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Statement No. 329

Franklin Edwards
917 921 4050

Statement of the Shadow Financial Regulatory Committee

Financial Stability and the Regulation of Money Market Mutual Funds

September 24, 2012

A few weeks ago, Chairman of the Securities and Exchange Commission (SEC), Mary Schapiro, announced that the SEC would abandon its effort to impose new regulations on money market mutual funds (MMMFs) because three of the five SEC Commissioners refused to support the proposed regulations. Chairman Schapiro had proposed two major reforms directed at preventing the re-occurrence of the kind of destabilizing “run” on MMMFs that was precipitated by institutional investors in 2008 after the collapse of Lehman Brothers. The first would have replaced the fixed $1 net-asset-value (“par value”) accounting rule now used by MMMFs with the requirement that MMMFs report their fund values at actual net-asset-value (NAV), or by using standard NAV accounting rules like all other mutual funds. The second reform would have imposed a regulatory-determined “cash reserve” on fund sponsors if their funds opted to continue to report fund values at the stable $1 value.

In response to the “run” on MMMFs in 2008, and the subsequent intervention of the federal government to provide a “temporary” guarantee of the par value of all pre-existing MMMF balances, the Shadow Financial Regulatory Committee (SFRC) proposed, in two prior statements, regulatory reforms similar to those recently considered by the SEC. The SFRC sees no reason now to abandon its previous MMMF proposals or not to support the recent proposals advanced by Chairman Schapiro.

In the first Statement (No. 309), issued on February 14, 2011, the SFRC highlighted the failure of MMMFs to use traditional NAV accounting as a significant cause of the “run” that occurred, concluding that “… if [MMMF] valuations were marked to market immediately using the full NAV approach – as required for other types

of mutual funds – this type of run would not have occurred ….” We also emphasized that the federal government's intervention in 2008 to stem the run on MMMFs "…represented a new major federal commitment, and left little doubt that in the event of another fund crisis the federal government would step in to protect MMMF investors." The Statement concluded:

> "… this extension of the federal safety net would be unnecessary if the SEC shifted to the floating NAV model for institutional money market mutual fund products. The relative sophistication of wholesale investors (compared to their retail counterparts) and their heightened tendency to run, as reflected in the 2008 crisis, would be greatly moderated. In fact, adhering to the semi-guaranteed par asset value arguably suggests that money market mutual funds should be regulated as banks. It may also be time to rethink our regulatory approach to retail MMMFs."

In the second Statement (No. 325), issued on February 13, 2012, the SFRC expanded its previous proposal to encompass four additional aspects:

> "1. Apply the proposed floating NAV model to retail as well as institutional MMMFs;
>
> 2. Permit MMMFs to be exempt from this floating NAV model if they are sponsored by fund companies that provide an explicit contractual guarantee to investors in these funds that their MMMF investments will be redeemed upon demand and at par value (a fixed $1 net-asset-value model);
>
> 3. Impose capital and liquidity requirements on fund companies that sponsor 'guaranteed' MMMFs (similar to what the SEC is contemplating); and
>
> 4. Mandate that all MMMFs publicly disclose sufficient information to assure that all MMMF investors are aware of and understand the differences between 'sponsor-guaranteed' MMMFs, MMMFs that operate under the floating NAV model, and FDIC insured bank deposits."

These proposals are similar to those recently advanced by Chairman Schapiro. Notwithstanding the failure of the SEC Commission to adopt these proposals, Chairman Schapiro's proposals still enjoy widespread support among many informed parties -- the White House, Treasury officials, the Federal Reserve, the Bank of England, The Wall Street Journal editorial page, the former Federal Reserve Chairman Paul Volcker, the former Treasury Secretary Henry M. Paulson Jr., and a diverse group of academics.

The main arguments against adopting the SFRC's or the SEC's proposed regulatory changes is that they will impose higher costs on fund sponsors and make MMMFs less attractive to investors, resulting in the shrinkage of the MMMF industry. In particular, it is argued that if net-asset-values were permitted to float, investors would be deterred from using MMMFs because of the added risk of incurring a loss due to changes in a fund's net-asset-values. Or, if fund sponsors were required to hold more capital (or liquidity) they would incur additional costs that would have to be passed on to investors in the form of lower yields on MMMF shares.

The SFRC does not find either argument compelling. Current regulatory policy provides an implicit government guarantee of the par value of all MMMF assets. This is not costless; we, as taxpayers, must assume the risks (costs) associated with the government providing "par value" insurance to the MMMF industry. Further, by providing free par value

insurance to the industry, the government in effect is extending a subsidy to both MMMF investors and the MMMF industry, which has undoubtedly led to a greater demand for MMMF shares and a larger MMMF industry than would have otherwise occurred. Thus, the fundamental issues are: should there be a government guarantee of the par value of MMMF assets, and, if there is, who should bear the costs associated with this guarantee – taxpayers, MMMF investors, or the MMMF industry?

The SFRC strongly believes that there should not be a government guarantee of the par value of MMMF assets. The likely effect of this guarantee would be to enlarge the already too large social "safety net" and increase moral hazard, resulting in an increase in systemic risk. Further, to the extent that regulatory policy continues to permit the par value "fixing" of MMMF assets, the SFRC believes that the costs of providing this guarantee should be shifted from taxpayers either to MMMF investors, or to fund sponsors, or to both.

Runs on MMMFs may be caused by (1) the opportunity for early withdrawals at par to avoid portfolio losses already incurred, (2) the failure of an issuer or fund which reveals new information about possible losses in other MMMFs, and (3) a general panic about possible MMMF losses in a time of economic turbulence.

A daily floating NAV fully resolves the first of these, but may only partially address the others. Both the SFRC's and Chairman Schapiro's proposals to adopt a policy of a floating NAV for MMMFs will desensitize investors to small changes in the value of MMMF assets, so that they will not "run" on MMMFs whenever there is a risk of loss due to changing asset values.

Requiring investors to internalize this risk appears to work well for the majority of mutual funds, which, unlike MMMFs, do not use a par value NAV model. (At year-end 2011, seventy-seven percent of all funds invested in mutual funds were held by mutual funds that did not use a par value NAV model.) Requiring fund sponsors to internalize the risk of a "run" by holding additional capital to meet such a threat will provide an incentive for fund sponsors to adopt more appropriate liquidity and portfolio strategies, and will reduce investor incentives to "run" because they will have greater assurance that fund sponsors will be able to meet withdrawal demands.

Finally, the SFRC also believes the adoption of either our proposals or those advanced by Chairman Schapiro would be superior to the alternative regulatory approaches mentioned in recent news articles, such as designating either large MMMFs as "systemically important financial institutions" or the entire MMMF industry as a systematically important industry.

Peter Wallison abstains from this statement.