

systemic risks posed by banking organization support for money market funds.[2] The Task Force statement is attached hereto.

Third, Moody's Investor Service has officially proposed a new rating methodology for money market funds that emphasizes the likelihood of sponsor support.[3] The new methodology is particularly troubling in light of the Federal Reserve staff report finding that reliance on sponsor support may increase moral hazard and systemic risk in the financial system. By emphasizing sponsor support in its rating methodology, Moody's rating system will heighten these risks. Moreover, by assessing "implicit" support arrangements, Moody's methodology will create potential regulatory and financial accounting issues for money market fund sponsors, particularly banking organizations.

Accordingly, we would urge the Board to (i) file a comment letter or other communication discouraging Moody's and other rating agencies from using sponsor support as a decisive factor in ratings of money market funds, and (ii) adopt the actions recommended by the ABA Task Force, or other appropriate actions, to minimize the perception that bank-affiliated money market funds are implicitly or explicitly guaranteed.

We greatly appreciate your attention to this matter and would welcome the opportunity to meet with you to discuss our concerns further.

Sincerely,

Melanie L. Fein

Melanie L. Fein

Enclosures

cc: Kathleen O'Day
Deputy General Counsel

Kieran Fallon
Associate General Counsel

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[2] Recommendations Regarding Banking Organization Support For Affiliated Funds, Task Force on Regulatory Reform, Banking Law Committee, American Bar Association. Enclosed herewith and available at: http://www.abanet.org/dch/committee.cfm?com=CL130055.

[3] Moody's Investor Service, Request for Comment on New Money Market Fund Rating Methodology and Symbols, September 7, 2010. Enclosed herewith and available at: http://v3.moodys.com/viewresearchdoc.aspx?docid=PBC_126642&cy=usa.

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Excerpts from

"The Cross Section of Money Market Fund Risks and Financial Crises"

Federal Reserve Board
Finance and Economics Discussion Series, Patrick E. McCabe
2010-51 (the "Report")

> The link between sponsor risk and holdings of distressed paper during the ABCP crisis indicates that the **sponsor-support option may distort incentives for portfolio managers**, and the role of sponsor risk in channeling concerns about financial institutions to their off-balance-sheet MMFs during the 2008 run suggests that **expectations for such support may contribute to transmission of financial shocks**. These concerns at least warrant greater attention to the **systemic risks posed by the MMF industry's reliance on sponsor support**.[1]

> **Supported funds also were more likely than other prime funds to have had a triple-A rating**: One-third of all MMFs had such a rating, but triple-A funds accounted for almost half the funds that received support.[2]

> **Sponsor-supported funds exhibited greater investor risk** than the rest of the prime fund industry by several measures: They had lower expense ratios, more rapid growth in the previous year, and greater flow volatility and sensitivity to yield. Supported funds were more likely than average to be bank-affiliated and to have sponsors with CDS spreads in the Markit database.[3]

> Riskier portfolios were more likely to experience losses that sponsors ultimately absorbed. In contrast, **a triple-A rating had no significant predictive power** in the full sample and had the "wrong" sign in the CDS sample: Controlling for

[1] Report at 3.
[2] Report at 29.
[3] Report at 29 (references omitted).

CDS spreads, funds with triple-A ratings were more likely to have been the recipients of sponsor support.[4]

Sponsor risk had a significant but somewhat ambiguous role in predicting sponsor support. **Bank-affiliated MMFs were more likely to receive support** . . . . bank-affiliated fund managers "were over-represented among support providers." As noted above, the link between banks and MMF support may reflect a greater propensity of deep pocketed sponsors to bail out troubled funds, conditional on similar exposures to distressed securities, or it may reveal a **moral hazard problem** for bank-affiliated portfolio managers. An additional consideration is that the banks may have been more likely to disclose financial support for affiliated MMFs because banks face more rigorous regulatory oversight and disclosure requirements than some other financial services firms.[5]

Apparently, aside from a sponsor's bank affiliation, **riskier sponsors were more likely to intervene** later to support their funds.[6]

A finding that **bank-affiliated advisers were more likely to have invested in problematic ABCP** would be evidence in favor of a **moral-hazard** explanation for the link between bank affiliation and sponsor support.[7]

MMFs with bank-affiliated sponsors were significantly more likely to hold distressed ABCP than other funds. Depending on specification and sample, bank affiliation increased the probability that a fund held distressed paper by between 26 and 41 percentage points. 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. For example, it is possible that

[4] Report at 30.
[5] Report at 30-31.
[6] Report at 31.
[7] Report at 31.

bank-affiliated managers were more likely to purchase risky ABCP for their funds because they had more institutional familiarity than other managers with complex instruments like paper issued by structured investment vehicles (SIVs).[8]

I find that **another possible indicator of portfolio risk—whether a fund had a triple-A rating—was of little use** in predicting crisis outcomes, including outflows during the run in 2008 or exposure to distressed paper during the ABCP crisis. This is perhaps surprising, as ratings organizations' publications suggest that a top rating should be useful as an indicator of an MMF's (low) risk, particularly as reflected in its portfolio quality.

Although sponsor risk was not a significant factor in the cross-section of net flows during the ABCP crisis, one proxy for sponsor risk—**whether an MMF was affiliated with a bank—was a significant predictor of poor outcomes during this episode**. Bank-affiliated money funds were more likely to receive sponsor support and to hold distressed ABCP in their portfolios.[9]

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 also suggests that the possibility of **sponsor support may undermine incentives for prudent asset management**.[10]

Furthermore, during the run in 2008, concerns about the ability of sponsors to support their MMFs evidently prompted heavier redemptions from money funds with weaker sponsors, and thus transmitted the sponsors' strains to off-balance-sheet MMFs and into short-term funding markets. Thus, **by fostering expectations of implicit recourse to sponsors, past support actions had created a channel for the transmission during crises of strains** between entities that should not have been related. **Whether or not such support was actually delivered, it may have contributed to financial strains.** Bailouts of MMFs during

[8] Report at 32.
[9] Report at 34.
[10] Report at 35.

the run required scarce capital from sponsors at a time when liquidity was in short supply and worsened some sponsors' financial condition (Standard & Poor's, 2008a). But Reserve's failure to provide support that investors had come to expect was catastrophic for the Reserve franchise and destabilizing for the financial system. Moreover, **despite the apparent importance of sponsor support for MMFs, the practice is discretionary, unregulated, and opaque, and it is probably most unreliable when systemic risks are most salient**.[11]

[11] Report at 35.

Task Force on Regulatory Reform
Banking Law Committee
American Bar Association[1]

Recommendations Regarding Banking Organization Support for Affiliated Funds

> **The federal banking agencies should strengthen the existing Interagency Policy Statement on bank support for affiliated funds to make clear that it applies to support for affiliated funds from bank holding companies and their affiliates as well as banks.**
>
> **The Federal Reserve Board should not allow a bank holding company or its affiliates to provide assistance to a fund to the extent that such assistance would materially diminish the ability of the company to act as a source of strength to its subsidiary banks or otherwise constitute an unsafe and unsound practice.**
>
> **The federal banking agencies should clarify the capital adequacy consequences for banking organizations that provide credit support for affiliated funds.**
>
> **The SEC and FINRA should consider whether enhanced disclosures are needed to improve investor understanding that the adviser and its affiliates have no obligation to provide support to a money market or other fund and may have limited ability to do so due to regulatory or other constraints.**

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[1] Available at: http://www.abanet.org/dch/committee.cfm?com=CL130055.
This recommendation was approved by members of the Banking Law Committee's Task Force on Regulatory Reform in their individual capacities and is to be used for information purposes only. The recommendation has not been approved by the American Bar Association, its Presidential Task Force on Financial Markets Regulatory Reform, or any section or committee of the American Bar Association, including the Business Law Section and the Banking Law Committee.

Background. Banking organizations have long-standing authority to act as investment advisers to money market and other funds. Such authority was upheld by the courts long ago as permissible under the Glass-Steagall Act.

Periodically in the past, and most recently during the past 18-24 months, a number of banking organizations, like other nonbank fund sponsors, have placed their resources at risk to "prop up" their affiliated funds by providing credit extensions, cash infusions, asset purchases, and acquisitions of fund shares. This support has been required to mitigate "reputation risk" posed to organizations that sold their customers interests in structured investment vehicles (SIVs) and to prevent affiliated money market funds from "breaking a dollar" due to credit downgrades or other impairments in the funds' portfolios. The total amount of fund assets supported by fund sponsors during the crisis has been large and resulted in significant losses to banking organizations.

As noted, both bank-affiliated and nonbank-affiliated fund sponsors supported their funds during the crisis. The expectation that fund sponsors will effectively guarantee their affiliated funds creates moral hazard in the financial system. It encourages the false perception among investors that the funds are safer than other investments. It allows portfolio managers of funds with sponsor backing to take risks without bearing the full consequences of their investment decisions, allowing them to earn marginally higher yields and putting pressure on other fund managers to do the same, resulting in incrementally higher risks.

Banking supervisors generally have sought to limit the safety net as a matter of policy and have voiced concerns about the expansion of the safety net to cover nonbank affiliates of banks and risks from non-traditional activities.[2] Related to this concern, a bank holding company's support for affiliated funds also may diminish its ability to serve as a source of strength to its subsidiary banks.

Interagency Policy Statement. In 2004, the federal banking agencies issued an Interagency Policy Statement to discourage bank support for affiliated funds.[3] The Policy Statement states that "a banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation, and can harm investors, if the associated risks are not effectively controlled." The agencies noted that, while banks are under no statutory requirement to provide

[2] These concerns have focused on the increased risks in the financial system, the potential for higher taxpayer costs stemming from large bank failures, and demands on supervisory resources as well as complaints that the safety net effectively subsidizes nonbank affiliates of banking organizations.

[3] *See* Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Interagency Policy Statement on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates (Jan. 5, 2004), available at: http://www.federalreserve.gov/boarddocs/srletters/2004/SR0401a1.pdf.

financial support to the funds they advise, "circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation."

Accordingly, the Policy Statement strongly discourages bank support for affiliated funds.[4] But it imposes no significant limitations on bank holding company support for bank-affiliated funds.

We recommend that the banking agencies strengthen the Policy Statement to make clear that it applies to support for affiliated funds from bank holding companies.

In addition, the Policy Statement should require prior notification to the Federal Reserve Board and a review by the Board of the circumstances that require such support. The Federal Reserve Board should prevent a bank holding company from providing assistance to a fund to the extent that such assistance would materially diminish the ability of the company to act as a source of strength to its subsidiary banks or otherwise constitute an unsafe and unsound practice.

Enhanced Disclosures. To ensure that investors understand that money market funds and other funds are not guaranteed by banking organizations or other fund sponsors, the Securities and Exchange Commission should consider whether enhanced disclosures are needed to the effect that a fund adviser and its affiliates have no obligation to provide support to the fund in the event the fund experiences an impairment of its assets and may have limited ability to do so due to regulatory or other constraints.

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[4] The Policy Statement requires banks to adopt policies and procedures governing routine or emergency transactions with bank-affiliated funds designed to ensure that a bank will not "(1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund."