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July 11, 2012

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

Dear Mr. Rosengren:

This letter comments on your recent speech entitled "Our Financial Structures—Are They Prepared for Financial Instability?" delivered on June 29, 2012, in which you again address the subject of money market funds ("MMFs").

Your speech reflects a new direction in the Fed's thinking on MMFs based on a more fact-based analysis targeting a specific problem within the Fed's own jurisdiction. By focusing on sponsor support for bank-affiliated MMFs, you have highlighted a significant source of moral hazard and systemic risk in the financial system that needs addressing. In particular, your recognition that bank-affiliated MMFs have required disproportionately higher levels of sponsor support in recent years than other MMFs pinpoints the problem at its source. Your proposal for addressing the problem, however, is perplexing.

Your proposal—to require banking organizations to calculate the amount of support that their affiliated MMFs will likely require under different stress scenarios, and thereby assure the public that such funds are safe and guaranteed by their sponsors—will increase, not decrease, moral hazard and systemic risk. The mere fact that the Federal Reserve is advocating such a proposal creates a public perception and expectation that bank-affiliated MMFs are guaranteed—a hazard complained of in your last speech. A regulatory directive to banking organizations to prepare to absorb the investment mistakes of their affiliated MMFs will only encourage portfolio managers of those funds to go further out on the risk curve in search of yield and thereby increases the likelihood that sponsor support in fact will be required. Your proposal makes both implicit and explicit the probability of a MMF "bailout" by a bank or bank holding company sponsor, with Fed approval.

In what follows, I analyze your speech in greater detail and reveal the serious implications of your proposal for systemic risk and the future role of MMFs in the financial system.

You first put forth an analytical framework for your proposal that creates a false construct lumping MMFs together with structured investment vehicles (SIVs), asset-backed commercial paper (ABCP), and other "problematic structures" (as you call them), as if there were any resemblance whatsoever between MMFs and these other, highly leveraged entities. Among other things, MMFs are almost completely unleveraged and have an entirely different operating structure based on regulations under the Investment Company Act of 1940 and other securities laws. There is no common identity between MMFs and these other mostly off-balance-sheet entities created by banks to avoid regulatory capital requirements.

You then invoke the specter of the "shadow banking system," the boogeyman that threatens financial stability but which in reality is operated by banking organizations under the direct supervision of the Fed and other banking regulators, as pointed out in my paper "Shooting the Messenger: The Fed and Money Market Funds." MMFs do not engage in shadow banking activities. Unlike banks, they do not leverage their capital, establish off-balance-sheet entities, engage in complex derivatives trading transactions, invest in exotic instruments, make subprime mortgages, or conceal their investments or true financial condition. MMF activities are limited to investing in high quality, short-term instruments on behalf of their shareholders subject to fiduciary duties and regulations that limit their credit risk and portfolio maturity and require a high level of liquidity and transparency.

You next suggest that MMFs have an unfair competitive advantage over banks because they allow investors to earn a higher rate of return on short-term investments than bank deposits because, you allege, "unlike banks" MMFs are "not required to hold capital." You fail to recognize that MMFs have more capital per assets than banks do—MMFs have 100 percent capital. Their capital to assets ratio is 1:1 compared to a capital to assets ratio of roughly 1:10 for banks. MMFs are able to pay a market rate of return because they have a simple structure that allows them to operate with a higher degree of efficiency than banks.

You express concern that the "implicit expectation" of MMF shareholders that their shares are as safe as insured bank deposits could cause a run by fund shareholders if risk conditions cause MMF shareholders to doubt the ability of a fund to meet redemption requests or maintain a stable $1.00 net asset value. I addressed concerns regarding the potential for MMF runs in my paper "How to

Reduce the Risk of Runs by Money Market Funds," which is available at www.ssrn.com and on the SEC's website. I will not repeat the facts and analysis of that paper here, but I hope you will read it and consider the many reasons I give as to why the prospect of damaging "runs" on MMFs is greatly exaggerated. My paper concludes that the best way to reduce the risk of runs is to allow MMFs to continue operating as they do now subject to strict regulations under the Investment Company Act and to prohibit or restrict the ability of MMF sponsors—particularly banking organizations—to prop up their affiliated funds. My view of the problem is not misaligned with your own, although our respective solutions diverge.

You state that your concerns about MMFs are amplified by the fact that many prime funds are sponsored by banks and their affiliates. Indeed, you note that more than half of prime MMF assets are held in bank-affiliated funds and that more than half of all prime MMFs are bank-affiliated. You do not state precisely why bank-affiliated MMFs warrant heightened regulatory concern, but a compelling reason is the one highlighted in a research paper by a senior economist on the staff of the Board of Governors—namely, the moral hazard that results when fund managers know they will be backed by a deep-pocket sponsor in the event they incur losses.[1] You cite this Fed research paper in your speech, but ignore its conclusions.

As you correctly point out, sponsor support for MMFs can strain bank capital at times when the bank is facing other capital pressures. You cite data showing that sponsors of bank-affiliated MMFs experienced "significant" losses due to their support for their funds in 2008 at a time when many banking organizations were already facing significant capital and liquidity pressures. You state that "support has been quite large and particularly prevalent for prime money market mutual funds which have depository institution or depository institution affiliated sponsors." Indeed, the data you cite show that these sponsors were called upon to provide approximately three times as much aggregate support as sponsors of non-bank-affiliated funds, with losses totaling roughly $9 billion. Moreover, more than three times as many sponsors of bank-affiliated funds needed to support their funds as did sponsors of non-bank-affiliated funds. This data provides compelling support for the conclusion of the Fed research paper that bank-affiliated MMFs are a source of moral hazard and systemic risk.[2]

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[1] See 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] As more recent evidence of this problem, you note that bank-affiliated prime MMFs were "over-weighted" relative to other MMFs in their holdings of the Belgian bank Dexia, both in the number of funds invested in Dexia and the value of Dexia assets, "less than one year" before the

Notwithstanding what the data and your own analysis show, you conclude that what is needed to address the problem of sponsor support is not *less* sponsor support but *more*. To remedy the problem, you suggest that sponsors of bank-affiliated funds be required to include in their stress tests the "likely" need to support such funds. These sponsors should calculate "the likely capital support needed from the organization in a stress scenario." Then, investors in bank-affiliated MMFs would be reassured that their investments are guaranteed: "it would also make clearer to money market mutual fund investors that banks had capital that could support funds during stressful periods." You even state, "In fact, this support might be *encouraged* by regulators during a crisis, in order to avoid broader problems of financial instability." (emphasis in your speech). You note that, "U.S. banking regulators have tacitly acknowledged that bank holding companies may provide such support."

Incredibly, your proposed solution to the sponsor support problem is to *increase*, not decrease, the likelihood of sponsor support. Your proposed solution thus will *increase*, not decrease, moral hazard and systemic risk.

One might ask, "what was he thinking?" to make such a proposal. The answer jumps out on the very same page in your speech where you state, "It would thus make clear that money market mutual funds with well capitalized sponsors [i.e., bank-affiliated funds] are likely to be less risky than those that do not have well capitalized sponsors."

Your proposal is nothing less than a naked threat to put non-bank-affiliated MMFs out of business, even if doing so would expose the financial system to substantially increased systemic risk. Your proposal would dramatically increase the risk profile of MMFs, vastly expand the size and concentration of financial resources in banking organizations, and expand the scope of the federal safety net beyond anything it was remotely intended to cover.

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bank was taken over by the Belgian and French governments. You use Dexia to support your assertion that MMFs "can and do invest in risky assets." If a "risky" asset is one that carries the remotest possibility of default, as some academics have argued completely discounting any credit rating or credit analysis whatsoever, then no one can quibble with your point, although it makes the concept of risk analysis meaningless. The Dexia example hardly shows that all MMFs invest in risky assets, especially as you acknowledge MMFs disposed of their shares of Dexia before it failed. The bank was given a clean bill of health by the European Banking Authority just months before its collapse, which was due to its holdings of Greek sovereign debt. The key fact, which you acknowledge and emphasize, is that bank-affiliated MMFs held significantly more of Dexia's obligations than other MMFs. This fact, to the extent it supports your thesis that MMFs invest in "risky" assets, provides further evidence for the conclusions of the Fed research paper showing that bank-affiliated MMFs are more prone to moral hazard and systemic risk than non-bank-affiliated MMFs.

Your proposal would transfer the risk of losses in MMFs from fund shareholders, who understand and accept such risks, to the American taxpayers, who neither want nor can bear such risks.

A key mandate of the Dodd-Frank Act is to purge the "too-big-to-fail" doctrine from banking regulation. Your proposal would not only expand and enshrine the "too-big-to-fail" doctrine but extend it to the MMF industry as well. It is not the case that you do not understand the concept of moral hazard. You understand it very well, as shown by your observation that bank-affiliated MMFs were willing to hold shares of Dexia "perhaps because many expected it to receive government support in the event of distress. . . . similar to what happened with the Lehman failure."

Your scheme makes sense only when viewed in light of what many in the MMF industry have long suspected—namely, that the Fed is on a mission to eliminate MMFs, and more particularly non-bank-affiliated MMFs, as competitors of banks. Your clear purpose is to bring the MMF industry within the Fed's supervisory grasp at any cost and to subject it to the only supervisory framework the Fed understands—namely, the bank supervisory framework. The Fed's faith in a supervisory system that failed so miserably to prevent either the financial crisis or the ongoing misadventures of banks not only calls into question the central bank's wisdom but its ulterior motives. Those motives are tainted by a long-standing institutional bias against MMFs evidenced by its irrational statements and proposals aimed at MMFs. While the Fed seems no longer bent on killing the MMF industry as a whole, if I read your speech correctly, there can be no doubt that the Fed remains fixated on crippling MMFs that are unaffiliated with banks and thus outside the Fed's supervisory purview.

MMFs have operated safely and successfully for decades without Fed supervision, much to the "consternation" of the Fed, as Fed economists told the Financial Crisis Inquiry Commission.[3] MMFs have demonstrated that they operate more safely without sponsor support than with it. As your own data show, bank-affiliated funds needed three times the amount of sponsor support during the financial crisis. Bringing non-bank-affiliated MMFs under the Fed's purview and subjecting them to Fed "banking supervision" almost certainly will expose them, their shareholders, and the American public to increased moral hazard and systemic risk.

[3] See Testimony of Michael Palumbo, Associate Director, Division of Research and Statistics, Federal Reserve Board, and Patrick McCabe, Senior Economist, Division of Research and Statistics, Federal Reserve Board, before the Financial Crisis Inquiry Commission, Sept. 28, 2010, audiotape at 1:17:15.

The President's Working Group found that sponsor support may increase the potential for MMF runs. In its report on MMFs, the PWG stated 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.[4]

Your proposal is contrary to the President's Working Group report and would only worsen the problem you have so astutely identified. Accordingly, I urge you to reassess your proposal and consider whether it would be more appropriate for the Fed, instead of encouraging and promising sponsor support for bank-affiliated MMFs, to prohibit or severely restrict it.

I also urge you to consider whether your proposal is even workable as a practical matter inasmuch as it likely would require consolidated accounting treatment of MMFs that are implicitly or explicitly guaranteed by their banking organization sponsors. Banking organizations do not appear to have sufficient capital to fully consolidate their affiliated MMFs. Although the Fed and other banking regulators apparently waived bank capital rules that would have required consolidated capital treatment when banking organizations supported their MMFs during the financial crisis, to do so on a routine basis going forward or even in an emergency undermines the integrity of the bank capital framework and is not sound public policy.

MMFs provide more investor safety, liquidity, diversification, and transparency than any other available financial product. They contribute market discipline, diversity, and competition. If the Fed, in its zeal to bring MMFs within its supervisory grasp, applies flawed bank supervisory policies to them, it will extinguish a financial product valued by tens of millions of investors and increase, not decrease, systemic risk.

As the Fed approaches its 100th anniversary, the public is entitled to expect that the Fed will pursue wise policies informed by lessons learned from past mistakes, in particular lessons from the recent financial crisis. One important

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

lesson is that bank supervisory policies sometimes have unintended consequences that are harmful to the financial system and the economy as a whole. The Fed should not attempt to compensate for past policy missteps or supervisory lapses by seeking to extend bank supervisory principles to entities that have little resemblance to banks and that neither caused the recent financial crisis nor pose a threat of any future crisis. The Fed should be capable of recognizing that a diversified financial system allowing different types of entities to offer financial services in response to consumer demand is likely to be more competitive and stable in the long-run than a system consisting solely of taxpayer-dependent institutions that are structurally inefficient, non-transparent, and based on an inherently risky business model that historically has resulted in devastating failures.

I am enclosing a letter I recently addressed to Governor Tarullo urging his attention to the problem of sponsor support for bank-affiliated MMFs. Also enclosed is a paper I recently presented at an American Enterprise Institute symposium entitled "Do Money Market Funds Create Systemic Risk?" My paper discusses the regulation of MMFs under the Investment Company Act and other laws and explains why MMFs—which are merely pools of securities—are not banks or bank-like, are not shadow banks or part of the shadow banking system, and are subject to stricter regulation than banks or bank holding companies. My paper also explains why MMFs are not appropriate candidates for SIFI designation under the Dodd-Frank Act. Also enclosed is a copy of my oral presentation. I hope you find these materials useful as you consider this matter further.

Sincerely,

Melanie L. Fein

Melanie L. Fein

cc: Ben S. Bernanke
Daniel K. Tarullo
Securities and Exchange Commission