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Preserving the Value of Money Market Funds for Investors and the Economy

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Money Market Expo

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As prepared for delivery.

Good morning. Thank you, Brian [Kalish, co-chair of conference], for that introduction and your warm words. I'd also like to thank iMoneyNet for giving me the honor of delivering the keynote to your conference today.

The Money Market Expo is in its 14th year, and has grown tremendously in that time. It serves a wide range of participants in the money market—treasurers, cash managers, issuers of money market securities, and, of course, money market funds.

You all are here because you recognize the vital role that the money market plays in fueling the American economy. Last month, I appeared on a panel with the treasurer of FMC Corporation, who described the delicate balance of investing and borrowing to meet FMC's daily cash needs as managing "the lifeblood of our company."

Whether you represent a company or a city government, a university or an insurance company, a pension plan or a brokerage, you know how vital the role of cash management is in your operations. Cash is truly the lifeblood of our economy—and the money market is the circulatory system. Indeed, America's economy today quickly would cease to function without a steady, efficient flow of liquid resources from investors to issuers and back again.

Money market funds are a crucial component of this market. Cash managers who need to balance daily income and outflow tell us that money market funds offer greater flexibility, diversification, and liquidity than either bank products or direct investments in money market instruments.

For 56 million individual investors, money market funds offer the *only* way to achieve a current money market yield and the safety of a diversified, professionally managed portfolio. Since 1990, retail investors have earned $242 billion more in returns from money market funds than they would have earned in competing bank products.

And the $2.7 trillion entrusted to money market funds is put to valuable uses throughout the economy—financing commercial paper, short-term municipal debt, asset-backed commercial paper, bank CDs, Treasury bills. In short, money market funds help keep the lifeblood of the economy flowing.

The question we face today is: Do we preserve the vital role that money market funds play? Will money market funds continue to serve investors and the economy?

As you all know, the Securities and Exchange Commission [SEC] has signaled its plans to unveil soon a set of structural changes to money market funds. These proposed changes may take one of two courses.

In the first option, money market funds will lose their stable $1.00 per-share value and will be forced to "float."

In the second, they will be subject to a complicated regime of capital buffers and redemption restrictions.

In either case, investors tell us that regulators will have crippled the very features that make money market funds so valuable to users as cash management tools.

The result is predictable—investors will reduce their use of money market funds, or abandon them altogether. And when that happens, the flow of finance through the money markets, that lifeblood for the economy, will be disrupted, creating a market with higher costs and *more* systemic risk—at great cost to investors and the economy.

Scores of organizations—representing corporate treasurers, finance officials from state and local governments, nonprofits, financial advisers, and individual investors—have written to the SEC warning of the consequences of misguided changes for their finances and for the economy. Many of you here

may have weighed in—and if you haven't, I hope you will.

In the fund industry, we have spent countless hours in recent years trying to help regulators find ways to make money market funds more resilient in the face of adverse markets.

We are confident we achieved that goal in 2010. With the fund industry's strong support, the SEC adopted rule amendments that raised the credit quality, shortened the maturity, enhanced the transparency, and increased the liquidity of money market fund portfolios.

These reforms were tested in the troubled markets of the last year—and they passed with flying colors. Thanks to the 2010 amendments, money market funds are stronger today—and today's money market fund is a very different product from its 2008 predecessor.

Money market funds in fact were the first component of the financial system to see comprehensive reform after the crisis. The SEC strengthened money market funds *six months* before the Dodd-Frank Act was passed—and, at the current rate, years before Dodd-Frank's rules will go into effect.

And these reforms were the first to be tested, and the first to succeed. By any measure, this is a great achievement.

The SEC should be proud that it achieved so much, so quickly, to strengthen money market funds—without undermining their core principles or their role for investors and the economy.

U.S. financial regulators should take credit for this success. Few do.

Instead, SEC Chairman Mary Schapiro pre-judged the force of the 2010 amendments. Even before voting on them, she declared that regulators wanted a "Round II" of "structural changes" to money market funds.

Two years later, as we see the SEC's trial balloons, we're discovering that "structural change" means proposals that will undermine the core features of money market funds and their value to investors and the economy.

The fact that the power of the 2010 reforms is not acknowledged—that's disappointing.

Even more troubling are the arguments that critics use to justify changes that clearly will undermine the value of money market funds to investors and the economy. The debate around money market funds is riddled with myths and misstatements.

There are at least three big myths at the heart of the case for "reforming" money market funds.

First, there's the myth of 2008—the notion that money market funds somehow caused or accelerated the financial crisis. That's a false narrative, and it's the source of a great deal of mischief.

The myth of 2008 feeds another misconception—the myth that money market funds are "susceptible to runs" and likely to trigger systemic risk.

And in the hands of some commentators, these first two myths fuel a third. That's the notion that banks offer the superior model for all financial activities and that capital market institutions like money market funds are really "shadow banks." This myth leads to proposals to impose bank-style regulation on money market funds.

Take these three myths together, and we end up where we are today—rushing headlong into unnecessary, flawed, and harmful regulatory changes.

I'd like to take some time today to set the record straight. It won't be easy, because these myths are deeply embedded. But I'll try.

Before I tackle the myths, let's start with a fact that *all* policymakers should acknowledge at the outset—the proven success of the 2010 amendments.

The SEC's amendments redefined what it means to be a money market fund—and the new model for these funds is far stronger and more resilient.

Remember what these amendments did:

- They shortened the maximum weighted average maturity of money market funds from 90 days to 60 days.
- They instituted more frequent portfolio disclosures by funds, including monthly reports of portfolio holdings and mark-to-market values.
- They raised the credit quality of the securities money market funds were allowed to hold.
- For the first time, the rule amendments set explicit standards for the liquid assets funds must hold—backing up those minimums with know-your-investor requirements and portfolio stress-testing to ensure that liquid assets are sufficient to meet expected redemption demands.
- *And* the rule amendments gave fund boards the power to assure a fair and orderly liquidation of a money market fund, should that be necessary.

As Fidelity Investments pointed out in a recent analysis, the industry's required weekly liquidity, at almost $800 billion, is more than five times the industry's peak borrowing from the facility created by the Fed to support commercial paper during the crisis. And the industry's *actual* weekly liquidity at the end of January was 40 percent above the requirements.

As it happened, we didn't have to wait long to put these reforms to the test. Last summer, financial markets were rattled by three significant events:

- The eurozone struggled to get ahead of the growing possibility of a Greek sovereign debt default.
- The U.S. Congress waited until the eleventh hour to increase the U.S. debt ceiling.
- And then, shortly afterward, Standard & Poor's downgraded the rating of U.S. government long-term debt.

At ICI, we monitored these challenges closely. And we fielded constant questions, fueled in no small part by statements from Federal Reserve officials, about whether these events would put money market funds at risk.

Well, what happened?

Money market funds did indeed see large redemptions. From early June to early August, investors withdrew 10 percent of their assets from prime money market funds—$172 billion in all. In fact, during the debt-limit showdown at the end of July, even government funds were affected. Together, prime and government funds saw an outflow of $114 billion in just four trading days.

One recent academic paper called the outflow from prime funds a “silent run.”

Now *there’s* an oxymoron—like a “routine emergency.” You have to wonder: If a “run” is so silent that no one can tell it happened—if it has no spillover effects on the broader markets—why does it matter?

In fact, while the eurozone and U.S. debt crises certainly took their toll on equity and fixed income markets, the withdrawal from money market funds had *no* discernable effects *at all*—either on the funds or on the markets. Consider this: from April through December, prime money market funds kept their daily liquidity at more than twice the required level, and weekly liquidity stayed one-third to one-half *higher* than the standard.

Did the redemption pressure put any funds at risk of breaking the dollar?

We’ve examined the portfolio data that all money market funds now are required to file with the SEC for public release. Among the prime funds with the greatest exposure to European financial institutions, the average mark-to-market price of their portfolio fell by nine-tenths of a basis point.

Let me see…on a $1.00 fund share, that’s a dollar sign followed by 0-point-0-0-0-0-9.

Right. Nine one-thousandths of a penny.

Put it another way—that change wouldn’t move the value of a share priced at $1.00, and it wouldn’t move the value of a $10 share. It would move the value of a share priced at $100—by one cent. We can’t call that breaking the buck—so I guess we’d have to call it “breaking the Benjamin.”

So—have the 2010 amendments been tested? Yes.

Have they made money market funds more resilient in the face of crisis? Yes.

Have they made investors more secure, at a reasonable price? Yes.

Are the new rules a success? Most emphatically—yes.

Indeed, I would go further. I would argue that the 2010 amendments are the latest chapter in one of the great success stories of modern financial regulation. Throughout the history of money market funds, the SEC has carefully crafted rules that balance these funds' competing objectives of convenience, liquidity, and yield. Under this regulatory regime, money market funds have flourished and innovated—to the great benefit of investors and the economy.

Yet regulators are not content. Despite the proven success of the 2010 reforms, SEC Chairman Mary Schapiro insists that the financial system is "living on borrowed time" because money market funds have "structural risks."

How do the SEC and other regulators justify such statements?

This is where the first of the three myths come in—the false narrative of 2008 that holds money market funds responsible for accelerating the financial crisis.

Let's all go back, in our minds, to Sunday, September 14, 2008. Yes—I know it's painful. But it will be instructive.

The worst financial crisis since the Great Depression was raging. In the prior 12 months, at least 13 major U.S. or European financial institutions had declared bankruptcy, been taken over, or received significant government or private help to survive—names like Citigroup, Northern Rock, and, of course, Bear Stearns. That count includes Fannie Mae and Freddie Mac, which were placed into government conservatorship on September 7. I'm sure you can all recall those anxious Monday mornings when we woke up and turned on the television to find out whether the latest candidate for failure had indeed been rescued.

On Sunday, September 14, the government abruptly broke that pattern and refused to rescue Lehman Brothers. And on September 16, the Reserve Primary Fund, which had invested in Lehman Brothers' paper, failed to maintain its $1.00 per-share value. It broke the dollar.

What happened next? According to Chairman Schapiro: "when the Reserve Primary Fund broke the buck…it set off a run so serious that the federal government was forced to step in and guarantee the multi-trillion dollar industry."

That's the conventional wisdom. But let's think about that narrative.

It's true that prime money market funds were hit by a strong wave of redemptions—about $300 billion in the week that Lehman failed. And these flows were destabilizing. The government's responses, designed to restore confidence and inject liquidity into the money market, were justified.

But it's also true that for every dollar that left prime funds, 63 cents flowed *into* Treasury and government funds. In fact, when you look at all taxable funds—combining prime, Treasury, and government—total assets were down by only 4 percent during the week of September 15.

Investors did not abandon *money market funds*. Instead, an equally plausible explanation for these flows is that investors were reacting to their concerns about the financial health of U.S. banks, the U.S. government's unpredictable response to financial institutions' collapse, and concerns about whether prime funds could continue to sell assets into the frozen commercial paper market.

As you might predict, under those conditions, investors sought the refuge of U.S. Treasury securities. And they chose money market funds as their vehicle.

The events of 2008 are used to justify the notion that money market funds are fragile teacups, likely to shatter at the slightest touch of trouble. You all know that they're not—but you can't tell that from the media commentary around this issue.

In fact, it took a tremendous financial shock to cause one prime fund to break, and others to suffer heavy outflows.

Consider again the environment of September 2008.

Federal authorities had just upended investor expectations of how they would handle failing banks. They then reversed themselves again with the extraordinary $85 billion rescue of AIG.

In the turmoil, *banks* were refusing to lend to *each other*, even overnight. Corporate treasurers were desperate to get their cash to safety—even if that meant getting out of the commercial paper market.

I submit to you—in that environment, outflows from prime money market funds were inevitable.

Critics like to talk about the "contagion" unleashed by Reserve's failure.

In fact, Reserve only failed in the *middle* of a raging epidemic.

Nonetheless, the false narrative of 2008 fuels the second myth of this debate—the idea that money market funds are "susceptible to runs."

I'll quote Chairman Schapiro again. She says: "Funds remain vulnerable to the reality that a single money market fund breaking of the buck could trigger a broad and destabilizing run."

I wanted to be on solid footing here, so I took out my dictionary. It says that the word "vulnerable" means…"susceptible."

So I looked up "susceptible." That means "easily influenced…likely to be affected."

That certainly doesn't describe money market funds. They are *not* "easily" broken. Nor are they "likely to be affected" in a significant way outside of extreme market conditions.

We all know that, in the first 25 years after Rule 2a-7 was adopted, exactly one money market fund broke the dollar, in 1994.

This is a sophisticated audience, but I doubt that 10 people in this room could name that fund. Do I have any takers?

It was the Community Bankers U.S. Government Money Market Fund. The reason it's not famous is because it broke the dollar and *did not* trigger a broad and destabilizing run. In fact, money market fund assets *grew* the month after Community Bankers broke the dollar.

The contrast between September 1994 and September 2008 is the fact that, in 1994, the *banking system* was not mired in crisis. There was no reason for investors in other funds to lose confidence in the assets their funds were holding. And so there were no aftershocks.

When Reserve Primary failed in 2008, there were aftershocks—caused, as I said, primarily by the financial crisis in which Reserve's failure was but one more of a seemingly endless series of events. And, as I noted, investors didn't lose confidence in the money market fund structure.

So I would submit to you that money market funds have *never* been "susceptible to runs."

What's more important for today's debate is whether destabilizing runs are likely in the future.

I am even more confident in saying that today's money market funds are *not* likely to trigger events that place the financial system in jeopardy.

In a free market, we can never stop investors from moving away from risks. In fact, blocking those movements would be dangerous and destructive. Mechanisms that try to blunt the natural reaction to risk, like deposit insurance, create moral hazard.

But we can *reduce* risks…we can *remove incentives* for investors to move rapidly…and we can *limit the impact* of the movements that do occur.

In fact, that's exactly what the SEC's 2010 money market fund reforms *have* achieved.

The reforms reduce the risks that money market fund investors face, by raising credit standards and shortening maturities. We've seen those changes in action. As I noted earlier, you have to go to the fifth decimal place to find any impact on portfolio values from last summer's trio of crises.

The reforms remove incentives that might encourage investors to move rapidly out of money market funds. Monthly disclosure gives investors information they need to judge the strength of a funds' portfolio. Required liquidity strengthens funds' ability to meet redemption demands. Today's prime funds could meet a $300 billion outflow in one week—and have $138 billion in liquid assets left over.

Finally, and perhaps most importantly, the 2010 reforms sharply reduce the spillover impact of money market fund redemptions on the broader markets.

When investors pulled out of prime funds in 2008, the economic harm came not from shrinking the funds, but from the funds' need to sell assets into declining markets when liquidity was scarce or nonexistent. The only place liquidity could be found was in the Treasury, government, and repurchase agreement markets.

Today's money market funds are different from 2008's. Today's funds carry substantial liquidity buffers. Those buffers are composed of cash, government securities, and repurchase agreements, mostly collateralized by Treasury and agency securities.

What does that mean? In essence, almost 30 percent of any prime fund today is a *government* fund, holding assets that *any* government fund could own.

So what would happen today if investors pulled 20 percent of their assets out of prime funds? The funds would not be forced to dump commercial paper or bank CDs into a declining market, taking losses and squeezing the economy's cash flow.

Instead, they could simply unwind their repos and liquidate their Treasuries and agencies. The most likely buyers would be government funds that are gaining assets from investors' move away from risk.

This is a remarkable change, and even more evidence of the value of the 2010 reforms.

Unfortunately, the power of this one important development has gone largely unrecognized.

By now, I think I've demonstrated that the drive for further regulatory changes is fueled primarily by two myths—the myth of 2008 and the myth of susceptibility to runs. But there's a third myth that motivates many of the critics of money market funds—including some of the most influential regulators.

That is the banking myth— the notion that banks offer the superior model for all financial activities and that money market funds are really "shadow banks."

This one has deep roots—long before money market funds.

In 1790, under the newly enacted Constitution, the federal government took two important steps: it assumed the debts of the states, creating the U.S. bond market, and it formed the First Bank of the United States.

Since then, capital markets and banking have existed side-by-side in this country. That has created healthy competition and innovation for both savers and users of capital—and it's an important reason why America's financial system is so dynamic and efficient.

Skip forward a couple of centuries to the modern era and the growth of the money market since the 1970s—a development that has changed the picture for banking regulators.

When a corporation sells its commercial paper to investors via a money market fund, the Federal Reserve's control over the U.S. financial system shrinks. Little wonder that the Fed opposed the creation of money market funds, or that central bankers around the world are spreading the idea that money market funds are "shadow banks" that need to be brought into the light of their control.

Paul Volcker, who has a 40-year record of fighting money market funds, has charged that they represent "regulatory arbitrage."

And Federal Reserve Chairman Ben Bernanke earlier this month suggested that the financial system could do just as well without money market funds. While he allowed that these funds are "a useful source of short-term money," the chairman went on to tell the Senate Banking Committee: "You know, Europe doesn't have any, and they have a financial system."

Well—Europe does have money market funds, with $1.5 trillion in assets. That's real money.

And here in the United States, money market funds aren't just "useful"—they're essential. Any vehicle that funds more than one-third of the commercial paper market and more than one-half of short-term municipal debt should not—*cannot*—be viewed as an afterthought.

Finally, I hope you all know that money market funds are not banks, and that they don't need bank-style regulation.

Banks are highly leveraged: 80 to 90 percent of the liability side of their balance sheets is deposits, CDs, long-term bonds, and other borrowings. They invest these borrowed funds in mortgages and other long-term loans, for households, small businesses, and other borrowers who lack access to public credit markets.

The maturities of bank loans can range from overnight to 30 years. These loans are usually highly illiquid, because they can't be called or sold quickly. Frequently, a bank's assets are concentrated in a particular region or industry. And most bank assets are opaque, because many bank borrowers have unique characteristics that make their credit quality hard to assess. Indeed, a banker's skill at separating good borrowers from bad is the bank's first line of defense.

But even with the most skilled bankers, this model of long-term, illiquid, concentrated, and opaque portfolios is *inherently* risky.

So banks are surrounded by a superstructure of regulation, capital requirements, and deposit insurance—a system that ultimately transfers that risk to the public. Despite these safeguards, 450 banks have failed since 2000, according to the Federal Deposit Insurance Corporation.

That's the banking model, and it serves many useful social purposes. But it's not the model of money market funds.

By contrast, money market funds' use of leverage is tightly limited—and these funds typically make very limited use of borrowed funds. Indeed, the liability side of a money market fund's balance sheet is essentially 100 percent capital. Money market fund shareholders are equity investors—with all of the risks of ownership, fully disclosed.

On the asset side, money market funds are required by Rule 2a-7 to invest only in short-term securities, with a maximum maturity of 13 months and a weighted average maturity of 60 days or less.

These securities must pose minimal credit risk and must meet strict standards for diversification. Fund investors know where their money is going, because funds disclose all of their holdings every month.

And since the 2010 amendments, money market funds are required to hold specified levels of liquid assets to meet redemption needs.

In short, banks are designed to make risky loans, and a variety of protections are built up around that structure. Money market funds, by contrast, are designed from the start to limit risks.

Would bankers exchange their lending system for the highly restricted portfolios of money market funds? I doubt it.

But by the same token, why should money market funds accept the regulatory burdens placed on banks—regulations designed for an entirely different system? The answer is clear: they shouldn't.

Now, I've given you a lot to think about. I have to tell you, as the fund industry's representatives in Washington, my ICI colleagues and I have been at the forefront of the debates over these issues for years now.

It's frustrating that the public dialogue is so riddled with myths and misconceptions.

It's disappointing that the success of the 2010 amendments is ignored in the pursuit of changes that will compromise core features of money market funds, their utility to investors, and ultimately their role in the economy.

It seems clear that we are now approaching a critical juncture in this debate.

We will muster all of our resources, in legal and economic analysis, in operational expertise and communications, to alert investors, issuers, businesses, state and local governments, and political leaders to the implications of any proposed structural changes.

Why?

Because this is a matter that is bigger than the fund industry alone.

Earlier I mentioned that scores of organizations representing investors and issuers have already spoken out against ideas like the floating NAV [net asset value]. If you want to add your voice, we've distributed a distinctive orange-and-blue flyer that lays out our mission: "Keep Money Market Funds Working for Investors, for America." Or you can find us on the Internet at www.PreserveMoneyMarketFunds.org.

Please add your voice to the chorus, and keep money market funds working for us all.

Thank you. I'll be happy to take your questions.

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