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Do Money Markets Pose Systemic Risk?

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Bloomberg Portfolio Manager Mash-Up

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February 16, 2012
New York, NY
Union Square Ballroom

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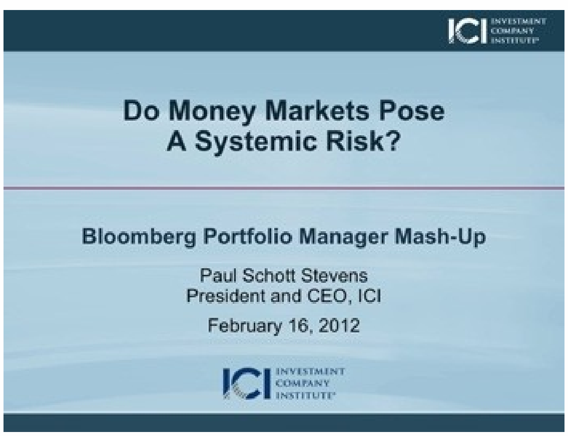
As prepared for delivery

Good afternoon. I'm Paul Stevens, president and CEO of ICI, the national trade association for mutual funds—including money market funds.



In recent weeks, several media outlets have reported stories that put investors and their advisers on alert. One headline said, "U.S. Sets Money-Market Plan." The reporting detailed the Securities and Exchange Commission's upcoming proposal to tighten the regulation of money market funds—a core product that 56 million individual investors and their financial advisers all depend upon.

In the fund industry's response to the reported proposals, I noted that these changes will "harm investors, damage financing for business and state and local government, and jeopardize a still-fragile economic recovery."

Quite a hat trick for the SEC—except that they're scoring against the interests of investors and the economy.

Now, those are strong words for a financial industry to level against its regulator—especially for the mutual fund industry. We recognize that our business is built on investor confidence and a strong foundation of investor-focused regulation.

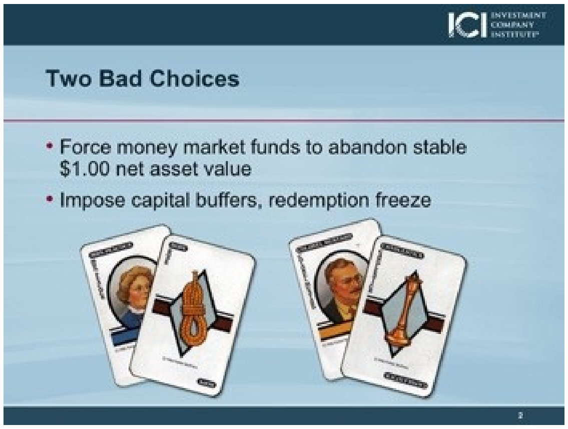
But the SEC's plans for money market funds will not help investors.

Instead, they will undermine the core features of money market funds that investors seek—stability, liquidity, and convenience. They will drive retail investors back to the fixed, low rates paid by banks…institutional investors to less regulated, higher-risk alternatives…and fund companies out of the business.

For you, that means fewer competitors vying for your business—and a product that few investors will want to buy and few brokers or advisers will want to offer.

What does the SEC plan to propose?

This spring, we expect the Commission to come forward with a proposed rule that gives money market fund sponsors a choice of two options.



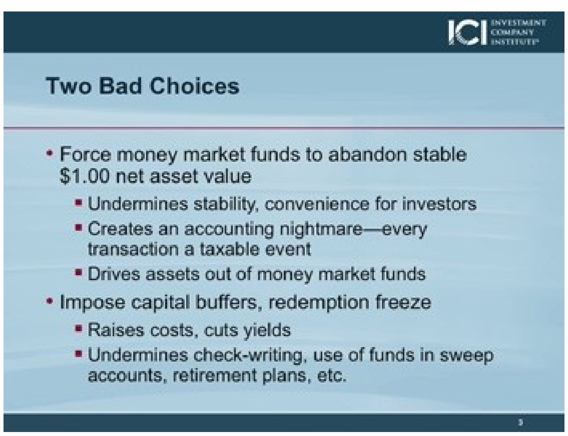
The first choice will be to abandon the stable $1.00 net asset value that has been a hallmark of money market funds since their inception in the inflationary 1970s.

The second choice will keep the $1.00 NAV, but will require money market funds to build a capital reserve and to put a freeze on part of each investors' assets. When an investor with cash in a money market fund sees an investment opportunity in stocks, the SEC reportedly will require that fund to hold back 3 to 5 percent of the investors' cash for 30 days—limiting investors' freedom to act.

Basically, for the money market fund industry and the investors and issuers who rely upon it, this is like a game of "Clue"—death by rope, or death by candlestick?

Let's look at each of these ideas and what they'll do to investors and the economy.

Forcing money market funds to float their NAV would drive millions of investors away from these funds.



Individual investors who write checks on their money market funds want to know that their shares are worth $1.00. If their share values floated, they'd lose that benefit—and they would have to treat every money market fund transaction as a taxable event, a huge accounting and tax headache.

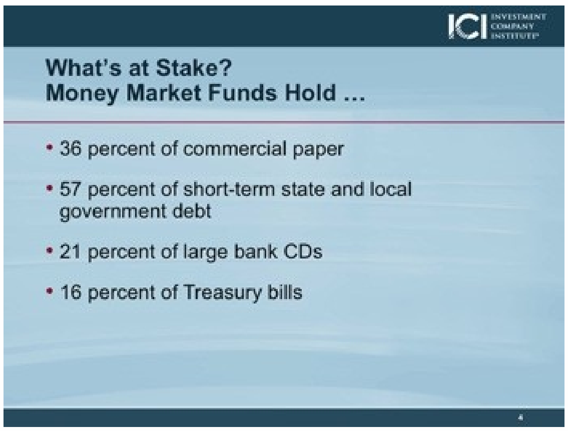
Institutional investors would face the same problems. Moreover, many institutional investors are required to put their cash in stable-value accounts. As one institutional money manager told us: "If your money market fund isn't dollar-in, dollar-out, then you won't get my dollar."

What would regulators gain by forcing money market funds to float their value? They won't reduce the chances of runs—after all, floating-value funds lost 60 percent of their assets in 2007 and 2008. And they won't reduce systemic risk. Businesses and institutions that require or demand stable-value products will find them—in less-regulated, riskier cash products, often offered offshore. That's not going to make our financial system safer.

The second choice the SEC could offer would require money market funds to build capital buffers and to freeze a portion of investors' assets in what are called "redemption holdbacks." The cost of building or paying for capital buffers would come from investors' yields—yields that have been near zero for more than 30 months.

The redemption freeze would strike directly at the convenience and liquidity that money market fund investors want. We estimate that implementing this freeze will cost investors, funds, and financial intermediaries hundreds of millions of dollars—and may wipe out the ability to offer check-writing or to use money market funds in a wide range of common investment programs, including sweep accounts, retirement plans, and securities lending.

The impact of driving investors away from money market funds will be felt throughout the economy.



Consider this: money market funds hold more than one-third of the commercial paper that businesses issue to fund payrolls and operations.

They hold more than half of the short-term municipal debt that state and local government rely upon to fund public projects.

They finance more than one-fifth of large bank CDs and more than one-sixth of short-term Treasury bills.

Truly—money market funds provide a major part of the financing that is the lifeblood of America's economy.

Is any of this necessary?

Regulators will argue that the financial crisis of 2008 exposed a fundamental weakness in money market funds, and that these changes are needed to prevent investor runs, systemic risks, and government bailouts.

That ignores the 40-year history of money market funds and the stability that they maintained through a wide range of market conditions and financial upsets. The fact is, it took the worst banking crisis in 70 years to call money market funds into question. Think of it—at least 13 major institutions—including Citigroup, Countrywide, Fannie Mae and Freddie Mac, and, of course, Lehman Brothers—failed or needed substantial government assistance before the one money market fund "broke the dollar."

What's more, the SEC has already succeeded in addressing the problems that emerged in 2008.

In January 2010—six months before the Dodd-Frank Act passed—the Commission adopted rules that made money market funds stronger by raising standards for credit quality, liquidity, and transparency, while shortening the maturity of these funds' portfolios. The fund industry strongly supported these reforms.

And these reforms have worked. I can say that because money market funds faced three severe challenges in the last 12 months—and emerged unscathed.

The first test—still going on—was the European sovereign debt crisis.

The second was last summer's impasse over the U.S. federal debt ceiling, and the subsequent downgrade of government securities.

And the third challenge is the long-running punishment of near-zero interest rates, compounded by unlimited insurance for noninterest-bearing checking accounts and payment of interest on business checking for the first time in 80 years.

In the face of these challenges, investors took cash out of money market funds. In fact, the assets of prime money market funds fell by 10 percent—more than $170 billion—in just two months, from June to August. Yet money market funds met these redemptions with nary a hiccup—because these funds held liquidity that met and exceeded the standards set by the 2010 reforms.

The SEC and Congress have also addressed the question of taxpayer risk.

In 2010, the SEC gave money fund boards the power to unwind a fund and treat all investors equally if a fund is hit by heavy redemption pressure—without taxpayer dollars or government intervention. And Congress has closed the taps that regulators used to pump aid into commercial paper through money market funds.

In short—the SEC has already succeeded in making money market funds stronger. Those reforms have been tested, and they've worked. The further changes that the Commission reportedly plans to propose won't reduce risks or help investors. Instead, they will harm investors, business and state and local government, and the economy.

As I noted at the outset, investors and their advisers should find this alarming—and they should speak out. So let me leave you with two web addresses…

…where you can find more information on money market funds and statements from scores of organizations opposing the SEC's changes. I'd invite you to add your voice to the effort to preserve money market funds.

Thank you.