INVESTMENT COMPANY INSTITUTE

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MONEY MARKET FUNDS IN 2012

A Bad Idea: Imposing Capital Requirements on Money Market Funds

The Securities and Exchange Commission (SEC) is considering imposing capital requirements on money market funds. In assessing potential capital buffer structures, the SEC reportedly is considering three sources of capital: (1) the fund's sponsor; (2) the fund's shareholders; or (3) the market, through the issuance of subordinated debt or equity.

Given the wide range of approaches that SEC requirements could take, ICI has analyzed several variations on the capital buffer idea, including requiring fund advisers to commit capital, requiring funds to raise capital in the market, or having funds build a capital buffer inside funds from fund income.

- See "The Implications of Capital Buffer Proposals for Money Market Funds."

Money market funds are not banks. Bank-like capital is inappropriate for money market funds.

- See ICI Talking Points, "Money Market Funds Are Not Banks."

None of the "capital buffer" options is workable.

- **Sponsor-provided capital** is beyond the reach of many fund sponsors, because the required levels of capital are large relative to the sponsors' current capitalization.
  - Mutual funds are owned by fund shareholders, not by fund sponsors.
  - Bank sponsors of money market funds could be forced to consolidate the funds' assets on their balance sheets, with significant impact on the parent bank's required capital.
- **Shareholder-provided capital** could not be accumulated at any appreciable rate in the current near-zero interest rate environment. Funds are already waiving billions of dollars in fees ($5.2 billion in 2011) to maintain a positive yield. Building capital from investors' returns is impossible until short-term interest rates return to a more normal level, which, judging from Federal Reserve pronouncements, now appears to be years in the future.
- **Detailed analysis of market-provided capital** indicates that it could in fact be a source of instability: market-provided capital would likely dry up during periods of financial stress, subjecting funds to the risk of having to find new sources of capital precisely when market participants are reluctant to offer it. It also shows that subordinated investors would require a return far greater than funds could afford to pay. Providing a favorable return for subordinated shares would hurt the funds' primary retail and institutional investors.

In any form, a capital requirement for money market funds would do little to reduce systemic risk but would reduce choice and competition.

- Proposed capital buffers fall far short of ensuring that a fund would not break the dollar under extreme market conditions. Protecting funds' shareholders from any and all potential credit losses would require levels of capital far beyond the amounts reportedly under consideration—and far beyond the ability of *any* money market fund or fund sponsor to provide.
- Capital requirements would likely drive some fund sponsors out of business, reducing competition and choice. Many fund sponsors would likely face very significant (perhaps insurmountable) hurdles in raising capital, either through an affiliate or through a third party. Sponsors instead may elect to use their expertise to manage less-regulated private cash pools that could serve as money market fund substitutes.
- Imposing capital requirements on funds would potentially force fund sponsors to consolidate money market fund assets on their balance sheets. Consolidation is particularly significant for bank-sponsored funds if it forces banks, under existing banking regulations, to raise additional capital relating to their consolidated money market fund's assets.
- Forcing funds to raise capital would raise costs and squeeze investors' returns from money market funds—particularly if capital requirements are excessive or are imposed in the current zero interest rate environment.
- With fund sponsors exiting the business, investors would be left to seek alternatives to money market funds, particularly in less-regulated private cash pools that lack risk-limiting investor protections—potentially increasing systemic risk.

A flight of assets from money market funds would have severe consequences for systemic risk and the economy.

- It is wrong to assume that banks would absorb the $2.6 trillion now invested in money market funds.
- Most institutional investors do not view an undiversified holding in an uninsured (or underinsured) bank account as having the same risk profile as a diversified short-term money market fund.
- Instead, many of those assets could end up in less-regulated cash pools that lack the requirements for credit quality, liquidity, maturity, and transparency applied to money market funds, and that may be beyond the reach of U.S. financial authorities.
- The flight of investors will disrupt the crucial role money market funds play in financing jobs, communities, businesses, and the U.S. economy.

For more information on money market funds, their role in the economy, ICI's efforts to make these funds more resilient in the face of adverse market conditions, and the significant risk of undermining money market funds' value to investors and the economy, please see www.ici.org/mmfs or www.PreserveMoneyMarketFunds.org.