THE GROUP OF THIRTY REPORT:

MISCONCEPTIONS ABOUT MONEY MARKET MUTUAL FUNDS

BY

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I. INTRODUCTION

The Group of Thirty recently issued a report entitled "Financial Reform: A Framework for Financial Stability" (the "Report").[1] The Report highlights concerns regarding vulnerabilities in the financial system that have become evident in the current financial crisis and makes wide-ranging recommendations for financial regulatory reform. The recommendations encompass all types of financial institutions, including depository institutions, investment banks, hedge funds, government sponsored enterprises, and money market mutual funds (referred to herein as "money funds").

The main theme of the Report is the importance of containing systemic risk and maintaining close oversight of "systemically important" financial institutions, including money funds.[2] The Report articulates guiding principles for this purpose and makes a number of specific recommendations.

The Report's recommendations pertaining to money funds would require substantial changes in the operations and regulation of money funds and fundamentally alter the character of the money fund industry. If fully

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[1] Group of Thirty, Financial Reform: A Framework for Financial Stability (Jan. 2009). The Group of Thirty describes itself as a "private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia." The members of the Group include former Federal Reserve officials, including Paul Volcker (the Group's chairman), Timothy Geithner, E. Gerald Corrigan, Roger W. Ferguson, Jr., and William McDonough. The Group also includes Lawrence Summers, Mervyn King, Jean-Claude Trichet, and Paul Krugman. The Group "aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers."

[2] According to the Report, the characteristics that make a financial institution systemically significant are size, leverage, scale of interconnectedness, and the degree to which the company provides infrastructure services critical to the markets. The principal systemic characteristic of money funds appears to be "scale of interconnectedness" referring to the "degree to which one financial firm's potential failure will have immediate and sizeable knock-on effects on a large number of other significant financial institutions." *Id.* at 19.

implemented, the Report's recommendations would cause money funds as we know them, and as they have successfully existed for decades, to become extinct. The loss money funds would significantly harm the financial markets by reducing liquidity and causing them to become less efficient.

The Report's recommendations are not based on an analysis of any systemic risks posed by money funds and reflect an overly simplistic view of the money fund industry and the existing regulatory framework that governs it. This paper examines the Report's recommendations, analyzes their potential consequences, and attempts to correct the misconceptions upon which they are based.

II. THE REPORT

A. Guiding Principles

The Report is based on several guiding principles for financial reform. The following principles would encompass money funds, as well as other institutions:

> **Financial Stability**: In order to maintain the health of the system and contain systemic risk, non-bank financial institutions that are potentially of systemic importance should be subject to some form of formal prudential regulation and supervision to assure appropriate standards for capital, liquidity, and risk management.[3]

This guiding principle is inapposite to money funds which, as described in the appendix, already are subject to extensive regulation addressing liquidity and risk management. Moreover, because money funds are pass-through investment vehicles, it is difficult to see what legitimate regulatory purpose would be served by imposing capital requirements on their assets, which belong to their shareholders. Money fund investment advisers generally do not engage in any activities other than providing investment advice and have no assets against which capital requirements could be imposed.

> **Fair and Effective Competition**: Regulatory policies should treat financial services common to different institutions uniformly by seeking a balance

[3] Report at 17.

> between the benefits of open and free competition and "the potential for unfair competition arising from explicit and implicit government protection."[4] Further, the Report seeks a balance between the protection implicit in access to central bank liquidity support for systemically important institutions and restrictions on risk-prone activities.[5]

This guiding principle also appears inapposite to money funds. Money funds generally do not compete directly with banks. They offer a distinct investment service designed to meet the short-term investment needs of customers for whom banks do not offer sufficient safety, liquidity or rate of return. In any event, money funds do not enjoy unfair competitive advantages over banks. To the contrary, during normal economic conditions, money funds do not have the benefit of federal insurance or access to Federal Reserve liquidity facilities that banks enjoy.

> **Governance and Risk Management**: High standards of institutional governance and risk management are needed, with emphasis on independent boards of directors, a corporate culture that incentivizes risk management and includes independent risk management staffs, and regulatory and supervisory policies that reinforce those practices and incentives.[6]

Money funds already have independent boards of directors and compliance staffs. Risk management is embedded in regulatory restrictions on the composition of money fund portfolios and other aspects of their operations.

B. **Core Recommendations**

In furtherance of the guiding principles, the Report makes the following four core recommendations:

> Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions,

[4] Report at 18.
[5] *Id.*
[6] Report at19.

> regardless of type, must be subject to an appropriate degree of prudential oversight.
>
> The quality and effectiveness of prudential regulation and supervision must be improved.
>
> Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital, and liquidity.
>
> Financial markets and products must be made more transparent, with better-aligned risk and prudential incentives.

These general recommendations seem more appropriate for banks, hedge funds, and other participants in the capital markets than for money funds. Money funds already are subject to a high degree of prudential regulation. Although improvements in money fund regulation always should be considered, the quality and effectiveness of money fund regulation already is strong.

C. **Concerns Regarding Money Funds**

In discussing gaps and weaknesses in prudential regulation of the financial system, the Report notes the following with respect to money funds:

> There was also a run on U.S. money market mutual funds, leading to a rushed program of temporary federal insurance, backed by an unprecedented use of the resources of the Treasury's Exchange Stabilization Fund. A series of central bank programs have provided sizeable direct support to the commercial paper funding markets.[7]

The Report articulates the following specific concerns regarding the role of money funds in the financial markets:

> The widespread run on money market mutual funds has underscored the dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity

[7] Report at 24.

> risk. These have been compounded by provision of transaction account services, with withdrawals on demand at par, mimicking the services of regulated commercial banks. A regulatory distinction should be drawn between those services that are most appropriately housed in regulated and supervised banks, particularly the right to withdraw funds on demand at par, and those that can reasonably be provided by mutual funds focused on short-term fixed-rate credit instruments.[8]

The Report does not probe the causes of the "run" on money funds or indicate what flaw in the existing framework of money fund regulation caused it. In particular, the Report provides no evidentiary basis to conclude that money fund transaction account services caused or exacerbated the run. As explained at length below, the statement that money funds have "no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk" misconceives the nature of money funds and their regulation.

The Report is correct in stating that a distinction should be drawn between those services that are most appropriately housed in regulated and supervised banks and those that can be provided by money funds focused on short-term fixed-rate credit instruments. But the law already draws that distinction by subjecting money funds to regulation under the Investment Company Act of 1940 and exempting banks from such regulation. The Report fails to explain why the right of money fund shareholders to withdraw funds on demand at par is appropriate only for regulated and supervised banks and not for regulated and supervised money funds. The statement that money funds "mimic" commercial banks is wrong.

D. **Recommendations for Money Funds**

To address the Report's concerns about money funds, the Report makes two principal recommendations:

> Money market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential

[8] Report at 29.

> regulation and supervision, government insurance, and access to central bank lender-of-last-resort facilities.
>
> Those institutions remaining as money market mutual funds should only offer a conservative investment option with modest upside potential at relatively low risk. The vehicles should be clearly differentiated from federally insured instruments offered by banks, such as money market deposit funds, with no explicit or implicit assurances to investors that funds can be withdrawn on demand at a stable NAV. Money market mutual funds should not be permitted to use amortized cost pricing, with the implication that they carry a fluctuating NAV rather than one that is pegged at US $1.00 per share.[9]

The Report does not address how these recommendations specifically relate to the Report's guiding principles or what effect they would have on the money fund industry. The recommendations appear to be based on fundamental misconceptions as to how money funds operate and are regulated, as further discussed below.

III. MISCONCEPTIONS ABOUT MONEY FUNDS

The Report's recommendations to remedy the "dangers" of money funds are premised on a view of investment companies as having "no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk." This view reflects some major misconceptions regarding money funds and their regulation under federal law.

A. **Money Funds Are Bank-Like**

The recommendations reflect the belief held by some proponents of the Report[10] that money funds function like banks and should be regulated

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[9] *Id.*

[10] Paul Volcker has long held the view that institutions that have bank-like functions—such as so-called "nonbank banks" and industrial loan companies—should be regulated like banks. This view remains a viewpoint held by Federal Reserve Board staff members. *See* Testimony of Paul Volcker before the Senate Committee on Banking, Housing and Urban Affairs, Feb. 4, 2009, stating that money funds are banks.

like banks.[11] According to this view, bank-like regulation is appropriate for money funds not only for competitive purposes but so they will be appropriately supervised and regulated, insured, and covered by central bank liquidity facilities.

In fact, as described in the appendix, money funds are fundamentally different from banks in nearly every conceivable way—in organizational structure, asset composition, method of valuation, ownership structure, scope of permissible activities, and their role in the marketplace.

Fundamentally, money funds are pass-through investment vehicles. Unlike banks, they are not operating companies. They do not take deposits, make loans, or invest in long-term assets. They do not leverage their assets in the way that banks do; nor do they do not create off-balance sheet liabilities by securitizing their assets in the way banks do. Unlike banks, their only activity is to invest in government securities and other high quality, short-term securities and money market instruments.

B. **Money Funds Pose Systemic Risk**

The Report's recommendations are based on the misconception that money funds create systemic liquidity risk in the financial system.

To the contrary, rather than posing such risk, money funds are a source of systemic liquidity in the financial markets. The freezing up of the credit markets in September of 2008 provided a vivid illustration of the vital role of money funds as a source of liquidity for the entire financial system. When investors lost confidence after the failure of Lehman Brothers and the breaking of a dollar by a single money fund (and the closing of another) as a result, money funds experienced extraordinary redemption requests and their ability to provide liquidity to the short-term money markets was impaired. The short-term credit markets froze up, causing systemic disruption to the economy.

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[11] The belief has its roots in an antipathy for money funds that originated in the early 1980's when money funds commenced offering check-writing features and thereby fueled a massive disintermediation of deposits out of banks (that were prohibited from paying market rates of return by Regulation Q) and into money market instruments that could pay market rates, such as credit union share draft accounts, NOW accounts at savings banks, Treasury bills, and money funds. As part of a program of credit controls to end inflation, the Federal Reserve Board, led by Paul Volcker, temporarily imposed reserve requirements on money funds in order to stem the outflow of funds from thrifts and small banks. The reserve requirements were controversial and the Board eliminated them after two months. *See* Stacey L. Schreft, Credit Controls: 1980, Federal Reserve Bank of Richmond, Economic Review, Nov.-Dec. 1990, at 38.

The systemic risk was caused by the temporary inability of money funds to perform their vital function in the marketplace due to a financial event beyond their control. Actions by the Federal Reserve and the Treasury in support of money funds quickly restored confidence and money funds resumed their normal function as a source of liquidity in the short-term financial markets. The government's actions recognized the important role of money funds and the need to ensure that the funds have access to central bank facilities to maintain their liquidity function in the financial system if needed in the future.

The fact that money funds required government assistance in order to perform their liquidity function does not mean that they are a source of illiquidity in the marketplace. It rather means that government support was needed to enable them to perform their liquidity function. This support did not require the expenditure of any taxpayers dollars. Indeed, money funds have paid substantial fees for the government's support.

The dramatic increase in money fund assets during the current financial crisis demonstrates that both retail and institutional investors view money funds as a safe haven for their liquid assets during troubled financial conditions. Money fund assets increased by approximately 20 percent from January of 2008 to January of 2009, much of the increase coming after September.

C. Money Funds Are Not Adequately Regulated

The Report reflects the view that money funds are not adequately regulated. To the contrary, money funds are highly regulated under the Investment Company Act of 1940. They are required to register with the SEC and are subject to strict limitations on their operations, investments, and activities. Among other things, federal law limits the types and maturities of securities in which money funds may invest, requires money funds to have independent boards of directors, and imposes rules against conflicts of interest.

The regulation of money funds is described in greater detail in the appendix hereto.

The notion that money funds would be better regulated under federal banking laws and the supervision of federal banking regulators is fatuous given the role of banks in the current financial crisis.

D. **Money Funds Enjoy Competitive Advantages Over Banks**

The Report views money funds as having a competitive advantage over banks. This view is mistaken. Money funds are not direct competitors of banks. Their activities are much more limited and they serve a purpose very different role from that of banks.

The current availability of federal insurance and liquidity facilities for money funds does not give money funds an unfair competitive advantage over banks. Unlike banks, money funds do not have access to such facilities during normal economic conditions, although such access might be appropriate in the future. In any case, money funds have been assessed fees for such support.

Money funds increase competition by offering an alternative to bank deposits for investors who seek greater flexibility and return than are available from bank certificates of deposit and who seek safety for amounts in excess of the federal deposit insurance limit. The fact that banks are hampered by regulatory constraints from offering similar services does not mean that money funds have an unfair competitive advantage.

Money funds also enhance the competitive position of U.S. financial markets relative to global markets by increasing the liquidity and efficiency of our markets.

IV. CONSEQUENCES OF THE REPORT

The recommendations of the Report would have severe consequences for money funds. If implemented, the recommendations would effectively eliminate money funds from the financial marketplace and thereby remove an important source of liquidity and efficiency for investors and other market participants. Without money funds, the U.S. capital markets would suffer a competitive disadvantage relative to foreign markets.

A. **Money Funds Would Be Regulated Inappropriately**

As noted, the Report recommends that money funds be required to reorganize as special purpose banks if they offer transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value at par. In other words, in order to continue their current operations, money funds would need to become banks, albeit banks with a special purpose.

If the Report's recommendations are given effect, money funds would be chartered, supervised, and regulated by federal banking regulators. They would be subject to capital requirements, reserve requirements, reporting and other regulatory requirements imposed by federal banking regulators. They would be examined by federal banking examiners and would be assessed premiums for insurance coverage by the FDIC or other federal insurer of their assets.

The extensive bank-like regulation contemplated by the Report is not appropriate to the limited activities of money funds. Money funds are pass-through investment vehicles that invest shareholder assets in high quality, short-term money market instruments. Unlike banks, they are not operating companies. They do not make loans or use shareholder funds for any purpose other than to invest in high quality short-term securities and money market instruments. Unlike banks, they have no means of leveraging their assets.

Because of their limited activities, money funds do not require extensive supervision and regulation of the type applicable to banks. They already are subject to appropriate regulation under the Investment Company Act of 1940 by the Securities and Exchange Commission. The SEC's staff is familiar with the activities and operations of money funds and has years of experience and expertise in their regulation.

The federal banking agencies do not have the expertise or regulatory focus required to effectively regulate money funds. Their full attention would seem to be needed in supervising the banking industry. If they were given jurisdiction over money funds as well, it is likely that the quality of money fund regulation would suffer, not only because the banking agencies are not expert in money fund regulation, but because their regulatory focus would be dominated by issues relating to banks.

The bank-like regulation recommended by the Report is inappropriate and disproportionate to the risks posed by money funds which, notwithstanding the extraordinary events of last September, are small compared to the systemic risks posed by banks. Unlike banks, money funds have existed for decades without the need for deposit insurance or access to Federal Reserve liquidity facilities. While money fund functions were temporarily impaired do to events beyond their control during the current financial crisis, they did not cause the crisis. The crisis rather has its origins in faulty supervision of banks, the creation of enormous off-balance sheet liabilities through the securitization of bank assets, and the Federal Reserve's failure to regulate nonbank mortgage brokers as mandated by Congress.

Bank capital requirements particularly are inappropriate for money funds, as described in the appendix hereto.

Regulatory improvements may be needed to tighten the investment limits on money fund portfolios. But wholesale elimination of the legal structure governing money funds is unjustified, particularly when the alternative is a regulatory system unsuited to their operations and activities.

B. **Money Funds Would No Longer Exist**

Money funds could not survive under the regulatory regime contemplated by the Report. The costs of banking regulation and capital requirements would impose an excessive and unnecessary burden on money fund shareholders who would find it too costly to invest in money funds. Money fund advisers similarly could not bear the costs of banking regulation. Money funds as we know them—and as they have operated successfully for decades— would cease to exist.

Commercial banks would be unable to fill the gap. While banks can and presently do manage money funds, it is quite a different matter for a bank to actually be a money fund.

The banking system would need to allocate capital against approximately $3.5 trillion in money fund assets. Even if banks were able to raise the additional capital, which is unlikely at present, it seems doubtful that federal banking regulators would countenance the allocation of bank capital to support investments in the securities markets.

C. **Investors Would Lose a Valuable Investment Vehicle**

Money funds serve a variety of purposes for large and small investors. They serve the short-term cash management needs of corporate treasurers, broker-dealers, bank trust departments, pension funds, municipal governments, and other institutional investors. They also provide a safe means by which individual investors can earn a return on short-term cash awaiting investment in their brokerage accounts.

Because of the high quality and short maturity of their portfolio investments, they are used as cash equivalents by investors. They provide a low-risk and low-volatility asset class as part of an overall investment strategy.

Money funds provide investors with a highly efficient means of investing in high quality, short-term securities.[12] Without money funds, the transaction fees and administrative costs of assembling and managing a portfolio of individual money market investments would be prohibitive for most retail investors and many institutional ones. Money funds offer a degree of diversification that individual investors would find difficult to achieve.

Bank deposits are no substitute for the role of money funds in the capital markets. Banks generally cannot pay money market rates of return on their deposits due to the substantially greater operational costs a bank incurs. Moreover, federal law historically has prohibited banks from paying interest on checking accounts of business customers. Money funds, because of their limited operations and purpose, do not have the same costs as a full service bank and can pay higher rates of return. Unlike banks, money funds are not subject to artificial regulatory limits on the amount of interest they can pay and their rate of return is directly linked to the return on their portfolio investments.

Money funds offer investors a degree of liquidity not available from bank certificates of deposits. Unlike bank CD's which carry penalties for early withdrawal, money funds offer their shareholders next day redemption capability as well as daily access through checking accounts linked to money funds. Money funds can offer this liquidity because their assets are short-term and can be easily liquidated to pay shareholders in normal economic conditions. In contrast, the assets backing bank CD's generally are loans with much longer-term maturities which cannot be easily liquidated.

The loss of money funds from U.S. financial markets would leave investors with limited opportunities for investing short-term cash.

D. The Financial Markets Would Lose Efficiency and Liquidity

If money funds ceased to exist, the financial markets would lose an important source of liquidity and efficiency.

Money funds are highly efficient intermediaries between issuers of high-quality short-term securities and investors. They enable issuers of investment grade commercial paper, government securities, and other money

[12] Money funds are required to invest at least 95 percent of their assets in U.S. Treasury obligations and privately issued securities carrying the highest credit rating by at least two major rating agencies.

market instruments to readily sell securities into the marketplace with reduced transaction costs. They provide investors with easy access to high quality investments to meet their short-term investment needs.

Direct investments in government securities or other short-term instruments generally are not as liquid as money market funds and may be disposable prior to maturity only at a discount from amortized cost.

Money funds have provided a critical source of liquidity for investors during the current financial crisis. Money fund assets have increased by nearly 20 percent since last September as investors have rushed to money funds as a source of safety and liquidity for financial assets.

The loss of money funds from U.S. financial markets would greatly diminish the liquidity and efficiency of our markets.

E. **The Government Securities Market Would Be Harmed**

Money funds are the single largest purchasers of U.S. government securities directly and through repurchase agreements. Without them, the government securities market would not function as efficiently as it does currently.

Investors in government securities would need to purchase individual securities and would incur increased transaction costs due to the greater number of transactions that would be required to assemble a portfolio with different maturities to meet anticipated cash needs. It is doubtful that an individually managed portfolio of government securities could ever be as liquid as a money fund, and certainly not as efficient.

Because of the inefficiencies in managing a portfolio of individual government securities, many investors instead might elect to place their uninvested cash in bank deposits, foregoing any interest and incurring the risk of bank failure for amounts in excess of deposit insurance limits.[13] As a result, the U.S. government could face higher funding costs.

F. **U.S. Capital Markets Would Be Less Competitive**

By eliminating money funds as market participants, the Report's recommendations would diminish, rather than increase competition in the

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[13] Although the FDIC has implemented a program to increase the deposit insurance limit to $250,000 and to provide unlimited insurance for non-interest-bearing checking accounts, these program are temporary.

capital markets. Sophisticated investors would find sources of liquid investments abroad, and U.S markets would lose capital and liquidity.

V. CONCLUSION

The recommendations of the Group of Thirty Report with respect to money market mutual funds are based on the misconceptions that money funds are bank-like, pose systemic risk, are not adequately regulated, and enjoy unfair competitive advantages over banks. The Report would apply inappropriate bank-like regulation to money fund operations without any analysis of the consequences. If the Report's recommendations were adopted, money funds would cease to exist and the U.S. financial markets would lose a vital source of liquidity and efficiency.

APPENDIX—THE TRUTH ABOUT MONEY FUNDS