Money Market Funds Are Under Attack

“I happen to think that money market funds are a very, very important part of today’s financial marketplace. I think that money market funds are under attack. I think there is a concerted effort to impose very, very, very troublesome regulations that, in some cases, I think do threaten the viability of the product itself. I think that is not by accident. And I think we should push back very aggressively, because in the absence of this product, our financial markets will be less liquid. I think they will have fewer choices. And I think we will all pay a price, both investors and borrowers, for that.”

– U.S. Senator Pat Toomey
Editor’s Note: August 6, 2012

As this inaugural edition of ICD Intelligencer™ goes to press high noon rapidly approaches for money market funds. The battle has reached a crescendo as a chorus of Federal Reserve, Treasury, and SEC regulators strain to defy analyses, logic, reason and historical facts. The idea of dismantling the utility of the most stable, the most efficient, and the most successful financial resource for short-term credit – as local and state governments face bankruptcy and credit downgrades – is incongruous to sound judgment. John Hawke Jr. writing for Arnold & Porter in a July 17, 2012 letter to SEC Chairman Mary Schapiro inquires as to the whereabouts of the evidence of the economic studies in the public file regarding regulatory efficiency, competition and capital formation that would substantiate this rule making. We too, want to know.

Money market funds have demonstrated an incredible pluck and resiliency in overcoming successive domestic financial challenges, deteriorating European debt markets, a multi-year zero interest rate regime, the lure of unlimited FDIC Insurance for institutional bank deposits, and the steady drum beat of unsubstantiated and misleading accusations from government appointees regarding the efficacy of money market funds. Yet, in spite of these enormous headwinds, the industry continues to thrive because money market funds are the preferred investment haven. More important, the industry continues to provide vital financial services to American business and municipal governments that rely on the availability of affordable short-term credit to fund operations and public projects.

This edition of the ICD Intelligencer is a distillation of a complex and continuing story. Our objective is getting out the industry’s essential arguments and putting veracity into the hands of regulators, policymakers, corporate treasurers, industry professionals and news media as the SEC moves to reform and vote. Thanks are in order to the ICD partners for their advocacy, to Melanie Fein and the other thought leaders for their insight and erudition, to the fund companies for their activism and to corporate treasuries who make money market funds a reality.

Please take a few minutes to familiarize yourself with these important debate issues and their corresponding arguments. Your comments, questions and suggestions are welcomed.

Sincerely,

Doug Brown
Editor, ICD Intelligencer
Head of Global Marketing
ICD - Institutional Cash Distributors, LLC
doug.brown@icdportal.com
INTRODUCTION

Today, a battle of historic proportions is taking shape over the direction of the free market system and over the future of money market funds. It has become clear that a contentious Federal Reserve campaign is underway to intimidate SEC commissioners as the central bank pursues the imposition of a new financial landscape and banking regime for money market funds. Additionally, through the newly minted Financial Stability Oversight Council (FSOC), Fed Chairman Ben Bernanke, Secretary of the Treasury Timothy Geithner, and other government officials are using their semi-autonomous powers to exert intense pressure on the SEC and its commissioners to vote for transformative regulation – crippling regulation that was initiated, at least in part, by the Fed in the first place.

The looming condemnatory reforms – that include capital buffers, redemption holdbacks and a fluctuating NAV – are overwhelmingly regarded by industry experts, market economists, and academia as life-threatening to money market funds and potentially disastrous to the greater economy. Our industry is fighting back.
MONEY MARKET FUNDS’ EXISTENTIAL THREAT

Thankfully, clear and coherent voices are boldly speaking out against this regulatory subterfuge. There is powerful rebuttal from Paul Scott Stevens, CEO, Investment Corporation Institute; Anthony Carfang, Senior Partner, Treasury Strategies Inc.; John Hawke Jr., former Comptroller of the Currency and partner, Arnold & Porter; and Melanie L. Fein.

Attorney, professor and financial regulatory reform expert Melanie L. Fein has written what ICD Intelligencer believes is the definitive exposé covering Money Market Fund’s existential threat at the hands of the Fed. The 236 page “Shooting the Messenger - The Fed and Money Market Funds” is a call to action. Everyone in our industry should read it. This meticulously documented account unravels the Fed’s motives and reveals a stratagem to transmogrify money market funds into ‘special limited-purpose banks’ within the U.S. central banking system. We are grateful for her brave work and thank her for her unswerving insight and clarity.

Fein’s white paper is so compelling we have taken the liberty to use her introductory arguments as a narrative thread for this latest ICD Intelligencer – a ‘CliffsNotes’ version of the clearest telling of the financial crisis – if you will. You can download Ms. Fein’s white paper at: http://ssrn.com/abstract=2021652

This edition of ICD Intelligencer also incorporates the ideas and arguments of Stevens, Carfang, Hawke and others who masterfully rebut MMF allegations from SEC Chairman, Mary Schapiro, Fed Chairman Ben Bernanke, Secretary of the Treasury Timothy Geithner, former Fed Chairman and White House advisor, Paul Volcker, Boston Fed President Eric Rosengren and others. To be sure, money market fund defenders have provided superior intellectual capital in mounting a fierce defense against bald attack on this industry by government regulators. Clearly, the disparity of argument and evidence favors MMFs but tactics may escalate from rational negotiation to intimidating force.

This ICD Intelligencer provides an abridged version of the story that is designed to highlight the issues to more quickly draw attention to the depth and breadth of the assault that is at hand with money market funds. We trust that this will inspire you to dig deeper – to better understand what is really going in our industry. We encourage corporate treasurers, everywhere, to take a stand in defense of money market funds.

IN DEFENSE OF MONEY MARKET FUNDS
CLOSING ARGUMENTS:

1. The Fed’s Central Dogma - MMFs’ Susceptibility to Runs Creates Systemic Risk - Not Supported by Evidence
2. MMFs Provide Efficient and Essential Economic Services
3. MMFs Are Superior to Banks As Investment Vehicles
4. MMFs Are Strictly Regulated by The SEC and Scrutinized by the Credit Agencies
5. In 2008 MMFs and U.S. Treasury Securities Were the Last Two Asset-Classes Standing
6. MMFs Actually Gained Assets During and Following the Financial Crisis
7. Euro Crisis False Narrative – MMFs Did Not Strain Europe or U.S. Financial System
8. MMFs Face Existential Threat of Debilitating Regulatory Reforms
9. The Fed is More Concerned About Banks – Not Future Runs on MMFs
10. The Fed’s MMF Attacks Are Increasing in Scope and Pressure
11. Troubling Perceptions Grow in Industry As Lawmakers Question the Fed’s Motives
12. Additional regulatory action will threaten the existence of MMFs and seriously jeopardize short-term credit markets. The SEC needs to consider both carefully.
ARGUMENT ONE:

THE FED’S CENTRAL DOGMA - MONEY MARKET FUNDS’ SUSCEPTIBILITY TO RUNS CREATES SYSTEMIC RISK - NOT SUPPORTED BY EVIDENCE

The Fed’s relentless narrative that MMFs are “susceptible” to runs and thereby create systemic risk—has little basis in fact.

The run on MMFs was caused by the Fed itself, not anything inherently unstable in MMFs.

The financial crisis was an outgrowth of the 2007 run on the bank-sponsored commercial paper market, not MMFs. That run left the banking system “effectively insolvent.”

MMFs served as a safe haven for investors during the run on bank-sponsored commercial paper before and during the financial crisis in 2008.

The “run” on MMFs in 2008 was not so much a run as a rapid reallocation of MMF holdings from non-government prime MMFs to government-only MMFs.

This shift meant that prime MMFs had to rapidly dispose of some of their assets, primarily bank-sponsored commercial paper which created pressure on banks and the bank commercial paper market.

ARGUMENT ONE SUMMARY:

The Fed caused the run itself, leaving the banking system “effectively insolvent” from the outgrowth of the 2007 run on bank-sponsored commercial paper. MMFs, instead, served as a safe haven for investors during the 2007 commercial paper run and running up to and during the 2008 financial crisis.

The Shadow Banking System?

Among other things, the Federal Reserve claims that money market funds are subject to runs, part of an unregulated shadow banking system, and a source of systemic risk.

[However,] money market funds are not subject to runs, are a source of systemic liquidity rather than risk, and are not part of the shadow banking system.

Rather, the banking organizations constitute the shadow banking system, acting under the supervision of the Fed. Moreover, the bank asset-backed commercial paper market, not money market funds, was the source of systemic risk that threatened the financial system during the recent crisis.

The Fed claims that a run on MMFs in September of 2008 destabilized the commercial paper market and ignited a global financial crisis. Instead, a run on bank asset-backed commercial paper in 2007 left the banking system effectively insolvent and commenced the crisis, and the Fed itself precipitated the run on MMFs and the entire financial system in September of 2008.

“Shooting The Messenger: The Fed and Money Market Funds”

Melanie Fein, April 2012
ARGUMENT TWO:
MONEY MARKET FUNDS PROVIDE EFFICIENT AND ESSENTIAL ECONOMIC SERVICES

MMFs provide a useful cash management tool for corporate treasurers for whom bank deposits are insufficiently diversified and risky.

MMFs are the main purchasers of commercial paper issued by non-financial U.S. corporations to finance their payrolls, inventories, and cash flow.

MMFs also purchase large amounts of short-term securities issued by states and local municipalities.

MMFs are used as short-term investments for pension funds, charitable foundations, and individual retirement accounts and 401(k) plans.

MMFs are the most efficient intermediary between short-term corporate and municipal borrowers on the one hand and institutional and retail investors on the other.

Any impairment of their ability to function efficiently could result in increased funding costs and a loss of funding sources for both the private and public sector.

ARGUMENT TWO SUMMARY:

MMFs are the most stable, most effective and most efficient intermediary between short-term corporate and municipal borrowers on the one hand and institutional and retail investors on the other.

MONEY MARKET FUNDS HELP FINANCE CORPORATE SHORT-TERM LIABILITIES

Money market funds currently invest in approximately 38% of total commercial paper assets. Assuming a 27% money market fund reduction as indicated by our March 2012 corporate treasury survey, their contribution to commercial paper financing would decrease by $110 billion. This would challenge companies like General Electric, Johnson & Johnson, Harley-Davidson, Procter & Gamble and other enterprise companies who rely on commercial paper as a means to finance accounts receivable, maintain inventories and meet short-term liabilities.

Companies will be forced into more expensive financing options to cover the short-term credit void caused by a significant decrease in Money Market Fund investments. This financial blow would put corporate America at a disadvantage against its global competitors, resulting in stalled growth and the loss of jobs.

Tory Hazard
COO/CFO, ICD
ICD Commentary
March, 2012

GOVERNMENTS DEPEND ON MONEY MARKET FUNDS

“Governments depend on the safety and liquidity of money market funds for their constantly flowing operating funds and as part of their cash management strategy. Without being able to invest in these funds, governments would have to look to other investment vehicles that would be less attractive, less liquid and may carry greater risks. Furthermore, if this major purchasing power of municipal bond were to exit the market, state and local governments would suffer higher borrowing costs on their short-term debt.”

Policy Statement By The Government Finance Officers Association, June 08, 2010
ARGUMENT THREE:
MONEY MARKET FUNDS ARE FAR SUPERIOR TO BANKS AS INVESTMENT VEHICLES

BANKS VS. MONEY MARKET FUNDS

| A bank’s assets are held largely in the form of illiquid assets – such as loans that cannot be liquidated to meet unusual depositor demands. | VS. | MMF assets are limited to high quality, short-term assets that can be readily sold off to meet redemption requests. |
| The maturity transformation function of MMFs is miniscule compared to that of banks. Banks transform assets with maturities of as long as 30 years into demand liabilities | VS. | The weighted average maturity of MMFs is 60 days or less as required by SEC regulations. |
| Banks assets are highly opaque to the public - and even regulators. | VS. | MMFs are required to disclose their portfolio holdings |
| Banks are leveraged | VS. | MMFs are unleveraged |
| When a bank fails and is closed, depositors are lucky to receive back 50 percent of their uninsured deposits | VS. | In the one instance when a MMF broke a dollar during the financial crisis, fund shareholders got back more than 99% of their money. |

40 YEARS LATER, MONEY MARKET FUNDS ARE NOT BANKS

Households, businesses, nonprofit institutions, and state and local governments look to money market funds as stable, convenient, and liquid tools for cash management. Just the direct cost of forcing savers out of money market funds would be substantial: retail investors alone have reaped an additional $225 billion in returns by investing with money market funds since 1985.

The economic damage could be even worse, because money market funds provide vital short-term financing for businesses, consumers, governments—and even banks. Money market funds hold more than one-third of the commercial paper that businesses issue to finance payrolls and inventories, including a significant share of the asset-backed commercial paper that funds credit card, home equity, and auto loans.

These funds hold more than half of the short-term debt that helps state and local governments fund operations and public projects, and $1 out of every $8 in short-term Treasury debt. There are few immediate substitutes to fill the financing gap that would be created by a rapid shrinkage of money market funds. Banks, in particular, can’t afford to pick up the slack, because carrying the assets would require billions in new capital.

“40 Years Later, Money Market Funds Are Not Banks”
Brian Reid
Investment Company Institute,
March 3, 2011
THE FED AND THE GREAT DEPRESSION

The Great Depression created a widespread misconception that market economies are inherently unstable and must be managed by the government to avoid large, macro-economic fluctuations, that is, business cycles. This view persists to this day despite the more than 40 years since Milton Friedman and Anna Jacobson Schwartz showed convincingly that the Federal Reserve’s monetary policies were largely to blame for the severity of the Great Depression.

Ironically, as a result of the banking crisis of 1930–33, the Fed was granted more responsibilities and more control over banking. As is often the case in politics, failure was used to justify an expansion of power.

Ivan Pongracic Jr.
Professor of Economics - Hillsdale College,
September, 2007

“The Federal Reserve System had been established to prevent what actually happened in the Great Depression. It was set up to avoid a situation in which you would have to close down banks, in which you would have a banking crisis. And yet, under the Federal Reserve System, you had the worst banking crisis in the history of the United States. There’s no other example I can think of, of a government measure which produced so clearly the opposite of the results that were intended.”

Milton Friedman, PBS, October 1, 2000

“Regarding the Great Depression, you’re right. The Fed did it. We’re very sorry.”

Ben Bernanke, November 8, 2002
The fact is that MMFs have a record of safety far superior to that of banks. Banks failed by the hundreds during the recent financial crisis and have a long history of failures during prior crises, despite their extensive government supervision, deposit insurance, and access to Fed liquidity. MMFs have weathered financial crises throughout their 40-year history without access to the federal safety net and have served as a safe haven for investors during times of stress.

ARGUMENT THREE SUMMARY:

Banks are fundamentally mismatched for short-term credit. Bank assets are highly-leveraged, highly opaque – even for bank regulators. Banks assets are illiquid with maturity transformations that are often decades long. Banking organizations are the real constituents of the shadow banking system.
ARGUMENT FOUR:

**MMFS ARE STRICTLY REGULATED BY THE SEC AND SCRUTINIZED BY THE CREDIT AGENCIES**

Volcker’s somewhat evocative characterization that MMFs are “truly hidden in the shadow of banking markets” conjures up an image of fly-by-night firms operating surreptitiously in the darkness of back alleys. But with thirty million investors and $2.6 trillion in assets, MMFs are hardly unseen or hidden.

Money market funds are subject to significant regulatory controls, examination and oversight by the Securities and Exchange Commission

- Minimum 10% daily liquidity and 30% weekly liquidity allowing only 5% in illiquid securities
- Detailed prospectus requirements for the issuance of shares
- Stringent Money Market Fund reporting requirements
- Regular surveillance
- Additional reporting requirements as to portfolio asset contents
- Strict standards and demanding evaluations of credit rating agencies
- Frequent public disclosure of portfolio content on websites and in regulatory filings – down to the individual security level.

Significantly, when the Federal Reserve established its liquidity facility for MMFs in September 2008, it was limited to asset-backed commercial paper bearing only the highest ratings. MMFs must satisfy the standards and evaluations of the rating agencies. To be sure, the rating agencies may not give everyone the comfort they once did, but their standards for rating MMFs are demanding. To suggest that MMFs exist in a hidden “shadow” world simply distorts reality.

“Money Market Funds and Folklore: A Response To Chairman Volcker”
John Hawke Jr. For Federated, 2011

The SEC should start by determining if the reforms it adopted in 2010 are working and examine how funds have performed in the wake of the U.S. debt ceiling negotiations and downgrade as well as the European sovereign debt crisis. If it can prove additional changes are needed it should find solutions that preserve the versatility and usefulness of the product. Needlessly reducing the choices companies have to finance their operations will neither help address perceived systemic risk nor advance our economic recovery.

David Hirschmann, SVP
U.S. Chamber of Commerce
Washington D.C.,
February, 2012
THE FED AND THE SEC HAVE SIGNIFICANTLY INCREASED THE MONITORING OF MONEY MARKET FUNDS

In 2010, the New York Fed published a staff paper that called on the SEC to significantly enhance its monitoring of MMF portfolios.

The SEC staff was asked to look for red flags indicating possible future trouble, such as unusually high yields and fast growth.

Analysts within the SEC now pour through weekly portfolio data submitted electronically by all MMFs, looking for trends, red flags, and signs of risk and trouble.

The SEC staff can now quickly pull up industry-wide data to look for investment concentrations by MMFs in particular commercial paper issuers that may experience financial difficulties.

The SEC not only has this information, they now follow up constantly with MMF managers, asking for explanations of adverse trends, portfolio red flags and potentially risky investments.

The SEC staff is doing the types of portfolio reviews the federal banking regulators do in analyzing bank portfolios.

“Leave Money Market Funds Alone”
John Hawke Jr. For Federated, 2011

ARGUMENT FOUR SUMMARY:

The SEC staff is using real-time information on MMF portfolios that is more thorough and more transparent than anything available to bank regulators retrospectively on illiquid, unmarketable and very opaque bank assets.
ARGUMENT FIVE:
IN 2008 MMFS AND U.S. TREASURY SECURITIES WERE THE LAST TWO ASSET-CLASSES STANDING

The first asset classes to “freeze” in mid-2007 were non-2a-7 enhanced cash funds and asset-backed commercial paper. These were followed by the collapse of the auction rate securities market and mortgage derivative markets.

Individual institutions also experienced runs. These included some local government investment pools and a college liquidity fund. An investment bank failed when its short-term funding dried up, essentially a run by sophisticated investors. Several well-capitalized corporations experienced difficulty in placing their highly rated commercial paper.

Several large commercial banks such as IndyMac, Washington Mutual, and Countrywide experienced runs as their short-term funding failed and depositors fled. Government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac were unable to fund themselves in the securities markets, investors refusing to reinvest.

In the case of these commercial banks, GSEs, and investment bank failures, government rescues protected investors and increased moral hazard in the marketplace.

ARGUMENT FIVE SUMMARY:
By August of 2008, only two major liquidity-related asset classes had not experienced a failure: U.S. government securities and money market mutual funds.

THE FED GETS IT WRONG AGAIN

“Strong U.S. housing prices reflect a healthy economy and I doubt there will be a national decline in prices. House prices have gone up a lot,” Bernanke said in an interview on CNBC television. “It seems pretty clear, though, that there are a lot of strong fundamentals underlying that. The pace of housing prices may slow at some point but they are unlikely to drop on a national basis. We’ve never had a decline in housing prices on a nationwide basis,” he said, “what I think is more likely is that house prices will slow, maybe stabilize...”

Ben Bernanke, Chairman
Council of Economic Advisors,
July, 2005

“There is really no material change in our expectations for the U.S. economy since I last reported to Congress a couple weeks ago. If the housing sector begins to stabilize and if some of the inventory corrections that are still going on in manufacturing begin to be completed, there is a reasonable possibility of strengthening of the economy sometime during the middle of the year.”

Ben Bernanke,
February, 2007

“The global economy continues to be strongly supported by solid economic growth abroad and U.S. exports should expand further in coming quarters. Overall the U.S. economy appears to likely to expand at a moderate pace over the second half of 2007 with growth then strengthening a bit in 2008 to a rate close to the economy’s underlying trend.”

Ben Bernanke,
July, 2007
During the financial crisis of 2007-09, investors staged runs on entire asset classes, not just specific institutions.

**FIRST ASSET CLASSES COLLAPSE**
6/2007 - The first asset classes to “freeze” in mid-2007 were non-2a-7 enhanced cash funds and asset-backed commercial paper.

**INSTITUTIONS EXPERIENCE RUNS**
3/2008 - Individual institutions also experienced runs. These included local government investment pools and a college liquidity fund.

**CORPS CAN’T SELL COMMERCIAL PAPER**
5/2008 – Several well-capitalized corporations experienced difficulty in placing their highly rated commercial paper.

**GOVT. ENTITIES BUCKLE**
6/2008 – Government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac were unable to fund themselves in the securities markets, investors refusing to reinvest.

**GSEs TUMBLE**
7/2008 – In the case of these commercial banks, GSEs, and investment bank failures, government rescues protected investors and increased moral hazard in the marketplace.

**STILL STANDING - MMFs and US GOVT. SECURITIES**
By August of 2008, only two major liquidity-related asset classes had not experienced a failure: U.S. government securities and money market mutual funds.

Curiously, in the aftermath of these developments, regulators have targeted money market funds as needing draconian regulatory change. This is in spite of the fact the MMFs were the last asset class to encounter difficulty and suffered the smallest losses in both real and proportional terms. The SEC has already enacted tightened MMF rules in 2010. However, it continues to debate additional changes to address run prevention.

*Treasury Strategies Proposed Capital Requirements – A Disaster On All Fronts, February, 2012*
ARGUMENT SIX:

MMFS ACTUALLY GAINED ASSETS DURING AND FOLLOWING THE FINANCIAL CRISIS

...In the days immediately following Lehman’s bankruptcy, investors (mainly institutional) withdrew approximately $196 billion from non-government funds and invested approximately $86 billion in government funds.

Historically, MMFs never have experienced a run that resulted in a fund breaking a dollar, other than the one in 2008. There was no “run” on MMFs prior to that in September of 2008.

A number of MMF sponsors—mainly banking organizations—purchased asset-backed commercial paper from their funds or provided direct liquidity in order to prevent the funds from breaking a dollar during the 2007-08 crisis. A number of MMFs experienced heavy redemption activity. But that did not constitute a run in the classic sense of an uncontrolled panic. To the extent that heavy redemptions did resemble a run, they were part of a larger flight to quality as investors en masse lost confidence in the banking and financial markets.

ARGUMENT SIX SUMMARY:

Overall, MMFs gained approximately $750 billion in net assets from January 2008 to January 2009 during the worst of the financial crisis, more than half of which came into MMFs prior to Lehman’s bankruptcy.
Fed officials recently have raised concerns about MMF investments in Europe.

I think the major vulnerability of our financial system to Europe has to do with the involvement in the money market funds. That we haven’t fixed the structural problems there. And until we do – they’re vulnerable to flights.

Jeffrey Lacker, President of the Federal Reserve Bank of Richmond, stated on a television program

MMFs are “adding to the strains on European banking stability”: Recently, in an effort to maintain some earnings, many of those funds invested heavily in European banks. Now, without the backstop official liquidity, they are actively withdrawing those funds adding to the strains on European banking stability.


Eric Rosengren, President of the Federal Reserve Bank of Boston similarly has criticized MMFs for creating pressures on European banks by reducing their investment exposure to Europe, as if MMFs should be a captive source of funding for Europe and other counterparties in which they invest.

Structural vulnerabilities in money market funds and tri-party repo amplified a number of shocks in the financial crisis. Reforms undertaken since the crisis have improved resilience, and money market funds report de minimis exposure to Greece, Ireland, and Portugal; however, amplification of a shock through these channels is still possible.

The Financial Stability Oversight Council, of which the Fed is a member, has adopted the Fed’s view and warned that MMFs could amplify shocks occurring in Europe and elsewhere in the financial system

Similarly, no “run” on MMFs occurred as a result of the sovereign debt crisis in the United States or Europe in 2011. Although MMFs that held European debt experienced outflows, MMFs overall gained net inflows, as the Fed itself observed:

Money market funds, a major provider of funds to short-term funding markets such as those for CP and for repo, experienced significant outflows across fund categories in July [2011], as investors’ focus turned to the deteriorating situation in Europe and to the debt ceiling debate in the United States. Those outflows largely shifted to bank deposits, resulting in significant pressure on the regulatory leverage ratios of a few large banks. However, investments in money market funds rose, on net, over the remainder of 2011, with the composition of those increases reflecting the general tone of increased risk aversion, as government-only funds faced notable inflows while prime funds experienced steady outflows.

Fed concerns that European debt holdings threaten the stability of MMFs are not borne out by industry analysts. Concerns that MMF withdrawals added to European banking troubles reflect an erroneous view.
At a recent Congressional hearing, Fed Chairman Bernanke was asked, “do money market funds play a useful role in the economy?” He replied, “generally speaking they do.” He added, however, “Europe doesn’t have any,” implying that, if Europe doesn’t need MMFs, then the United States doesn’t either.

European holdings represent 35% of the assets of prime U.S. money market funds [as of February 2012]. And those funds remain structurally vulnerable despite some constructive steps taken since the recent financial crisis. U.S. financial firms and money market funds have had time to adjust their exposures and hedge their risks to some degree … but the risks of contagion remain a concern both for these institutions and their supervisors and regulators.

Ben Bernanke, Federal Reserve Chairman,
Testifying before the House Oversight and Government Reform Committee, March 21, 2012

WASHINGTON – Federal Reserve Chairman Ben Bernanke says the threats from Europe’s debt crisis have eased, but U.S. money market funds remain exposed to risky European assets.

“Although U.S. Banks have limited exposure to peripheral European countries, their exposures to European banks and to the larger core countries is much more material.” Bernanke continued, “Europe must take further steps, including strengthening its banking system even more and making “a significant expansion of financial backstops” to guard against troubles in one country spilling over to other nations.

Moreover, European holdings represent 35% of the assets of prime U.S. money market funds [as of February 2012]. And those funds remain structurally vulnerable despite some constructive steps taken since the recent financial crisis.”

“U.S. financial firms and money market funds have had time to adjust their exposures and hedge their risks to some degree … but the risks of contagion remain a concern both for these institutions and their supervisors and regulators,” Bernanke said.

Bernanke also said “In particular, if Europe took a severe turn for the worse, the U.S. financial sector likely would have to contend not only with problems stemming from its direct exposure to European loans and investments but also with broader market movements, including declines in global stock prices, increased credit costs and reduced availability of funding.”

USA Today Money – by Martin Crutsinger,
Associated Press: Federal Reserve Chairman Ben Bernanke Testifying before the House Oversight and Government Reform Committee, March 21, 2012

ARGUMENT SEVEN SUMMARY:

Money market funds proved their stability during the 2011 US & Euro Sovereign Debt Crises
ARE THE 2010 2A-7 AMENDMENTS A SUCCESS?
MOST EMPHATICALLY – YES!

Paul Schott Stevens, President and CEO, Investment Company Institute

So – have the 2010 amendments been tested? Yes.
Have they made money market funds more resilient in the face of crisis? Yes.
Have they made investors more secure, at a reasonable price? Yes.
Are the new rules a success? Most emphatically – yes.

Indeed, I would go further. I would argue that the 2010 amendments are the latest chapter in one of the great success stories of modern financial regulation. Throughout the history of money market funds, the SEC has carefully crafted rules that balance these funds’ competing objectives of convenience, liquidity, and yield. Under this regulatory regime, money market funds have flourished and innovated – to the great benefit of investors and the economy.

Yet regulators are not content. Despite the proven success of the 2010 reforms, SEC Chairman Mary Schapiro insists that the financial system is “living on borrowed time” because money market funds have “structural risks.”

We’ve examined the portfolio data that all money market funds now are required to file with the SEC for public release. Among the prime funds with the greatest exposure to European financial institutions, the average mark-to-market price of their portfolio fell by nine-tenths of a basis point.

**$1.00 SHARE**

**$0.00009 AVERAGE EXPOSURE TO EUROPE**

Put it another way – that change wouldn’t move the value of a share priced at $1.00, and it wouldn’t move the value of a $10.00 share. It would move the value of a share priced at $100.00 — by one cent. We can’t call that breaking the buck – so I guess we’d have to call it “Breaking the Benjamin.”

**Preserving the Value of Money Market Funds for Investors and the Economy**

Money Market Expo
Paul Schott Stevens - President and CEO
Investment Company Institute
March 12, 2012
ARGUMENT EIGHT:
MMFs FACE EXISTENTIAL THREAT OF DEBILITATING REGULATORY REFORMS

THE FED LACKS OPERATIONAL AND REGULATORY MMF EXPERTISE

The Fed has made efforts to discredit MMFs and subject them to inappropriate structural changes, particularly capital requirements.

There are questions about whether the Fed has a proper basis for recommending changes in the regulation of MMFs.

The central bank does not have apparent expertise in the operations or regulation of MMFs.

Its published research and official statements do not indicate that the Fed has performed any in-depth analysis of the economic impact of its MMF restructuring proposals.

THE SEC HAS EXTENSIVE REGULATORY EXPERTISE WITH MMFS

The SEC has extensive expertise in regulating MMFs under the Investment Company Act.

The SEC acted quickly after the financial crisis to review its regulations.

The SEC modified Rule 2a-7 regulations in 2010 to further enhance the safety of MMFs.

The SEC requires continuous fund monitoring and frequent transparency reporting.

U.S. Rep. Spencer Bachus, House Financial Services Committee Chairman

LETTER TO SEC CHAIRMAN MARY SCHAPIRO, APRIL 17, 2012

We are concerned about recent press reports and public statements you have made indicating that the issuance of further money market fund reforms is a high priority for you and one that you believe the Securities and Exchange Commission (SEC or Commission) should take up in short order. Given that the SEC has already missed numerous deadlines for mandatory rulemakings, the suggestion that the agency is devoting time and resource to a discretionary rule without providing Congress or the public with empirical data and economic analysis to justify such a rulemaking raises significant questions regarding the Commission’s priorities and ability to manage its resources.

While we all recognized the need to reform money market funds following the 2008 financial crisis, significant reforms have already been implemented through the 2010 amendments to Rule 2a-7.

continued...
Accordingly, we were surprised to read your comments in a November 7, 2011, speech, in which you stated that money market fund reform is an “important policy issue that has not been fully resolved following the financial crisis of 2008” and that “additional steps should be taken to address the structural features that make money market funds vulnerable to runs.”

These observations stand in stark contrast to comments made by Commissioner Daniel Gallagher in a December 14, 2011, speech in which he questioned what is “prompting this urgency to reform money market funds.” Commissioner Gallagher also questioned what “problems or risks” are sought to be addressed through the SEC’s rulemaking, and whether “necessary data” exists to allow the Commission to “regulate in a meaningful and effective way.”

**ARGUMENT EIGHT SUMMARY:**

**MMFs are highly risk-averse. Historically, they have not been subject to runs. Regulated banking organizations – not MMFs – are the shadow banking system whereas MMFs are merely the equivalent of the system’s depositors.**
ARGUMENT NINE:

THE FED IS MORE CONCERNED ABOUT BANKS – NOT FUTURE RUNS ON MMFS

Fed economists have concluded that the financial crisis started in 2007 with a run – not on MMFs – but on bank-sponsored asset-backed commercial paper (“ABCP”). According to these economists, ABCP is a source of systemic risk. ABCP was at the core of the shadow banking system and provided the means by which banks transmitted the risks of subprime mortgages throughout the financial system.

The run on MMFs in 2008 was caused not by anything inherently unstable in MMFs but by the Fed itself when it abruptly changed course and reneged on its publicly avowed commitment to act as the nation’s ‘lender of last resort’ amid a systemic crisis. The run on MMFs was a secondary effect of the run on bank ABCP and occurred only when the crisis appeared to have reached epic proportions beyond the Fed’s control.

The Fed’s concern is not future runs on MMFs…

- The Fed’s real concern is runs on the short-term credit markets, particularly bank-sponsored ABCP and other commercial paper on which large banking organizations and non-financial corporations depend for funding.

- The Fed’s reform proposals would force MMFs and their shareholders to serve as stabilizers of the commercial paper market—and indirectly the banking system—a role that Congress intended the Fed, not MMFs, to fulfill.

- Reputable scholars have found that the central bank is far from infallible in understanding how its actions affect the financial system.

- The Fed’s proposed structural changes for MMFs are not supported by economic research and analysis.

- A number of economists believe that Fed policies exacerbated the recent crisis as well as prior financial crises.

- There is wide agreement by economists, including Ben Bernanke, that Fed policies gave rise to the Great Depression.

- This criticism suggests that the Fed’s concepts for financial reform – particularly those relating to MMFs—should not be accepted without close scrutiny.

ARGUMENT NINE SUMMARY:

If MMFs survive, the Fed wants MMFs and their shareholders to serve as lenders of last resort for the commercial paper market and thereby support banking organizations that issue and sponsor asset-backed commercial paper.
ARGUMENT TEN:
THE FED’S MMF ATTACKS ARE INCREASING IN SCOPE AND PRESSURE

Despite changes in the assets they hold, money market funds remain susceptible to a sudden deterioration in quality of holdings and consequently, remain susceptible to runs. While many say our 2010 reforms did the trick – and no more reform is needed – I disagree. The fact is that those reforms have not addressed the structural flaws in the product. Investors still have incentives to run from money market funds at the first sign of a problem.

Mary L. Schapiro, SEC Chairman,

The combination of fixed net asset value, the lack of loss absorption capacity, and the demonstrated propensity for institutional investors to run together make clear that Chairman Schapiro is right to call for additional measures.

Daniel Tarullo, Federal Reserve Board of Governors,
May 2, 2012

Notwithstanding the new regulations, the risk of runs created by a combination of fixed net asset values, extremely risk-averse investors, and the absence of explicit loss absorption capacity remains a concern, particularly since some of the tools that policymakers employed to stem the runs during the crisis are no longer available. SEC Chairman Mary Schapiro has advocated additional measures to reduce the vulnerability of money market funds to runs, including possibly requiring funds to maintain loss-absorbing capital buffers or to redeem shares at the market value of the underlying assets rather than a fixed price of $1. Alternative approaches to ensuring the stability of these funds have been proposed as well. Additional steps to increase the resiliency of money market funds are important for the overall stability of our financial system and warrant serious consideration.

Ben Bernanke, Federal Reserve Bank Chairman,
At the 2012 Federal Reserve Bank of Atlanta Financial Markets Conference, Stone Mountain, Georgia, April 9, 2012
SECRETARY OF THE TREASURY TIMOTHY GEITHNER AND THE FED STAFF WANT TO SHUT DOWN MMFS

Former Federal Reserve Bank of New York president Timothy Geithner has referred to MMFs as among the “weakest parts” of the financial system, which the government aims to “shut down” or “restructure”:

We have shut down or restructured the weakest parts of our system that played a central role in the crisis. Banks and other financial institutions with more than $5 trillion in assets at the end of 2007 have been shut down, acquired, or restructured. The asset-backed commercial paper market has shrunk by 70 percent since its peak in 2007, and the tri-party repo market and prime money market funds have shrunk by 40 percent and 33 percent respectively since their 2008 peaks.

The view that MMFs should be “shut down” appears to underlie the Fed’s MMF proposals. Fed researchers have referred to MMFs as the “weakest links” in the shadow banking system and said it is imperative for policymakers to assess whether MMFs should have access to official backstops permanently or “be regulated out of existence.” The reason why MMFs are weak links, according to the staff report, ironically is because they are highly risk averse.

Top Fed and Treasury officials have urged the SEC to not back down despite the pressure from the industry and lawmakers, increasing their calls for the agency to act. They have pointed out that money-market funds remain vulnerable but regulators no longer have the tools they did in 2008. Fed and Treasury staffers have worked closely with the SEC on developing a proposed rule. “The chairman believes the unique structure of money-market funds makes them susceptible to destabilizing runs and accordingly the staff is continuing to work with the commission to propose reforms,” SEC spokesman John Nester said.

Andrew Ackerman and Victoria McGrane, Wall Street Journal, May 7, 2012

We worry that runs on money-market mutual funds in a stress circumstance could be the start of something very dangerous.

Neil Wolin, Deputy Treasury Secretary, May 2, 2012

ARGUMENT TEN SUMMARY:

No one questions that the Fed is motivated by concerns to strengthen the resiliency of the financial system. Yet, there is justifiable concern that, by eliminating MMFs, the Fed’s proposals could decrease rather than increase systemic resiliency. There also is evidence that the Fed is interested in protecting the competitive position of banks and their affiliates (which are its main clientele) relative to MMFs.
Timothy Geithner, Secretary of the Treasury and Ben Bernanke, Federal Reserve Bank Chairman

THE FED SHOULD NOT ATTEMPT TO COMPENSATE FOR PAST POLICY MISSTEPS

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 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.

Melanie Fein

ARGUMENT ELEVEN:
TROUBLING PERCEPTIONS GROW IN INDUSTRY AS LAWMAKERS QUESTION THE FED’S MOTIVES

The Fed is on a mission to eliminate or impair one of the most well-regulated, well-managed, and successful sectors of the financial services industry – money market funds.

The Fed does not view MMFs as an important part of the financial system but rather as a type of unregulated “shadow bank” that should be subjected to bank-like regulation.

The Fed has sought to deflect blame from itself and regulated banking organizations to MMFs for the events of 2008 that destabilized the financial system.

The Fed believes that MMFs divert deposits from banks and wants to encourage MMF shareholders to transfer their short-term cash to banks, which in turn will deposit the cash with the Federal Reserve in the form of excess reserves.

The Fed is using its role as a member of the Financial Stability Oversight Council to force the SEC into proposing inappropriate bank-like capital or other requirements that would effectively eliminate MMFs as competitors of banks for short-term cash deposits.

If MMFs survive, the Fed wants MMFs and their shareholders to serve as lenders of last resort for the commercial paper market and thereby support banking organizations that issue and sponsor asset-backed commercial paper.

The Fed’s proposed structural changes for MMFs are not supported by economic research and analysis.

ARGUMENT ELEVEN SUMMARY:
The Fed has maintained an institutional antipathy to MMFs since 1980 when Congress rejected the Fed’s attempt to thwart MMFs as competitive alternatives for bank customers seeking a market rate of return on their deposits.
ARGUMENT TWELVE:

ADDITIONAL REGULATORY ACTION WILL THREATEN THE EXISTENCE OF MMFS AND SERIOUSLY JEOPARDIZE SHORT-TERM CREDIT MARKETS. THE SEC NEEDS TO CONSIDER BOTH.

- Survey poll of ICD’s clients represents 14% of the MMF Portal industry.
- More than 95% of the respondents stated that their company would reduce MMF investments.
- This reduction would lead to a $714 billion decrease in MMF investments.

Clients Will Reduce Their Investments In Money Market Funds

Many clients stated they would exit MMF investments entirely, with the average net estimated reduction of all respondents totaling 41%. Total institutional MMF investments are approximately 66% of the $2.6 trillion in U.S. MMF investments.

Applying the survey’s 41% asset reduction across U.S. institutional MMFs, these SEC proposed MMF regulations would result in an estimated loss of $714 billion in MMFs.

ICD Estimates Reduction in Commercial Paper Assets As Much As 27% or $110B

MMFs currently invest in about 38% of total commercial paper assets. Assuming a 27% (66% x 41%) MMF reduction, their contribution to commercial paper financing would decrease by $110 billion.

This would challenge companies like General Electric, Johnson & Johnson, Harley-Davidson, Procter & Gamble and other enterprise companies who rely on commercial paper as a means to finance accounts receivable, maintain inventories and meet short-term liabilities.

Money Market Funds Contribute 12% Of U.S. Treasury Securities - Decrease By $89B

MMFs contribute 12% of all U.S. Treasury securities. Assuming a 27% reduction, MMF contributions to Treasury Department securities financing would decrease by approximately $89 billion.

This lowered credit supply for treasuries would increase U.S. borrowing costs. With the nonpartisan Congressional Budget Office projecting total U.S. debt at greater than $20 trillion by 2016, it is critical that treasury financing remain as low as possible.

Money Market Funds - 37% Of Total U.S. Gov. Agency Securities - Decrease by $103B

MMFs contribute 37% of the investment funding for all U.S. government agency securities. Assuming a 27% reduction, MMF contributions to agency securities financing would decrease by $103 billion. This would burden these agencies, which are integral components of the home loan and farm credit systems.

ARGUMENT ELEVEN SUMMARY:

The significant corrective reforms made to Rule 2a-7 by the SEC in 2010 are working, witnessed by MMF steadiness and control during the 2011 U.S. debt ceiling showdown, U.S. credit rating downgrade and the ongoing Eurozone debt crisis. Further unnecessary regulation will negatively impact U.S. corporations, municipalities and the U.S. Treasury with more expensive financing which would hinder economic recovery.
HAD 2010 RULE 2A-7 AMENDMENTS AND FUND EXPOSURE ANALYTICS APPLICATIONS BEEN IN PLACE IN 2008:

1. The Reserve Primary Fund would have been a smaller, lower risk fund – as it would not have the market incentives to incur greater risk for higher yield
2. MMF portfolios would have been much better diversified – as greater transparency into the funds would encourage fund managers to meet investor demands for higher diversification
3. Institutional investors would not have been forced to sell out of lower-risk MMFs – as they would have more visibility into underlying holdings
4. The MMFs and short-term marketplace would have been more liquid – the short-term market would have been less likely to seize

Individually these factors would have minimized the 2008 run on MMFs. Collectively, these factors should have eliminated it.

Tory Hazard, COO/CFO, ICD
ICD Commentary,
September 2011

BREAKING NEWS:

SEC MAJORITY NIXES MONEY FUNDS REFORM PACKAGE

In the strongest sign yet that money fund reforms lack sufficient Securities and Exchange Commission support, three commissioners have issued a joint statement opposing reforms laid out by global regulators.

Commissioners Luis Aguilar, Troy Paredes and Daniel Gallagher said the International Organization of Securities Commissions’ recent report “cannot be considered to represent” the SEC’s views.

“We feel that it is important to state for the record that the consultation report does not reflect the views and input of a majority of the commission,” the statement reads. “In fact, a majority of the commission expressed its unequivocal view that the commission’s representatives should oppose publication of the consultation report and that the commission’s representatives should urge losco to withdraw it for further consideration and revision.”

The losco report describes money funds as subject to systemic risks, given their role as key sources of short-term funding to financial institutions, businesses and governments, and proposes a floating net asset value, net asset value buffers and mandatory private insurance as potential responses.

The statement clearly exposes a schism within the commission.

Joe Morris,
Ignites, A Financial Times service,
May 14, 2012

For reporting and analysis of Money Market Funds Regulatory Reform, these ICD Commentaries can be downloaded at:
www.icdportal.com/icd_intel_commentary.shtml
For further reporting and analysis of Money Market Funds Regulatory Reform these commentaries can be downloaded at: www.icdportal.com/icd_intel_commentary_closingarguments.shtml

A Disaster On All Fronts - Proposed Capital Requirement For Money Market Mutual Funds: Treasury Strategies, Inc.


U.S. Treasurers Will Leave Money Market Funds Should the SEC Change Regulation, According To Treasury Strategies Study ICI, TSI


Oral Testimony of ICI’s Paul Schott Stevens / Perspectives on Money Market Mutual Fund Reforms: Investment Company Institute

The Latest Falacy About Money Market Funds - Melanie Fein, July 2012

Shooting The Messenger; The Fed and Money Market Funds Melanie Fein, April 2012

Melanie Fein’s Response Letter to Eric Rosengren, Federal Reserve Bank of Boston