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Jeffrey M. Lacker
President

January 10, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via www.regulations.gov

Dear Ms. Murphy:

President's Working Group Report on Money Market Fund Reform—File Number 4-619

The Federal Reserve Bank of Richmond appreciates the opportunity to respond to the Securities and Exchange Commission's request for comment on options offered by the President's Working Group on Financial Markets.

The President's Working Group Report (Report) suggests a range of possible policy options that could reduce the susceptibility of money market funds (MMFs) to runs. As explained in the attached document, we find the Report's first option, a requirement that all MMFs move to floating net asset values – meaning that shareholder redemptions are paid based on the current market value of fund assets – to be, by far, the most attractive.

Sincerely yours,

Jeffrey M. Lacker
President

Enclosure

President's Working Group Report on Money Market Fund Reform—File Number 4-619

Why we prefer the floating net asset values option As discussed in the Report, MMFs are susceptible to runs because the first shareholders to redeem, when asset values of the fund are declining, are likely to receive 100 cents on the dollar, given MMFs' current practice of attempting to maintain stable net asset value payouts. Shareholders who delay redemption can receive less if the MMF breaks the buck. As a result, any hint of bad news about the MMF's investments can cause shareholders to run, on the hope that they will be one of the shareholders allowed out before the MMF is forced to break the buck. This is a typical maturity transformation problem that is present for all financial firms, like banks, that pay out full principal on demand, but invest in anything other than overnight assets.

Because of the government aid that was made available in the fall of 2008, investors will almost certainly expect such aid to flow again whenever a widespread run seems possible. Of course, an expectation of (unpriced) government aid means that MMF risk-taking is being subsidized, shareholders are likely receiving inappropriately high returns, and too many funds are currently flowing into MMFs. Additionally, because the form and amount of any government aid to troubled MMFs or their investors is uncertain, the incentive to run will remain, heightening market instability in a crisis.

While one can mitigate the problems associated with stable NAV MMFs to an extent by imposing restrictions on the maturity and liquidity of MMF investments, as the Commission recently has done, the only certain solution is to require MMFs to always redeem funds based on current market values of their investments (in other words require MMFs to maintain a floating net asset value). If shareholder redemptions must be paid based on current market values of MMF investments, then there is little or no value for being first in line, and inappropriate runs will not arise. (Some redemption flows will reflect warranted reactions to incoming economic news.) Other restrictions, while perhaps more likely to preserve the current structure and size of the MMF industry, are unlikely to be as successful at reducing the danger of runs, and the attendant expectation of government aid in a crisis. Alternatively, the government could provide an explicit guarantee for MMFs or require MMFs to organize as special purpose banks. While we view these as preferable to the current situation, they needlessly expand the government safety net and thus are second best (for reasons discussed below) to requiring floating NAVs.

Addressing concerns raised by the floating net asset value option Many will object to a floating net asset value on the grounds that it will reduce the scale of MMFs and require costly adjustments to long-standing financial arrangements. Such objections should be evaluated from the broad perspective of the effectiveness of the financial system as a whole in intermediating between savers and borrowers. The mutual fund industry, apart from the money market sector, has a long history of performing such intermediation successfully while coping with volatile investor flows and asset prices. MMFs are unique among mutual funds, however, in that they are afforded the privilege of amortized cost accounting in exchange for limiting investments to short term liquid paper. This privilege is what allows them to provide investors with the advantages of bank-like maturity transformation but without the costs associated with bank capital requirements and safety and soundness regulations. Those costs are motivated precisely by a desire to limit the excessive risk-taking that a government safety net might otherwise encourage. Allowing MMFs

to by-pass the bank regulatory regime may have been warranted prior to the crisis under the assumption that they would not benefit from government support. Given the precedents set in 2008, however, that assumption is no longer appropriate. Thus costs and regulatory constraints associated with the financial intermediation currently performed by MMFs must increase if we are to achieve an appropriate balance of costs and benefits across alternative forms of financial intermediation and truly address the industry's instability problem.

While valuable, any move to a floating net asset value (NAV) requirement for all MMFs could well induce significant shifts in funding that require costly adjustments. If many shareholders move into insured deposits, the banks receiving those funds would need to raise additional capital. The potential magnitudes appear manageable, however. For example, if half of all MMF shareholdings were shifted to banks, then banks would need to add something like \$150 billion in capital, but during 2009 banks increased their equity capital by \$178 billion. Moreover, additional capital is going to be required in any event, whether investor funds remain in MMFs or not.

If such shifts in funds were to occur abruptly, the adjustment process could be somewhat disruptive. Therefore, a requirement that MMFs maintain floating NAVs must be carefully announced well before the requirement is implemented (by for example, requiring prominent disclosures by MMFs). If informed well ahead of a change, investors are more likely to move gradually, mitigating the disruption. Further, such a move might be phased in starting perhaps with institutional funds (in which investors are likely to be more easily informed of upcoming changes) and moving later to retail funds.

A requirement that MMFs shift to floating NAVs might lead current MMF investors to seek non-MMF stable NAV investments in anticipation that such funds might benefit from government support in a financial crisis due to their promised or implied stable NAVs. Policymakers will need to scrutinize alternatives to ensure that they will not elicit government support in the event of run-like withdrawals.

Weaknesses of other policy options While the Report's alternative options could be useful for strengthening MMFs, none offers as complete a solution as does the floating-NAV option.

- **Private Emergency Liquidity Facilities for MMFs** Private liquidity facilities indeed have some appeal, since private providers of liquidity would be likely to price their liquidity guarantees based on the riskiness of MMF portfolios, helping to encourage low risk investment policies, even beyond those required by 2a-7. And private liquidity facilities might successfully deliver funding when a few MMFs face runs. But such arrangements cannot possibly eliminate completely the risk of breaking the buck without in effect eliminating maturity transformation, for instance through the imposition of capital and liquidity standards on the private facilities. Thus, in the case of a pervasive financial shock to asset values, MMF shareholders will almost certainly view the presence of private facilities as a weak reed and widespread runs are likely to develop. In turn, government aid is likely to flow. Because shareholders will expect government aid in a pervasive financial crisis, shareholder and MMF investment decisions will be distorted. Therefore we view emergency facilities as perhaps a valuable enhancement, but not a reliable overall solution either to the problem of runs or to the broader problem of distorted investment decisions.

- Mandatory Redemptions in Kind A regime in which large redemptions are paid in-kind, while others are paid based on a stable NAV, seems likely to be complicated, and unlikely to eliminate the threat of runs. Most investors would rather not receive the in-kind payment; otherwise they could have held the underlying securities directly themselves. So while the incentive for investors to run may be reduced, they will continue to have an incentive to run if a MMF is threatened with losses sufficient to cause it to break the buck. Given that the threat remains, the simpler and more comprehensive solution, in our view, is a floating NAV for all shareholders.
- Insurance for MMFs – Given the size of the MMF industry, private insurance would almost certainly require a government backstop in order to be credible. If such backstop support is going to be forthcoming, then explicit insurance provision, with associated regulation, capital requirements, and insurance premia, is superior to the current situation in which insurance is provided implicitly with no pricing and limited regulation. Still we think of government insurance as a second best solution compared to floating NAVs. Insurance premia and regulation are very difficult to calibrate correctly, so subsidies, and therefore distortions, are likely to remain under the best of insurance schemes. Floating NAVs remove the incentive to run, and thus the need for government intervention, so are superior.
- Two-Tier System, with Enhanced Protections for Stable NAV MMFs – Given that calibrating regulations such that they eliminate market distorting subsidies is very difficult, or perhaps impossible, and that creating a new regulatory apparatus for MMFs that attempts to achieve this calibration will be expensive, we prefer floating NAVs to this two-tier approach. Our view is the same whether stable NAVs are allowed for all categories of investors, policy option e., or if stable NAVs are allowed only for retail investors, policy option f.
- Regulating Stable NAV MMFs as Special Purpose Banks (SPB) – This alternative appears to recognize the need to have similar activities (deposit banking and MMFs) regulated similarly. But if regulations are going to be truly harmonized, then the case for creating a new special-purpose bank charter seems weak because the costs of doing so would likely be large relative to the costs of simply allowing more of this activity to be absorbed into the existing banking sector. After all, banks can amortize assets held to maturity. Conceivably, one could regulate stable NAV MMFs as SPBs while allowing flexible NAV MMFs to continue to operate as MMFs, but again, it is not clear this provides any advantages over the straightforward banking alternative.