SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 275

For Information Contact:

Chester Spatt
412.268.8834

Statement of the Shadow Financial Regulatory Committee on

Strengthening the Resiliency of Money Market Mutual Funds

September 14, 2009

One of the unanticipated consequences of the Lehman Brothers bankruptcy fifty-two weeks ago was that the Reserve Fund, the oldest institutional money market fund, which held a substantial amount of defaulted Lehman Brothers commercial paper, was forced to "break the buck" under Securities and Exchange Commission (SEC) rules for money market funds. In contrast to other mutual funds, money market funds maintain a fixed value of $1 per share, based upon the value of their holdings. When the market value of the underlying holdings deviates by more than ½ percent of the $1, then the fund is forced to change its price and "break the buck." This sets up an incentive for fund investors to redeem their shares at $1 before the fund is re-valued, which would create a run. The collapse highlighted the fragility of the current system for valuing money market funds. Doubts about the ability of other funds to maintain their $1 value spread to institutional money market funds and even affected retail funds. In order to meet the demand for redemptions, funds were forced rapidly to liquidate their assets, including commercial paper. In turn, this led to the temporary freezing up of the commercial paper market, which is one of the primary funding mechanisms for corporate America.

Federal authorities felt pressured to take extraordinary actions with regard to this run. The Treasury guaranteed the full amount of money market fund holdings as of the time of the collapse. The Federal Reserve created a special facility to support the commercial paper market. Further, in response to complaints by the banks that the Treasury guarantees created an unfair comparative advantage for money market mutual funds, the FDIC increased deposit insurance from $100,000 to $250,000. These extraordinary actions have caused policymakers to reconsider the structure of money market funds as presently constituted. These actions have led to a general expectation that in future emergencies the federal safety net again will be extended to cover money market mutual funds. Indeed, Paul Volcker has argued that if the current structure is maintained, then money market funds should be regulated as banks because they were being used as substitutes for bank deposits.

Extension of the federal safety net during a crisis to prevent runs entails very large potential costs to taxpayers. The incentives for a run and the associated costs of the safety net could be removed in at least two alternative ways: First, the convention of maintaining a stable valuation could be dropped. Instead, the portfolio could be fully marked to market each day, just like other mutual funds. This would limit the financial advantage of withdrawing funds prior to other shareholders. Second, the asset composition of money market mutual funds could be further constrained to reduce the probability that they would be forced to break the buck.

The SEC has advanced a proposal along the latter line. The proposal would restrict the risks taken by money market funds with regard to liquidity, duration, and credit quality. The liquidity restrictions would require retail money market funds to maintain at least 5% of their assets in cash or cash equivalents and at least 15% must be convertible to cash within one week. For institutional money market funds, the corresponding figures would be 10% and 30%. Currently, rule 2a-7, which governs money market mutual funds, contains no liquidity requirements. The proposal would also shorten the average maturities allowed to 60 days, down from the current limit of 90 days, which would reduce exposure to interest rate risks. The proposal would limit money market funds to investing only in very high quality securities (currently most funds are permitted to invest up to five percent of their assets in lower quality securities) as judged by the rating agencies.

To ensure that these constraints have the desired effect, fund managers would be required to run periodic stress tests designed to evaluate the fund's ability to maintain a stable net asset value in the event of shocks such as interest rates changes, higher redemptions, and declines in the credit quality of the portfolio. The proposal also would require the money market fund to post its portfolio holdings on its website monthly rather than quarterly and to report these holdings to the SEC the holdings in a format that could be used to create an interactive database. These reports would allow the SEC to evaluate the likelihood that several funds might experience similar shocks at the same time.

The Committee has a number of concerns about the proposal as currently constituted. One important concern is that restricting the permissible maturities, liquidity, and quality of a fund's portfolio would greatly reduce the market for commercial paper. The proposal does not address the fundamental vulnerability of money market mutual funds, i.e., that the market value per share can differ from the stable value of $1, due to credit and interest rate losses. While the restrictions reduce the risk of a deviation, they do not eliminate it. However, the Committee supports the notion of building a database that would enable the SEC to identify highly correlated risks facing money market mutual funds.

More importantly, the Committee views the proposal as disappointing in further increasing regulatory reliance upon ratings and a departure from an earlier SEC proposal striving to reduce the reliance on credit ratings in the regulatory process more generally.

We feel that outsourcing credit quality judgments to the ratings organizations increases the likelihood of highly correlated portfolio changes and outsources what should be a primary function of the investment adviser. The SEC also has posed the issue of whether to maintain the stable $1 value, while disclosing the shadow market value. This price signal could provide an additional source of discipline on management contemplating operating the fund in ways near breaking the buck and also would level the playing field for less sophisticated investors compared to more sophisticated investors.

We think that encouraging at least institutional money funds to sell and redeem shares at actual market values rather than a fixed $1 price deals effectively with the fundamental motive for a run and will generally lead to relatively stable values for portfolios following current Rule 2a-7. We encourage the Commission to allow this accounting procedure for institutional funds and, if it proves successful, then to extend it to retail funds. Ultimately, this could be the best way to shore up the stability of money market mutual funds and avert the temptation to again extend the federal safety net to this important sector.