

FEDERALLY-INSURED
MONEY MARKET FUNDS AND NARROW BANKS:
THE PATH OF LEAST INSURANCE

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ABSTRACT

In September 2008, the Treasury created a temporary insurance program for money market funds (“MMFs”), which had never previously been covered by government insurance. This essay argues that this program should be made permanent. To the extent that deposit insurance is intended to protect cash accounts that provide a stable foundation for our payments system, similar insurance should be made available to MMFs, which serve this function while presenting less risk than bank deposits. The argument that only bank accounts should be insured because the liquidity they create for long-term ventures otherwise would dry up might once have made sense, but it no longer reflects modern financial markets where liquidity creation has become broadly diversified. Deposit insurance also should be made available to bank deposits backed by short-term assets (like MMFs) that would be relieved of burdens to which other bank deposits are subject, such as the Community Reinvestment Act.

One aspect of the federal government’s effort to stabilize financial markets has been the Treasury Department’s temporary extension of federal insurance to money market funds (“MMFs”), which had never previously been federally insured.¹ The circumstances of the Treasury’s extension of federal insurance to MMFs begs the question of why the government has

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¹ The Temporary Guarantee Program for Money Market Funds was created on September 19, 2008 and is scheduled to terminate on April 30, 2009. See generally U.S. Department of the Treasury, *Treasury’s Temporary Guarantee Program for Money Market Funds*, at <http://www.treasury.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml>; U.S. Department of the Treasury, *Frequently Asked Questions About Treasury’s Temporary Guarantee Program for Money Market Funds*, HP-1163 (Sep. 29, 2008) at <http://www.treasury.gov/press/releases/hp1163.htm>; U.S. Department of the Treasury, *Treasury Announces Extension of Temporary Guarantee Program for Money Market Funds*, HP-1290 (Nov. 24, 2008) available at <http://www.treasury.gov/press/releases/hp1290.htm>. The Treasury has stated that it “may” extend the program until September 18, 2009. *Id.*

not always insured MMFs. Money market funds are viewed by their shareholders as providing the same safe cash management services provided by banks, albeit with generally higher yields and more limited transactional services. Over the last three decades, MMFs have steadily siphoned short-term cash from banks to the point where MMFs, whose \$4 trillion in assets now rival bank deposits totaling \$8.7 trillion, have assumed a similarly crucial role in the payments system. It was the threat to the payments system, among other risks, of an imminent run on MMF assets that prompted the Treasury to roll out the temporary MMF guarantee. If the purpose of deposit insurance is to provide a government guarantee of safe cash accounts, in part to ensure the stability of the payments system, then MMFs, like banks, should be insured. Indeed, the argument for insuring MMFs is much stronger than for banks because MMFs present significantly less risk.²

In times of market stress, the nature of an MMF's assets makes it far less susceptible to failure than a bank, as reflected by the long history of bank failures and the almost perfect record of MMFs.³ Money market funds and banks both are funded by short-term liabilities in the form of demand accounts, but they make very different investments with their cash. Money market funds in effect make short-term loans, such as through purchases of 60-day commercial paper. The term of an MMF's liabilities (demand accounts) therefore hues closely to the term of its assets (short-term loans). In contrast, banks make long-term loans with maturities that can run for decades, such as 30-year mortgages. This term-mismatch between a bank's liabilities (demand deposits) and its assets (long-term loans) creates

² See Kenneth Scott, *Mutual Funds as an Alternative Banking System*, 154 J. INST. & THEORETICAL ECON. 86, 87 & 92 (1998). ("there have been 25 years of experience to indicate that MMFs are highly, though not perfectly, safe institutions – certainly safer for accountholders than banks, even with FDIC insurance.").

³ See *infra* discussion accompanying notes 18 - 20.

liquidity risk. Long-term loans are less liquid and their value is more variable than short-term loans. Therefore, the underwriting of bank risk is more complex than for MMFs, and banks are more susceptible than MMFs to failure in the event of a surge of withdrawals by depositors (the proverbial “run on the bank”) because they are less able than MMFs, in times of market stress, to quickly convert their assets to cash without suffering large losses.⁴

An economist might ask what it means to argue that insuring smaller risks is necessarily safer than insuring larger risks. When risk is efficiently priced by an insurer, the insurer generally should be indifferent to the magnitude or likelihood of the potential loss. Over the long term, insurers that fail to price risk efficiently will be unprofitable or become insolvent, and those that price risk efficiently will be rewarded. Similarly, if the government efficiently priced bank risk it would be indifferent to the magnitude of the potential losses. But government-sponsored deposit insurance necessarily reflects political goals that often are inconsistent with efficiency values.⁵ The potential for political influence and inefficiency increases with the complexity of the risk and the variance of potential claims. The risks entailed by MMF portfolios are smaller and less complex, and the variance of potential MMF losses is substantially narrower, than for banks.

This essay argues that making MMF insurance permanent would reduce inefficiency created by government-sponsored insurance for cash accounts. Admittedly, it might seem counterintuitive to suggest that creating a new government program would reduce rather than increase such

⁴ See Geoffrey Miller, *On the Obsolescence of Commercial Banking*, 154 J. INST. & THEORETICAL ECON. 61, 64 (1998).

⁵ See *infra* discussion accompanying notes 42 - 44.

inefficiencies. In an ideally efficient world, all insurance would be provided by private markets. But this essay takes government-sponsored insurance for cash accounts as a given, in which case insuring MMFs would improve efficiency by reducing the financial markets' exposure to the distorting effect of deposit insurance. For decades, consumers have been moving cash from banks to MMFs even without the inducement of federal insurance. Making MMF insurance permanent would likely accelerate this disintermediation of bank deposits to MMFs. Every insured dollar that is exposed to term-matched MMF risk rather than term-mismatched bank risk would be a dollar that was less likely to be lost with taxpayers left to make accountholders whole. Insuring MMFs would not lead directly to eliminating government insurance, but it would represent a significant step down the path of least government insurance.

The same goal could be accomplished in a bank-like structure. Deposit insurance could be offered to deposits that are invested only in assets subject to the same kind of constraints that apply to MMFs. Such a term-matched bank is known as a "narrow bank."⁶ In order to compete with MMFs, this new type of narrow bank could be relieved of regulatory burdens that do not apply to MMFs, such as the Community Reinvestment Act ("CRA"), while also retaining the advantages of their central role in the payments system and their access to the Federal Reserve discount window. Narrow banks, like MMFs, also would promote efficiency by encouraging the disintermediation of term-mismatched deposits to term-matched deposits. Narrow banks would promote competition in the financial markets by offering savers an alternative to MMFs and term-mismatched

⁶ See Miller, *supra* at 65. See generally, William Miles, *Can Narrow Banking Provide a Substitute for Depository Intermediaries?* Missouri Economics Conference (2001) available at <http://research.stlouisfed.org/conferences/moconf/papers/miles.pdf>; Kenneth Spong, *Narrow Banks: An Alternative Approach to Banking Reform*, Levy Economics Institute Working Paper No. 90 (1993), available at <http://ssrn.com/abstract=142832>.

deposit accounts with its own special set of characteristics.

The principal argument made for insuring only term-mismatched bank deposits – *i.e.*, denying government insurance to all other cash management vehicles – is that insurance is necessary to entice savers to commit their short-term assets to long-term ventures, which creates liquidity that promotes economic investment and growth, and that insuring any other form of cash account would result in a net reduction in such liquidity creation.⁷ Banks' term mismatch creates liquidity by converting short-term claims (demand deposits) into capital for long-term ventures, which enables such ventures to access capital that otherwise would not be available. Insuring any other cash accounts would reduce liquidity creation by shifting short-term capital away from banks to cash vehicles that would create less liquidity. While this theory may hold for less mature economies, modern economies have developed a wide variety of financial instruments and markets that, like banks, create liquidity for long-term ventures.⁸ Banks continue to play an important role in creating liquidity, but they are no longer special in this respect. Too much liquidity creation has moved far afield of deposit institutions to justify insuring only bank deposits on liquidity-creation grounds. Deposit insurance therefore serves only to distort the broader liquidity market by competing with and thereby

⁷ See Biagio Bossone, *Should Banks be Narrowed?* Levy Institute Working Paper No. 354 at 13 (2002); *Liquidity Risk, Liquidity Creation, and Financial Fragility: A Theory of Banking*, *supra* note 7 (discussing liquidity-creating role of banks); Miller, *supra* at 63; Anthony M. Santomero, *Deposit Insurance: Do We Need It and Why?* Wharton Financial Institutions Center Working Paper 97-35 at 5 (1997) available at <http://fic.wharton.upenn.edu/fic/papers/97/9735.pdf>; Douglas Diamond and Philip Dybvig, *Bank Runs, Deposit Insurance and Liquidity*, 91 J. POL. ECON. 401 (1983) (same).

⁸ See Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 374 – 75 (2008) (“Increasingly, the financial system is characterized by disintermediation, which enables companies to access the ultimate source of funds, the capital markets, without going through banks or other financial intermediaries.”); Bossone, *supra* (“it is undoubtedly the case that in the advanced economies nonbank quasi-money and financing products are taking increasing business shares away from banks”); Akash Deep & Guido Schaefer, *Deposit Insurance: An Outmoded Lifeboat for Today’s Sea of Liquidity?* AFA 2002 Atlanta Meeting, at 8, 11 – 13 (2001) (“The evolution of capital market instruments like corporate bonds, commercial paper, mutual funds, money-market funds and securitized assets has significantly undercut the relative size and scope of the banking sector as liquidity providers.”) available at SSRN: <http://ssrn.com/abstract=295760>; Miller, *supra* at 67.

suppressing the development of private liquidity sources, such as private insurance, lines of credit, and other mechanisms that provide a better structural fit for managing liquidity risk than using government-sponsored insurance to dissuade depositors from withdrawing their funds.

But this commentary on deposit insurance goes further than necessary for purposes of this essay, which argues only for the mutual coexistence of insurance for term-mismatched banks, narrow banks and MMFs, not for the abolition of term-mismatched deposit insurance. In any case, there is no practical possibility that the current deposit insurance regime will be eliminated in the foreseeable future. In the current environment, it may be more likely that deposit insurance will gain a stronger political foothold.⁹ The real practical question is whether banking interests will prevail not only in stripping insurance from MMFs, but in subjecting them to a banking regulatory regime and thereby removing a significant competitive threat to banks and banking regulators' turf.¹⁰ The banking industry's lobbying arm publicly identified the threat posed by insured MMF before the ink was dry on the announcement of the temporary MMF insurance program, complaining that, as a result of the program, MMFs "will be in a significantly superior market position to FDIC-insured bank deposits," and that "[f]unds will be moved from bank deposits to the guaranteed funds."¹¹ An ad former Federal Reserve Chairman has proposed dismantling MMFs altogether.¹²

⁹ Last fall, the general \$100,000 FDIC limit was raised to \$250,000. Legislation has been proposed to make the increase permanent. See Michael Crittenden & Jessica Holzer, *FDIC Raises Estimate of Bank Failures' Cost*, WALL. ST. J., Feb. 4, 2009 (pending legislation to make \$250,000 permanent).

¹⁰ See Shefali Anand, *Treasury Pads Coffers in Bailout*, WALL. ST. J., Feb. 17, 2009 (quoting Paul Volcker, former Fed Chairman and current head of President Barack Obama's Economic Recovery Advisory Board: "If [MMFs] are going to talk like a bank and squawk like a bank, they ought to be regulated like a bank.").

¹¹ Letter from Edward Yingling, President, American Bankers Association, to Henry Paulson, Secretary of the Treasury, & Ben Bernanke, Chairman of the Federal Reserve System (Sep. 19, 2008) available at <http://www.aba.com/aba/documents/press/LetterGuarantyProgramMoneyMarketFunds091908.pdf>.

¹² See Group of Thirty, *Financial Reform: A Framework for Stability*, at 29 (2009) (recommending that

Notwithstanding the powerful forces aligned against MMFs, this essay argues that making federal insurance for MMFs permanent has a realistic possibility for success. Banking regulators might support granting unlimited coverage to MMFs if supervision of MMFs were shifted from the SEC to the FDIC, which has stronger expertise in administering prudential regulatory regimes. As discussed further below, large and small banks alike would have good reason, such as an insured, CRA-free narrow bank option, to support this proposal. The investment company industry should be satisfied with avoiding the elimination of its MMF franchise, not to mention the added benefit of federal insurance coverage. Moreover, the alternatives to making MMF insurance permanent may present even greater obstacles. Permanent MMF insurance may be the least problematic option.

Part I of this essay explains why MMFs and narrow banks are safer insurance risks than conventional banks, followed in Part II by an analysis of why federal insurance should be made permanent for MMFs. Part III sets forth a practical proposal to provide federal insurance to MMFs and narrow banks. Part IV concludes.

I. Term-Structure Risk: Money Market Funds and Banks

To understand why MMFs are safer insurance risks than banks, it is necessary to discuss briefly some of the regulatory and operational differences between them. Like shareholders of other types of mutual

MMFs either become special purpose banks or allow their share value to fluctuate) available at <http://www.group30.org/pubs/reformreport.pdf>. See generally John Morgan, *Money Funds Seen as Endangered Species*, financialplanning.com, Feb. 23, 2009 (quoting Investment Company Institute Paul Schott Stevens: "If the recommendations are implemented, there will be no more money-market funds, period") at http://www.financialplanning.com/news/Money_Funds_Endangered-2661075-1.html; Stephen Keen, *Volcker, Group of 30 Over the Top on Money-Market Funds*, FINANCIAL WEEK, Feb. 16, 2009, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20090216/REG/902109987>; Robert Gordon, *Say Goodbye to Money Market Funds*, INVESTMENT NEWS, Feb. 15, 2009, available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090215/REG/902139987/1011>.

funds, a shareholder in an MMF owns an undivided interest in a pool of securities.¹³ Mutual fund shareholders are entitled to receive the approximate net asset value of their shares on short notice (normally one day and up to seven days in unusual circumstances).¹⁴ Mutual funds therefore are required to price their shares daily based on the market value of their assets, which accordingly fluctuate with the market.¹⁵ Money market funds differ from other mutual funds because they seek to maintain a constant net asset value of \$1.00 per share. They are able to maintain a stable value because they invest in a diversified pool of high credit quality, short-term obligations.

An MMF is permitted to maintain a \$1.00 per share NAV only as long as the per share market value of its holdings does not drop below \$0.995.¹⁶ A decline of 0.51 percent in the value of an MMF's portfolio would reduce its per share value to \$0.9949, which would round down to a per share price of \$0.99. In this case, the MMF would be deemed to have failed or, in industry parlance, to have "broken a dollar" or "broken a buck."¹⁷

¹³ See generally U.S. Securities Exchange Commission, *Investment Wisely: An Introduction to Mutual Funds* (2008) at <http://www.sec.gov/investor/pubs/inwsmf.htm>; Investment Company Institute, *A Guide to Understanding Mutual Funds*, at 3 (2007) available at http://www.ici.org/pdf/bro_understanding_mfs_p.pdf. In contrast, a "money market account" is an insured bank account that functions like a checking account but often with limited transaction services. See Federal Deposit Insurance Corporation, *Insured or Not Insured?* (last updated Oct. 4, 2008) at <http://www.fdic.gov/consumers/consumer/information/fdiciorn.html>.

¹⁴ See 15 U.S.C. § 80a-22(e) (2005); 17 C.F.R. § 270.22c-1(a) (2005).

¹⁵ See generally Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1277 – 78 (2006) (discussing mutual fund pricing).

¹⁶ 17 C.F.R. § 270.2a-7 (2008) (setting forth conditions for using amortized cost method to value MMF portfolio securities).

¹⁷ Division of Investment Management, U.S. Securities Exchange Commission, *Responses to Frequently Asked Questions about The Reserve Fund and Money Market Funds* (last modified Oct. 10, 2008) (explaining meaning of "break a dollar") available at <http://www.sec.gov/divisions/investment/guidance/reservefundmmffaq.htm>; Internal Revenue Service, National Technical Advice Memorandum No. 200247004 at 2 (July 29, 2002) (same); Jack Phelps & Kim Lowry, *Effect of Interest Rates on Money Market Mutual Funds*, Federal Deposit Insurance Corporation (May 19, 2004) at <http://www.fdic.gov/bank/analytical/fyi/2004/051904fyi.html>.

Prior to the recent failure of the Reserve funds,¹⁸ the only MMF to have broken a dollar was a small, institutional fund that lost less than 4 percent of its value.¹⁹ Money market funds' almost unblemished safety record – during a period in which thousands of banks have failed²⁰ – is attributable to the restrictive terms of the rules under which they operate. Rule 2a-7 under the Investment Company Act requires that an MMF hold a diversified portfolio of high-quality, short-term assets the value of which necessarily fluctuates very little.²¹ Diversification reduces the risk that

¹⁸ On September 16, 2008, the Reserve Management Company, the investment adviser to a prominent family of fixed income mutual funds with approximately 2 million shareholders, announced the liquidation of 17 of its funds and suspended redemptions for 15 of those funds because of a run on assets by shareholders. See Kevin McCoy, USA TODAY, Nov. 11, 2008, at 7A. See generally Complaint, In the Matter of Reserve Management Company, Inc., Docket No. 2008-0079 (Jan. 13, 2009) available at <http://www.sec.state.ma.us/sct/sctreserve/reservecomplaint.pdf>. A run on the Reserve Funds on September 15 triggered the run on money market funds that caused the Treasury to institute its insurance program on September 19. See McCoy, *supra* (redemption requests totaling \$41 billion on September 15 from \$64 billion Reserve Primary Fund). The Treasury effectively agreed to protect shareholders of the Reserve U.S. Government Fund from loss of principal, see Press Release, *Treasury Enters into Agreement to Assist the Reserve Fund's US Government Money Market Fund*, U.S. Department of the Treasury, hp-1286 (Nov. 20, 2008), available at <http://www.treasury.gov/press/releases/hp1286.htm>, but shareholders in other Reserve Funds were not covered. See Diana Henriques, *Treasury to Support a Frozen Money Market Fund*, NEW YORK TIMES, Nov. 21, 2008, at B6. To date, liquidations of 8 of the 12 funds that are money market funds have been completed, with shareholders in each case being made whole. See *The Reserve Distributes Some More Sunshine*, MFWIRE.COM, Feb. 9, 2009 (on file with author); Sue Ascii, *Reserve Commences Payouts for 12 Money-Market Funds*, FINANCIAL WEEK, Dec. 11, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081211/REG/812119985>.

¹⁹ The only institutional MMF to have lost principal is the U.S. Government Fund, which suffered losses on derivatives investments. See generally *In the Matter of Craig Vanucci*, Admin. Proc. File No. 3-9804 (Jan. 11, 1999). The U.S. Government Fund, which had maintained a per share net asset value (NAV) of \$1.00, paid investors \$0.961 per share upon liquidation. See *In the Matter of Craig Vanucci*, Admin. Proc. File No. 3-9804 (Jan. 11, 1999). Investors recovered some of their losses in private litigation. See *id.* In addition, some of the fund's losses were attributable not to a decline in the value of its portfolio, but to the redemption of some shares at \$1.00 after the fund's per share NAV had already broken a dollar. See *In the Matter of John E. Backlund*, Admin. Proc. File No. 3-9805 (Jan. 11, 1999); Mercer Bullard, *Insider Trading in Mutual Funds*, 84 OR. L. REV. 821, 850 (2005) (discussing insider trading in U.S. Government Fund). Thus, losses probably were significantly less than 4 percent.

²⁰ From 1980 to Feb. 27, 2009, more than 3,000 banks failed. See Federal Deposit Insurance Corporation, *Historical Statistics on Banking* at Table BF02 (2,993 banks failed from 1980 through 2007), at <http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=1934&EndYear=2007&State=1>; Federal Deposit Insurance Corporation, *Failed Bank List*, (Feb. 13, 2009 (41 banks failed from January 1, 2008 through February 27, 2009) at <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Mar. 1, 2009). See generally Federal Deposit Insurance Corporation, *A Brief History of Deposit Insurance in the United States* (1998) available at <http://www.fdic.gov/bank/historical/brief/brhist.pdf>. In contrast, the MMF industry probably will turn out to have been the only financial services sector that helped to fund the bailout. To date, there have been no claims by MMFs on the temporary insurance program, leaving the Treasury with a \$813 billion windfall. See Anand, *supra* note 10.

²¹ See 17 C.F.R. § 270.2a-7 (2008). See generally *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 7275 at Part I (1996). Modern money market funds owe their creation to rule 2a-7 under the Investment Company Act, which was adopted in 1983. Previously, the SEC had generally

credit problems experienced by single issuer will have a material effect on the MMF's portfolio.²² The high quality of the debt instruments minimizes the likelihood that a systemic credit crunch that causes weaker issuers to fail will affect an MMF.²³ The short term of the instruments minimizes the likelihood that interest rates will rise so quickly as to materially reduce their value.²⁴ As long as an MMF invests in compliance with the requirements of Rule 2a-7, it is extremely unlikely that it will break a dollar.²⁵ On occasions when MMFs' share values have declined below or have come close to declining below \$0.995, their sponsors have purchased the impaired portfolio securities at their face value, injected cash into the fund, or taken other steps to prevent the fund's price from dropping below \$1.00 per share.²⁶

In contrast to MMFs, the term-mismatched structure of banks makes failures virtually inevitable.²⁷ A loss of only 3 percent after a bank failure

prohibited money market funds from using the amortized cost method to value short-term debt, which prevented them from maintaining a stable net asset value. *See Proposal Concerning Valuation of Short-Term Debt Instruments Owned by Registered Investment Companies Including Money Market Funds*, Investment Company Act Rel. No. 8757 (Apr. 15, 1975); *Valuation of Debt Instruments by Money Market Funds and Certain other Open-End Investment Companies*, Investment Company Act Rel. No. 9786 (May 31, 1977). After granting numerous requests for exemptions from this prohibition and holding a public hearing on the issue, *see Valuation of Portfolio Securities by Money Market Funds*, Investment Company Act Rel. No. 10082 (Jan. 5, 1978), the SEC relented, adopting rule 2a-7 in 1983. *See* Investment Company Act Release No. 12206 (Jan. 29, 1982) (proposing release); *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, Investment Company Act Rel. No. 13380 (July 18, 1983) (adopting release). *See generally* Kenneth S. Gerstein, *Money Market Fund Valuation and the Responsibilities of Directors*, C841 ALI-ABA 139 (Apr. 23, 1993).

²² *See generally* *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 6882 at Part II.B (1991) (discussing diversification test).

²³ *See generally id.* (discussing portfolio quality test); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U.L.Q. 619, 698 - 99 (1999) (same).

²⁴ *See generally* *Revisions to Rules Regulating Money Market Funds*, *supra*, at Part II.C.

²⁵ *See generally*, William Miles, *Can Money Market Mutual Funds Provide Sufficient Liquidity to Replace Deposit Insurance?* 25 J. ECON. & FIN. 328 (2001) (discussing dependability of MMFs compared to banks).

²⁶ *See, e.g., SEI Liquid Asset Trust -- Prime Obligation Fund*, SEC No-Act (Dec. 3, 2007) *available at* <http://www.sec.gov/divisions/investment/noaction/2007/seiliquidasset120307.pdf>. *See generally* Mark Bruno, *Money Fund Rescue Smacks Banks*, FINANCIAL WEEK, Oct. 5, 2008, *available at* <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081005/REG/810039951>.

²⁷ Juha-Pekka Niinimäki, *Maturity Transformation without Maturity Mismatch and Bank Panics*, 159 J. INST. & THEORETICAL ECON. 511, 511 (2003) ("The fundamental cause of self-fulfilling bank runs is maturity

would be considered a good outcome.²⁸ Banks and MMFs are similar in that bank depositors can liquidate their accounts on short notice. Thus, both banks and MMFs are in the business of investing funds held as by demand accounts. The difference between banks and MMFs is that banks invest their cash in long-term assets. Banks create a mismatch between the terms of their liabilities (demand accounts) and their assets (long-term loans). Although banks also invest in some highly liquid investments, they do not make any pretense of standing ready to liquidate their assets on short notice to honor a mass exodus of depositors.²⁹

Bank regulations employ two principal mechanisms to minimize the risk created by banks' term-mismatched assets and liabilities.³⁰ One mechanism is FDIC insurance, which protects the vast majority of bank depositors against loss and mitigates their incentive to rush for the exits during times of financial uncertainty.³¹ The second mechanism is a complex set of risk-based rules that are designed to maintain a constant equity buffer between the value of a bank's assets and amount of its

mismatch. The combination of illiquid assets and liquid demand deposits makes a bank financially fragile.”). Diamond & Rajan, *supra* note 7, at 289 (discussing banks' “fragile capital structure”).

²⁸ See Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REV. 26 (2000) (estimating that the S&L crisis had cost taxpayers \$124 billion as of the end of 1999); Christopher James, *The Losses Realized in Bank Failures*, 46 J. FIN. 1223 (1991). Government payments pursuant to the current crisis probably will cost taxpayers hundreds of billions of dollars. See generally Maya Jackson Randall, Meena Thiruvengadam & Michael Crittenden, *Bank Bailout Grows in Obama's Budget Plan*, WALL ST. J., Feb. 26, 2009. It will be difficult to determine how much of this amount should be directly attributed to deposit insurance obligations as opposed to systemic stabilization and other motives. It is not yet clear whether the cost of bank failures will exceed available insurance funds. See Eric Lipton, *F.D.I.C. Set to Raise Fees to Replenish Bank Fund*, NEW YORK TIMES, Feb. 27, 2009.

²⁹ The technical term for this is “fractional reserve banking,” but it is best illustrated in the dramatic scene in the 1946 movie *It's a Wonderful Life* in which George Bailey (played by Jimmy Stewart) explains to panicking bank customers: “You're thinking of this place all wrong, as if I had the money back in the safe.”

³⁰ Spong, *supra* note 6, at 12 -13 (“This traditional bank asset/liability structure violates the basic principles of financial management by failing to provide an asset base with sufficient liquidity and security to support withdrawable deposits.”).

³¹ See Steven Ramirez, *The Law and Macroeconomics of the New Deal* at 70, 62 MD. L. REV. 515, 543 – 45 (2003); Miller, *supra* note 4, at 65.

liabilities.³²

Banking rules generally regulate banks' equity buffer by requiring that they maintain minimum risk-based capital ratios.³³ When a bank's equity buffer shrinks, additional capital restrictions are triggered until the required capital ratio has been restored. If the equity buffer continues to shrink, the discretion afforded to bank managers narrows and the oversight authority of regulators expands until the deterioration is stabilized or reversed, or the bank is taken over by the FDIC. To illustrate how risk-based capital ratios operate, the capital ratio for a bank with \$100 million in assets, \$95 million in liabilities and \$5 million in shareholders' equity would be 5 percent (\$5 million/\$100 million). Under one type of capital ratio test, the bank would be deemed to be "significantly undercapitalized."³⁴ The bank typically would be required to raise capital by issuing stock or subordinated debt in order to restore its capital ratio. If its capital ratio continued to deteriorate and it became "critically undercapitalized,"³⁵ regulators would be authorized to force the bank into receivership. If the bank recapitalized by issuing \$6 million in new stock, giving it \$106 million in assets, its capital ratio would exceed 10 percent (\$11 million/\$106 million). It would then qualify as "well capitalized" and be relieved of additional regulatory constraints.

Admittedly, an MMF's term-matched structure does not guarantee that it would be able to pay 100 cents on the dollar in the face of mass redemptions. A fire-sale liquidation of an MMF's assets would likely generate proceeds representing at least a 0.51 percent loss, if not

³²See Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317 (1993).

³³ See *id.* at 328 – 48 (discussing risk-based capital ratio rules).

³⁴ 12 U.S.C. § 4616 (2008).

³⁵ 12 U.S.C. § 4616 (2008).

significantly more. Indeed, an MMF recently froze its assets when the high rate of redemptions threatened its ability to repay shareholders in full.³⁶ Many more MMFs might have found themselves in the same position had the Fed not implemented the MMF insurance program the same day that hundreds of billions of dollars in redemption requests reportedly were waiting in the wings.³⁷ However, the likelihood of bank failures and the size of losses incurred in bank failures are of a different order of magnitude from that of MMFs, as reflected in the history of bank and MMF failures.³⁸

Money market funds not only are less likely to fail than banks, their risks also are easier to evaluate. Term-mismatched banks create a complex underwriting problem because of the wide variance in the investment returns of their relatively diverse asset base. Underwriting MMF asset risk is far less complex. Money market funds are essentially commodities, as reflected in the fact that their investment returns are almost entirely explained by the fees that they charge, rather than their managers' portfolio management skill.³⁹ The range of returns on MMF assets is much narrower than the range of returns on bank assets. These factors dramatically reduce

³⁶ See Douglas Appell, *Crisis Aftershocks to Hit Cash Management*, PENSIONS AND INVESTMENTS, Nov. 24, 2008, at 1 (describing closing and transfer of Putnam money market fund, with no loss to shareholders, under pressure from redemptions); Eileen Ambrose, *Treasury Will Guarantee Investors' Principal to Stabilize Mutual Funds*, BALT. SUN, Sep. 20, 2008, at 1A (same).

³⁷ See Research Report #110-25, Joint Economic Committee at 9 (Sep. 2008) <http://www.house.gov/jec/Research%20Reports/2008/tr110-25.pdf>; Kathleen Pender, Now What? September 30, 2008, SAN FRANCISCO CHRONICLE at A1 (insurance for money market funds was "designed to stop the mass exodus from money funds that started after the Reserve Primary Fund became only the second money fund in history to "break the buck," or fall below \$1 per share, on Sept. 19"); Lee Barney, *Extraordinary Cooperation Puts End to Run on Funds*, MONEY MGMT. EXEC, Sep. 29, 2008, 2008 WLNR 18474773 (reporting \$186 billion run on money market funds in week ending Sep. 19); Matt Krantz, *Plan to Aid Money Funds May Alter How Some Save*, Sep. 22, 2008, USA TODAY (same). Some commentators have dismissed the risk of a run on an MMF, *id.* at 69 ("the highly liquid and broadly diversified asset base of most mutual funds makes this concern [about a run on a MMF] largely theoretical."); Scott, *supra* note 2, at 92 – 93 (insurance for MMFs is unnecessary because the risk of a run on MMFs "would be close to non-existent."); see generally Sean Collins & Phillip Mack, *Avoiding Runs on Money Market Funds: Have Regulatory Reforms Reduced the Potential for a Crash*, Finance and Economics Discussion Series No. 94-14 (June 1994), available at SSRN: <http://ssrn.com/abstract=5603>.

³⁸ See *supra* notes 18 - 20 and accompanying discussion.

³⁹ Susan Christoffersen, *Fee Waivers in Money Market Mutual Funds*, Wharton Financial Institutions Center 97-46-B (May 2000) (almost all of money market performance is explained by fees) available at <http://fic.wharton.upenn.edu/fic/papers/97/9746.pdf>.

the potential variance in losses to insurance providers to MMFs in comparison with insurance providers to banks. This difference means that potential size of losses arising from inefficient underwriting is greater when insuring bank deposits than when insuring MMF accounts. This is not such an important difference in a free market for insurance, where competition among insurers disciplines such inefficiencies and mistakes generally are not borne by taxpayers. But market discipline is lacking and taxpayer backing abundant when insurance is government sponsored. Money market funds therefore are a safer government insurance risk than banks not so much because they are less likely to fail, but because losses due to efficient underwriting are minimized.

In summary, banks pose a greater risk of loss than MMFs and the greater complexity of underwriting bank risk exacerbates the potential for inefficiency losses resulting from government sponsorship of deposit insurance. It bears emphasizing that this follows not from a normative view of the appropriate level of risk-taking by banks, but rather from the inherent structural characteristics of banks. Banks create liquidity by providing long-term borrowers with access to short-term capital. It is this term-mismatched structure that necessarily creates the liquidity risk that short-term capital will flee, thereby wiping out bank shareholders and inflicting losses on uninsured depositors, the insurance fund and taxpayers.⁴⁰ This essay does not argue, however, that banks should be as safe as MMFs. There is no policy reason that banks, like other financial intermediaries, should be excluded from the business of providing the kind of liquidity risk created by any term-mismatched capital structure. Nor is the question whether the insuring of liquidity risk, whether created by banks or other financial intermediaries, should be permitted, or even, at least in this essay,

⁴⁰ See Santomer, *supra* note 7, at 7.

whether the government should provide such insurance. Rather, the question is whether federal insurance of money market funds should be made permanent, as discussed in the next section of this essay.

II. Insuring Cash Accounts: Money Market Funds and Narrow Banks

If the government is going to insure cash accounts, MMFs offer a superior insurance risk. As discussed in the preceding section, in comparison with banks MMFs are less likely to fail, their losses are less likely to be large, and their risks are easier to underwrite efficiently. This is not to say that private insurance cannot efficiently mitigate the greater risk presented by term-mismatched demand accounts, such as by charging risk-based premiums, instituting stricter asset tests, requiring minimum capital ratios and taking other steps to internalize liquidity risk by fully incorporating its cost into the price of liquidity. Rather, such liquidity risk cannot be efficiently insured by the government.⁴¹ Government insurance programs are highly susceptible to the prerogatives of political, social and other non-efficiency values that are virtually certain to distort the accurate pricing and efficient mitigation of risk. As stated by Fischer Black, Merton Miller and Richard Posner,

Because regulation is a part of the political process, as well as a market surrogate, the thrust toward efficiency that a market generates is blunted. The point is not that regulatory agencies deliberately squander resources (theirs or the regulated firms') but that they are often constrained to pursue goals that are

⁴¹ In 1991, FDICA authorized the FDIC to reinsure privately a small percentage of its deposit insurance risk. See *Pricing Reinsurance Contracts on FDIC Losses*, 17 FIN. MARKETS, INST. & INSTRUMENTS 225 (2008) (proposing private reinsurance pricing model for FDIC reinsurance risk).

incompatible with efficient resource use, such as the subsidization of favored customers or small sellers.⁴²

If governments are less likely to accurately assess the risks of insuring demand accounts, then the best risk for the government to insure is the one least likely to result in losses, the losses of which are likely to be smallest, and the potential harm of inefficient (government) underwriting is minimized.⁴³

Pure free market principles admittedly would militate for eliminating of government insurance for term-mismatched accounts rather than making government insurance for MMFs permanent. As long as the elimination of government insurance is not foreseeably practicable, however, the immediate goal should be to find the path of least government insurance. Making MMF insurance permanent would level the playing field between banks and MMFs, which would enhance the efficient flow of short-term capital to its highest value users by removing the distorting effect of insuring only one type of short-term capital intermediary, and a riskier, term-mismatched intermediary at that.⁴⁴ Extending government insurance

⁴² Fischer Black, Merton Miller & Richard Posner, *An Approach to the Regulation of Bank Holding Companies*, 51 J. Bus. 379, 382 (1978).

⁴³ A narrow bank, like an MMF, would pose a smaller risk of loss and or government inefficiency. See Scott, *supra* note 2, at 89 (discussing a narrow bank: “the existence of an active trading market would enable the bank’s asset portfolio to be marked-to-market on a daily basis at little cost, and the bank to be closed swiftly at negligible loss if it should become insolvent.”) & 91 (MMF losses “a mere trifle in relation to losses encountered in bank failures”). Scott also argues that steering consumer deposits to narrow banks (or, implicitly, to MMFs) would leave funding of long-term ventures to institutions and more sophisticated investors that would be less likely “to be able to obtain a political bailout in the event of a loss.” *Id.* at 89.

⁴⁴ See Richard Posner, *ECONOMIC ANALYSIS OF LAW* at 485 – 86 (7th ed. 2007) (noting inefficient aspects of deposit insurance); Federal Deposit Insurance Corporation, *HISTORY OF THE EIGHTIES* 35 (1997) (“thrift regulators permitted (or were forced by a depleted insurance fund to permit) a large number of thrifts to operate for lengthy periods with little or no equity”); George Kaufman, *Depositor Liquidity and Loss-Sharing in Bank Failure Resolutions*, Federal Reserve Bank of Chicago, WP 2003-2 (Jan. 1, 2003) (discussing political risk that regulators will cover uninsured depositors’ losses at taxpayer expense); Rosalind Bennett, *Evaluating the Adequacy of the Deposit Insurance Fund: A Credit-Risk Modeling Approach*, FDIC Working Paper 2001-02 at 39 (2001) (estimating under one set of assumptions that deposit insurance funds would receive a credit rating below BBB, *i.e.*, below investment grade); Scott, *supra* note 2, at 87 – 88 (discussing government’s uneven record in pricing deposit insurance risk) & 89 (discussing “distortion of risk-taking behavior and pricing through the banking system.”); Randall Bennett & Christine Loucks, *Politics and Length of Time to Bank Failure*, 14 CONTEMPORARY ECON. POLICY 29 (Oct. 1996) (finding that “undercapitalized banks with representation on the House banking

to newly created narrow banks that are subject to prudential regulation similar to rule 2a-7 and freed of social obligations (*e.g.*, CRA requirements) would further expand the free market for government-insured intermediation of short-term capital.

One objection to providing permanent MMF insurance is that the resulting disintermediation from banks to MMFs would reduce liquidity creation in the financial markets. Proponents of this liquidity creation theory of exclusive deposit insurance contend that: (1) net societal wealth is increased by enabling banks to convert short-term deposits into long-term assets, (2) insuring short-term deposits is necessary to prevent a run on banks by depositors, and (3) insuring MMFs accounts would reduce net societal wealth by disintermediating demand deposits from banks to MMFs and thereby reducing the availability of short-term sources of capital to long-term ventures.⁴⁵ They argue that, if insuring MMFs significantly accelerated the outflow of demand accounts from banks to MMFs, net liquidity creation would be reduced, which could strangle financial markets. Financing for long-term ventures could dry up and economic growth could be suppressed.

There are many flaws in this argument, the first of which is that there is no clear evidence that the availability of deposit insurance actually increases liquidity creation. The literature espousing the liquidity creation theory of deposit insurance is largely theoretical. Almost no research has been done on the actual correlation between deposit insurance and liquidity creation. Only one study has specifically addressed whether deposit

committee were allowed to remain open longer than were other undercapitalized banks”). Spong, *supra* note 6, at 14.

⁴⁵ See generally Bossone, *supra* note 7, at 13; Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393 (1984) (financial intermediaries monitor loan performance and thus reduce monitoring costs for individual lenders); *Bank Runs, Deposit Insurance, and Liquidity*, *supra* note 7 (banks will be able to transform illiquid assets into liquid assets as long as investors maintain their confidence to the banking system).

insurance increases liquidity creation, which concluded that:

the amount of liquidity transformed by US commercial banks is surprisingly low. The evidence suggests that protection offered by deposit insurance, the putative objective of which is to protect banks against the risk of liquidity crises, has only modest success in promoting liquidity transformation.⁴⁶

The authors found that, rather than enhancing the flow of capital to long-term enterprises, deposit insurance was correlated with increased investment in riskier short-term assets. This finding would be a reason to eliminate deposit insurance, not to make it available, much less exclusively available, to banks.

Even assuming that insuring bank deposits enhances liquidity creation, there is no evidence that banks' role in liquidity is so important as to warrant an *exclusive* insurance franchise. Decades ago, banks might have been critical suppliers of credit to long-term ventures because capital markets arguably did not offer adequate alternatives for such ventures to access short-term cash. However, the credit markets have become substantially diversified with a variety of non-bank service providers providing access to short-term capital not derived from bank deposits.⁴⁷ The claim that banks as such are essential cogs in the machinery of liquidity creation is no longer viable. Securitization of various asset classes has provided broad access to short-term capital for long-term ventures, thereby

⁴⁶ Akash Deep & Guido Schaefer, *Are Banks Liquidity Transformers?* KSG Faculty Research Working Paper RWP04-022 at 2 (2004). This author has not found any research that contradicts Deep's and Schaefer's findings. Many studies find the banks increase liquidity creation, but none finds that such creation is directly correlated with, much less caused by, the insuring of deposit accounts. See Allen Berger & Christa Bouwman, *Bank Liquidity Creation*, __ REV. FINANCIAL STUDIES __ (forthcoming 2008) (finding evidence of pre-crisis bank liquidity creation) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=672784; Elisabeta Pana, Jin Park & Tim Query, *The Impact of Bank Mergers on Liquidity Creation*, FMA Annual Meeting (2007), available at http://www.fma.org/Orlando/Papers/The_Impact_of_Bank_Mergers_on_Liquidity_Creation_FMA.pdf; (finding indirect evidence of liquidity creation related to deposit insurance).

⁴⁷ See generally See Miller, *supra* note 4, at 67; Gordon Sellon, *Changes in Financial Intermediation: The Role of Pension and Mutual Funds*, ECON. REV. 53 (Fall 1992) available at <http://www.kansascityfed.org/PUBLICAT/ECONREV/EconRevArchive/1992/3q92sell.pdf>.

permitting term-mismatched financing without any federal insurance subsidy.⁴⁸ For example, huge volumes of mortgage-backed securities comprised of pools of mortgages trade (normally) in very liquid markets.⁴⁹ Venture capital firms also have proliferated, with much of their funding coming from mutual funds the shares of which also trade in very liquid markets.⁵⁰ Auction-rate securities have provided another means whereby liquid assets fund long-term obligations.⁵¹ There are now many avenues by which the capital of investors who need liquidity finds its way into the hands of long-term projects, and private insurance against liquidity risk is available to and used by these market participants.⁵² This is not to say that term-mismatched banks no longer play an important role in providing financing for long-term ventures, but rather that their role is no longer so exclusive or critical as to warrant an exclusive insurance subsidy.⁵³

The argument that outflows to MMFs resulting from making MMF insurance permanent will adversely affect liquidity creation has no foundation. First, cash has been disintermediating from banks to MMFs for three decades⁵⁴ – even without an insurance subsidy to lure savers – with no

⁴⁸ Banks play a fairly small role in these markets. See Akash Deep & Guido Schaefer, *Are Banks Liquidity Transformers?* KSG Faculty Research Working Paper RWP04-022 at 4 - 5 (2004); *Deposit Insurance: An Outmoded Lifeboat for Today's Sea of Liquidity?* *supra* note 8, at 8, 11 – 13 (“The evolution of capital market instruments like corporate bonds, commercial paper, mutual funds, money-market funds and securitized assets has significantly undercut the relative size and scope of the banking sector as liquidity providers.”) available at SSRN: <http://ssrn.com/abstract=295760>.

⁴⁹ See Sellon, *supra* note 48, at 65 – 66 (role of securitization of mortgages in displacing banks).

⁵⁰ See Spong, *supra* note 6, at 8 (increasing investment in stock, bond and money market mutual funds “at the expense of banks”).

⁵¹ See generally Liz Rappaport & Randall Smith, *UBS to Pay \$19 Billion as Auction Mess Hits Wall Street*, Aug. 9, 2008, WALL ST. J.; Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, Feb. 15, 2008, NEW YORK TIMES.

⁵² For example, some U.S. MMFs have privately insured their portfolios.

⁵³ See *Are Banks Liquidity Transformers?* *supra* note 49, at 2; Spong, *supra* note 6, at 8 (“it is unlikely that bank deposits will ever regain the importance they once held in the portfolios of banking customers”).

⁵⁴ See Investment Company Institute, 2008 INVESTMENT COMPANY FACT BOOK 32 – 34, 142 (2008) (showing increase, from 1996 to 2007, in money market fund assets from \$902 billion to \$3.107 trillion and in money market funds’ share of business short-term assets from 12 to 31 percent); Spong, *supra* note 6, at 7 (1993)

evidence of any effect on liquidity creation in the financial markets. Second, no has evidence been adduced that recent increases in MMF assets subsequent to the creation of the temporary MMF insurance program have hindered liquidity creation.⁵⁵ Indeed, now that the temporary insurance program appears to have encouraged increased savers' faith in MMFs, there is a real risk that terminating MMF insurance would cause a run on MMFs and further destabilize financial markets. Outflows from banks to MMFs reflect the efficient operation of free market forces that should be limited or reversed only in the face of solid empirical evidence that the adverse consequences of such outflows demonstrably exceed the benefits. There is no such evidence. Insuring MMFs would level the playing field with banks and increase the free flow of short-term capital to the most efficient intermediaries.

Another argument against making MMF insurance permanent has merit, however. As argued by the ABA, permanently insured MMFs would have an unfair advantage because they are not subject to the same "range of regulation and examination" as banks.⁵⁶ Banks are subject to regulatory constraints, such as the Community Reinvestment Act, that do not apply to any other financial intermediaries, much less to other short-term capital intermediaries.⁵⁷ Many view CRA compliance as part of the price paid for

(discussing loss of bank customer base to disintermediated commercial paper market).

⁵⁵ See *Money Fund Assets Top \$4 Trillion*, MMEXECUTIVE.COM, February 17, 2009, available at <http://www.mmexecutive.com/news/190260-1.html?ET=mmexecutive:e2007:43795a:&st=email> ("Money market fund assets have topped \$4 trillion for the first time, greatly buoyed by the Treasury Department's \$1 NAV guarantees and financing to purchase asset-backed commercial paper from money funds, which has eased the credit markets.").

⁵⁶ Letter from Edward Yingling, *supra* note 11. See also Bonnie McGeer, *Money-Fund Guarantee Plan Draws Sharp Rebuke*, AM. BANKER, Sep. 22, 2008, at 1. Cf. James Baker, *Viewpoint: Money Market Funds Need Insurance, Too*, AM. BANKER, Sep. 19, 2008, at 10.

⁵⁷ The CRA requires banks to provide credit based on the needs of local communities. See generally John Taylor & Josh Silver, *The Community Reinvestment Act at 30: Looking Back and Looking to the Future*, 53 N.Y.L. SCH. L. REV. 203 (describing operation of CRA).

the federal insurance subsidy,⁵⁸ and if federal insurance were extended to non-banks the banking industry would demand that the CRA apply to all such entities or that the CRA be abolished for banks. Neither option is politically viable in the near term.

On the one hand, the MMF insurance program should not be conditioned on MMFs' being subject to the CRA. On the other hand, banks should not be forced to compete with MMFs that have the advantage of being CRA-free. A practicable solution would be to insure both MMFs and newly created narrow banks without either type of entity being subject to the CRA.⁵⁹ The CRA currently does not apply to MMFs, and it is unlikely that public interest groups would insist on CRA coverage as a condition for making federal MMF insurance permanent (they have not objected to CRA-free temporary MMF insurance). Public interest groups might view an insured narrow bank as threatening to drain assets from CRA-covered banking activities to narrow banks, but functionally this is no different from the long-term shrinking of the CRA's reach through disintermediation of short-term assets from banks to MMFs.⁶⁰

Notwithstanding the distorting effect of deposit insurance and the lack of empirical support for the liquidity creation theory, there is no realistic possibility that deposit insurance will be eliminated or even reduced in the near-term. Indeed, the current crisis has resulted in a

⁵⁸ See, e.g., Michael Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 75 N.Y.U. L. REV. 198 - 202 (2005) (subsidies such as deposit insurance partly justify imposition of CRA requirements on banks).

⁵⁹ See Ronnie Phillips, *Credit Markets and Narrow Banking*, Levy Institute Working Paper No. 77 at 12 (1992) ("Perhaps the strongest argument for narrow banking, however, is that it allows a way out of the federal deposit insurance mess."); Spong, *supra* note 6, at 12 ("narrow banking would eliminate the fundamental problem in the current banking system – deposits available at par and on demand that are backed with illiquid risky loans.").

⁶⁰ Whatever one's position on the CRA, imposing community lending requirements on only one source of loans ultimately will undermine its efficacy. The CRA-bank connection, like the FDIC insurance-bank connection, needs to be reconsidered in light of the diversification of sources of capital. Over time, the additional costs of the CRA will either drive assets to non-bank financial intermediaries (thereby reducing the CRA's reach) or require continuing indirect, market-distorting subsidies to banks to compensate them for this expense.

temporary expansion of deposit insurance that is likely to become permanent.⁶¹ Policymakers therefore should pursue the path of least insurance by insuring cash management vehicles that are safer, less likely to experience large losses, and present more commoditized, less complex underwriting challenges. The creation of the temporary MMF insurance program has provided a political opportunity to make progress on the path of least insurance by making this program permanent and establishing insured narrow banks. As insured demand account assets continue to shift from term-mismatched banks to MMFs and narrow banks, short-term capital would be free to find the highest value user among a broader range of short-term capital intermediaries. These steps would also bring about incidental benefits, such as enhancing the stability of the payments system,⁶² reducing the risk to unsophisticated depositors created by arbitrary and confusing FDIC coverage limits,⁶³ and reducing the systemic risk and moral hazard created by deposit insurance. There is no longer any rational basis for granting banks an exclusive government insurance franchise for demand accounts. The current financial crisis demonstrates that public insuring of financial risk, whether through explicit insurance programs or implied guarantees, must account for the full spectrum of

⁶¹ See *supra* note 9.

⁶² See, e.g., Spong, *supra* note 6, at 24 (“narrow banks might represent the best structure for developing a more efficient and stable payments system.”); James Burnham, *Deposit Insurance: The Case for the Narrow Bank*, 2 CATO REV. BUS. & GOV. 35, 37 (1991) (making narrow banks exclusive point of access for payments system would reduce risk of a major payment system failure).

⁶³ Unsophisticated FDIC-insured savers are less likely to be unaware that they risk potentially catastrophic losses if they fail to open multiple bank accounts to circumvent the \$250,000 coverage limitation or overlook a temporary deposit that causes their balance to exceed \$250,000 (e.g., the proceeds of a home sale). In contrast, sophisticated depositors who monitor banks’ financial health are likely to withdraw uninsured funds prior to the bank’s failure, thereby increase losses for less savvy uninsured depositors. See Andrew Davenport & Kathleen McDill, *The Depositor behind the Discipline: A Micro-level Case Study of Hamilton Bank*, FDIC Center for Financial Research Working Paper 2005-07 (2005) (case study finding that uninsured individual retirement accounts owners withdrew a small fraction of uninsured relative to uninsured business accountholders).

financial intermediation and shed the traditional bank-centric regulatory view of systemic financial risk.⁶⁴

III. The Path of Least Insurance: A Practical Proposal

As with any major policy shift, making MMF insurance permanent can be accomplished only by appeasing affected industry and regulatory interest groups.⁶⁵ First, to satisfy the banking industry deposit insurance should be extended to narrow banks that are relieved of bank-specific regulatory burdens and regulated as MMFs. Second, to mollify banking regulators prudential MMF oversight should be shifted from the SEC to the FDIC with MMFs continuing to be regulated under rule 2a-7. These conditions would further the goals of minimizing the government's role in insuring cash management vehicles, promoting efficiency in the capital markets, and reducing systemic risk -- while also defusing the likeliest source of opposition to permanent MMF insurance.

Under this proposal, the FDIC would insure 100 percent of MMF and narrow bank deposits that were subject to rule 2a-7 or (for narrow banks) similarly structured prudential rules. Unlike the temporary MMF insurance program, the insurance would be unconditional. It would not depend on the insured entity's compliance with applicable prudential rules or only to certain assets, as is the case with the temporary MMF program. The temporary program covers only assets that were eligible under rule 2a-7 at

⁶⁴ See David Skeel, *Governance in the Ruin*, 122 HARV. L. REV. 696, 735 – 36 (2008) (book review) (“because lending is done by so many other forms of intermediaries, the collapse of which could threaten the financial system, the narrow focus on commercial banks no longer makes sense”). See Schwarcz, *supra* note 8, at 374 -75 (“somewhat anachronistic focus on banks, not markets, ignores new trends in the global marketplace. . . . an exclusive bank-focused approach simply does not keep up with underlying changes in the financial system. In a financially disintermediated world, the old protections are no longer reliable.”).

⁶⁵ See generally George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON & MGMT SCIENCE 3 (1971).

the time that the insurance was approved. This can hardly be characterized as insurance, for it leaves the insured assuming the risk that the MMF is not rule 2a-7 compliant, yet noncompliance with rule 2a-7 is the principal cause of loss against which MMF shareholders should expect to be covered. In addition, the MMF program covers accounts only up to the amount that was invested in a covered fund as of September 19, 2008.⁶⁶ Reinvested dividends (which occurs daily for MMFs) and investments of new cash occurring after that date are not covered to the extent that the total value of the account exceeds its September 19 value.⁶⁷ Reports that recent MMF inflows have favored MMFs that have joined the programs suggest that many investors are being misled regarding the true scope of MMF insurance,⁶⁸ although some of these inflows probably reflect the view that an implied guarantee now stands behind all MMF assets.⁶⁹

The same insurance should be extended to narrow banks, that is, banks that invest deposits only in a diversified pool of high quality, short-term debt in compliance with rule 2a-7 or similar prudential rules. These banks would be relieved of costly social obligations such as the CRA while

⁶⁶ See *Frequently Asked Questions*, *supra* note 1. Even stranger is the Treasury's position that an investor is covered in the amount of shares owned on September 19, even if all of those shares were sold and subsequently repurchased. *Id.* Thus, if a shareholder held 100 shares of insured Fund A on September 19 and transferred the investment to insured Fund B on September 20, the shareholder would have an incentive, if both Fund A and Fund B were about to break a dollar, to transfer assets from Fund B back to Fund A where it would be covered. It also appears that a MMF account in Fund A held in a 401(k) plan would not be covered if rolled over into an IRA. *Id.* This means that a forced rollover from a 401(k) plan could have the effect of stripping shareholders of insurance protection.

⁶⁷ *Id.* Money market funds distribute their income on a daily basis, and virtually all MMF shareholders opt to have the income automatically reinvested in the fund. This means that on September 20 new shares representing reinvested fund income or new investments were not insured to the extent that the balance exceeded the balance as of September 19. This restriction reportedly resulted from pressure on the Treasury Department from the banking lobby. See Leslie Wayne, *Lobbyists for Financial Institutions Swarming All Over the Bailout Bill*, NEW YORK TIMES, Sep. 26, 2008.

⁶⁸ This does not seem to be the result of misleading fund prospectuses. A survey of 23 fund complexes found that money market fund prospectuses funds participating in the temporary MMF insurance program consistently cited the limitation of insurance coverage to the amount invested as of September 19.

⁶⁹ See Anand, *supra* note 10 (referring to Treasury MMF insurance program: "It worked. Money-fund assets began climbing and are now close to hitting a record \$4 trillion, \$450 billion more than in mid-September."); *Money Fund Assets Top \$4 Trillion*, *supra* note 56.

retaining advantages unique to banks, such as their central role in the payments system and their access to the Federal Reserve discount window.⁷⁰ The benefits of higher-yielding, term-matched cash accounts would become available to consumers in an alternative format to MMFs that offered different advantages, thereby increasing competition in the financial markets.

Both MMFs and narrow banks would be regulated and insured by the FDIC. Banking regulators have deeper technical expertise and longer experience in operating inspection programs designed to identify and moderate risk-taking, in comparison with the SEC's disclosure-oriented approach and mandate to promote efficient risk-taking. The SEC's prudential oversight of the five largest investment banks and the Reserve Primary Fund reflect failures of prudential regulation, with the former leading to regulation of the survivors by banking regulators.⁷¹ Functional regulation of similar prudential regulatory regimes by a single regulator would increase efficiency and reduce regulatory arbitrage.

The foregoing proposal should substantially mitigate potential opposition to making MMF insurance permanent. Banking regulators would expand their jurisdiction to include four trillion dollars in MMF assets. Banks would gain a viable competitor to MMFs through the creation

⁷⁰ The discount window is the rate at which the Federal Reserve lends funds to eligible banks. It is not clear whether discount window access will continue to be exclusive to banks; the Federal Reserve recently provided access to the discount window to non-financial institutions for the first time. See U.S. Dept't of the Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, at 7 (2008) available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

⁷¹ By analogy, the SEC's failure to monitor net capital rules under which five largest investment banks recently operated has indirectly resulted in two becoming bank holding companies (Goldman Sachs and Morgan Stanley), two being acquired by banks (Bear Stearns and Merrill Lynch) and one to declare bankruptcy (Lehman Bros.). See John Coffee, *Missing in Action? Meltdown Raises Doubts About SEC Regulation*, N.Y.L.J., Nov. 20, 2008, at 5 (net capital rules and failure of investment banks); Patrick Temple-West, *Investment Banks: Raymond James Financial Will Apply for Bank Holding Company Status*, BOND BUYER, Sep. 29, 2008, at 5 (holding company conversion because bank holding companies "are perceived as being safer under Fed regulations"). The SEC also failed to anticipate the Reserve Primary Fund's failure, notwithstanding that it was one of the highest yielding money market funds prior to its collapse and was not insured or managed by a large financial services firm that could afford to make shareholders whole.

of narrow banks that had the potential, by being relieved of regulatory constraints while retaining certain bank-specific advantages, to stem or even reverse the persistent disintermediation of deposits to MMFs.⁷² In any case, large banks that manage substantial MMF should be indifferent to the proposal because their MMFs would receive a substantial percentage of any outflows from deposit accounts. The primary lobbying firm for the banking industry, the American Bankers Association, should view the proposal as increasing its jurisdiction because MMF assets would be regulated by banks, and narrow banks present the possibility of further expansion. The investment company industry and its primary lobbying firm, the Investment Company Institute, who are currently facing the potential elimination of a four trillion dollar franchise, should be relieved to escape with the preservation of MMF assets in an investment company structure and the addition of permanent FDIC coverage.

This leaves two gored oxen: the SEC and small banks that neither manage MMFs nor have the scale to offer narrow bank services. In the current political climate, a beleaguered SEC is unlikely to oppose vigorously the transfer of MMF oversight to banking regulators. The Commission might even agree that it would be better off leaving prudential regulation to banking regulators and focusing on its core expertise: the enforcement-oriented, disclosure-based regulation of free capital markets and investor protection. These activities often conflict with the kind of safety and soundness regulation embodied by the SEC's own rule 2a-7 and broker net capital rules as well as the capital requirements administered by banking regulators. Conversely, the banking industry's propensity for secrecy, antipathy for transparent market value accounting,⁷³ and hands-on

⁷² *But see* Miller, *supra* note 4, at 68 – 69 (narrow banks were not offered in the past because of the absence of a short-term debt markets and are not offered today because this role has been served by MMFs).

⁷³ *See, e.g.*, Letter from Edward Yingling, American Bankers Association, to Christopher Cox, Chairman,

regulatory oversight are an inevitable corollary of their safety and soundness mission.⁷⁴

Small banks would be a force to be reckoned with. A direct competitor, MMFs, would be 100 percent insured, as would narrow banks that larger banks might be more likely to have the wherewithal to create, while small banks were left with deposits subject to the \$250,000 FDIC limit. If the deposit insurance limit increase to \$250,000 has not been made permanent, doing so could be offered as a *quid pro quo* for small banks' acceptance of permanent MMF insurance.⁷⁵ Another alternative might be to make narrow banks available only to small banks. Even if the cost of creating narrow banks made it difficult for small banks to compete with MMFs, they nonetheless might gain a comparative advantage relative to large banks that might make the tradeoff worthwhile. Perhaps the assumption that small banks would not be able to offer competitive narrow banks is incorrect and they would find this option an attractive incentive.

One reason that permanent MMF insurance is a real possibility is that the alternatives pose even greater political and practical obstacles. For example, allowing MMF insurance program to expire could trigger a new run on MMFs, a risk that the Treasury Department probably would not be willing to take. Even if an MMF run were not triggered, MMF shareholders will likely assume that their accounts are covered by an implied guarantee

U.S. Securities and Exchange Commission (Oct. 13, 2008) (requesting that the Financial Accounting Standards Board position requiring fair valuation be overturned); Letter from Donna Fisher, Senior Vice President, American Bankers Association, to Jim Kroeker, Deputy Chief Accountant, U.S. Securities and Exchange Commission (Nov. 13, 2008) at <http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/56796/ABAletterFairvalueSECstudyNovember132008final.pdf> ("moves to require fair value for all financial instruments should be abandoned").

⁷⁴ See generally Monica Langley & David Enrich, *Citigroup Chafes Under U.S. Overseers*, WALL. ST. J., Feb. 25, 2009 (discussing intrusive federal oversight of Citigroup).

⁷⁵ See *FDIC Raises Estimate of Bank Failures' Cost*, *supra* note 9 (pending legislation to make \$250,000 FDIC coverage limit permanent).

that the Treasury,⁷⁶ if confronted with another crisis, would be hard-pressed to deny and for which it would not have collected any insurance premiums with which to avoid a taxpayer-funded bailout. Former Fed Chairman Paul Volcker has suggested that MMFs be converted to a kind of bank, but it is unlikely that the investment company industry would accept the elimination of 41 percent of investment company assets that would occur if MMFs disappear into a non-investment-company structure.⁷⁷ In addition, Volcker's proposal implies a massive expansion of the CRA's reach to \$4 trillion in MMF assets, a prospect that many free market advocates would vigorously oppose.

Some have suggested that MMFs' per share NAV be allowed to float rather than be fixed at \$1.00,⁷⁸ but this proposal creates the same risk of triggering a run on MMFs as the expiration of the insurance program. It is unclear why MMF shareholders who would be willing to accept the possibility of losses would not simply shift their assets higher-yielding short-term bond fund. Money market funds have always been viewed as bank equivalents. A conversion to floating-NAV MMFs would likely reverse three decades of market-driven disintermediation from banks to MMFs and thereby eliminate competition for bank deposit accounts, increase the cost of short-term capital intermediation, and risk a destabilizing run on MMFs.

The Treasury's creation of the temporary MMF insurance, like many of the recent, unprecedented governmental intrusions into the operation of U.S. financial markets, has irrevocably forced policymakers to

⁷⁶ See Letter from Edward Yingling, *supra* note 11 ("money market mutual funds now have a permanent implicit government guaranty – much like Fannie Mae and Freddie Mac did").

⁷⁷ As of November 2008, money market fund assets comprised \$3.8 trillion of \$9.3 trillion in mutual fund assets. See Investment Company Institute, *Trends in Mutual Fund Investing November 2008*, available at http://www.ici.org/stats/latest/trends_12_08.html#TopOfPage.

⁷⁸ See, e.g., Group of Thirty, *supra* note 12.

choose between paths leading to fundamentally different destinations. Some paths already have lead to an even greater role for government and a further shrinking of free markets, such as the recent increase of FDIC coverage from \$100,000 to \$250,000 (in the absence of any real threat of a run on banks). The ultimate decision regarding the fate of MMF insurance offers an opportunity to take a different path, a path of least insurance. Providing unlimited FDIC insurance for MMFs and narrow banks subject to streamlined regulation would reduce taxpayer exposure and systemic risk, while promoting competition by expanding the market for the intermediation of short-term capital.

IV. Conclusion

The Treasury Department's creation of a temporary insurance program for MMFs has raised serious question about the long-term fate of a \$4 trillion industry. Just as the creation of the program has induced an influx of cash into MMFs, allowing the program to expire could trigger a new run on MMFs with serious adverse consequences for the stability of financial markets. This essay argues that MMF insurance should be made permanent. Money market funds serve the same cash management function as banks, and they are less likely to fail -- or to experience large losses when they do fail -- than banks. The risk of government inefficiency in the operation of an MMF insurance program is lower relative to banks because underwriting term-matched MMF risk is less complex and more commoditized than underwriting term-mismatched bank risk. Banking regulators should offer unlimited insurance to narrow banks that invest deposits only in a diversified pool of high quality, short-term debt, and assign the FDIC to oversee both MMFs and narrow banks under a single

regulatory umbrella. The presence of fully insured MMFs and narrow banks in the financial marketplace would promote competition in and enhance the stability of financial markets.