

September 17, 2013

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

Re: Money Market Fund Reform, Number S7-03-13

We thank you for the opportunity to comment on the money market mutual fund reform proposals put forth by the Securities and Exchange Commission on June 5, 2013. The Squam Lake Group is a non-partisan group of 13 academic economists that was formed in the fall of 2008 to offer guidance on the reform of financial regulation.¹

The members of the group include:

Martin N. Baily	Brookings Institution
John Y. Campbell	Harvard University
John H. Cochrane	University of Chicago
Douglas W. Diamond	University of Chicago
Darrell Duffie	Stanford University
Kenneth R. French	Dartmouth College
Anil K Kashyap	University of Chicago
Frederic S. Mishkin	Columbia University
David S. Scharfstein	Harvard University
Robert J. Shiller	Yale University
Matthew J. Slaughter	Dartmouth College
René M. Stulz	Ohio State University

Overview

The structure of money market funds (MMFs) makes them vulnerable to rapid large-scale redemptions (“runs”). Our largest concern is with prime MMFs, which invest primarily in the short-term paper of financial institutions, because they are a key source of short-term financing to large global financial institutions. As long as such financing is allowed, a run on prime MMFs can become part of a run on these financial institutions, or could instigate such a run. This, in turn, threatens the ability of these financial institutions to process payments and to extend credit to other market participants, businesses and households. Indeed, this threat led the U.S. Treasury to provide a temporary guarantee of all outstanding MMF balances after the failure of Lehman Brothers in September 2008 precipitated a run on prime MMFs.

¹ Our letter reflects the view of the Squam Lake Group; we are not representing any other organizations with which we are affiliated. The homepages of members of the group provide disclosures on their outside activities either in a disclosure page or as part of their curriculum vitae. Martin Baily dissents from the conclusions of this letter.

The Securities and Exchange Commission (SEC) has asked for comments on two main reform alternatives: requiring a floating net asset value (NAV) for all prime institutional money market funds (Alternative One); allowing money market funds to impose liquidity fees and redemption gates if liquid assets fall below a pre-specified threshold (Alternative Two); or a combination of these alternatives.

First, we believe that the floating NAV described in Alternative One would not achieve the goal of materially decreasing the systemic risk posed by MMFs because the NAV would not reflect actual prices at which investors and the fund itself could transact in a crisis. Unless the SEC is able to create a system whereby reported NAVs reflect actual NAVs, investors will have incentives to run. At a minimum, if this alternative is adopted, MMFs should not be allowed to use amortized cost accounting for instruments maturing in 60 days or less. Second, we believe that the liquidity fees and redemption gates described in Alternative Two could actually exacerbate run incentives and could be detrimental to financial stability. As we have written previously, an appropriately sized capital buffer for prime money market funds would have a more meaningful impact on financial stability.

Alternative One: Floating NAV

While a floating NAV structure prevents runs for most types of mutual funds, the mere floating of net asset value would not be effective at preventing runs on money market mutual funds for two reasons. First, mutual funds have the option to account for assets at amortized cost if they have a maturity of 60 days or less. With that option, the “floating NAV” is not a true reflection of the fair market value of fund assets.² Whenever investors can redeem at a NAV that is higher than the fair value of the assets, investors have incentives to run.

Second, and more fundamentally, prime MMFs invest substantially in assets without a liquid secondary market. This creates an incentive for fund investors to run during a period of financial stress, because even “fair market value” may exceed by a significant amount the value at which the fund can quickly sell assets to meet investor redemptions. Therefore, investors who ask for redemption first receive the NAV before the fund is forced to sell assets. Currently, the majority of the assets of prime MMFs consist of commercial paper (CP) and certificates of deposits (CDs).³ These assets have extremely limited secondary markets⁴ and an average maturity⁵ well in

² Although the SEC has indicated that funds are supposed to use fair value where it is less than amortized cost, we believe that this provision effectively makes amortized cost the default option and provides a degree of discretion to fund managers that is unwarranted.

³ See, for example, Exhibit 10 of “U.S. Fixed Income Markets Weekly, Short-Term Fixed Income,” January 11, 2013, by Alex Roever. Of his sample of \$1,069 billion of prime MMF assets, \$487 billion are invested in CDs, \$144 billion in CP, \$95 billion in time deposits, and \$72 billion in Asset Backed Commercial Paper (ABCP).

⁴ About 8% of CP transactions occur in the secondary market, according to Daniel Covitz and Chris Downing, 2007, “Liquidity or Credit Risk? The Determinants of Very Short-Term Corporate Yield Spreads,” *Journal of Finance*, Vol. 62, pp. 2303-2328. See, also, B. Duygan-Bump, Patrick M. Parkinson, Eric S. Rosengren, Gustavo A. Suarez, and Paul S. Willen, 2013, “How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility,” *Journal of Finance*, Vol. 68, pp. 715-737, as well as Arvind Krishnamurthy, 2002, “The bond/old-bond spread,” *Journal of Financial Economics*, Vol. 66, pp. 463-506.

⁵ Currently, the weighted average maturity (WAM) of MMF assets is approximately 43 days, as reported by Alex

excess of the period over which a run would occur.⁶ Although MMFs have recently increased their liquidity profiles above those required by regulation, this may be a temporary response to current market uncertainty.⁷

Thus, even with a floating net asset value, the first MMF investors to redeem their shares during a crisis are likely to receive a higher price for their shares than those who follow once the fund is forced to meet redemption demands by selling assets that have not yet matured. As was noted by the Financial Stability Oversight Council, for many MMFs, fund redemptions experienced during the run on prime MMFs following the collapse of Lehman would have significantly exceeded the liquidity requirements currently imposed on MMFs. This first-to-redeem advantage, which is exacerbated by amortized cost accounting, creates an incentive for MMF shareholders to run. Thus, given current accounting rules and the absence of a liquid secondary market for many money fund assets, floating NAV is unlikely to materially increase the stability of the financial system.

If the SEC adopts a floating NAV, at a minimum, it should not allow MMFs to use amortized cost accounting for instruments maturing in 60 days or less. It should also work towards creating a system whereby prices used in the calculation of NAV reflect the actual prices at which funds could transact both in normal times and in a crisis. Such a system will not be easy to develop, particularly one that generates real-time prices in a crisis.

Alternative Two: Liquidity Fees and Redemption Gates

The SEC has proposed allowing funds to impose a 2% liquidity fee and redemption gates if liquid assets fall below 15% of fund assets. This alternative has the potential to exacerbate runs as investors race to withdraw their funds before liquidity fees are imposed and gates are lowered. Furthermore, once one fund has imposed fees or gates, it increases the risk that there will be large withdrawals from other funds as their investors become concerned about the imposition of fees or gates. Rather than enhancing financial stability, this alternative has the potential to undermine financial stability. While we believe that under a floating NAV regime there needs to

Roever, who indicated an increase in WAM of 3 days from his previous report. In the “Fitch Money Market Fund Report” of December 21, 2012, Fitch reported a sample-average WAM for prime MMFs of 41 days.

⁶ *FSOC, Proposed Recommendations on Money Market Mutual Fund Reform*, p. 61: “At the height of the run in 2008, 40 institutional prime MMFs (excluding the Reserve Primary Fund) had one-day outflows in excess of the new 10 percent daily liquidity requirement, and 13 of those funds’ one-day outflows exceeded 20 percent of assets. In addition, 10 institutional prime funds had five-day outflows exceeding the new 30 percent weekly liquidity requirement, including eight funds with five-day outflows greater than 40 percent of assets. Notably, outflows in 2008 probably would have been considerably larger in the absence of the unprecedented government interventions to support MMFs and short-term funding markets.”

⁷ See Fitch, Macro Credit Research, “Money Fund Liquidity, Regulation versus Risk Aversion,” November 14, 2012. Fitch reports, for their sample of 10 large prime MMFs in September 2012, average liquid assets of 45%, in excess of the 30% requirement of Rule 2a7 for the minimum fraction of assets which must be liquid within one week. An asset (meeting other 2a7 requirements) is defined to be liquid within one week if it matures within one week, or is a government security that matures within 60 days. Fitch considers any government security, including floating-rate notes, to be liquid, irrespective of maturity. The “Fitch Money Market Fund Report” of December 21, 2012, reports a sample average daily liquidity of 29.6% of assets. The fund showing the lowest the daily liquidity, as reported by Fitch, was the Federated Prime Cash Obligations Fund, with 17.9% daily liquidity.

be some mechanism to deal with runs, the current proposal for liquidity fees and redemption gates is not a desirable mechanism.

Capital Buffers: Our Preferred Alternative

A suitably sized capital buffer for a fixed NAV MMF would mitigate the risk and impact of runs on prime MMFs. A capital buffer that takes losses before ordinary MMF shareholders gives these shareholders an extra layer of protection that reduces their incentives to run. Moreover, providers of capital buffers would have incentives to evaluate and control the risk of the MMFs they back, as they would be effectively responsible for the first losses on the assets of these funds.

The capital buffers need not be as large as those required of banks, given that MMFs are required to have portfolios with shorter maturities, lower levels of credit risk, and greater transparency than those of banks. Based on existing evidence, including joint research by one of the authors of this letter, a suitably sized buffer should be in the range of 3 to 4% of risk-weighted assets.⁸ Given the modest size of an MMF capital buffer and the relative safety of MMF assets, an appropriately sized capital buffer is unlikely to have a significant impact on the returns earned by ordinary MMF shareholders. The research cited above suggests that a 3% capital buffer would reduce the yields of ordinary shareholders by approximately 5 basis points.⁹ Capital market frictions could reduce the yields further but the yield reduction would still be relatively modest.

There has been much concern in the industry about the cost of such a capital buffer, but the statements made by some representatives of the industry are contradictory. On the one hand, they argue that there is no need for a capital buffer because money market funds are extremely safe. On the other hand, they claim that the cost of the buffer would be very high.¹⁰ We note, however, that the cost of the buffer depends on the likelihood that it will be used. If the buffer will almost never be used, buffer investors would not need to be compensated at a rate substantially higher than that of ordinary fund shareholders because they would bear a risk similar to that borne by these shareholders. The more likely it is that the capital buffer will be used to pay for losses on assets, the higher would be the required compensation to the provider of the capital buffer. That is, a high compensation to buffer providers means that there will be a significant chance that the fund will “break the buck,” posing risks to the financial system. In short, it simply cannot be the case that the buffer will be expensive if it is not going to be used.

⁸ See Samuel Hanson, David Scharfstein, and Adi Sunderam, 2012, “An Evaluation of Money Market Fund Reform Proposals,” Harvard Business School working paper, which uses a standard methodology in bank capital regulation to determine the size of the capital buffer. Consistent with this approach, they conclude that a capital buffer of 3%-4% of risk-weighted assets would reduce the probability of “breaking the buck” to 0.1%, the threshold insolvency probability used in bank capital regulation. In addition, research reported in Steffanie Brady, Ken Anadu and Nathaniel Cooper, 2012, “The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007-2011,” Federal Reserve Bank of Boston working paper, shows that there was some form of sponsor support in over 20% of the funds they studied, with some support in excess of 3% of assets.

⁹ Hanson, Scharfstein and Sunderam, *op. cit.*

¹⁰ See, for example, “The Implications of Capital Buffer Proposals for Money Market Funds,” Investment Company Institute, May 16, 2012.