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The Seventh-Inning Stretch: The State of Play for Money Market Funds

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Opening Address

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Thank you, Peter [Crane, President, Crane Data], for that introduction, and thank you for the outstanding service you and your company provide to America’s short-term financing markets and to money market funds in particular.

Crane Data is also a key source of intelligence and insight for this vital market – as the program for this Symposium makes quite clear. I’m pleased to be here for what promises to be an outstanding conference, and honored to be your opening speaker.

My only regret, in fact, is that through some error in scheduling, the Symposium is here in Boston at the same time that the Red Sox are 3,000 miles away on the West Coast. Pete – weren’t you supposed to check that before you scheduled the conference? Well – as they say in Chicago – maybe next year.

My topic today is the “Washington and the New Regulatory Regime” for money market funds. This is an opportune time to check the scoreboard and see where we stand. Here are the points that I’d like to

discuss with you today.

First, the industry and the Securities and Exchange Commission have already scored some impressive gains in making money market funds more secure.

We've worked together with a common goal – to make money market funds more resilient under extreme market conditions, to ensure they can withstand another deep and widespread loss of liquidity in the money markets. ICI's Money Market Working Group offered responsible and innovative ideas for making these funds stronger, and the SEC built upon those concepts in its final Rule 2a-7 amendments. In this process, the best thinking of the private sector came together with the expertise of government, to the benefit of investors, issuers, the markets, and the economy. I think those new rules are already making a difference, as I'll discuss a little later.

Second, we're not through with this process. In baseball terms, you might say we're in the seventh-inning stretch – there's been a lot of action, but we still don't know how the final innings will play out. The biggest potential game-changer, of course, is the report that the President's Working Group on Financial Markets is expected to issue on money market funds. But we are also working with regulators on other fronts, including the Federal Reserve Bank of New York's efforts to strengthen the underpinnings of tri-party repurchase agreements.

A third point I'd like to make is that money market funds remain firmly opposed to proposals that would force them to abandon their stable per-share value. And we are not alone in that stance. America's businesses, along with state and local governments, are rallying in opposition to any suggestion that regulators would force money market funds off their stable $1.00 net asset value.

The idea of floating these funds' value is likely to be discussed in the President's Working Group report, whenever it may be issued. And it's still in the air at the SEC, which is contemplating a "round two" rulemaking to address any lingering issues in money market funds and Rule 2a-7.

Proponents of the floating NAV see this idea as a home run – a way to solve any problems of systemic risk that might somehow arise from money market funds with one swing of the bat.

We think it's more of a foul ball.

Forcing money market funds to float their NAV will not eliminate the chances of investor runs. Nor will it reduce risks to the financial system in a severe liquidity crisis. What it will do is destroy money market funds as we know them – imposing severe dislocations on America's households, businesses, and governments, and disrupting the American economy.

At ICI, we have been making this case to anyone who will listen, and urging users of money market funds and issuers in the money markets to speak out. And I'm pleased to report that they are responding.

In the last several weeks, groups representing state and local governments have come out squarely in opposition to forcing money market funds to float. The National Association of State Treasurers; the Government Finance Officers Association; and the National Association of State Auditors, Comptrollers, and Treasurers – all have voiced their support for the ability of funds to operate with a stable NAV.

The SEC's own Investor Advisory Committee has before it a resolution, strongly backed by one of its subcommittees, that calls upon the Commission to preserve the stable NAV as a core feature of money market funds.

And America's businesses are also mobilizing. Just last week, four of the leading organizations in corporate finance joined in a letter to Treasury Secretary Timothy Geithner urging him to reject the notion of abandoning the stable NAV. The letter was signed by the National Association of Corporate Treasurers; the Association for Financial Professionals; Financial Executives International; and the U.S. Chamber of Commerce.

They note that floating these funds will drive away investors, and the resulting drain of assets will [QUOTE] "severely impair the ability of companies to raise capital in the U.S. and undermine efforts to strengthen the American economy."

More than 40 companies – many of them household names – have signed on to this letter or others urging the President's Working Group to drop the idea of floating NAVs.

These organizations and others have emphasized that it is vital to preserve the essential, defining characteristic of money market funds – because they all recognize the highly important role that these funds play in our markets and our economy.

What is that role?

Well, money market funds are about jobs. They hold almost 40 percent of the commercial paper that businesses issue to finance payrolls and inventories.

Money market funds are about communities. They hold nearly two-thirds of the short-term debt that finances state and local governments.

Money market funds are about ordinary Americans. Credit-card, home-equity and auto loans are substantially financed by asset-backed commercial paper held by money market funds.

Money market funds even play a vital role in financing the U.S. government. One dollar out of every six in short-term paper issued by the Treasury ends up in a money market fund.

Forcing money market funds to float their value would put all of that at risk — without any offsetting benefits.

Hard experience shows that mutual funds that float their NAV are not immune to redemption pressure. That's clear from the record of floating-value ultra-short bond funds – they lost half of their assets in the course of 2008. Similarly, some floating-value money market funds outside the United States lost about 40 percent of their assets in the three months from July to September 2007. Clearly, experience demonstrates that a fluctuating per-share value would not eliminate the possibility of wholesale redemptions from money market funds during a future crisis.

What's just as important, and even more worrisome, are the severe dislocations that floating these funds' value might cause for investors and issuers – and, by extension, American businesses and workers.

Investors, both retail and institutional, clearly see the advantages of money market funds. They've voted with their dollars. For almost a year, taxable money market funds have paid their investors an average yield of less than one-tenth of 1 percent. Yet at the end of May, investors still had $2.5 trillion invested in taxable money market funds. That compares with just $200 billion in higher-yielding short-term bond funds, whose share prices vary day to day.

In today's rate environment, money market funds' 13-to-1 advantage in total assets over short-term bond funds speaks volumes about the needs and preferences of investors.

A retail investor expects that $1 put into a money market fund will count for $1 when writing a check or making a withdrawal. If money market funds cannot provide that, retail investors will have no alternative but to use bank accounts – by no means an ideal substitute.

Institutional investors already have many alternatives. But they stick with money market funds in large part because a floating-value fund would mean constant accounting and tax headaches. In such funds, investors must track realized or unrealized capital gains and losses in their position and conduct detailed recordkeeping when there are changes in the value of their money market fund investments.

So if regulators forced money market funds to abandon their stable $1.00 value, institutional investors would leave. As one institutional investor has told us, "If a money market fund is not dollar-in, dollar-out, you won't have my dollar." Indeed, many institutions are required by law or by investment policy to keep cash in stable-value accounts.

Where would they go if money market funds did not provide that stable value? Banks might seem to be the obvious choice. But banks don't want large institutional deposits. In fact, banks now "sweep" institutional deposits off of their books and into money market funds and other short-term instruments, so that the banks can avoid carrying large demand balances. Wiping out stable-value money market funds won't make banks any more eager to assume those liabilities.

Instead, institutions that want or require stable value would probably wind up investing in private pools, here and overseas, that promise to maintain a fixed price. Indeed, as ICI's chief economist, Brian Reid,

will describe tomorrow, these pools are already drawing institutional dollars out of money market funds.

But these alternatives are neither registered with the SEC nor subject to regulation under the Investment Company Act 1940, including Rule 2a-7. They don't assure investors the same protections that money market funds do with respect to credit quality, maturity, liquidity, and disclosure. And as we saw in late 2007 – well before Lehman Brothers failed and Reserve Primary Fund broke the dollar – investors are quick to abandon these less-regulated pools and flood into the security of regulated money market funds when a crisis threatens.

In short, forcing money market funds to float their values would kill these funds as we know them – without reducing systemic risk. In fact, it seems highly likely that the world would be a riskier place for investors, for issuers, and for the markets.

At the same time, the flow of hundreds of billions of dollars that money market funds supply to various sectors of the economy would be severely disrupted. Short-term financing that is vitally important to businesses would be at risk, and with it jobs for American workers. A gaping hole would emerge in municipal finance, exacerbating the budget woes of communities around the nation. Consumer lending would become less available and more expensive. None of this would be good news for a struggling economy. With money market funds out of the picture, there is no ready substitute that can match the dual advantages that today's money market funds provide – financing the economy while offering strong investor protections.

Given this analysis, it should be no surprise that the groups I mentioned earlier – representing both investors and issuers that depend on these funds – all have spoken out against floating the value of money market funds. Users of money market funds, and the municipalities and businesses that rely on them for financing, do not want to see changes that will destroy the fundamental nature of this product.

Let me be clear: That is not to say we should disregard the experience of the money markets and money market funds in the fall of 2008, during the worst financial crisis in decades. To the contrary, both the industry and regulators already have taken significant steps to make money market funds stronger, without undermining their core features.

The heavy redemption pressure on money market funds during the financial crisis clearly revealed vulnerabilities that needed to be addressed – not just to sustain money market funds, but to protect the financial markets and the economy. We have taken those problems very seriously, and continue to do so.

First, ICI's Money Market Working Group issued a set of wide-ranging proposals to address weaknesses in money market fund regulation. When that report was issued in March 2009, ICI's members pledged to adopt those recommendations voluntarily.

Then, the SEC approved final amendments to Rule 2a-7 that will raise credit standards and shorten the maturity of money market funds' portfolios – reducing credit and interest rate risk. They require more frequent disclosure of money market funds' holdings, so both regulators and investors will better understand funds' portfolios.

One issue that arose in the SEC's process was the role of credit rating agencies in money market funds' decisions about credit-worthiness. The Commission considered whether to remove Rule 2a-7's requirement that a fund must consider a security's credit rating as one element in the fund's credit assessment. While I am sympathetic to many of the arguments for removing that requirement, ICI reasoned – and the Commission ultimately agreed – that credit ratings are useful as a foundation upon which funds can build their own rigorous credit analysis.

Congress has now decided, in the Dodd-Frank legislation, that regulators should remove references to credit ratings from all their rules. We look forward to working with the SEC as it crafts an appropriate new standard of creditworthiness for money market fund instruments that complies with the legislation. Meantime, we strongly encourage fund boards to adopt policies that match or improve upon Rule 2a-7's long-standing procedures and protections.

One of the most crucial items raised by the Money Market Working Group and in the SEC amendments is liquidity. For the first time, money market funds must meet explicit liquidity requirements: 10 percent of taxable money market funds' assets must be liquid on a daily basis, and 30 percent of all funds' assets must be available within seven days. As substantial as they are, these levels are minimums. Funds also must adopt "know your investor" procedures and stress-test their portfolios to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly.

What is the practical effect of these new liquidity requirements?

In September 2008, when the redemption pressure on money market funds was at its greatest, the net withdrawal from prime funds peaked at $300 billion before the Treasury announced its Temporary Guarantee Program. That was 14 percent of those funds' assets.

If the new rules had been in effect then, prime funds in the aggregate would have had $217 billion in assets liquid on a daily basis. And their aggregate weekly liquidity would have totaled $652 billion.

Liquidity at these levels should do much to reassure money market fund investors that there is no need to rush for the exits in a financial crisis – thus reducing the risk to the money markets and the financial system.

If investors should bring heavy redemption pressure to bear, the SEC has given money market fund boards a powerful weapon to stop any run. A fund's board can suspend redemptions if a fund is about to break the dollar – assuring all of the fund's shareholders of equitable treatment and ensuring an orderly liquidation of a troubled fund.

With money markets and money market funds operating more smoothly, many people have overlooked the significant progress that the SEC's amendments to Rule 2a-7 represent.

To its credit, the Commission moved promptly and decisively in its new rules for money market funds. It certainly outpaced its regulatory counterparts responsible for addressing other issues arising from the financial crisis.

And the Commission's amendments to Rule 2a-7 are already having a marked impact. To take just one example: Last December, 15 percent of taxable money market funds had a weighted average maturity longer than 60 days. By May, that was down to 2 percent of these funds – and this was before the rule amendments requiring shorter maturities had fully kicked in.

Regulators in other jurisdictions have taken note of the SEC's approach to making money market funds stronger. The Committee of European Securities Regulators has issued guidelines to provide a common definition for money market funds across Europe, including a category of "short-term money market funds" that must meet strict credit-quality and maturity standards. And securities regulators in Canada recently published a proposal to improve the credit quality and liquidity, and reduce the maturities, of their money market funds. Properly implemented, these proposals will help protect both investors and the integrity of the money markets.

Even with this progress, our search for ways to weather-proof money market funds has not stopped. ICI and its member firms are not resting.

For example, we are actively engaged in a task force sponsored by the Federal Reserve Bank of New York to strengthen the underpinnings of a vital portion of the money market – tri-party repurchase agreements. The task force includes regulators, clearing banks, cash borrowers, and lenders, including money market funds. It has developed a set of recommendations intended to reduce the risks related to this $1.7 trillion repo market. The goal is to improve the clearance and settlement arrangements and credit and liquidity risk management practices of market participants, while also providing greater transparency into this market for regulators. These reforms will be crucial for all participants, including money market funds, which provide about one-third of the lending in this market.

The task force is working quickly to meet the aggressive timetables set forth to implement the recommendations in its May report. ICI has been assisting with this process, including drafting a set of guidelines for money market funds that detail the steps they would take to liquidate securities subject to a repo in the event of a dealer default. We have submitted this checklist to the SEC and are awaiting its comments.

ICI also continues to explore the feasibility of a liquidity backstop for prime money market funds in times of extreme redemption pressures. As I discussed in March, ICI's Money Market Working Group has been at work on a blueprint for such a facility, established by and for prime money market funds, dedicated to providing them yet more liquidity in case of need.

In sum, we now have a multi-layered approach to making money market funds stronger.

The foundation is the sound risk-limiting regulations that have been in place under Rule 2a-7 since 1982, reinforced by new credit, maturity, and disclosure standards.

These have been enhanced by the SEC's new liquidity, stress-testing, and "know your investor" requirements, all designed to anticipate and prepare for shareholder redemptions.

Add to that the authority provided to a money market fund board to halt a run on a fund and implement an orderly liquidation fair to all the fund's shareholders.

New reforms of the tri-party repurchase agreement market will ensure that money market funds will have greater confidence in their collateral and enhanced security in those agreements.

And we are open to other ideas – like the establishment of a liquidity facility – that would meet the goal of making money market funds even more resilient.

Taken together, these measures would provide a wholly new level of protection for money market funds, their investors, and the markets.

What will the next financial crisis look like? No one can say where it will arise or how it will spread.

But when that storm strikes the short-term credit markets, all these measures I have described will make money market funds better prepared.

That is good news for money market fund investors, because it offers them greater protections. That's also good news for the economy, because it means the critical flow of financing that these funds provide is more likely to continue unimpeded.

I'm proud of the progress that we've made to make money market funds even stronger. I'm proud of the leadership our industry has shown in making those changes.

Thank you for your time and attention, and thanks again to Crane Data for the opportunity to participate in this conference.

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