



January 15, 2013

Financial Stability Oversight Council  
Attention: The Honorable Timothy Geithner  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

By Internet: <http://www.regulations.gov>

**Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC -2012-0003) – Alternative Three: NAV Buffer**

Members of the Financial Stability Oversight Council:

We are writing in response to the Financial Stability Oversight Council's (the Council) recommendations on money market mutual fund (MMF) reform, "Proposed Recommendations Regarding Money Market Mutual Fund Reform" ("the Proposal(s)"). Treasury Strategies, Inc. has prepared the following opinion regarding the Council's recommendation that MMFs be required to establish a risk-based NAV buffer.

Treasury Strategies is the world's leading Treasury consulting firm working with corporations and financial institutions in the areas of treasury, liquidity, and payments.

The Council is focused on reducing the risk of runs on MMFs, as one way to lower the likelihood of systemic breakdown in the larger financial sector. You believe requiring MMFs to incorporate a risk-based NAV buffer of three percent to provide explicit loss absorption capacity will reduce MMF's **perceived and heretofore unproven** susceptibility to runs.

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We believe you are attempting to address a problem that is arguably not a problem. During the 40-year history of MMFs, there have only been two instances of any MMF investors incurring even a small loss. Although it has demonstrated remarkable reliability, the \$2.6 trillion MMF industry is in danger of being dismantled by draconian proposals such as those suggested in the Proposal.

Significantly, the Proposal minimizes the very real possibility that institutional investors **would abandon MMFs en masse** as a cash management tool if the proposal were adopted.<sup>1</sup> The Proposal does not adequately consider potential damage to short-term liquidity markets, investors, or the financial system as a whole that would result if MMF assets shrank drastically.

Not only will this proposal **fail** to achieve regulators' objectives of preventing a financial run or loss, but also it may in fact **stimulate** these undesirable events.

<sup>1</sup> Treasury Strategies, "Money Market Fund Regulations: The Voice of the Treasurer," April 2012.

The proposal has several key dangers:

- Introduction of bias which places Prime MMFs at a competitive disadvantage;
- Reduced transparency for investors;
- Confusion leading to more risk-averse/panic-prone investors;
- Increased moral hazard for fund companies and investors;
- Increased volatility;
- Increased costs and decreased yields, especially for retail investors and smaller fund companies;
- Increased concentration of assets into the largest banks;
- Exit of both monoline firms and bank advisors from the business; and
- Creation of new AIG-like risks.

We believe the NAV buffer will **fail to achieve the regulatory objective** of preventing MMF runs (a rare occurrence to begin with), while it significantly **harms or destroys the \$2.6 trillion market for MMFs**, creating a huge vacuum in short-term credit markets. Furthermore, Treasury Strategies believes the proposal will have **severe negative consequences** for investors, short-term borrowers, banks, businesses of all sizes, and the broader global economy.



## The Proposal Ignores the Sufficiency of Current MMF Regulations

The Council proposes introducing up to a 3% NAV buffer or capital requirement on prime MMF funds, potentially with other requirements such as more stringent diversification. The Council intends the NAV buffer to “serve as the primary tool to increase the resiliency of MMFs and reduce their vulnerability to runs.”

However, neither the Council nor any other regulatory body has produced quantitative evidence of MMFs’ supposed vulnerability to runs. Furthermore, regulators continue to ignore both the anatomy and timing of financial runs, and the fact that no regulation can completely prevent a run.

As the Federal Reserve of Boston recently stated, the “crucial role that policymakers could play [to prevent or minimize reactions of panic during financial crisis] would be to provide investors with new, compelling narratives about the market or about a commodity in crisis, to supplant the narrative that has shattered existing narratives (for example, the belief that some banks, such as Lehman Brothers, are too big to fail)<sup>2</sup>.”

During the financial crisis of 2007-09, investors staged runs on entire asset classes, not just specific institutions.

The first asset classes to freeze in mid-2007 were non-2a-7 enhanced cash funds and asset-backed commercial paper. Market collapses in auction rate securities and mortgage derivatives followed.

Individual institutions also experienced runs. These included some local government investment pools and a prominent higher-education liquidity fund. An investment bank failed when its short-term funding dried up, which was essentially a run by sophisticated investors. Several well-capitalized corporations had difficulty placing their highly-rated commercial paper. Large commercial banks like IndyMac, Washington Mutual and Countrywide experienced runs as their short-term funding failed and depositors fled. Government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac were unable to fund themselves in the markets, because investors refused to reinvest.

In the case of these commercial banks, GSEs and investment bank failures, government rescues protected investors and increased moral hazard in the marketplace.

By August of 2008, **only two major liquidity-related asset classes had not experienced failure**: U.S. government securities and money market mutual funds.



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<sup>2</sup> Federal Reserve of Boston – Public Policy Discussion Papers, “A Psychological Perspective of Financial Panic,” Anat Bracha and Elke U. Weber, September 2012.

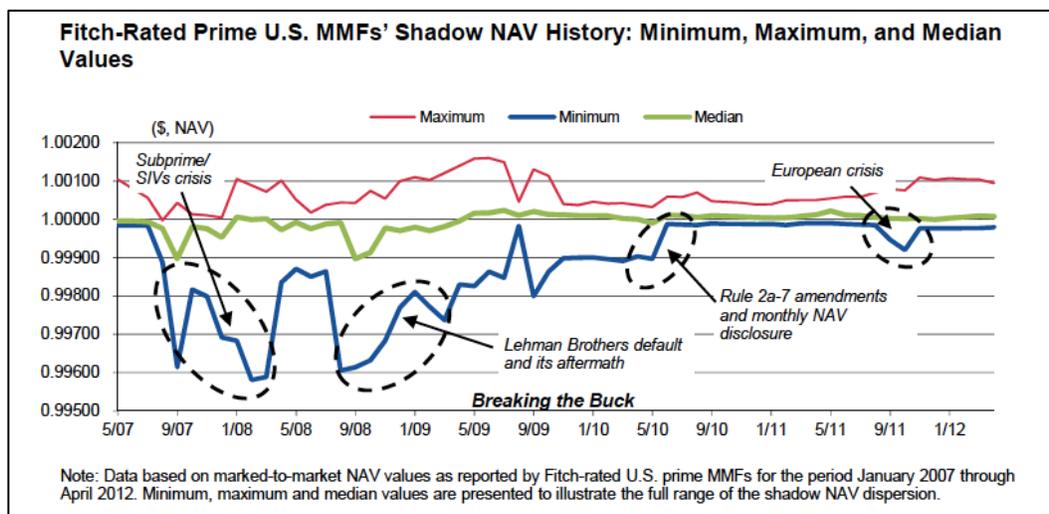
Then Lehman Brothers failed and the government did not come to its rescue. That led directly to two other failures that same week. AIG failed to the tune of \$185 billion and was rescued by the federal government. The Reserve Fund sustained a credit loss of \$785 million and was not rescued, resulting in investors ultimately receiving \$0.99 for each share that originally cost \$1.00.

MMFs were the **last asset class to encounter difficulty** and suffered the smallest losses in both real and proportional terms. Furthermore, The Reserve Fund suffered a loss as a result of its exposure to Lehman Brothers, a AAA-rated holding at the time.

The SEC enacted tightened MMF rules in 2010. The Council continues to debate further changes to address run prevention concerns. However, the Rule 2a-7 changes in 2010 addressed all three types of runs: credit-driven, liquidity-driven and speculative runs. They substantially reduced the likelihood of a fund breaking the buck due to a run and were executed in a way that did not destroy the money fund business. They mandated:

- More robust fund liquidity measures;
- Stronger portfolio quality standards;
- Shorter maturity limits;
- Increased transparency of portfolio holdings and valuations; and
- Independent ratings and reporting requirements.

With these changes, MMFs have become even more stable, evidencing less underlying portfolio volatility, as demonstrated by a Fitch Ratings June 19, 2012 Special Report.<sup>3</sup>



This chart shows that prior to the 2010 changes (a period during which only one MMF broke the buck), MMFs were capable of sustaining massive volatility during very turbulent market conditions. Since the changes, MMFs have endured both firestorm and prolonged credit-driven and liquidity runs with ease<sup>4</sup>.



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<sup>3</sup> FitchRatings Special Report, "U.S. MMFs Show Shadow NAV Stability," June 19, 2012.

<sup>4</sup> Refer to Appendix for explanation of the three types of runs.

At a minimum, measures such as capital requirements will distort the market equilibrium and dilute the positive effects of the successful 2010 reforms. However, Treasury Strategies believes such measures will be far more damaging, as described below.

### **Introduction of Bias, Which Places Prime MMFs at Competitive Disadvantage**

This proposal introduces a clear bias, and places disproportionate complexities and increased operational costs on Prime MMF funds. By explicitly excluding Treasury MMFs from proposed additional regulations, the Council indicates its preference for the Treasury MMF asset class.

With or without added diversification or liquidity requirements, imposing a NAV buffer will decrease investor yields and increase advisor costs. This will destroy the economic value of Prime MMFs for both investors and advisors, especially in the current rate environment.

The Council realizes that raising significant buffer funds will be burdensome for fund advisors. It recommends three alternatives: an escrow account, subordinated buffer shares, or retained earnings for advisors. However, the Council fails to acknowledge that each option, or any other alternative, presents Prime fund advisors with these harsh realities:

- Increased costs;
- Decreased yield to investors;
- Reduced profit margins; and
- Increasingly narrow spreads between Treasury and Prime MMFs.

The Council also does not adequately address how certain negative consequences of buffer creation would be diminished or prevented:

- Increased risk of MMF runs due to a mass exodus by investors;
- Increased systemic risk due to greater concentration of assets at large, complex financial institutions; and
- Monoline and boutique fund providers and retail MMF investors taking on a disproportionate part of the additional capital burden.

Assuming the reduced Prime MMF yield remains above Treasury MMFs, fund advisors and investors will reassess whether the Prime MMF is worth the risk premium, relative to Treasury MMFs.

Finally, accumulating a buffer from investors will almost assuredly result in a mass exodus, i.e., a run, out of Prime MMFs. No rational investor will accept zero or negative return when zero-yield federally-insured deposit accounts are available at banks. Faced with this trade-off, investors will exit Prime MMFs en masse for more attractive instruments. Institutional investors, who hold the bulk of MMF assets, are able to move hundreds of million dollars instantly – likely producing the type of firestorm run regulators seek to prevent.

In essence, the Council's proposal would create a winner of Treasury MMFs while severely hampering, if not eliminating the market for Prime MMFs.



## Reduced Transparency for Investors

The proposed capital requirement raises disclosure issues that will reduce transparency, increase complexity and precipitate a run.

Increased transparency is an important weapon in the fight against speculative runs because it counteracts rumors and fears that fuel them. In addition to increasing credit standards and shortening the weighted average maturity, the 2010 Rule 2a-7 changes improved MMF transparency. They mandated monthly disclosure of all portfolio holdings on the fund's website and monthly filings of portfolio holdings with the SEC.

If an NAV buffer is implemented, new transparency issues arise, as described below. The capital requirement adds complexity, uncertainty, and lack of transparency to an instrument whose hallmarks are simplicity, stability and transparency. This would be an issue for a wide variety of investors – from sophisticated corporations to less sophisticated retail customers.

Were the capital buffer drawn on, the fund manager would have two disclosure options, both with problematic consequences:

- Risk creating a run by disclosing that the buffer has been breached; and
- Reduce transparency by avoiding full disclosure.

The capital-buffer-as-run-prevention idea rests on the assumption that investors will not be alarmed when the buffer is breached. Yet, alerting the public of buffer deployment could easily precipitate a run. And, it may start earlier. Instead of beginning when the fund breaks the buck, the run will now start when the buffer is impaired. Instead of being an investor safety net and preventing a run, buffer deployment will trigger investor fear.

The second option, not disclosing a capital buffer drawdown, contradicts the transparency Rule 2a-7 has sought to increase. Omitting capital buffer actions from required monthly reporting creates uncertainty and complexity for investors. This is contrary to MMF investor goals – they choose MMFs because of simplicity, stability, and certainty of the investment.

## Confusion Leading To More Risk Averse/Panic-Prone Investors

A capital requirement for MMFs encourages the false notion in investors' minds that MMFs are more like bank deposits than investments. If a capital buffer existed, investors would be more likely to view an MMF as a deposit rather than an investment. This would attract an investor class that is **more** likely to flee at the first sign of distress or rumor, thus **increasing** the likelihood of a run.

Investors have alternatives if they want a place to put their cash that is insured and therefore not, by definition, an investment. Several types of bank deposits are available to individuals and corporations.



In contrast, investors opt for investments, such as MMFs, knowing there is principal risk. MMFs inform investors of relevant risks through disclosures, which state that an investment is not guaranteed and may fluctuate in value. The existence of a capital buffer presumes investors are unable to understand such disclosure and need to be protected from the risk inherent in their investments.

### **Increased Moral Hazard for Fund Companies and Investors**

Another consequence of requiring MMFs to maintain a capital buffer is increased moral hazard, for both fund advisors and investors.

Just as insurance can change the behavior of the insured, a capital buffer will encourage fund advisors to buy riskier investments, as they seek higher yields to increase assets under management. There is an obvious parallel between an MMF capital requirement and FDIC deposit insurance, which exhibits this moral hazard consequence.

Empirical studies support the idea that moral hazard associated with deposit insurance leads to increased systemic risk. A 2000 study based on data from 61 countries found “explicit deposit insurance tends to be detrimental to bank stability,”<sup>5</sup> an effect that increased as coverage became more extensive.

A more recent study examined data from 203 banks across ten central and eastern European countries. It found that “banks take on higher risk in the presence of explicit insurance and hence that explicit deposit insurance has generated moral hazard incentives for banks.”<sup>6</sup> Neither data set included the financial crisis of 2007-2008, which would certainly have strengthened these findings.

The guaranteed protection of principal implied by a capital buffer reinforces the false notion that MMFs are deposits, increasing moral hazard from the investor perspective as well. If they view invested principal as either insured or protected, investors will increasingly seek funds with the highest yields, regardless of the funds’ risk profile.

### **Increased Volatility**

The imposition of a capital requirement will not achieve regulators’ stated goal of reducing the likelihood of a fund breaking the buck and precipitating a run. In fact, it would have the opposite effect. It would create new moral hazard for fund advisors and investors, inciting them to take additional risks in search of higher yield, and transferring that risk to whoever funded the buffer.



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<sup>5</sup>Asli Demirgüç-Kunt and Enrica Detragiache, “Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation,” April 2000.

<sup>6</sup>Isabelle Distinguin, Tchudjane Kouassi, Amine Tarazi, “Bank Deposit Insurance, Moral Hazard and Market Discipline: Evidence from Central and Eastern Europe,” June 2011.

A buffer would also change the concept of the constant \$1 Net Asset Value (NAV), and in so doing encourage more investment volatility. A mandated capital requirement of 300 basis points would widen the effective NAV fluctuation on a \$1 fund from \$0.995-\$1.005 to \$0.97-\$1.03 cents. This would incent fund advisors to take on additional risk, increasing volatility. This could also increase the probability of a fund breaking the buck and experiencing a run.

A Federal Reserve Report found that “sponsor support has likely increased investor risk for money market funds.” Moreover, the report found that “sponsor-supported funds exhibited greater investor risk than the rest of the prime fund industry by several measures: they had lower expense ratios, more rapid growth in the previous year, and greater flow volatility and sensitivity to yield.”<sup>7</sup> This furthers the notion that a sponsor-funded buffer would increase systemic risk through greater volatility and moral hazard.

### **Increased Concentration of Assets into the Largest Banks**

We have argued that imposing a capital buffer on Prime MMFs will cause a mass exodus of assets. Even if a run were avoided as this occurs, the migration of huge amounts of money will substantially increase systemic risk.

Investors leaving MMFs will have three basic options:

- Riskier investments with higher yield;
- Off-shore investments; and
- Bank deposits.

The first two options increase systemic risk, as large amounts of assets move from relatively safe MMFs into riskier and less regulated investments. It is far more difficult for regulators to track these less transparent asset flows and to manage the resulting dislocations.

The third option also increases systemic risk. It drastically expands asset concentration in the banking sector, exacerbating the “too big to fail” phenomenon.

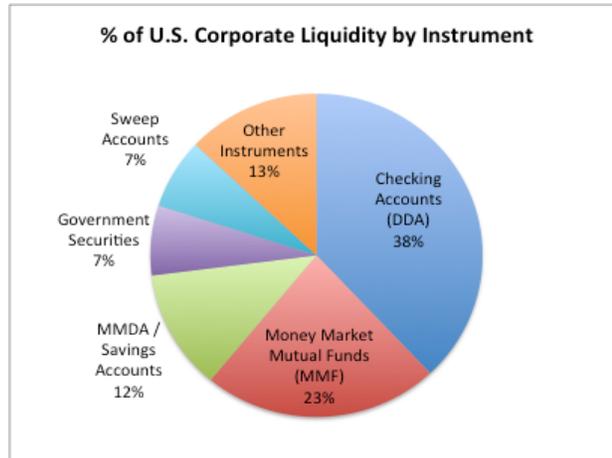
Large corporations and institutional investors have funds to invest that dwarf the balance sheets of all but the largest U.S. banks. Corporations place 23% of their liquidity in money market mutual funds. A corporation redeploying these assets into bank deposits will concentrate them with the largest banks. Even at the largest banks, such potentially huge flows will strain the already bloated balance sheets and lower the returns to bank investors.



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<sup>7</sup> Federal Reserve Board, Finance and Economics Discussion Series, “The Cross Section of Money Market Fund Risks and Financial Crises.” Patrick E McCabe, 2010-51 (the “Report”), at 35.



Source: Treasury Strategies Quarterly Corporate Cash Report, December 2011

### **Both Monoline and Bank Advisors Would Be Forced to Exit the Business**

While the Council proposes three methods to build a capital buffer, the end result of these or any other alternatives amounts to MMF sponsors providing a level of insurance to their own funds. Requiring fund sponsors to replenish their own capital buffers will only create more complexity and interconnectedness in the financial system. Further complicating the issue is the fact that other regulations, such as Basel III, will make it unfeasible for banks to move fund assets to their balance sheets.

MMF advisors are already under sharp profit pressure from prolonged low rates and regulatory changes. Unable to absorb new capital requirement costs and still maintain profitability, advisors will pass at least some costs on to investors. When this occurs, sophisticated institutional investors will redeploy assets elsewhere for better yield, putting the entire burden on individual investors who have fewer investment choices. This will also reduce assets under management for the affected funds, further exacerbating profit pressure.

This devastating cycle of cost increases – asset declines will disproportionately harm monoline fund providers, which are solely mutual fund companies. Monoline fund companies do not have revenues from other business lines to support the accumulation of a buffer. This would place them at serious disadvantage, relative to more diversified firms. Many monoline firms would simply be forced to exit the business.

Yet diversified financial firms and banking institutions would also face a serious dilemma. They could draw on their extensive resources to build a buffer, and could more easily absorb buffer-related costs. But this would shift scarce resources away from core banking activities to support their MMF business. More troubling, should the capital requirement be judged under Basel III or IFRS to be tantamount to a guarantee, banks would have to consolidate MMFs on their balance sheets. This would be the death knell of bank-sponsored funds.



Much like an exodus of investors, the exit of numerous monoline advisors and bank fund advisors could destroy a \$3 trillion industry, in the process creating the type of run regulators seek to prevent with a buffer.

### **Creation of New AIG-like Systemic Risks**

There is an undeniable component of risk tied to a sponsor's obligation to replenish its own buffer. However, fund sponsors may choose not to hold additional risk for balance sheet purposes, shareholder perception, etc. Those opting not to hold additional risk will look for creative ways to shift or disperse the risk, finding ways to package and sell the risk, passing the fees to shareholders.

Packaging and selling MMF credit risk has an undesirable parallel to the credit default swap model for the financial system. Similar to AIG, buyers or insurers of this risk will reap financial benefits without having to invest in the fund – a dynamic that opens the door for speculation. Savvy investors will look for MMFs in danger of drawing on their buffers and place bets accordingly. This repackaging and selling of risk adds complexity and reduces MMF transparency, increasing systemic risk as more financial institutions become stakeholders in funds.

## Conclusion

The stated objective of the Council is to reduce the likelihood of a financial run in MMFs. The modifications to Rule 2a-7 instituted in early 2010 adequately deal with each of the three types of financial runs. Furthermore, the negative effects of the NAV buffer proposal, listed below, will roll back the benefits already attained.

The capital requirement proposal will not only **fail** to achieve regulators' objectives of preventing a run or loss, but may in fact **stimulate** these undesirable events. Key dangers of the proposal include:

- A bias toward Treasury MMFs and competitive disadvantages for Prime MMFs;
- Reduced transparency for investors;
- Confusion leading to more risk averse/panic-prone investors;
- Increased moral hazard for fund companies and investors;
- Increased volatility;
- Increased costs and decreased yields, especially for retail investors and smaller fund companies;
- Increased concentration of assets into the largest banks;
- Forced exits from the business for monoline and bank advisors; and
- Creation of new AIG-like risks.

Treasury Strategies believes this proposal will result in **severe negative consequences for investors, fund advisors, businesses of all sizes, and the broader overall economy**. We advocate that the Council **abandon this proposal**.

Sincerely,



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cc: The Honorable Ben S. Bernanke  
Chairman  
Board of Governors of the Federal Reserve System

The Honorable Thomas J. Curry  
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Securities and Exchange Commission

The Honorable Troy A. Paredes  
Commissioner  
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The Honorable Daniel M. Gallagher  
Commissioner  
Securities and Exchange Commission



## Appendix I: The Anatomy of a Financial Run

Before evaluating a proposal's effectiveness in preventing a run, it is important to understand the anatomy of a financial run. Financial institutions are susceptible to runs because they support highly liquid short-term liabilities with less liquid and longer-term assets. This maturity transformation is crucial to a well-functioning economy, because it facilitates the flow of funds from those with surplus to those with a shortage, in the form of deposits/investments and loans.

However, a maturity mismatch can be problematic when many investors want to withdraw funds over a short period of time. This is far more problematic with a bank than with a money fund. In a money fund, the difference between the average maturity of the assets and the liabilities can be measured in days or weeks. In a typical commercial bank portfolio, the difference is measured in months, if not years.

A run is caused by investors who believe if they wait too long to withdraw their money, they may lose some or all of it. It is this psychological aspect combined with people's natural aversion to loss that make runs so dangerous.

Three types of financial runs are relevant to financial institutions:

- Credit-driven runs occur as a result of a confirmed negative credit event in a security in which the institution invested; this leads investors to liquidate shares to limit possible losses.
- Liquidity-driven runs are precipitated by investors redeeming shares out of fear that, if they fail to do so immediately, they will be unable to do so later.
- Speculative runs occur as a result of rumors or speculation about what may or may not occur within a fund.

Although interrelated in terms of outcome, the proximate causes are quite different. Quite simply, the proximate cause of a credit-driven run is poor credit quality of the underlying assets. The proximate cause of a liquidity-driven run is a seizing up of the markets. The proximate cause of a speculative run is rumor based on a lack of transparency into the financial institution's assets and liabilities.

The reforms instituted in early 2010 by the SEC and the MMF industry have already adequately dealt with **each** of these three situations.

Type of Financial Run	Proximate Cause	2010 MMF Regulations
Credit Driven Run	Credit Loss	Tightened Credit Standards
Liquidity Driven Run	Market Seizing	Instituted Liquidity Requirement of 10% Next Day, 30% Weekly Shortened Maturity Structure
Speculative Run	Uncertainty / Misinformation	Reporting of Holdings Reporting Shadow NAV

Source: Treasury Strategies, Inc.



## Appendix II: The Timing of a Financial Run

It is also important to understand that there are two ways in which a financial run plays out:

- Firestorm runs occur in a panic environment in which investors rush cash out at any price, notwithstanding any barrier. In today's electronic world, these are likely to play out within hours or a day or two at most.
- Prolonged runs occur when investors fail to roll over maturing investments or reinvest in instruments upon which the institution had come to rely.

Given its nature and speed, it is unlikely that any intervention or barriers to exit will succeed in preventing the firestorm run. A holdback provision will be useless in this type of run since investors will most certainly want to exit at any cost. It is best to have in place the safeguards that prevent the proximate causes of the run. These are precisely the safeguards that went into effect for the money market fund industry with the Securities and Exchange Commission's Rule 2a-7 amendments in early 2010.

A prolonged run, on the other hand, occurs over an extended period of time. It is usually quite visible well ahead of time. For example, investors refuse to roll over their maturing commercial paper or holders of auction rate securities fail to bid at future auctions. Because of the slow nature of these runs, regulators have a number of tools at their disposal. However, efforts to "bar the door" have no usefulness, since these runs are not caused by investor withdrawals, but rather by investors refusing to reinvest.