INVESTMENT COMPANY INSTITUTE

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February 21, 2013

Mr. William C. Dudley
President
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Dear Mr. Dudley:

I read with interest your recent remarks before the 2013 New York Bankers Association Annual Meeting & Economic Forum.[1] To its credit, the Federal Reserve Bank of New York has been instrumental in pursuing reforms to strengthen the financial markets, particularly in the market for tri-party repurchase agreements. As in the past, the Investment Company Institute (ICI)[2] and its members stand ready to assist in ongoing efforts to ensure that the repo market is able to operate effectively during future periods of financial market stress. For example, we recently hosted a webinar during which some of your staff updated our members on recent developments in the tri-party repo market as reform efforts move forward.

I was disappointed, however, that your speech suggested that money market funds are the key source of instability in the money markets. Your speech conveyed narratives of the financial crisis that are contradicted by the facts. Moreover, in discussing money market funds, you diminished the value of the 2010 reforms to Rule 2a-7 by the Securities and Exchange Commission (SEC)—reforms that have made these funds even more stable, liquid, and transparent than ever before. And while you state a preference for market-level reforms for making the tri-party repo market more resilient, you single out money market funds for reform in your approach to broader wholesale funding concerns. The structural changes that you favor would make money market funds uneconomical and drive them from the market. As a result, the supply of funding in the wholesale market would devolve to products that are less regulated and less transparent and pose greater systemic risks. I elaborate on these points below.

Narratives of the Financial Crisis

At the beginning of your remarks you mention the "extensive use of short-term funding" prior to the financial crisis and the contribution of supply-side factors to the mispricing of risk. You do not

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[1] Available at www.newyorkfed.org/newsevents/speeches/2013/dud130201.html

[2] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.2 trillion and serve more than 90 million shareholders.

explicitly mention the supply-side effects of money market funds, but your focus on money market fund reforms implies that these funds were the primary source of supply-side factors.

As we discuss in our comment letter on the *Proposed Recommendations Regarding Money Market Mutual Fund Reform* of the Financial Stability Oversight Council (FSOC),[3] the increase in taxable money market funds' holdings prior to the financial crisis cannot credibly account for the expansion in the supply of credit to the money markets. From the beginning of 2000 to mid-2007, the money markets expanded by $4.5 trillion, while assets of taxable money market funds increased by only $299 billion. The repo and commercial paper markets grew substantially during this period; yet, money market funds accounted for only 11 percent of the increased supply of funding to the repo market and less than 1 percent of the increase in the commercial paper market. In addition, money market funds financed, at most, 6 percent of home mortgage borrowing over this period. During this same time, a wide range of other products and services, such as bank collective investment trusts, short-term investment funds, and other unregistered cash pools with constant net asset values, supplied the bulk of the increase of credit to these markets.

Your remarks also implied that money market funds were the primary source of pressure in the repo and commercial paper markets during the financial crisis. The evidence is to the contrary—it demonstrates that investors other than money market funds triggered the abrupt pullbacks in short-term markets.[4]

The experience of the financial crisis, properly interpreted, shows that focusing on one product will not address the vulnerabilities in these markets. For example, during September 2008, the repo market declined by $400 billion. Money market funds did not contribute to that contraction: instead, they *increased* their holdings of repurchase agreements by a little over $90 billion during that month. Even during the week between September 16 and 23, money market funds expanded their lending in the repo market by $67 billion. Clearly, the pullback in the repo market and the subsequent difficulties of financial institutions in obtaining this type of short-term wholesale funding originated from investors other than money market funds. In addition, these other investors did not return quickly to the repo market. The repo market continued to contract through the remainder of the year, and by year-end 2008 had shrunk by $1.6 trillion from its August 2008 level. During this same time, money market funds increased their supply of credit to the repo market by $44 billion. Gorton and Metrick (2012) have recently made the same point: money market funds provided credit in the repo market while other investors fled.[5]

The evidence from the commercial paper market likewise indicates that a wide range of investors pulled out of these markets during periods of stress. As you are aware, the commercial paper market went through a rapid contraction in the summer of 2007. In August and September 2007, outstanding

[3] Available at www.ici.org/pdf/13_fsoc_mmf_recs.pdf.
[4] Id at pages 31–33 and pages 35–36.
[5] G. Gorton and A. Metrick, *Who Ran on Repo?* (2012), available at http://ssrn.com/abstract=2157174.

commercial paper fell by more than $300 billion, in part because investors rapidly pulled back from issuers of asset-backed commercial paper (ABCP). Investors other than money market funds accounted for 95 percent ($285 billion) of that decline.

After the collapse of Lehman Brothers in September 2008, the commercial paper market rapidly contracted again. Investors began to pull back on Monday, September 15, before money market funds recorded any substantial outflows. Issuance of commercial paper with maturities beyond one week, particularly for asset-backed commercial paper and financial paper, all but dried up. For the month as a whole, commercial paper outstanding declined $185 billion. After accounting for sales to the AMLF,[6] money market funds' share of that decline was only $12 billion.[7] Other investors accounted for more than 90 percent of the $185 billion decline in the commercial paper market in September 2008.

The commercial paper market continued to contract through much of October even though money market funds became net buyers during this time. It was not until the Commercial Paper Funding Facility (CPFF) became operational in late October that outstanding commercial paper started to expand. For the month of October as a whole, total outstanding commercial paper grew by $29 billion with money market funds increasing their commercial paper holdings by $43 billion. As is evident, other investors continued to pull back from this market and more than offset money market funds' purchases in October. Despite this data—in part drawn from Federal Reserve reports—you specifically attributed the need for the CPFF to the decrease in funding from money market funds in your remarks. That argument simply does not accord with the facts.

2010 Money Market Fund Reforms

Today's money market funds are stronger and substantially more resilient than the funds that were available in 2008 because of the tools and regulatory requirements provided by the SEC's 2010 reforms.

First, the amendments addressed the liquidity challenges that prime money market funds faced during the financial crisis by imposing, for the first time, explicit minimum daily and weekly liquidity requirements. All taxable money market funds are required to hold at least 10 percent of their portfolios in assets that can be turned into cash within a day, and all funds must hold at least 30 percent in assets that are liquid within a week.

In practice, money market funds' liquidity is well above the required minimum levels. Treasury and government money market funds have virtually all their portfolios invested in short-dated Treasury, agency, and repurchase agreements backed by Treasury and agency securities. Prime money market funds have exceeded the liquidity minimums by a significant margin and now hold twice as much in

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[6] Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility.
[7] Money market funds sold a total of $152 billion of ABCP to the AMLF from September 22, 2008, to October 1, 2008. These sales did not contribute to the contraction in outstanding commercial paper in September 2008, as they merely represented a transfer of ownership from money market funds to the Federal Reserve via the AMLF.

weekly liquid assets ($667 billion as of November 2012) as the heaviest redemptions they faced in the worst week of the financial crisis in September 2008. Furthermore, many of the assets that make up prime money market fund portfolios today constitute "high-quality liquid assets" that the Basel Committee has proposed that internationally active banks be required to hold to protect against illiquidity. According to the Basel Committee on Banking Supervision, liquidity coverage ratio (LCR)–eligible assets have the following liquidity-related characteristics: (i) they are traded in active and sizable markets; (ii) they have committed market makers; (iii) they have low market concentration; and (iv) they are "flight to quality" assets. Indeed, the overnight repurchase agreements and Treasury and other government securities that now make up more than one-third of prime money market funds' portfolios are precisely the asset classes favored by the LCR framework.

The 2010 reforms put in place strong preventions against fire sales of assets when money market funds are faced with large redemption requests. By construction, the mandated liquidity standards require funds to hold securities from their daily and weekly liquidity buckets that can be sold to meet redemptions. The securities that are used to meet these liquidity requirements are those that are highly sought after in a crisis. Another reform that is often overlooked is that money market fund sponsors are now allowed to suspend redemptions and close a fund to prevent a fire sale of assets from spilling over into the markets and affecting other funds and investors. Gating and redemption fees, which are discussed more fully below, also would serve to help prevent fire sales of assets. If such reforms had been in place, Reserve Primary Fund could have suspended redemptions and conducted an orderly liquidation of the fund without forcing a fire sale of its assets.

Additional Reforms for Money Market Funds

As you are aware, money market funds and their sponsors, led by ICI, have diligently worked with the SEC, the Treasury Department, and the Federal Reserve System to explore further reforms that would enhance the resilience of money market funds under the most adverse market conditions. In 2009, a white paper issued by the Treasury Department identified the creation of a liquidity facility as one promising idea.[8] ICI and its members spent nearly two years developing a detailed concept of such a facility, meeting on numerous occasions with staff at the SEC, Treasury, Federal Reserve Board, and the Federal Reserve Bank of New York before regulators ultimately rejected the idea. Similarly, we have explored potential means of providing capital buffers for money market funds[9] and have provided regulators with extensive research on the implications of, and investor reaction, to various proposals.

Recently, ICI and many of our members have supported providing funds with additional tools to manage shareholder redemptions during a period of stress. As I noted above, the 2010 reforms allow a fund that can no longer maintain its $1.00 share price to suspend redemptions and liquidate the fund.

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[8] See *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at www.treasury.gov/initiatives/Documents/FinalReport_web.pdf
[9] See *The Implications of Capital Buffer Proposals for Money Market Funds* (May 2012), available at www.ici.org/pdf/ppr_12_mmfs_capital_buffer.pdf.

ICI also supports allowing a fund that experiences liquidity pressures to suspend redemptions temporarily, and, at the fund board's discretion, charge a fee to investors needing immediate liquidity to redeem shares. Funds in Europe have similar mechanisms to manage investor redemptions and protect investors, and some funds relied on such tools during the financial crisis. There is no evidence that the existence of such mechanisms causes investors to run on a fund preemptively.

ICI opposes the capital requirements and the minimum balance at risk (MBR) concept proposed by FSOC. As we discuss at length in our comment letter to FSOC, the capital requirements envisioned by FSOC are uneconomical even if short-term interest rates return to more normal levels. The principal challenge of proposals to impose capital buffers is that money market funds would have to increase fees on their funds to compensate capital investors providing the capital. In addition, the fees for these products are set in the market, and overcapitalizing one type of product would make them unattractive relative to similar products, including Treasury money market funds and unregistered cash pools, such as bank collective investment trusts.

Similarly, the MBR concept, by denying investors complete access to their fund shares, would make money market funds less liquid than other investment pools, including other mutual funds, or even a portfolio of repos and short-dated commercial paper and time deposits. The MBR also creates serious operational issues for funds, intermediaries, and investors that would reduce or eliminate the usefulness of many services that money market funds provide. Given investors' stated reaction to such "holdback" proposals,[10] it would be difficult for funds, intermediaries, and service providers to justify the significant costs of complying with an MBR in the face of a rapid shrinkage of money market fund assets.
The danger here is that a policy response that focuses solely on one product—and in this case, on the most regulated and transparent product in the market—will drive investors into less-regulated, less-transparent alternatives. This exit would in turn increase, not reduce, risks to the financial system and reduce information available to regulators.

ICI remains committed to working with regulators to make money markets and money market funds more resilient. I continue to believe, however, that careful, objective analysis of the empirical evidence and clear recognition of market realities offer the best means to reach effective public policies.

Sincerely,

/s/

Brian Reid
Chief Economist

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[10] See *Money Market Fund Regulation: The Voice of the Treasurer* (April 2012), available at www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf; and BlackRock ViewPoint, *Money Market Funds: The Debate Continues—Exploring Redemption Restrictions, Revisiting Floating NAV* (March 2012), available at https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_IND&source=GLOBAL&contentId=1111160117

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