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For more than 40 years, since the time he served as Chairman of the Board of Governors of the Federal Reserve System, Paul A. Volcker has made clear his strong antipathy to money market mutual funds (MMFs). His most recent attack came in his William Taylor Memorial Lecture to a conference of the Group of 30, a private body made up of public and private representatives and academics.

The essence of the Volcker attack is that MMFs are creatures of "regulatory arbitrage" that have cannibalized demand deposits from the conventional banking system, that exist "truly hidden in the shadow of banking markets," and that "are demonstrably vulnerable in troubled times to disturbing runs." He argues that if MMFs wish to continue to provide a service that "mimics commercial bank demand deposits," they should be subject to the same kind of regulation as conventional banks, including "strong capital requirements, official insurance protection, and stronger official surveillance of investment practices." This is necessary, he argues, to avoid the need for the government to "resort to highly unorthodox emergency funds to maintain the functioning of markets." Alternatively, he believes MMFs "should be treated as ordinary mutual funds, with redemption value reflecting day by day market price fluctuations."

These comments, from such a towering figure in the world of finance, present such a distorted picture of MMFs that they call out for a response.

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First a bit of history. In October of 1979 then Chairman Volcker, in an heroic battle against rampant inflation, changed the Fed's methodology for implementing monetary policy and took steps to curtail significantly the growth of the money supply. The result was the creation of a wide gap between market interest rates, which reached the high teens in the early 1980s, and the very low rates available on deposits from commercial banks subject to the interest rate ceilings of the Fed's Regulation Q. It was this disparity that not only caused the bankruptcy of the thrift industry, but fueled the growth of money market mutual funds as depositors sought a means of obtaining a market rate on their liquid assets. MMFs not only offered market rates on liquidity, but some offered transaction features comparable to bank demand deposits, on which the payment of interest was prohibited[1].

Because MMFs were not yet included in the Fed's basic definition of the money supply, unlike bank demand deposits, and because, unlike banks, they did not have to keep reserves with the Fed, the explosion of such funds created challenges for the Fed's conduct of monetary policy — much to the Chairman's frustration. He now characterizes the burgeoning of MMFs following the Fed's severe tightening of monetary policy as a "diversion" of demand deposits from banks, or "regulatory arbitrage." While the use of the term "arbitrage" seems intended as a disparagement or denigration of those who moved funds from banks to MMFs, it should be remembered that the term carries no moral implications. It is simply descriptive of conduct that occurs when price differences exist in different markets for identical or similar instruments, and is no more than a mechanism for insuring that prices do not deviate substantially from fair values, and that markets operate efficiently. Having created the environment for "arbitrage," in a real sense Chairman Volcker himself was the godfather, if not the progenitor, of money funds.

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. Not only are they subject to significant control, examination and oversight by the Securities and Exchange Commission, with detailed prospectus requirements for the issuance of their shares, demanding reporting requirements, regular surveillance, and substantial requirements as to asset quality and maturities, but they must

[1] Today, about a third of MMFs offer a check-writing feature.

publicly and frequently disclose the contents of their portfolios on their websites and in regulatory filings — down to the individual security level. And, of course, they 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.[2] To suggest that MMFs exist in a hidden "shadow" world simply distorts reality.

His comment that MMFs "are demonstrably vulnerable in troubled times to disturbing runs" is equally exaggerated, suggesting as it does a significant history of runs or an appreciable threat of future runs. The fact is, of course, that there was a run on MMFs in September of 2008 after the Reserve Primary Fund "broke the buck" because of the write-off of its improvident investment in Lehman Brothers debt. But nothing remotely comparable had occurred in the money fund industry in the 38 years since the Volcker-era actions had given life to MMFs. Moreover, the events of 2008 took place not merely in "troubled times," but 20 months into a financial crisis of exceptional magnitude and in the context of truly extraordinary financial disasters involving failures or forced sales of some of the country's largest financial institutions. The run that occurred — largely reflecting the uncertainty of institutional investors as to whether redemptions would be suspended or their funds would otherwise be inaccessible — has to be viewed in the context of that extreme turmoil.

Of course, no one can predict with certainty that financial Armageddon will not visit us once again, despite the best efforts of the Dodd-Frank legislation and the new Financial Stability Oversight Council – just as it is possible that two disastrous "hundred-year" hurricanes might occur within a few years of one another. But some reasonable perspective is required. Does it make sense to reengineer an entire industry, potentially destroying the utility of what has been an extremely safe, useful and efficient financial tool and imposing significant costs, disruption and inconvenience on millions of investors, because of speculation about the remote possibility that such circumstances might recur?

Moreover, the SEC's amendments to its regulation 2a-7 governing MMFs, significantly increasing liquidity requirements, have shown that the threat of runs can be significantly ameliorated with measures far short of a complete overhaul of the money fund industry. It is instructive that MMFs were able under the new rules to meet significant demands for redemptions during 2011 in

[2] Signicantly, when the Federal Reserve established its liquidity facility for MMFs in September 2008, discussed below, it was limited to asset-backed commercial paper bearing only the highest ratings.

the face of the Greek debt crisis and the downgrade of the United States' credit rating. And with new robust disclosure requirements and enhanced oversight, the regulatory environment for MMFs is materially different from what it was in 2008.

A similar exaggeration inheres in Volcker's contention that MMFs should be subject to bank-like regulation — indeed, he has suggested that the funds held by MMFs should really be repatriated into the banking system — in order to avoid the need for government to "resort to highly unorthodox emergency funds to maintain the functioning of markets." Unlike the banking system, which he holds out as the desideratum and which has been the recipient of literally trillions of dollars of government support, not a single penny of public money has been spent on MMFs.

To be sure, during the liquidity crunch of 2008 the Treasury Department created a voluntary fee-based insurance program for MMFs and the Federal Reserve made non-recourse credit available to member banks to purchase high-quality assets from money funds, which were used to collateralize the Fed advances. Fed advances, made through 11 banking organizations to 105 MMFs, peaked at about $150 billion in the first ten days of the program and tapered off and became sporadic very rapidly after that, and all of the advances were repaid in full. The insurance offered by Treasury was never drawn upon. Both programs in fact generated substantial profits for the government.

While Volcker is obviously unhappy about these programs, one should put them in perspective as well. The $150 billion in peak period Fed advances to fund the purchase of virtually riskless MMF assets, advances that substantially ran off in a very short period of time, compares quite modestly with the $700 billion in TARP funds pushed out to banks, the $1.2 trillion in Fed advances to banks outstanding in December 2008, or, as Bloomberg has recently calculated, the $7.7 trillion shoveled out by the Fed as of March 2009 to support the banking system — support that earned some $13 billion for recipient banks.

As for the MMF programs being "highly unorthodox," one might recall that in the face of the Penn Central bankruptcy in mid-1970, at a time when it became clear that the government would not guarantee Penn Central's debt and there was a concern that even "blue chip" issuers of commercial paper might have difficulty rolling over their outstanding debt, the Fed told member banks that it would provide them, at the normal discount rate, with the reserves necessary to provide credit to their customers to pay off maturing debt. Some

$500 million flowed out through the discount window in response. With Penn Central, as with the MMFs — however infrequent such events might be — the Fed was doing no more than using its statutory authority to provide liquidity in unusual and exigent circumstances.

Volcker has insisted that the price of continued existence for MMFs should be their regulation as banks, subject to bank-like capital, reserve and insurance requirements, reflecting his abiding hostility toward an industry that he views as having sucked deposits out of banks while offering services that "mimic" those of banks. When told at a recent SEC forum that there are 650 MMFs, he quipped that "this country needs — could use 650 more banks. We just lost about a thousand due to the crises . . . ."

But this desire to turn back the clock to the pre-1980 days ignores the stark realities of such a far-reaching conversion of the industry, and does not take into account the costs that would be involved in transmuting $2.6 trillion in MMF investments into bank deposits. Over $100 billion in new leverage-ratio capital alone would be required to support such an enormous volume of new deposits – a practical impossibility at a time when banks are facing diminished loan demand and significant capital demands – not to mention the vast additional costs of paying a return on such funds, of risk-based capital requirements, deposit insurance, reserves and the panoply of bank compliance requirements. Nor does it take into account the hazards of making existing banking behemoths even larger, and therefore more systemically important,[3] or the pressures that would be created for riskier lending by banks seeking to earn returns on the vast and costly volume of new deposits, or the truly monumental additional exposure to the FDIC insurance fund.[4] Even more important, it ignores the impact of such a transmutation on issuers of commercial paper, for whom MMFs have been an extremely important supplier of credit – a market in which banks have not been a significant player.

In a parting shot Volcker observes that many funds have invested in European banks "in an effort to maintain some earnings," but now "they

[3] Today the 10 largest U.S. banks account for 65% of banking assets. If as little as two-thirds of MMF investments moved into the banking system and 75% of that flowed to the ten largest banks, the concentration in those banks would increase by $1.3 trillion to 74% of total deposits.

[4] Based on the current ratio of insured deposits to total domestic deposits (approximately 65%, excluding non-interest bearing deposits temporarily insured until the end of 2012 under Dodd-Frank), an inflow of $2.6 trillion to the banking system would add about $1.7 trillion in new "permanently" insured deposits, against which the FDIC would be required to hold additional reserves (at the statutory designated reserve ratio of 1.35%) of about $23 billion (or $52 billion to meet the FDIC's internally targeted reserve ratio of 2%). As of September 30, 2011 the deposit insurance fund, only recently having emerged from seven successive quarters of deficit, stood at $7.8 billion. Simply to meet the Dodd-Frank 1.35% minimum reserve target for the current amount of permanently insured deposits by the statutory deadline of September 30, 2020, the fund would need an additional $68 billion. Any notion that the fund could feasibly add still another $23 billion to this shortfall, to accommodate an inflow of MMF balances, requires a willing suspension of disbelief.

are actively withdrawing those funds adding to the strains on European banking stability." Unburdened by any facts relating to the identities, strength or creditworthiness of these banks, or the magnitude of their exposures to troubled economies, let alone funds' detailed credit work and investment experience, the comment reflects a kind of xenophobia – "European" is clearly meant to be understood as a euphemism for "high risk." And while the funds' reduction or shortening of these investments might have been praised as an exercise of prudent risk management by conservative fund managers concerned about global bank exposure to the Eurozone, he turns this fact into the "Catch-22" comment that the funds have simply put added strains on the stability of the issuing banks.

Finally, Volcker argues that if nothing else is done and MMFs continue business as they have been doing, they should be treated "as ordinary mutual funds," with redemptions at a net asset value that reflects "day by day market price fluctuations." While he does not explain how a floating net asset value would be a substitute for all of the other remedies he proposes, it can be assumed that he is reflecting the folklore that a floating NAV would deter or dampen "runs." But that folklore ignores the fact that 30 million investors have put their liquid funds in MMFs precisely because of funds' long history of dollar-in-dollar-out treatment. Systems constructed for the management of millions of brokerage and trust accounts, as well as innumerable cash management programs, have been calibrated on the assumption of a stable NAV, and both investors and money managers have recognized that, notwithstanding the Reserve Primary Fund experience, MMF credit risk is not a significant concern.[5]

They also appreciate, I believe, that while short-term interest rate fluctuations might potentially affect the value of their shares, funds have been very successfully managed to minimize the impact of these fluctuations. What attracts investors to MMFs, in addition to their record of being far safer than uninsured bank deposits, is the convenience and predictability of the stable NAV for liquidity and cash management uses. Those who believe the myth that a floating NAV would do away with runs should ponder what the average fund shareholder would be likely to do either when such a change was announced, or when their fund first broke the buck with a downward adjustment, or when a downward adjustment might be anticipated. Indeed, the experience of 2008 itself demonstrates that it was the mere anticipation of a breaking of the buck that caused institutional investors to flee.

[5] **Even in the watershed case of the Reserve Primary Fund shareholders lost less than one cent per share following the Lehman write-off.**

Quite apart from the misguided notion that a floating NAV would dampen runs, it would clearly do nothing to ameliorate the kind of liquidity crunch that occurred in 2008. If at some future time, in an environment of financial Armageddon, a money fund were to experience a default comparable to that experienced by the Reserve Primary Fund, even shareholders in variable NAV funds might be inclined to scramble to higher ground unless there were adequate assurances of fund liquidity. This simply underscores the conclusion that those who busy themselves with inventing new ways to reengineer the industry would do better to focus on means for assuring the availability of abundant liquidity in times of extreme stress.

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