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July 12, 2012

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Role of Federal Reserve in Supporting Short-Term Credit Markets
File No. 4-619; Presidents Working Group on Money Market Funds

Dear Chairman Schapiro:

A recurrent theme raised by supporters of radical change to the regulation and structure of money market mutual funds (MMFs) is that the Federal Reserve lent money to MMFs to bail them out during the Financial Crisis, that Congress in the Dodd-Frank Act prohibited the Federal Reserve from ever doing so again, and therefore the continued existence of MMFs in their current form poses a grave financial risk to the world economy.

The Federal Reserve did not lend to MMFs under the Asset-Backed Commercial Paper MMF Liquidity Facility (AMLF), it lent to banks, and it did so to address illiquidity in the commercial paper market, not to bail out MMFs. As discussed below, this is exactly the purpose for which the Federal Reserve was created in 1913. MMFs did not cause the recent financial crisis – the crisis had been underway for 20 months before the Reserve Primary Fund "broke a buck" in September 2008 – but MMFs were not immune from its effects. The AMLF program was one small part of a large number of credit programs put in place by the Federal Reserve and Treasury Department to deal with illiquidity during the recent Financial Crisis.

As you no doubt are aware, the history of the United States has included many financial panics characterized by sharp contractions in lending and the availability of credit, accompanied by economic contraction in the form of increased unemployment and decreased output of goods and services. Notable financial panics (and their economic aftermaths) have included the Panics of 1819 and 1837 (both of which were related to the Bank of the United States), the Panic of 1857 (triggered by an economic downturn, the sinking of the S.S. Central America with a loss of 550 passengers and crew and a cargo of 30,000 pounds of California gold, and the collapse of an Ohio insurance company and trust company), the Panic of 1873 (triggered by economic downturn, tumult in the silver market, the failure of Jay Cooke & Co. and the bankruptcy of numerous railroads and businesses), the "Hard Times" of 1893 (rapid overexpansion in agriculture and agricultural debt, decline in agricultural commodities prices, and general economic contraction), the Panic of 1901, the Financial Panic of 1907, the Great Depression of 1929-1939, the Penn Central bankruptcy in 1970, and the Financial Crisis of 2007-2009. When lenders and investors become nervous, they hold back on new extensions of credit, stop rolling over notes, call loans, and seek to move to less risky alternatives for investing short-term funds. A financial panic involves a sudden decrease in liquidity in the short-term credit markets. Like the financial panics that came before it, the Financial Crisis of 2007-2009 was fundamentally a sharp contraction of credit and market liquidity.

After the Financial Panic of 1907, Congress created the National Monetary Commission (NMC) to develop a set of recommendations for improvements to our financial system to prevent or reduce the harms caused by financial panics, by providing a mechanism for providing extraordinary credit to short-term credit markets in times of stress. In its final report to Congress in 1912, the Committee recommended the creation of a series of reserve banks to provide liquidity in times of financial emergency.[1]

The plan recommended by the NMC formed the basis for the Federal Reserve Act, which was enacted by Congress in 1913. The Federal Reserve Act of 1913 created the Federal Reserve System, including the Federal Reserve Banks and the Board of Governors of the Federal Reserve System. The purpose underlying the Federal Reserve Act of 1913, as stated by Congress, was "[t]o provide for the establishment of the Federal reserve banks, to furnish an elastic currency, to afford a means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."[2] Of the four stated Congressional purposes behind the Federal Reserve Act, one is specifically to provide liquidity to the commercial paper market, and that purpose was listed by Congress *ahead* of regulation of banks.

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[1] Report of National Monetary Commission to Congress, Sen. Doc. No. 243, 62nd Cong., 2d Sess. (Jan. 9, 1912).

[2] Federal Reserve Act, H.R. 7837, Pub. L. No. 43, 63rd Cong. 1st Sess. (1913). See also, Board of Governors of the Federal Reserve System, *The Federal Reserve System, Purposes & Function* (2005), avail. online at http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.

Sections 13 and 14 of the Federal Reserve Act (which are currently codified as amended at 12 U.S.C. §§ 342-361) contain the main provisions by which the Federal Reserve System provides liquidity to banks, through banks to the underlying short-term credit markets, and in some instances directly to the short-term credit markets. When the Federal Reserve extends credit, it does not provide a "bail out." Instead, it lends on commercially appropriate terms against sound collateral. The Federal Reserve extends credit to protect the short-term credit markets from seizing up, in order to protect the economy. Providing this short-term credit is the purpose for which the Federal Reserve was created. It is the reason the Federal Reserve is sometimes referred to as "the lender of last resort." The primary purpose and function of the Federal Reserve, the essential reason it was created by Congress, is to address financial panics by providing liquidity by lending into the short-term credit markets, when no one else will.[3]

The Federal Reserve has provided liquidity to the short-term credit markets many times. For example, after Penn Central defaulted on its commercial paper and filed for bankruptcy in 1970, the commercial paper market become illiquid for other issuers. Issuers were no longer able to roll over their paper as it matured and holders of commercial paper were unable to sell it. The Federal Reserve provided an extraordinary credit facility to banks, secured by commercial paper purchased by the banks, as a way to encourage banks to purchase and hold commercial paper and provide liquidity to the commercial paper market. The Chairman of the Federal Reserve at the time announced that the Federal Reserve stood by to lend directly or indirectly to firms that were unable to retire commercial paper, but this became unnecessary since its other steps resolved the crisis.[4] Notably, MMFs were not even in existence at this time.

Similarly, during the recent Financial Crisis, there were a number of instances in particular credit markets becoming illiquid. These included the February 2008 freezing up of the auction rate municipal securities market, a tightening of the repo markets in 2007-2008, and a general tightening and illiquidity in the market for securitized assets

[3] *See, generally*, Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet*, available online at www.federalreserve.gov /monetarypolicy/bst.htm.

[4] Dusan Stojanovic and Mark D. Vaughan, *The Commercial Paper Market: Who's Minding the Shop?* in Federal Reserve Bank of St. Louis, The Regional Economist (April 1998); Charles W. Calomaris, *Is the Discount Window Really Necessary? A Penn Central Perspective,* NBER Working Paper No. 4573 (Dec. 1993).

beginning in 2007. Indeed, as early as August 2007, in recognition of banks' unwillingness to lend to each other and the deterioration of conditions in the financial markets, the Federal Reserve began taking extraordinary steps to inject liquidity into the market. In December 2007, it launched the Term Auction Facility, the first of over a dozen special liquidity programs.

In September 2008, during the Financial Crisis, the market for commercial paper (including, in particular, asset backed commercial paper "ABCP")) became illiquid. This made it difficult to holders of commercial paper, including banks, MMFs and other investors, to sell commercial paper, which in turn made investors unwilling to roll over existing commercial paper or purchase new issues of commercial paper. The Federal Reserve responded very quickly with the creation of the AMLF, by which banks were able to borrow from the Federal Reserve against the collateral of performing ABCP purchased by the banks from MMFs. The collateral for the Federal Reserve loans was high-quality commercial paper, and the loans were all repaid with interest in full and on time at a profit to the Federal Reserve.

The AMLF was one of the smaller and shorter-lived financing programs of the Federal Reserve and Treasury during the Financial Crisis of 2007-2009. The attached chart showing the balance sheet of the Federal Reserve System during the Financial Crisis puts the size and limited duration of the program in the context of the many, much larger, and longer duration extraordinary credit programs that were put in place by the Federal Reserve during the Financial Crisis. The small crescent-shaped area marked in violet in the center of the chart represents the AMLF. The AMLF balances represented less than 1% of the aggregate amount of the various emergency lending programs put in place by the federal government during the Financial Crisis. A larger lending facility, the Commercial Paper Funding Facility was put in place by the Federal Reserve in October 2008 to provide a liquidity backstop directly to commercial paper issuers, and the Money Market Investor Liquidity Facility was put in place for investors in money market instruments in October 2008 but was never called upon. These programs were terminated in 2009 and 2010.

Sections 214, 1101, 1306 and 1501 of the Dodd Frank Act placed restrictions on government lending to insolvent institutions or foreign governments,[5] and Section 131 of the Emergency Economic Stabilization Act of 2008 precluded the Treasury Department

[5] Pub. L. No. 111-203, §§ 214, 1101, 1306, 1501.

from creating future MMF guarantee programs similar to its 2008 MMF guarantee facility.[6] Sections 1101-1109 of the Dodd Frank Act, however, which tightened somewhat the Federal Reserve's emergency lending authority, preserves the basic function and authority of the Federal Reserve System under Sections 13 and 14 of the Federal Reserve Act to provide liquidity to the financial markets. If needed tomorrow, the Federal Reserve could launch a program similar to the program it undertook to address the Penn Central crisis in 1970 or something very much like the AMLF (the fact that asset backed commercial paper – a subset of the overall commercial paper market – has shrunk in size is irrelevant).

Although the Federal Reserve retains the authority under the Federal Reserve Act to make future extensions of credit to provide liquidity in the commercial paper market, changes in 2010 to SEC rules governing MMFs liquidity requirements make it unlikely that MMFs would need to rely on that source of secondary market liquidity in the future. The SEC's 2010 amendments to Rule 2a-7 now require MMFs to hold massive amounts of short-term liquid assets in their portfolios (at least 10% overnight liquidity, 30% 7-day liquidity, plus additional amounts based on an assessment of their shareholders' liquidity needs and plans, with current liquid assets of MMFs estimated to exceed $1 trillion on $2.6 trillion in total assets). Moreover, MMFs currently hold very little ABCP, so it is unlikely that a facility similar to the AMLF will be needed in the future.

A current example of an extraordinary short-term liquidity facility being provided by the Federal Reserve is the extension of over a trillion dollars in short-term dollar financing to the European banking system through the European Central Bank.[7]

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[6] Pub. L. No. 110-343, § 131, 122 Stat. 3797, 12 U.S.C. § 5236. The Treasury's temporary guarantee program for MMFs was limited in size and duration, was never called upon, and earned the Treasury $1.2 billion in premiums. Press Release, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 19, 2009), http://www.treasury.gov/press-center/press-releases/Pages/tg293.aspv. In contrast, the Transaction Account Guarantee program providing unlimited amounts of deposit insurance for banks has continued for more than three and one-half years, and, to date, estimated losses under the program total approximately $2.5 billion. Letter from Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation to Hon. Shelley Moore Capito (June 29, 2012).

[7] Gerald O'Driscoll, *The Federal Reserve's Covert Bailout of Europe*, Wall Street Journal (Dec. 28, 2011); Neil Irwin & Michael Birnbaum, *Federal Reserve boosts flow of dollars to European Central Bank*, Washington Post (Sept. 15, 2011); Board of Governors of the Federal Reserve System, *Central Bank Liquidity Swaps*, avail. online at www.federalreserve.gov/monetarypolicy/bst_liquidityswaps.htm;
Footnote continued on next page

Our point is not to criticize the Federal Reserve for these programs, as many have done. Instead, in our view the Federal Reserve and Treasury did an extraordinary and highly effective job during the recent Financial Crisis to provide liquidity to various sectors of the economy. This was exactly what was needed, and this was precisely the role for which the Federal Reserve was created in 1913. The Federal Reserve and Treasury deserve praise, rather than criticism, for these extraordinary credit programs.

Financial panics existed long before MMFs were invented. If the Federal Reserve and its supporters succeed in their efforts to do away with MMFs, financial panics will continue to occur. Whether they invest in MMFs or invest directly in commercial paper and other short-term credit instruments, lenders and investors will continue to withhold new loans and cease to roll over existing credit in the face of a financial crisis. There will continue to be a "flight to quality" in times of uncertainty. If MMFs no longer exist, the Federal Reserve will still be required, from time to time, to provide liquidity to short-term credit markets to resolve a financial panic.

In your testimony on June 28, 2012 to the Senate Banking Committee, you did not accept the use of the term "shadow banks" for MMFs, noted that the Securities and Exchange Commission, rather than the federal banking agencies, is the appropriate regulator of MMFs, and stated that the Commission has taken strong steps through the 2010 amendments to Rule 2a-7 to address the liquidity issues in MMFs and to strengthen and improve the program of regulation and supervision of MMFs. We agree.

We disagree, however, with concluding that because the Federal Reserve in September 2008 provided liquidity through the AMLF to the commercial paper market, MMFs are inherently unstable, that MMFs make the short-term credit markets less stable, that MMFs caused or worsened the Financial Crisis that began 20 months earlier and was brought to a head by the receiverships of two government sponsored enterprises, the forced sale of Merrill Lynch, and the bankruptcy of Lehman Brothers *before* the Reserve Primary Fund "broke a buck" and the bailout of AIG at about the same time. In uncertain times there is always a market flight to quality, a contraction of private credit, and a tightening of liquidity in the short-term credit markets. This will occur regardless of whether MMFs exist and regardless of the structure of MMFs. The purpose of the

Footnote continued from previous page
Frequently asked questions: U.S. Dollar and Foreign Currency Liquidity Swaps, avail. online at www.federalreserve.gov/monetarypolicy/bst_swapfaqs.htm.

Federal Reserve is to provide liquidity to the short-term credit markets in uncertain times. It served that role for 60 years prior to the creation of MMFs. Changing the fundamental structure of MMFs or doing away with them entirely will not lessen the need for the Federal Reserve to serve as the lender of last resort to provide liquidity to the short-term credit markets.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

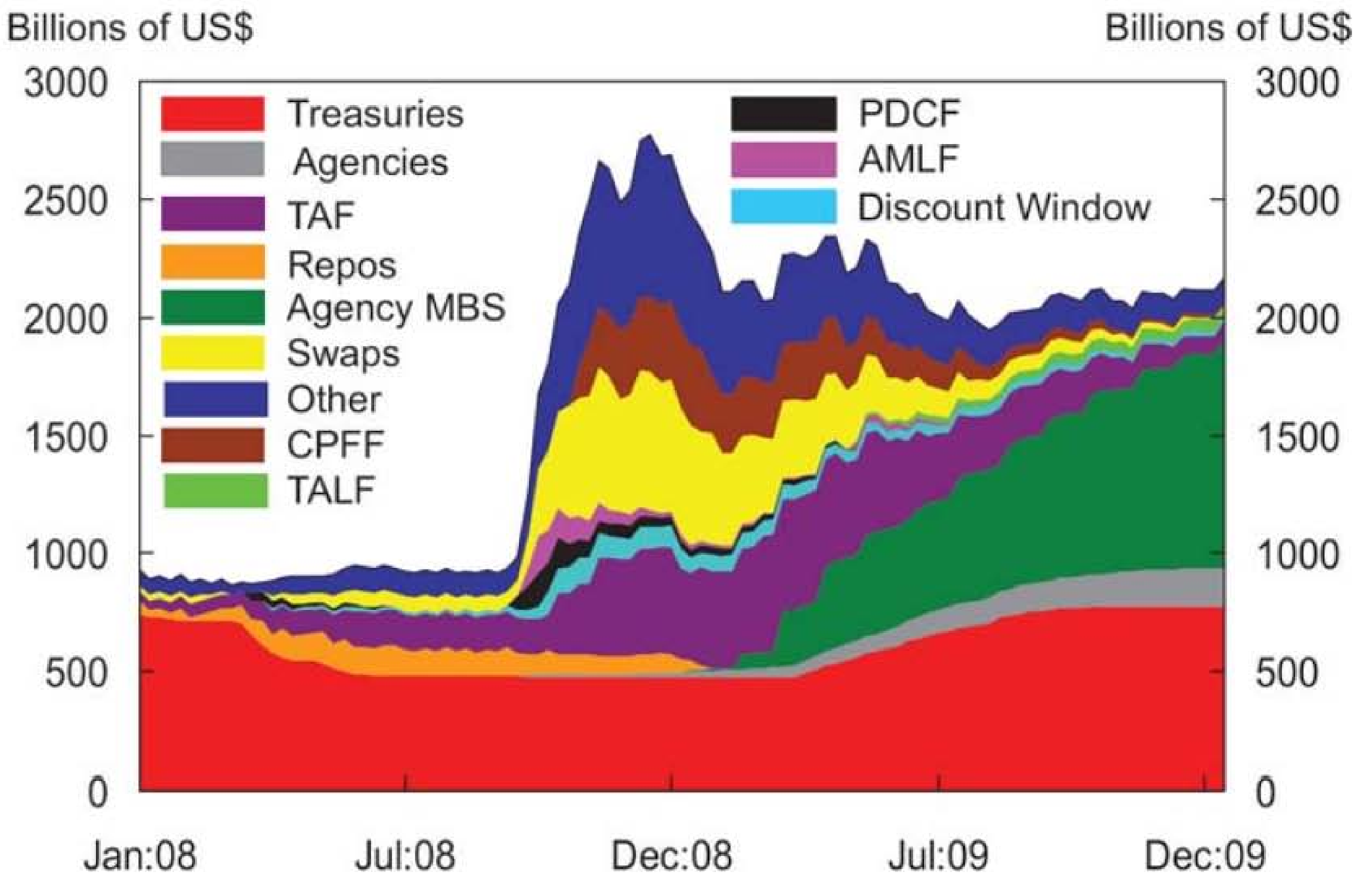
cc: Hon. Elisse B. Walter
Commissioner

Hon. Luis A. Aguilar
Commissioner

Hon. Troy A. Paredes
Commissioner

Hon. Daniel M. Gallagher
Commissioner

Chart 5.1.1 Federal Reserve Balance Sheet: Assets



Source: Federal Reserve