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Money Market Mutual Funds and Stable Funding

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Unstable Funding an Important Element of the Financial Crisis

- Crisis made clear that runs on non-depository financial intermediaries could be damaging
- Series of runs during the crisis
  - Broker-dealers could not finance their securities portfolios
  - Structured Investment Vehicles (SIVs) and other structured entities could not obtain rollover financing
  - Significant run from prime MMMFs

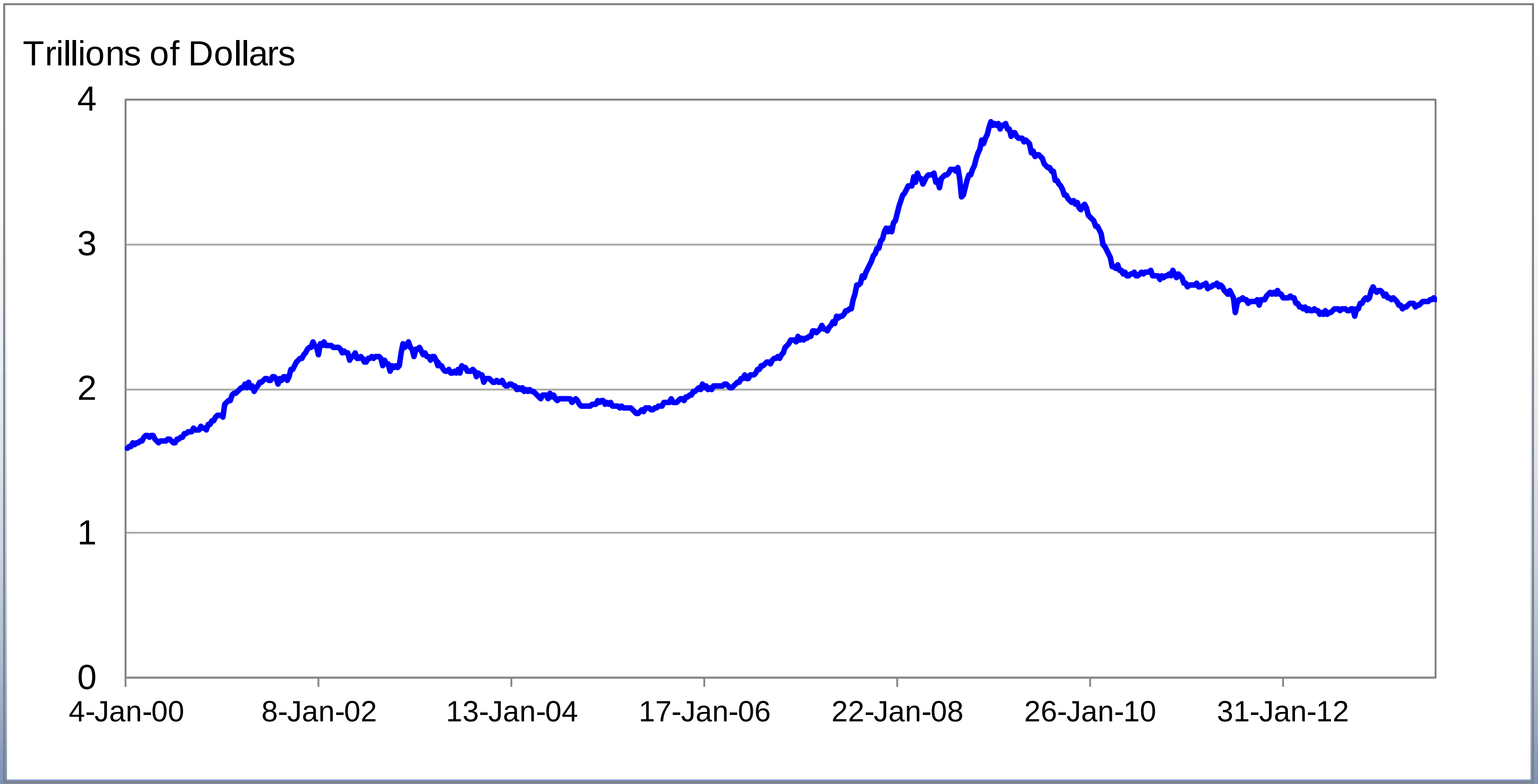
Focus on MMMFs and Stable Funding

Today I will:

- Discuss how prime MMMFs contributed critically to the financial instability experienced in the fall of 2008
- Describe challenges posed by current structure of MMMFs, drawing on comment letter sent to the SEC by all 12 Reserve Bank Presidents
- Discuss needed enhancements to the SEC proposals for MMMF reform

Figure 1
Money Market Mutual Fund Assets Under Management

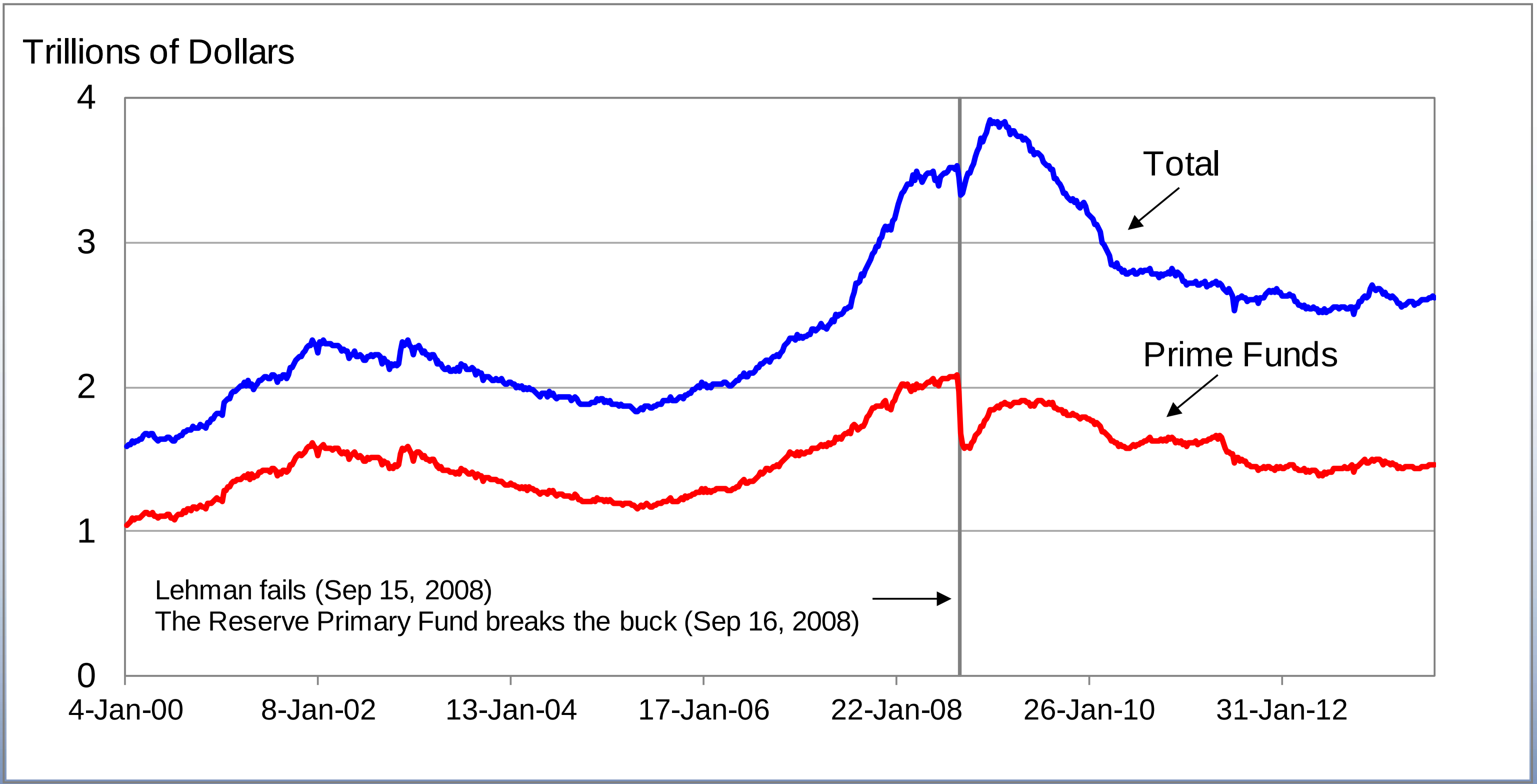
Weekly, January 4, 2000 - September 3, 2013



Source: iMoneyNet

Figure 2
Money Market Mutual Fund Assets Under Management

Weekly, January 4, 2000 - September 3, 2013



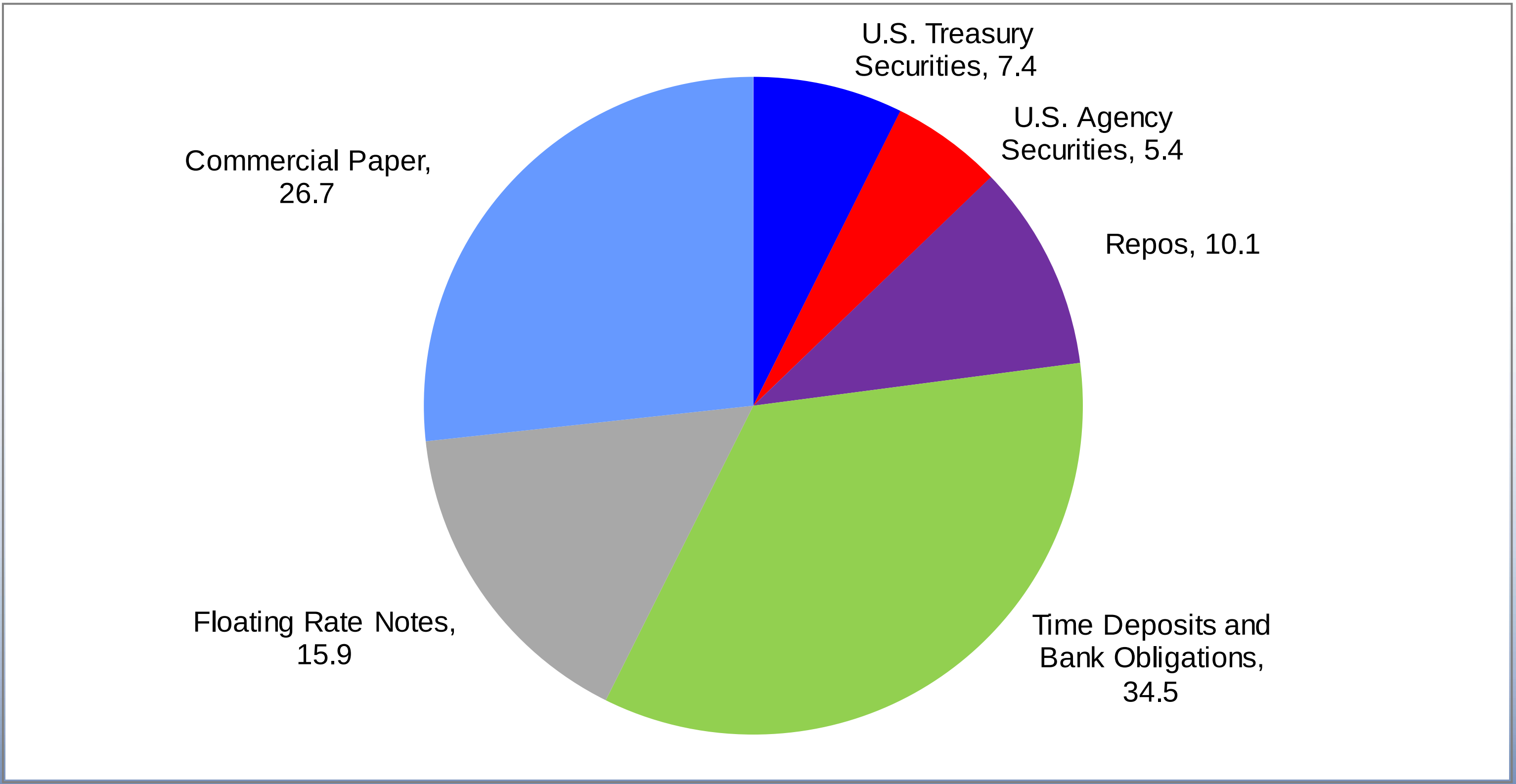
Source: iMoneyNet

Run Was Limited by Government Intervention

- Treasury announced a temporary guarantee program, which provided insurance to money fund investors
- The Federal Reserve set up an emergency lending facility that provided needed liquidity to MMMFs experiencing (or concerned that they might soon experience) significant withdrawals

Figure 3
Weighted Average Portfolio Composition of Prime Money Market Mutual Funds

August 27, 2013



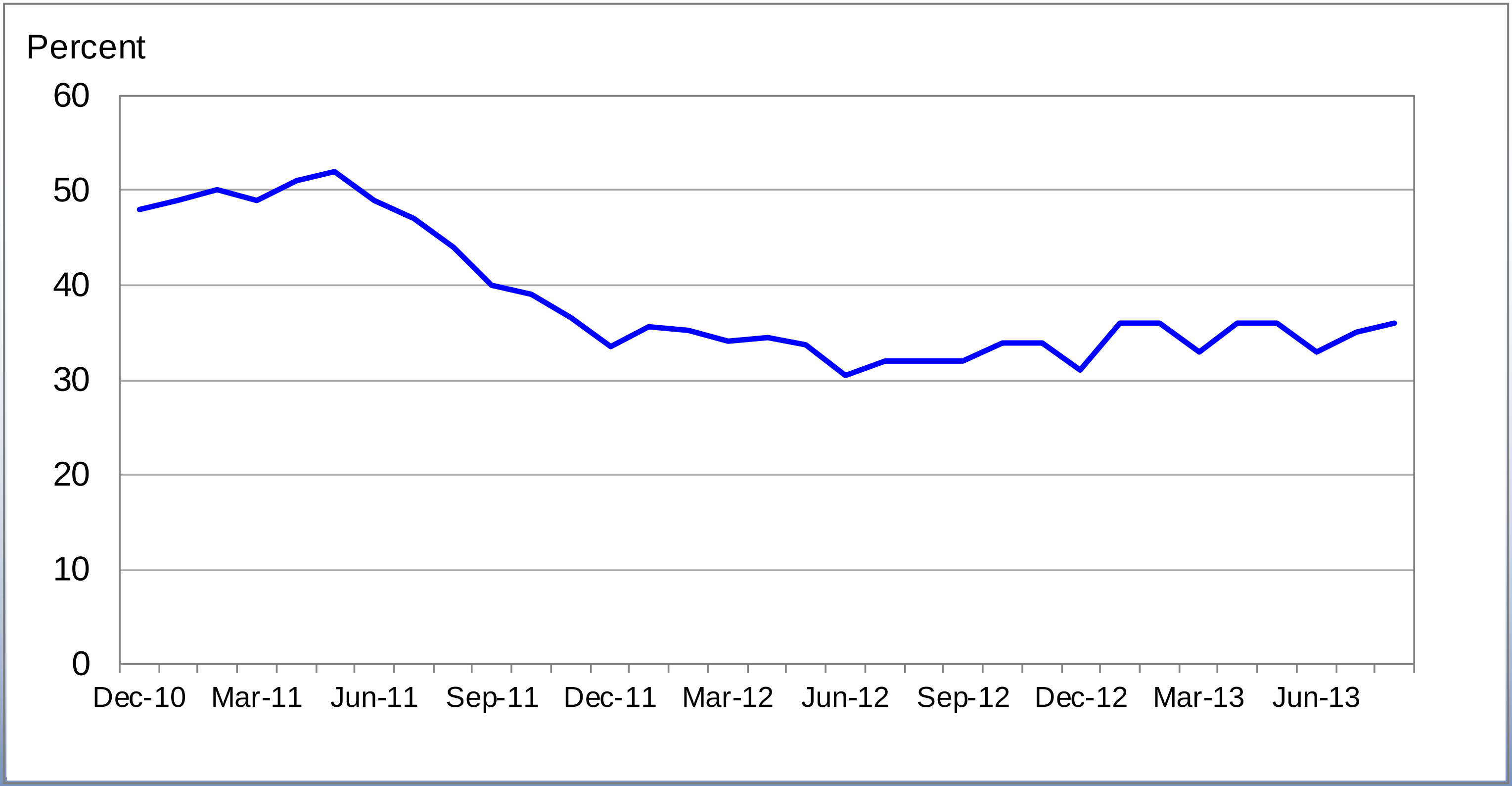
Source: iMoneyNet

Where Are We Now?

- Currently we have new limitations on public-sector safety nets for MMMFs
- Risk of a significant disruption to short-term credit markets, were MMMFs to again experience runs

Figure 4
European Exposure of
Prime Money Market Mutual Funds

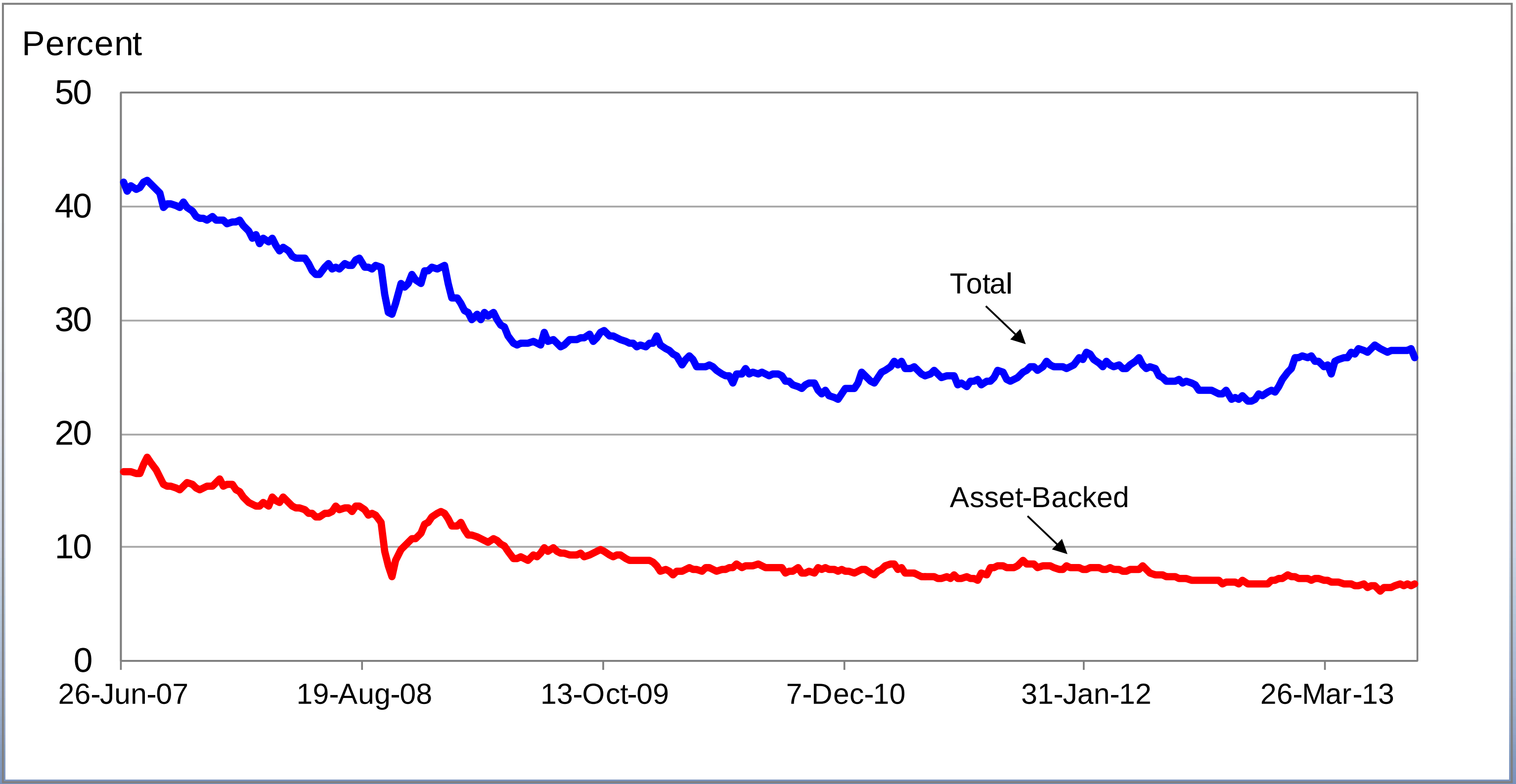
December 2010 - August 2013



Source: SEC Form N-MFP, Federal Reserve Board Staff

Figure 5
Commercial Paper Exposure of Prime Money Market Mutual Funds

June 26, 2007 - August 27, 2013



Source: iMoneyNet

Summary

- MMMFs remain a very important source of financing for short-term debt instruments
- Many of the tools used to offset the 2008 run by MMMF investors have been ruled out by legislation
- Financial stability concerns surrounding MMMFs remain real, five years after the financial crisis
- Implicit promise to return a fixed net asset value, even as they take credit risks against which they hold no capital

SEC Reform Proposals

- Financial Stability Oversight Council (FSOC) proposed three potential reforms, with the one requiring MMMFs to hold capital quite similar to proposals currently being considered in Europe
- SEC has advanced only two proposals, only one of which was included in the FSOC proposals (floating NAV)

Floating NAV Proposal

- Suggested by the FSOC, would treat institutional prime MMMFs like other mutual funds and allow the value of a share of the fund to float with the value of its underlying assets
- SEC’s proposal limits this reform option to institutional prime MMMFs (funds serving institutional investors)

Floating NAV and Runs

- Floating NAV removes the implicit promise to redeem shares at a fixed net asset value – this short-circuits the run dynamic
- Funds must determine appropriate values for money market instruments that often see little secondary market trading
- Inappropriate valuation – application of amortized cost accounting – could degrade the effectiveness of this proposal

Liquidity Fees and Redemption Gates Proposal

- Not proposed by FSOC
- Could impose a fee of not more than 2 percent on all redemptions in the event that the fund experienced liquidity problems – fund’s directors have discretion on utilization
- Fund’s directors could, at their discretion, impose temporary “gates” to prevent redemptions for a time

Liquidity Fee Concerns

- The liquidity fee imposes a haircut on investors who are redeeming funds – a haircut that may not be associated with the underlying value of the assets
- Would impose significant fees on investors that had viewed the account as a means of paying for transactions

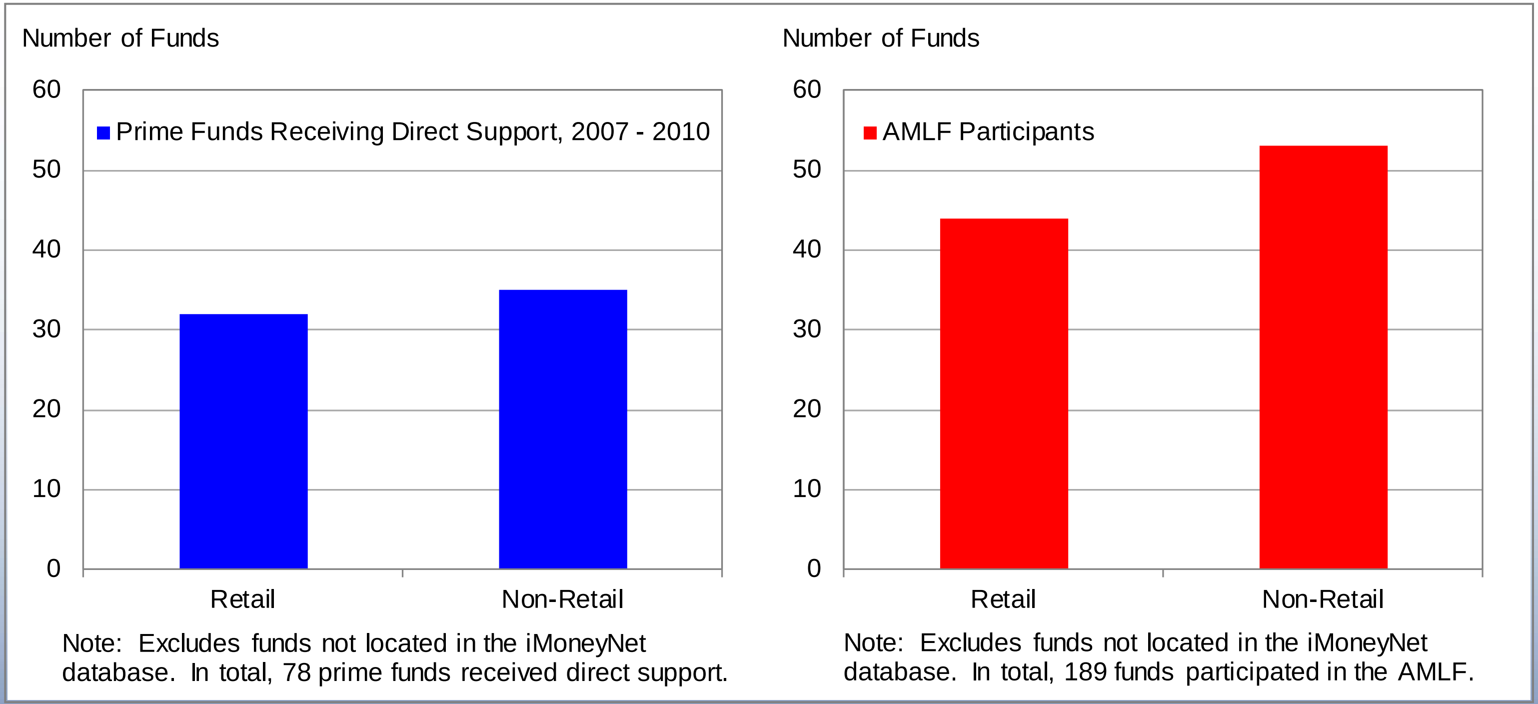
Redemption Gate Concerns

- Temporary redemption gates would restrict investors’ access to their funds
- Financial crises are exactly the time that many investors most need access to their liquid funds

Fees and Gates Proposal Would Actually Increase Incentive to Run

- Fundamentally changes the MMMF product during a crisis
- The investor must now consider how other co-investors in the same fund will behave: If other investors run, the investor could be faced with gates and fees even though the underlying assets have experienced no change in value
- Risk of “contagious” runs (to avoid fees or gates) is increased

Figure 6
Money Market Mutual Funds Receiving Direct Support and AMLF Participants by Fund Type



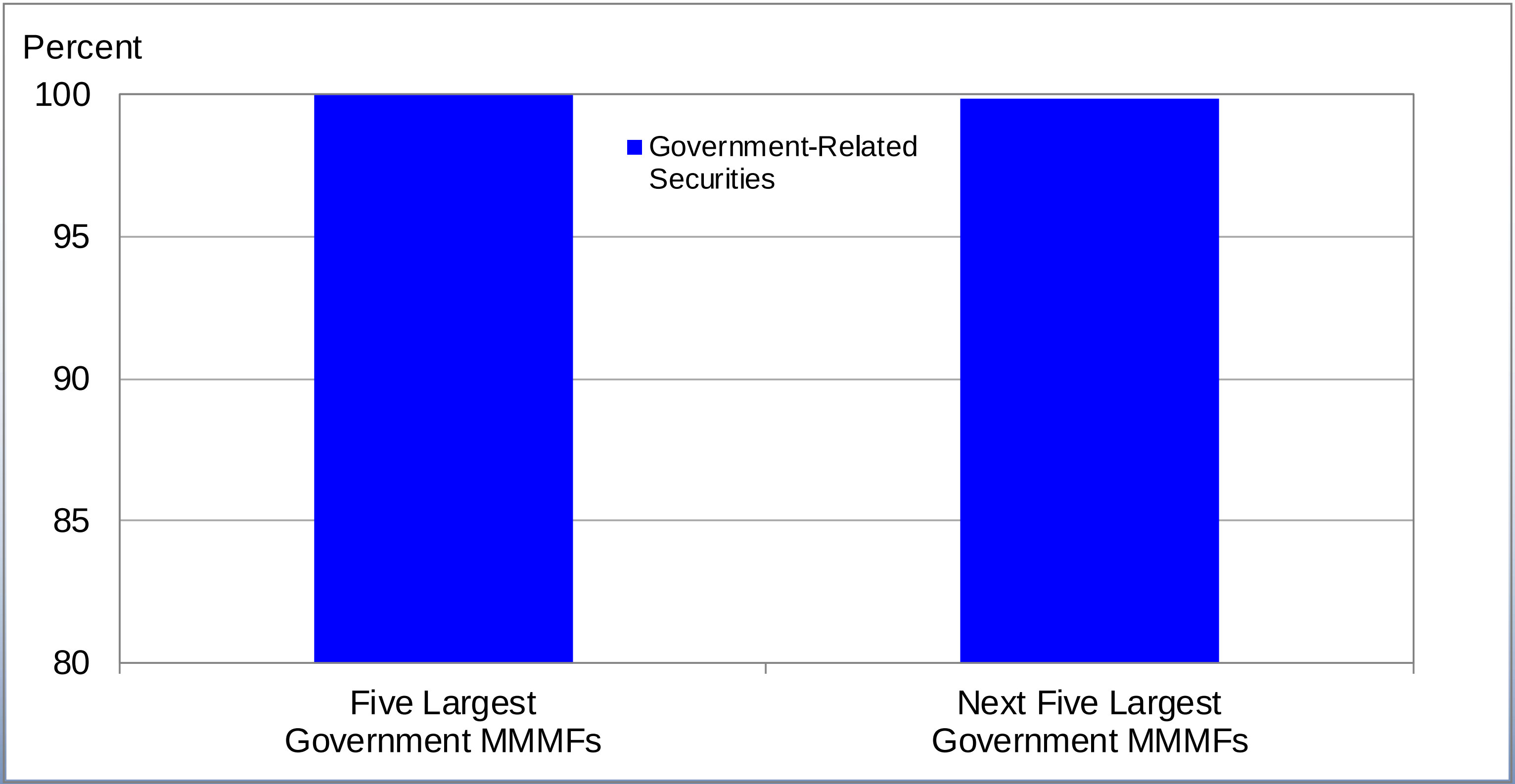
Source: iMoneyNet, Federal Reserve Board, Federal Reserve Bank of Boston

Recommendation: Eliminate the Retail Exemption

- More than 30 of the *retail* prime money market funds needed support during the crisis
- More than 40 retail funds took advantage of the emergency liquidity facility administered for the Federal Reserve System by the Boston Reserve Bank
- Institutional investor may start investing in retail funds in order to get the fixed NAV

Figure 7
Government-Related Securities as a Share of Assets at Ten Largest Publicly Available Government MMMFs

June 30, 2013



Note: Government-related securities include cash, U.S. government securities, and repos collateralized by such securities.

Source: Fund Companies' Monthly Holdings Reports, as of June 30, 2013

Recommendation: Set a Higher Threshold for "Government Funds"

- Government funds are exempt from the floating NAV requirement as long as at least 80 percent of their total assets are in cash or government-related securities
- An 80 percent threshold allows funds to create a prime/government fund hybrid
- Government funds should be government funds

Concluding Observations

- MMMF reform is overdue
- Promising a fixed NAV with no capital while taking credit risk is not sustainable
- Allowing funds to impose liquidity fees and redemption gates is, in my view, worse than the status quo and should be dropped
- I strongly support requiring a floating NAV for all prime funds, both institutional and retail, which would treat these funds like other mutual funds