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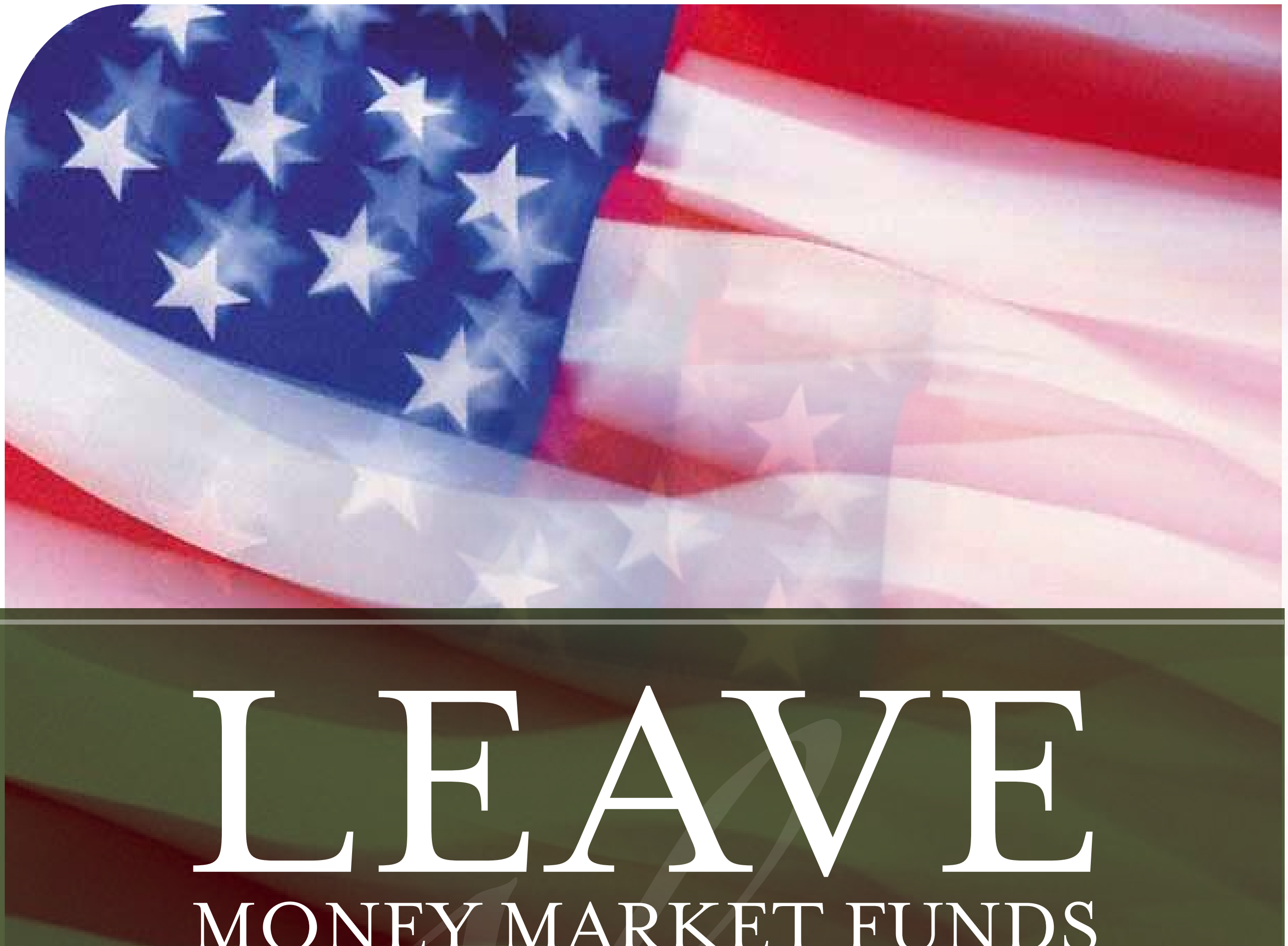

LEAVE MONEY MARKET FUNDS ALONE!

BY JOHN D. HAWKE, JR.

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There is an unseemly — and entirely unwarranted — amount of bashing of money market mutual funds (MMFs) going on in Washington and Academia these days. Unseemly because much of it is uninformed and wrongheaded, and unwarranted because MMFs do not present a threat to our economic health that the bashing would imply. The “remedies” that the bashers would propose would not only threaten the continued viability and availability of MMFs, but could themselves have unintended consequences that would be harmful, such as the constriction of short-term credit to businesses and state and local governments.

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The genesis of this clamor traces back to the experience of the Reserve Primary Fund in September 2008. In an effort to increase the yield of the fund, and thereby to attract new investors, the managers of the Reserve fund imprudently invested heavily in paper issued by Lehman Brothers. When Lehman failed, the fund "broke the buck" — that is, its net asset value dropped below $1.00. When the dust settled fund shareholders lost less than a penny on the dollar.

Under normal circumstances such an inconsequential loss would not have been a matter of great concern, although in the history of MMFs there have only been two occasions on which a fund has broken the buck. But in the Reserve case, occurring in the midst of much broader financial turmoil, when some of our largest institutions were on the brink of failure, many investors were spooked and ran for the exits. As a result, MMFs were faced with severe liquidity pressures, which were eased when the Federal Reserve and the Treasury stepped in with programs to liquefy MMF assets—assets that inevitably would have paid off at par within a very short period of time. Indeed,

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it was precisely because these assets were “money good” that neither Treasury nor the Fed took any losses on these programs. On the contrary, they made substantial profits.

In other words, it was not widespread credit deterioration that caused the problem — MMFs have had an excellent record of creditworthiness — rather it was a liquidity crunch that threatened MMFs with losses on otherwise perfectly good assets simply because of the volume of redemptions.

The Federal Reserve has been in the forefront of the attack on MMFs, labeling them as unregulated and unsupervised “shadow banks.” — somewhat ironically, since it was the Volcker-era Fed that really gave life to MMFs by driving market interest rates up in the neighborhood of 20 percent at a time when Regulation Q severely limited the rates that banks could pay on deposits. The latest salvo from the Fed came in a speech on September 29 by Eric Rosengren, President and CEO of the Federal Reserve Bank of Boston. Rosengren and other clamorers espouse fundamental changes to the structure and regulation of MMFs, including abandonment of the stable $1.00 per share net asset value (NAV), and a new subordinated capital buffer to protect fund shareholders.

Those arguing for these changes have not only failed adequately to assess the consequences of such changes, but seem also to be uninformed as to the changes in MMF regulation and oversight that have been put into place by the Securities and Exchange Commission, and the recent experience demonstrating the efficacy of those changes.

The future of the structure and regulation of MMFs is an important issue, and radical change should not be undertaken lightly or without searching examination of the potential consequences. Over 30 million investors, with investments in excess of $2.6 trillion, have chosen to use MMFs as a safe, convenient, efficient and predictable means of holding their liquidity. They have consciously chosen MMFs over banks, not merely because of higher yields and the absence of prepayment penalties, but because they believe that MMFs are a lower risk investment, particularly in denominations in excess of federal deposit insurance limits. They value the constant NAV, notwithstanding prospectus disclosures that $1.00 per share is not guaranteed, as well as the ability to convert their investment into cash virtually immediately.

Similarly, issuers of short-term debt and commercial paper, including businesses and state and local governments, see MMFs as an efficient and low-cost provider of debt financing—a facility that banks have not typically provided. Indeed, MMFs that invest solely in Treasury securities are an important outlet for U.S. government debt.

It is no wonder that many borrowers and investors have a favorable view of MMFs as compared to banks. Banks have overhead costs — principally occupancy and staff expense — that are more than 2 % higher per year per dollar of assets than the operations costs of MMFs. The efficiency of MMFs is reflected in higher returns to their investors and lower interest charges for issuers whose paper is held by MMFs as compared to bank depositors and borrowers. This was demonstrated recently when some banks began turning away large new institutional deposits, or charging customers for the privilege of making deposits rather than paying interest, because the banks had no ready means to invest the cash profitably after taking into account their high cost structures. If MMFs disappeared and were fully replaced by banks, the higher cost of borrowing would translate directly into less economic growth, fewer jobs, and less money available for state and local governments to provide services.

In addition to their inefficiency, banks are much riskier than MMFs. Over the 40 years that MMFs have existed, more than 2800 banks have failed at a cost of over $188 billion to the federal government, while only two MMFs were unable to meet shareholder redemption requests at 100 cents on the dollar (one paid 96 cents and the other over 99 cents on the dollar to its shareholders at no cost to taxpayers). The Fed's suggestion that it could do a better job than the SEC at regulating MMFs is rather overinflated and not supported by their failed efforts at regulating banks. The plain facts are that the MMF industry has not cost the government a single penny, and losses to investors have been virtually imperceptible.

MMF critics at the Fed and in some corners of academia nevertheless argue that something must be done. They have proposed that MMFs be required to abandon the constant $1.00 NAV and move to a floating NAV, and they have also proposed that MMFs maintain a capital "buffer" that would absorb the first losses on the MMFs portfolios. The premise behind both proposals is that they will prevent "runs" — the rapid withdrawals of large amounts of MMF balances — in the event of a new financial crisis.

But logic and evidence compel a contrary conclusion. In the first place, the very announcement of a regulatory requirement of a floating NAV would likely cause runs, as investors who are prohibited from investing in floating NAV funds, and those who want the predictability and convenience of a fixed NAV, headed for the doors. Moreover, even if such a change were put in place, any downward movement in the NAV would threaten the prospect of increased redemptions.

The experience in Europe, where there are floating NAV funds, is informative. During the 2007-2008 financial crisis, floating NAV MMFs experienced rapid shareholder withdrawals very similar to those seen at fixed NAV MMFs. While floating NAVs do not prevent investor runs, they can be useful when a fund is under severe stress in order to assure that all redeeming investors get paid the same amount and that redemption requests continue to be honored, even if at a reduced price. The SEC's Rule 2a-7 already provides for this. MMFs are required by that rule, as amended by the SEC in 2010, to monitor the market values of their portfolio assets, and if market prices of portfolio assets do not support the continuation of redemptions at a stable $1 per share NAV, funds must immediately switch to a floating NAV and continue honoring redemptions at reduced prices.

Those who argue that MMFs should be required to have a capital "buffer" are similarly off the mark. In the first place, in order to attract such risk capital MMFs would have to pay a risk premium that would inevitably diminish the yield to the primary fund shareholders, making an MMF a much less attractive investment vehicle. Moreover, since credit losses have not been a significant concern for MMFs, given the requirement that they invest only in high quality, short-term assets, this reduction in yield would not serve a useful purpose. In particular, it would be highly unlikely to dampen runs, and it would do nothing for liquidity. Rather, it would simply create an advance warning for shareholders to redeem their shares as soon as possible, before the buffer was exhausted, and would thus increase the risk of shareholder runs rather than reduce it. .

Mr. Rosengren asserts that the "absence of capital, together with the stable net asset value, results in a structure [for MMFs] that … is prone to shareholder 'runs' during times of financial stresses." But neither a capital "buffer" nor a variable NAV will stop runs. It is the availability of liquidity that will deter runs or allow an MMF to cope with a run. The clamorers have failed to recognize that the need for liquidity, not protection against credit losses, should be the foremost concern.

The SEC recognized this when it amended its Rule 2a-7 in 2010 to increase fund liquidity quite substantially. MMFs now must hold at least

10% of their assets in overnight cash and 30% in assets that mature within one week. In addition, the rule now requires MMFs to consider potential redemption levels and hold even more cash if needed to meet anticipated redemption needs. In fact, most MMFs now hold cash and near-cash items well above the 10% and 30% minimums. Of the $2.6 trillion in assets presently held by MMFs, over $260 billion is in overnight cash and roughly $800 billion or more must have a maturity that permits it to be converted to cash within one week.

Recent experience demonstrates that these new requirements have been very effective in meeting unusually large requests for redemptions. In June, late July and early August of this year, MMFs experienced dramatic shareholder redemptions as investors reacted first to the Greek debt crisis and later to the U.S. federal budget impasse. In June and July, investors redeemed over 10% of their prime (taxable non-government) MMF investments, a total in excess of $167 billion. Some prime MMFs experienced redemptions of between 20% and 45% of their assets. Much of the redemption activity was in short bursts around the key events of each financial episode. Yet no MMF broke a buck, none faltered or was unable to meet redemption requests, and everything went smoothly. The key reforms adopted by the SEC in 2010, which shortened MMF maturities, increased cash holdings and portfolio diversification, and improved credit quality, worked effectively and exactly as intended.

But the changes wrought by the amendments to Rule 2a-7 are only half the story on the new ways in which the SEC supervises and regulates MMFs. In 2010, the New York Fed published a staff paper that called on the SEC to significantly enhance its monitoring of MMF portfolios and to look for red flags indicating possible future trouble, such as unusually high yields and fast growth. In fact, the SEC now does exactly that. Analysts within the SEC now pore 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, except they are using real-time information on MMF portfolios that is much deeper and more transparent than anything available to bank regulators retrospectively on illiquid, unmarketable and very opaque bank assets.

In his recent remarks, Mr. Rosengren comments that under the new requirements, MMFs must report portfolio data to the SEC monthly, which he says somewhat puzzlingly would allow MMFs to engage in "window dressing" — a practice with which bank regulators are familiar, where a bank significantly lowers its debt prior to a quarterly call report in order to hide portfolio and leverage risk from regulators, shareholders and analysts. What Mr. Rosengren does not seem to be aware of, however, is that while MMFs file their reports monthly with the SEC, those reports include weekly data. To engage in window dressing, a MMF would need to turn over their portfolios at least twice per week to hide risky assets. And, unlike banks, MMFs do not borrow money, but instead are financed entirely by the equity capital of their shareholders. The size of an MMF's balance sheet is dictated by the number of shares that investors buy or redeem, and MMFs cannot expand and contract their balance sheets using borrowed money between reporting periods. In addition, *daily* asset size data are submitted by most MMFs to publications (such as iMoneyNet and Crane's) and are available to regulators and the public. Thus, it is fanciful to suggest that MMFs might engage in window dressing—which is, after all, a form of securities fraud.

The SEC has made dramatic enhancements to its rules and its methods of supervising MMFs since 2008. The SEC continues to refine its methods and requirements from the hard lessons of experience and from careful analysis of financial and economic data. The SEC's program for supervising and regulating MMFs is robust. Its track record with the stability of the MMF industry is far better than the Federal Reserve's track record in maintaining the solvency of banks, where reliance is put on the express promise of a federal guarantee and the deep pockets of the Federal Reserve and FDIC to maintain the solvency of the system. Replacing the SEC's current successful program of MMF regulation with an untested variation of the failed model of bank regulation and capital structure will not enhance the stability of MMFs or our financial system. It would make MMFs and our economy less efficient, riskier and more volatile.

At a time when markets are extremely skittish, reacting with wild volatility to the latest news reports, it would be foolhardy—certainly in the absence of the most compelling evidence of need and a deeply informed assessment of the consequences—for policymakers to take action that could send the erroneous message to investors that MMFs pose serious threats. The SEC has done a conscientious and effective job of overseeing the money fund industry, and the recent changes to its regulations, together with its substantially enhanced oversight, are all that is called for at the present. The clamorers should leave money funds alone, and be guided by the maxim “Do No Harm.”

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