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Meddling in Money Market Funds

by

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Summary

This paper questions why twelve Federal Reserve Bank presidents have interposed themselves in a rulemaking by the Securities and Exchange Commission concerning money market funds. The Reserve Bank presidents recently submitted a joint letter urging the SEC to prohibit MMFs from pricing their shares at $1.00 per share and to require them to reflect infinitesimal fluctuations in net asset value in their share price. Numerous other letters to the SEC argue that such action would destroy the utility of MMFs and unnecessarily deprive investors of an efficient investment product while potentially increasing financial instability and systemic risk.

The Reserve Banks have no jurisdiction over money market funds, no collective expertise in their operations, and no experience regulating them. The Reserve Banks have done seemingly little to advance the outstanding agenda of bank regulatory reforms mandated by the Dodd-Frank Act to address the causes of the 2008 financial crisis. It thus is curious why they have made money market funds a cause célèbre when so many critical areas of banking supervision require their attention. Equally curious is why they have advocated changes in MMFs that are greatly at odds with informed views of investors, industry experts, and academic economists.

This paper examines the substance of the Reserve Bank letter and concludes that it reflects a flawed view of the causes of financial crisis and current threats to financial stability. This paper also suggests that the Reserve Bank presidents may have ulterior motives unrelated to legitimate financial stability concerns. Among other things, they may be seeking to invent a new role for themselves as their relevance in the financial system declines when they should instead be focusing their joint advocacy efforts on bank compliance and supervisory issues. As far as the public record shows, the Reserve Banks have not submitted any written recommendations to the Federal Reserve Board of Governors for action in critical bank regulatory reform areas, either singly or as a group. Their reticence is striking compared to their highly publicized demands that the SEC adopt radical changes to MMFs.

The Reserve Banks have an important role to play in their designated sphere within the financial system. Whether twelve of them are needed for that role is unclear. What is clear is that their sphere is *not* MMFs and that twelve of them are *not* needed to advise the SEC on how it should regulate MMFs. Rather than lobby the SEC to resolve what in reality are *bank* financial stability issues, the Reserve Bank presidents should focus their collaborative efforts on encouraging the Board of Governors to complete its unfinished agenda of bank supervisory reforms mandated by the Dodd-Frank Act.

Meddling in Money Market Funds

I. INTRODUCTION

Among the many letters submitted to the Securities and Exchange Commission in response to its invitation for comment on potential regulatory changes for money market funds,[1] only a handful supported eliminating the stable net asset value of $1.00 per share. Among these was a letter from the presidents of the twelve Federal Reserve Banks.[2]

In addition to supporting a "floating" NAV for all MMFs, which the vast majority of other commenters said would destroy the utility of MMFs and not prevent runs, the Reserve Bank presidents opposed the SEC's proposal to allow MMFs to temporarily suspend redemptions in a crisis, which many commenters said is the only way to stop a run in the rare event one should occur.

The Reserve Bank letter is remarkable in several respects. For starters, it raises the question of just who are the Reserve Banks, what is their role in the financial system, why are there twelve of them, and why are they all immersed in the details of MMF regulation under the Investment Company Act, a statute not within their area of expertise or jurisdiction? More fundamentally, what policy is motivating them to meddle in the SEC's rulemaking process? What analysis and expertise qualifies them to make recommendations contradicted by so many other commenters including financial industry experts, individual and institutional investors, and academic economists?

The Dodd-Frank Act mandated numerous improvements in banking regulation to prevent another financial crisis, many of which have not yet been adopted or even proposed. Congress did not view MMFs as a cause of the financial crisis or a problem requiring substantive regulatory reforms. Why have the twelve Reserve Bank presidents not marshalled their resources with as much unanimity to demand solutions to outstanding problems in the banking industry? Why are they focused on MMFs, which were not a subject of the Dodd-Frank Act, not within their jurisdiction, and not a substitute for needed bank regulatory reforms?

This paper suggests answers to some of these questions.

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[1] 78 Fed. Reg. 36834 (June 19, 2013).

[2] Letter dated Sept. 12, 2013, submitted by Eric S. Rosengren, President, Federal Reserve Bank of Boston, on behalf of presidents of Federal Reserve Banks of New York, Philadelphia, Cleveland, Richmond, Atlanta, Dallas, St. Louis, Kansas City, Chicago, Minneapolis, and San Francisco (the "Reserve Bank letter"). The Reserve Bank presidents filed a similar letter with the Financial Stability Oversight Council urging structural changes to MMFs. See letter dated Feb. 12, 2013, to the Financial Stability Oversight Council, submitted by Eric S. Rosengren on behalf of the twelve Federal Reserve Bank presidents.

II. WHO ARE THE FEDERAL RESERVE BANKS?

A. **What Do They Do?**

The twelve Federal Reserve Banks are private corporations that provide back office financial services to depository institutions and the federal government.[3] They were created as part of the Federal Reserve System in 1913 to help ensure an “elastic currency” by providing a variety of payment services including collecting checks, transferring funds, and distributing and receiving currency and coin throughout the country.

The Reserve Banks also assist the Board of Governors in formulating monetary policy. Five of them serve on the Federal Open Market Committee on a rotating basis and all of them provide economic data and feedback from their local districts.[4] The Reserve Banks have large staffs of economists and analysts who provide economic research on a wide range of topics (many of which have nothing to do with monetary policy, banks, or MMFs). Recent titles include:

- The Impact of Managed Care on the Gender Earnings Gap among Physicians
- Merit Aid, Student Mobility, and the Role of College Selectivity
- Even One Is Too Much: The Economic Consequences of Being a Smoker
- The Cycles of Wind Power Development
- Properties of the Vacancy Statistic in the Discrete Circle Covering Problem
- Do Newspapers Matter? Short-Run and Long-Run Evidence from the Closure of The Cincinnati Post
- Temptation and Self-Control: Some Evidence and Applications
- Donor Motives for Foreign Aid
- What Ever Happened to the Puerto Rican Sugar Manufacturing Industry?[5]

The Reserve Banks also are responsible for supervising state member banks in their districts, a large number of which failed during the past five years. Acting with authority from the Board of Governors, the Reserve Banks also are the front-line supervisors of bank holding companies, which hold over 90 percent of all banking assets in the United States.

[3] The stock of each Bank is owned by banks within its district, which select each Bank’s governing board and a president who is subject to approval by the Board of Governors of the Federal Reserve System. The holding of Reserve Bank stock does not carry with it the characteristics of control or financial interest normally attached to stock in a corporation.

[4] The Federal Reserve Bank of New York is a permanent member of the FOMC.

[5] Selected titles of research papers by Federal Reserve Bank staff published on Federal Reserve Bank web sites.

The role of the Reserve Banks is important. But the need for twelve of them is unclear. Even less clear is the need for twelve of them to be attacking illusory problems in the MMF industry and making recommendations to the SEC that would destroy an investment product with proven safety and utility for millions of investors.

B. **Why Are There Twelve of Them?**

A former vice chairman of the Board of Governors has suggested that only four Reserve Banks are needed to do the job.[6] Another former vice chairman of the Board has suggested that only one Reserve Bank would suffice.[7] He asked: "Will a decentralized system of twelve Reserve Banks located nationwide continue to make sense?"[8]

Certainly the need for twelve Reserve Banks to perform payment services is dubious as the nation's payment system becomes more automated and "checkless."[9] Key Reserve Bank operations have been consolidated and scaled back.[10] The chief purpose for which the twelve Reserve Banks were created has

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[6] See Comments of Alice Rivlin, former vice chairman, Federal Reserve Board, reported in Wall St. J., Jan. 30, 2006 ("It's very clear the Fed doesn't need 12 regional banks," says Ms. Rivlin. "Maybe you need four or six."). Rivlin headed a committee established by the Board of Governors to evaluate the need for continued involvement of the Reserve Banks in providing payment services. Her committee considered the possibility of eliminating the Reserve Banks' role and withdrawal from the payment system.

[7] Donald L. Kohn, Vice Chairman, Federal Reserve Board, Evolution of Retail Payments and the Role of the Federal Reserve, Sept. 11, 2006 ("Ultimately, perhaps sometime late in the next decade, the Reserve Banks might process checks at only a single office nationwide.").

[8] Donald L. Kohn, Vice Chairman, Federal Reserve Board, The Evolving Role of the Federal Reserve Banks, Speech before the American Bar Association, Banking Law Section, Nov. 3, 2006.

[9] Electronic payments by credit card, automated clearing house (ACH), PayPal, and similar means have exceeded check payments since 2003, in part due to the Check Clearing for the Twenty-first Century Act which authorizes "paperless checks." Treasury securities now are issued almost exclusively in electronic book-entry form.

[10] Donald L. Kohn, "The Evolving Role of the Federal Reserve Banks," Nov. 3, 2006, *supra* ("Since 1999, the number of checks collected through the Reserve Banks has fallen by about 30 percent….Today, twenty-two offices offer check processing, down from forty-five just three years ago….At some Branches, cash processing by the Federal Reserve has been replaced by a cash depot operated under contract by armored carriers....The Federal Reserve System has also consolidated certain other services for banks and the U.S. Treasury, such as automated clearinghouse (ACH), offline Fedwire, and savings bond services….The Reserve Banks have found it more efficient to have a few central offices perform certain internal support and back-office services…. Several Reserve Bank Branch offices now have, or soon will have, no remaining financial services operations.").

become increasingly irrelevant or redundant.[11] Privately operated clearinghouse networks—such as the Automated Clearing House Network—now handle large volumes of electronic payments.[12]

The Reserve Bank role in banking supervision also has declined, in some cases markedly. Mergers and acquisitions in the banking industry along with bank failures have shrunk the number of state member banks within the Reserve Banks' supervisory purview.[13] Nearly all large banks have converted to a national charter under the supervision of the Office of the Comptroller of Currency. Local banking needs in many Reserve Bank districts are met by branch offices of national banks headquartered elsewhere. Bank holding companies have merged their subsidiary banks and consolidated their operations geographically, leaving some Reserve Banks with little to supervise.[14] The Reserve Banks oversee bank holding companies but, except for the largest ones, these are shell companies engaged in no significant activities.[15] The Reserve Banks also supervise U.S. operations of foreign banks, but these are concentrated largely in New York.

The Dodd-Frank Act significantly curtailed the Reserve Banks' involvement in bank regulatory policy.[16] Among other things, the Act prohibits the Board of Governors from delegating to any Reserve Bank any policymaking function for supervising and regulating bank holding companies or other financial firms under its jurisdiction.[17] It also prohibits the Board from delegating voting authority to any Reserve Bank with respect to decisions the Board is required to

[11] See Federal Reserve Banks, Payment System Improvement—Public Consultation Paper, Sept. 10, 2013, soliciting public comment on what the Reserve Banks' future role in the payments system should be.

[12] Congress enacted a provision in the Monetary Control Act of 1980 to prevent the Reserve Banks from competing unfairly with private payment service providers, and these providers have grown. In 2003, the Reserve Banks processed only 58 percent of all interbank checks (checks not drawn on the institution at which they were deposited). Depository institutions cleared the remaining checks through private arrangements among themselves. Federal Reserve Board, Purposes and Functions, 9th ed. (2005) at 90.

[13] The Reserve Banks have responsibility to examine and supervise state member banks that subscribe to their stock ("state member banks"). 12 U.S.C. 325. These include only 486 of approximately 7,000 banks in the United States. Of these 486, most have assets of less than $1 billion. Only six have assets of more than $100 billion. Source: FDIC data.

[14] For example, there were only 17 state member commercial banks in the Boston Federal Reserve District as of February 2011, most of which had assets of less than $1 billion. Of these, apart from one large non-retail custodial bank, only two banks had assets of $1-2 billion and the rest had assets of less than $1 billion. Other banks in the Boston district are regulated by the FDIC and OCC. The Reserve Bank also oversees a handful of small savings banks and cooperatives.

[15] The largest bank holding companies actively engage in a wide array of financial activities, but most bank holding companies have no significant operations other than ownership and operation of their subsidiary banks.

[16] Dodd-Frank Act § 1108.

[17] 12 U.S.C. § 248(k), as amended by Dodd-Frank Act.

make under the Dodd-Frank Act relating to the regulation of systemically important financial institutions.[18] Thus, the Reserve Banks have been consigned mainly to an advisory role on bank regulatory policy, which nevertheless is an important role.

The Reserve Banks provide a useful function in providing information to the Board of Governors about economic conditions in different geographic regions, although none of them saw the financial crisis coming. Much of the data from their districts now is collected electronically and analysed in a centralized database, obviating the need for staffs of number crunchers. The need for Reserve Bank participation in decision-making on national monetary policy matters also is debatable as the seven members of the Board are required to be selected from different geographic regions and be representative of different financial, agricultural, industrial, and commercial interests.[19]

The frequent appearances of Reserve Bank presidents as guests or "guest hosts" on television talk shows such as CNBC's "Squawk Box" suggests they provide a public relations function for Federal Reserve, but whether twelve of them are required for this purpose is doubtful.[20]

C. **Why Are They Meddling in MMFs?**

Given the Reserve Banks' limited role in the financial system, which the Dodd-Frank Act shrank even further, it is fair to ask why the Reserve Bank presidents are meddling in the affairs of MMFs. This question is especially pertinent given the many areas of unfinished banking reforms where their collective advice might be more appropriate and useful. Possible answers include the following:

- The Reserve Banks are creating issues to make themselves appear useful as their traditional duties and relevance decline;

[18] 12 U.S.C. 5614 (note). The Act provides: "The Board of Governors may not delegate to a Federal reserve bank its functions for the establishment of policies for the supervision and regulation of depository institution holding companies and other financial firms supervised by the Board of Governors. * * * (1) No decisions by federal reserve bank presidents.—No provision of title I relating to the authority of the Board of Governors shall be construed as conferring any decision-making authority on presidents of Federal reserve banks. (2) Voting decisions by board.—The Board of Governors shall not delegate the authority to make any voting decision that the Board of Governors isauthorized or required to make under title I of this Act in contravention of section 11(k) of the Federal Reserve Act.

[19] 12 U.S.C. 241.

[20] See Federal Reserve Bank of St. Louis press release dated Oct. 8, 2010 ("President James Bullard Guest Hosts CNBC's *Squawk Box* from the St. Louis Fed."). See also press releases dated May 24, 2013, Aug. 23, 2013, Sept. 20, 2013, announcing Mr. Bullard's recent appearances on media talk shows. Other Reserve Bank presidents make similar appearances in the media.

- The Reserve Banks are furthering the Board's policy of using MMFs as scapegoats to deflect blame for the financial crisis;

- The Reserve Banks are distracting media attention away from the fact that major banking reforms mandated by the Dodd-Frank Act are incomplete;

- The Reserve Banks believe they know more about MMFs than the SEC;

- The Reserve Banks are angling for new regulatory business as the number of state member banks in their districts dwindles;

- The Reserve Banks are furthering the Board's long-held goal of eliminating MMFs as competitors of banks;

- The Reserve Banks are concerned about the availability of short-term credit for large banking organizations in the event of another crisis.

All of the above have a degree of plausibility. Only the last is a valid concern. As this paper will show, the idea that this concern can be remedied by eradicating MMFs is misguided. The only solution that will truly remedy the problem is one that recognizes the source of the problem and treats it there. The source of the problem is not MMFs.

III. THE RESERVE BANKS MISS THE MARK

A. **MMFs Are Not the Problem**

In their letter, the Reserve Banks acknowledge that MMFs play a valuable role in the financial markets:

> MMMFs serve an important function in the short-term credit markets by acting as intermediaries between investors seeking a highly liquid, diversified fixed income investment, and a variety of corporate and government entities seeking short-term funding.[21]

The Reserve Banks claim this role is "critical."[22] Nevertheless, they argue that this role will be undermined if MMFs are allowed to continue offering their shares at a $1.00 rounded NAV rather than a "floating" NAV. Under a floating

[21] Reserve Bank Letter at 2.

[22] *Id.* See also Eric S. Rosengren, President, Federal Reserve Bank of Boston, Money Market Mutual Funds and Stable Funding, speech at Federal Reserve Bank of New York, Sept. 27, 2013.

NAV, MMFs would be required to reflect miniscule NAV fluctuations in their share price. Instead of offering their shares at $1.00, they would be required to offer their shares at $1.0001 or $.9999, for example. Under current law, MMFs are required to float their share price only if their market-based NAV falls below $.995. At that point, MMFs are said to have "broken the buck" and generally must close and distribute their assets to their shareholders.

MMFs have operated with a rounded $1.00 NAV for over thirty years. During this time, only two MMFs ever have broken the buck, including the Reserve Primary Fund which did so at the height of the financial crisis in 2008 but nevertheless still paid its investors 99 cents on the dollar. During the same period, over two thousand banks failed, including some very large banks.

The Reserve Banks argue that more than one MMF would have broken the buck in 2008 had not a number of funds received sponsor support. The fact of the matter is that more than one fund did *not* break the buck, with or without sponsor support, under unprecedented stress in the financial markets. The Reserve Banks also argue that more than one MMF would have broken the buck had not the Treasury imposed a temporary guarantee program on MMFs. The fact of the matter is that MMFs did not ask for the program, no MMF used it, and MMFs were forced to pay $1.2 billion in fees for the program.

The safety of MMFs is due in large measure to strict credit quality, liquidity, diversification, and other requirements imposed under the Investment Company Act of 1940. In addition, MMFs benefit from professional portfolio management by investment advisers who know that, unlike the banking industry, the MMF industry is not guaranteed by the federal government.

MMFs are able to play their critical role as intermediaries in the financial system precisely because of their stable $1.00 NAV, which the Reserve Bank presidents want to eliminate. Investors place money in MMFs because of their simplicity and efficiency, based on the $1.00 NAV. The $1.00 NAV allows investors to treat MMFs as cash equivalents for accounting purposes and greatly simplifies recordkeeping, cash management, tax reporting, and administration of investments. Without a $1.00 NAV, MMFs would lose their utility for many investors and their role as suppliers of short-term credit would diminish.

The $1.00 NAV is not some accounting gimmick that allows MMFs to misrepresent the value of their portfolios and deceive investors. The $1.00 NAV represents an accurate statement of the value of a MMF's portfolio, both on an amortized cost basis and market-based measure, rounded to the nearest penny within a narrow range of half a penny (i.e., $1.005 and $.995). MMFs are required to calculate and disclose their NAVs based on available market quotations or an appropriate substitute reflecting current market conditions. These values are required to be calculated to the fourth decimal point and reported to the SEC as well as disclosed publicly on MMF websites. Details regarding every security in a MMF's portfolio also are required to be disclosed and posted on MMF websites.

Investors value MMFs for their liquidity, convenience, market rate of return, and higher level of diversification than most investors can achieve individually. For investors with more than $250,000 to invest, MMFs are safer than banks, which have a history of repeated failures notwithstanding supervision by federal banking regulators and deposit insurance. But the $1.00 NAV is the key feature that attracts most investors to MMFs and enables MMFs to play a critical intermediary role in the financial markets.

B. **The Reserve Banks Ignore Important Facts**

Nothing in the legislative history or language of the Dodd-Frank Act suggests that Congress viewed MMFs as a threat to financial stability or in need of substantive reform. The Act contains no provisions requiring substantive changes in the regulation of MMFs, and certainly not elimination of the $1.00 NAV.

Nevertheless, the Reserve Bank presidents claim that MMFs pose a risk to financial stability. They refer to "risks to financial stability" from MMFs at least a dozen times in their letter. Their purported fear is that MMFs will cease their "critical role" as intermediaries in the short-term credit markets—particularly the commercial paper market—in times of financial stress. Ironically, their recommendation to do away with the $1.00 NAV would have the result they say they wish to avoid.

As stated in their letter, the Reserve Bank presidents are concerned about disruptions in the ability of MMFs to act during a crisis as intermediaries between investors and "a variety of corporate and government entities seeking short-term funding."[23] This statement is highly misleading. It fails to acknowledge that banks are the primary seekers of short-term funding and conceals the role of bank holding companies as large borrowers of short-term credit. The "corporate entities" to which the Reserve Banks refer are banking organizations, which are the largest issuers of commercial paper.

The Reserve Banks also say they are concerned that disruptions in MMFs' ability to function as credit intermediaries can have a significant negative impact on the "broader financial system." Here too they create a misimpression, blurring the fact that banking organizations are the "broader financial system" they care about. The Reserve Bank presidents either knowingly or ignorantly are deceiving themselves as to the true threat to financial stability, which is not MMFs.

The facts concerning the commercial paper market paint a very different picture than the one portrayed by the Reserve Banks. Commercial paper represents only approximately 3.7 percent of all credit instruments in the marketplace.[24] Moreover, most outstanding commercial paper is financial paper

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[23] Reserve Bank Letter at 2.

[24] According to Federal Reserve data, total commercial paper outstanding as of March 12, 2012 was $504 billion compared with $13.7 trillion of total credit market

issued or guaranteed by banking organizations. Although non-financial institutions issue commercial paper, they are not dependent on the commercial paper market to fund their operations. SEC staff have estimated that commercial paper provides less than one percent of financing for nonfinancial businesses.[25] Nonfinancial commercial paper represents a relatively small fraction of MMF portfolio holdings—less than three percent. Thus, the short-term funding needs of nonfinancial issuers of commercial paper are not the driving force behind the Reserve Banks' concerns regarding MMFs.

In reality what the Reserve Banks fear is that MMFs will refuse to purchase commercial paper issued by banks and their holding companies, which are the largest issuers of commercial paper. MMFs could refuse to purchase such commercial paper if the paper fails to meet MMFs' strict credit standards, for example, or if rational MMF shareholders re-allocate their assets to government-only MMFs amid financial turmoil.

A withdrawal from the short-term credit markets by MMFs potentially could be problematic for banking organizations that rely excessively on commercial paper with inadequate capital or liquidity and unrealistically expect MMFs to be a captive source of funding in all economic scenarios. Indeed, a number of these organizations faced insolvency during the 2007-2008 financial crisis due to their inherently unsound practice of relying on commercial paper to finance long-term assets, including subprime mortgages, with insufficient capital or liquidity. These organizations would have become insolvent had not the Federal Reserve established liquidity facilities to purchase their commercial paper.

Contrary to what the Reserve Banks imply, however, banking organizations today are not dependent on the commercial paper market or on MMFs to fund their operations.[26] Banking organizations have greatly reduced their reliance on commercial paper since the financial crisis. The amount of commercial paper outstanding has declined by more than 50 percent. From a height of approximately $2.2 trillion in July 2007, outstanding commercial paper has decreased to just under $1.0 trillion as of June 2013.[27] This reduction is due

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instruments. See SEC Division of Risk, Strategy and Innovation, Response to Questions posed by Commissioners Aguilar, Paredes, and Gallagher, Nov. 30, 2012 ("Staff Report") at 50, n. 91.

[25] SEC Staff Report at 49. The Staff Report found that nonfinancial company commercial paper totaled $127.6 billion compared with $11.9 trillion of total credit market instruments outstanding for nonfinancial companies as of March 31, 2012, based on Federal Reserve flow of funds data. Staff Report at 50, n. 90.

[26] See generally Fein, Melanie L., The Latest Fallacy About Money Market Funds (July 2012), available at SSRN: http://ssrn.com/abstract=2118338.

[27] Source: Federal Reserve statistical data. Of the $2.2 trillion in commercial paper outstanding in July 2007, only $188 billion was issued by non-financial companies. http://www.federalreserve.gov/pubs/supplement/2007/12/table1_32.htm. As of July 2013, $185 billion of commercial paper outstanding was issued by non-financial companies. http://www.federalreserve.gov/releases/cp/outstanding.htm.

in part to regulatory changes that have forced banks to reduce their use of short-term funding to finance long-term assets. Among other things, the Board of Governors and other banking regulators in 2010 revoked the exemption they unwisely adopted in 2004 that allowed banks to sponsor and guarantee asset-backed commercial paper conduits with only marginal capital. Additional reforms will ensure that banks maintain a prudent balance between their long-term assets and use of short-term credit.

Moreover, banks are well-positioned to quickly increase their primary source of funding—deposits—through competitive interest rates and brokered deposits.[28] They also have access to other sources of funding to meet their short-term liquidity needs, including interbank loans, advances from the Federal Home Loan Banks and, of course, the Federal Reserve's discount window. Neither commercial paper nor MMFs are a substitute for these sources of liquidity.[29]

Thus, the Reserve Banks' fear that MMFs pose a risk to the financial stability of banking organizations is misguided and contradicted by the facts. Banking organizations are the biggest threat to their own financial stability.

C. Excessive Short-Term Borrowing by Banks is the Problem

What should be of concern to the Reserve Banks is the possibility that large banking organizations may increase their reliance on commercial paper funding to unsafe levels if the Board of Governors does not impose prudential limits on such borrowing, or such limits are not implemented effectively. To understand how excessive reliance on short-term credit can destabilize banks, it is helpful to review events in 2007 and 2008 in the commercial paper market, where the crisis began.

Leading up to the crisis, banking regulators had allowed banks to fund large volumes of long-term mortgages and other loans with short-term liabilities through the process of securitization. The regulators amended their capital rules in 2004 in a way that incentivized banks to create securitization vehicles with minimal capital and liquidity requirements.[30] Then followed a ballooning of securitization through asset-backed commercial paper conduits (ABCP) and structured investment vehicles (SIVs) into which banks placed large pools of loans they originated, purchased, or sponsored. The pooled vehicles then issued short-term liabilities in the form of commercial paper or other notes, typically with maturities of 30-days or less, depending on investor demand. In order to sell the commercial paper to MMFs and other risk-averse investors, banks obtained

[28] See Acharya, Viral V. and Mora, Nada, Are Banks Passive Liquidity Backstops? (December 2011). NYU Working Paper No. 2451/31364. Available at SSRN: http://ssrn.com/abstract=2323474.

[29] Deposits currently comprise roughly 30 percent of the portfolios of prime MMFs, but only a small amount of these deposits are issued by U.S. banks, few of which currently meet MMF credit standards.

[30] See 69 Fed. Reg. 44908 (July 28, 2004).

the highest credit rating for the commercial paper by issuing guarantees, letters of credit or other arrangements to ensure investors would be repaid. Investors included domestic and foreign institutional investors, hedge funds, banks, and governments, as well as MMFs.

Bank securitization vehicles proved unstable to the financial system because they allowed banks to generate excessive volumes of subprime and other mortgages with little regard to the creditworthiness of the borrowers on the assumption that investors would bear the risk.[31] Moreover, regulators did not require banks to maintain adequate capital or liquidity to meet their guarantees in the event investors did not renew or "rollover" their commercial paper holdings, as occurred in 2007 and 2008. Investors pulled back from the commercial paper market when mortgage defaults increased and credit rating agencies downgraded some securitization vehicles.[32] Banks were forced to take much of the commercial paper onto their own books and some faced insolvency because they lacked capital to hold the assets.[33]

The Financial Stability Oversight Council has described the vulnerability of banks to their own ABCP during the financial crisis:

> These entities also became a source of vulnerability to the commercial banking system. For example, banks and other financial institutions implicitly and explicitly supported a large volume of short-term wholesale funding instruments, including ABCP conduits and a variety of other short-term collateralized debt []. Before recent accounting reforms [], assets underlying these funding arrangements were generally off-balance sheet. This kind of accounting allowed for favorable capital treatment, bolstered equity returns of the sponsoring institution, and reduced perceptions of the risk associated with these arrangements. However, investors' [MMFs'] concerns regarding the quality of ABCP collateral, the viability of financial guarantors, and the ability of financial institutions to

[31] Recent enforcement actions have charged large banking organizations with misleading investors by packing their securitization vehicles with mortgages that failed to meet applicable credit underwriting standards. See, e.g., U.S. Department of Justice, Press Release dated Aug. 6, 2013, "Department of Justice Sues Bank of America for Defrauding Investors in Connection with Sale of Over $850 Million of Residential Mortgage-Backed Securities."

[32] Commercial paper maturities were as short as one day in August of 2007. In 2008, following Lehman's bankruptcy, more than 75 percent of commercial paper issued had a maturity of only one to four days.

[33] See Sandra C. Krieger, Executive Vice President, Federal Reserve Bank of New York, "Reducing the Systemic Risk in Shadow Maturity Transformation," March 8, 2011 ("The banks did not have the capital to bring all of their off-balance-sheet liabilities onto their balance sheets….").

> provide the promised liquidity support prompted a sharp contraction in demand for these instruments beginning in mid-2007. Banks and other financial institutions purchased the underlying assets out of implicit or explicit obligation, placing significant strain on their funding and capital positions.[34]

The Federal Reserve responded to the 2007 commercial paper crisis by, among other things, establishing the Term Auction Facility (TAF). TAF provided a huge volume of short-term loans to banks secured by a wide range of collateral, including residential mortgages, mortgage-backed securities, and collateralized mortgage obligations—in other words, assets that had been held in bank-sponsored securitization vehicles financed with short-term commercial paper.[35]

As large banks faced insolvency, MMFs remained resilient. From July 2007 through August 2008, MMFs absorbed more than $800 billion in new assets as investors sought safety. Only in September of 2008 did prime MMFs experience significant investor withdrawals. The tumultuous events of that time are well documented—the chairman of the Federal Reserve Board has said the crisis was the "worst financial crisis in global history, including the Great Depression."[36] Nearly all of the nation's largest financial institutions failed, merged, or were bailed out by the federal government. Prime MMFs, facing heavy redemptions, trimmed their holdings of commercial paper, which by this time had an average maturity of 1-7 days.

In response to the 2008 crisis, the government took a number of additional actions to prevent the banking industry from collapsing. Among other things, Congress authorized $750 billion to recapitalize the industry. Stretching the limits of its authority, the FDIC provided unlimited deposit insurance and guaranteed debt issued not only by banks but by their parent holding companies. The Federal Reserve further bolstered the commercial paper market by establishing two liquidity facilities through which it purchased commercial paper issued, sponsored, and guaranteed by banks and bank holding companies, as well

[34] Financial Stability Oversight Council, 2011 Annual Report at 71. See also Covitz, Liang, and Suarez, "The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market," August 24, 2009, available at papers.ssrn.com.

[35] See Federal Reserve Board, Press Release dated Dec. 12, 2007. Aggregate liquidity under this program totaled $3.8 trillion from December 2007 through January 2010. The peak amount outstanding at any one time was $493 billion. See Federal Reserve Board, Usage of Federal Reserve Credit and Liquidity Facilities (Nov. 30, 2011).

[36] Testimony of Ben Bernanke before the Financial Crisis Inquiry Commission, Transcript dated Nov. 17, 2009 at 24 ("As a scholar of the Great Depression, I honestly believe that September and October of 2008 was the worst financial crisis in global history, including the Great Depression. . . .out of maybe the 13—13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two.").

as other issuers.[37] These liquidity facilities relieved the pressure on bank balance sheets and allowed the commercial paper market to continue functioning with support from the central bank, just as Congress intended when it gave the Federal Reserve broad emergency liquidity powers. Contrary to what one Reserve Bank has suggested, the Dodd-Frank Act did not curtail the central bank's ability to take similar broad-based emergency lending action in any future crisis.[38]

The emergency commercial paper facilities were necessitated not by MMFs but by banks, which banking supervisors had allowed to accumulate unsustainable amounts of commercial paper obligations without capital or liquidity to withstand a market contraction. Stress tests, which were not rigorously applied then, would have shown that banks were incurring dangerous levels of liabilities. Minimum liquidity requirements and limits on short-term funding, which did not (and still do not) exist, would have kept these liabilities in check and ensured that banks could withstand severe market stresses. The financial crisis revealed serious deficiencies in banks' liquidity risk management, including "insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans."[39]

During the crisis, MMF shareholders behaved as rational investors in a collapsing market. MMFs complied with SEC rules to preserve the credit quality of their portfolios while meeting heavy shareholder redemptions in prime MMFs. One MMF broke the buck but ultimately its shareholders received 99 cents on the dollar. Another MMF suspended redemptions for seven days, as permitted by the Investment Company Act, but its shareholders received full value at the end of the suspension period.[40]

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[37] See Federal Reserve Board Press Release dated Oct. 7, 2008 announcing creation of the Commercial Paper Funding Facility (CPFF), a facility to purchase unsecured and asset-backed commercial paper directly from issuers (including large banks). The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility was created on Sept. 22, 2008, to purchase commercial paper held by MMFs through banks.

[38] The Dodd-Frank Act amended the Federal Reserve Act to authorize the Board of Governors to provide emergency assistance to participants in a program or facility with broad-based eligibility. Dodd-Frank Act § 1101. The Board can no longer lend to prop up an individual nonbanking firm. The Act required the Federal Reserve to adopt regulations to govern the use of its emergency lending authority but the Board as yet has not proposed any such regulations.

[39] Federal Reserve, Interagency Policy Statement on Funding and Liquidity Risk Management, 75 Fed. Reg. 13,660 (Mar. 22, 2010).

[40] See New York Times, Professional Money Fund Is Closed by Putnam, by Diana B. Henriques, Sept. 18, 2008. The Putnam fund suspended redemptions rather than sell assets into the marketplace and risk losses for non-redeeming investors. Federated Investors, Inc. made an in-kind purchase of the fund's assets, the fund's shareholders received an equivalent amount of shares of a Federated MMF, and the fund was liquidated in a prompt and orderly manner with no loss to investors.

An SEC staff report examined MMF investor movements during September 2008 and found "many possible explanations" for the shift from prime MMFs to government MMFs. These explanations include a flight to quality, a flight to liquidity, a flight to transparency, a flight to performance, and incentives to redeem before other shareholders.[41] Regardless of the reasons, MMF shareholders responded as rational investors seeking to protect their interests amid unprecedented financial chaos, and MMFs uniformly met their obligations to investors.

These facts demonstrate the strength and durability of MMFs, not the need to deprive investors of the $1.00 NAV as the Reserve Bank presidents urge.

D. A Floating NAV Would Increase Risks to Financial Stability

The Reserve Bank idea that a floating NAV will prevent MMFs from withdrawing from the commercial paper market in a future crisis is unsupported by empirical data or logic. A floating NAV would not prevent MMFs from complying with SEC rules that limit the credit quality and liquidity of their portfolio investments. Nor would a floating NAV prevent MMF investors from acting rationally to protect their assets in a crisis.

The overwhelming weight of comment letters, even from academic economists who otherwise agree with Federal Reserve truisms, shows that a floating NAV would be ineffective, could exacerbate instability in the short-term markets, and might trigger other adverse systemic effects. The following excerpts from comment letters by academics highlight the flaws in the floating NAV idea:

> We believe these potential benefits of a floating NAV are significantly overstated. In practice, a floating NAV system would be almost identical to the existing stable NAV system. The basic problem stems from the illiquidity of secondary markets for commercial paper and other private money market instruments such as bank CDs.[42]
>
> [F]loating NAV is unlikely to materially increase the stability of the financial system.[43]
>
> A recent study of European floating NAV funds provides empirical support for this contention: during the 2008 crisis, investors in European accumulating NAV and fixed

[41] SEC Division of Risk, Strategy and Innovation, Response to Questions posed by Commissioners Aguilar, Paredes, and Gallagher, Nov. 30, 2012, at 7-9.

[42] Comment letter to SEC dated Sept. 16, 2013, from Samuel Hanson, Assistant Professor of Finance, Harvard Business School; David Scharfstein, Edmund Cogswell Converse Professor of Finance and Banking, Harvard Business School; and Adi Sunderam, Assistant Professor of Finance, Harvard Business School.

[43] Comment letter to SEC dated Sept. 17, 2013, by the Squam Lake Group.

> NAV funds were equally likely to run.... Indeed, it is even plausible that imposition of a floating NAV system would increase the likelihood of run behavior, as the constant marking to market required under such a system could exacerbate the incidence of fire sales.[44]

> The proposal to require institutional prime money market funds to switch to floating NAVs will fail to achieve its primary objective of preventing runs on MMMFs in a financial crisis. Indeed, floating NAVs will actually increase the likelihood of runs in the next crisis….The floating NAV proposal imposes significant costs on the economy with no corresponding benefit….The floating NAV proposal increases the risk of runs on money market mutual funds and the banking sector and thus increases systemic risk, a further drag on efficiency….The floating NAV proposal will have two major deleterious impacts on capital formation.[45]

Numerous letters in the SEC's public comment file explain how a floating NAV would increase, rather than decrease, risks to financial stability.[46] A number of commenters expressed concern that elimination of the $1.00 NAV would result in the transfer of substantial investor assets to too-big-to-fail banks, thereby increasing the size of the taxpayer-subsidized banking industry and exacerbating the systemic risks posed by large banking organizations.

The SEC itself has stated that a floating NAV "may not deter heavy redemptions from certain types of money market funds (e.g., prime money market funds) in times of stress if shareholders engage in a flight to quality, liquidity or transparency."[47] The President's Working Group on Financial Markets warned of potential unintended consequences of eliminating the $1.00 NAV:

> Such a change may have several unintended consequences, including: (i) reductions in MMFs' capacity to provide short-term credit due to lower investor demand; (ii) a shift of assets to less regulated or unregulated MMF substitutes such as offshore MMFs, enhanced cash funds, and other stable value vehicles; and (iii) unpredictable investor responses as MMF NAVs begin to fluctuate more

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[44] Comment letter to SEC dated Sept. 17, 2013, from R. Glenn Hubbard, John L. Thornton, Hal S. Scott, Committee on Capital Markets Regulation.

[45] Comment letter to SEC dated Sept. 17, 2013, by James J. Angel, Visiting Associate Professor, University of Pennsylvania, The Wharton School.

[46] See SEC comment letter website: http://www.sec.gov/comments/s7-03-13/s70313.shtml.

[47] 78 Fed. Reg. 36834, 36914 (June 19, 2013).

> frequently. . . . MMFs with floating NAVs, at least temporarily, might even be more prone to runs.[48]

The certitude with which all twelve Reserve Bank presidents have urged eliminating the $1.00 NAV in the face of overwhelming credible opinion to the contrary suggests the Reserve Banks might not have given this matter as much analysis and consideration as it deserves. The cogent possibility that the Reserve Bank recommendation would actually *increase* the potential for financial instability suggests the Reserve Bank presidents have acted with an incomplete understanding of risk dynamics in the financial system.

E. **Temporary Redemption Suspensions Would Halt Runs**

As an alternative to eliminating the $1.00 NAV, the SEC has proposed giving MMF boards of directors the ability to temporarily suspend redemptions in the event of a future crisis. A temporary pause in redemptions could prevent depletion of a MMF's daily or weekly liquid assets in an extreme crisis. MMF boards already have the ability to suspend redemptions if they conclude the fund is about to break the buck. But the fund cannot reopen and must liquidate.[49] The SEC's proposal would give MMFs greater flexibility to manage their liquidity in a severe crisis and the ability to resume operations rather than liquidate. Investors would be less likely to panic if they know that access to their liquid assets will be restored after an interval while the markets calm.

Commenters on the SEC's proposal overwhelmingly supported this alternative in order to give MMFs greater flexibility to manage redemption pressure in a crisis. The twelve Reserve Bank presidents, on the other hand, unanimously opposed this alternative. Their opposition is inexplicable given their ostensible concern about the susceptibility of MMFs to destabilizing investor runs. Investors are more likely to run if they fear their MMF will break the buck and liquidate than if the fund closes temporarily while the markets stabilize. MMFs have no incentive to suspend redemptions except in the most dire of circumstances such as occurred in 2008, in which case such action could act as a circuit breaker and have an important calming effect on the markets.

IV. WHAT THE RESERVE BANKS SHOULD BE DOING

Rather than recommend that the SEC adopt a proposal that would likely worsen the problem they purportedly want to solve, the Reserve Bank presidents should focus their regulatory reform advocacy on areas of banking regulation where direct remedies to the problem are available. The Board of Governors has pending before it numerous unfinished proposals that, when implemented, will

[48] President's Working Group on Financial Markets, Report on Money Market Fund Reform Options, Oct. 2010 ("PWG Report"), at 4 and 19-23. The PWG was comprised of the Secretary of the Treasury and chairmen of the Federal Reserve Board, Securities and Exchange Commission, and Commodity Futures Trading Commission.

[49] Investment Company Act of 1940 § 22(e); 17 C.F.R. § 270.22e-3.

improve the ability of banks to withstand periodic contractions in the short-term credit markets. The twelve Reserve Bank presidents should work together to help the Board finalize and implement those proposals.

The Board has yet to propose any significant plan for downsizing too-big-to-fail banks, which have a dismal safety record and continue to pose a systemic risk to U.S. financial stability. The Reserve Bank presidents should collaborate in formulating recommendations to restructure these organizations rather than harass MMFs, which have a superior history of safety and pose no systemic threat.

A. **Dodd-Frank Act Reforms**

The Dodd-Frank Act directed the Board and other banking regulators to adopt approximately 135 new regulations to address bank regulatory weaknesses believed to have caused or contributed to the financial crisis. More than three years later, many key regulations have not been adopted or even proposed. Banking regulators have met deadlines set by Congress for less than one-third of the required rulemakings.[50]

The areas of unmet mandates include bank securitization practices, enhanced capital and other requirements for large banking organizations, leverage ratios, bank liquidity, and Volcker Rule limits on bank proprietary trading and hedge fund activities, among others. Regulatory action in these important areas, particularly enhanced prudential standards for too-big-to-fail banks, will do much to address Reserve Bank concerns about bank reliance on short-term credit.

As far as the public record shows, however, the Reserve Banks have not submitted any written recommendations for Board action in these areas, either singly or as a group. Their reticence is striking compared to their highly publicized demands that the SEC adopt radical changes to MMFs.[51] While the Reserve Banks unanimously agree on what needs to be done to address non-existent problems in the MMF industry over which they have no supervisory jurisdiction, it appears they cannot agree on what needs to be done to address funding and liquidity risks in the banking industry, for which they are the front-line supervisors.

B. **Prudential Limits on Large Banks**

Section 165 of the Dodd-Frank Act requires the Board to adopt regulations imposing enhanced prudential standards on bank holding companies with total consolidated assets of $50 billion or more. The standards must be more stringent than would apply normally and must increase in stringency based on the

[50] See Davis Polk & Wardwell, LLP, Dodd-Frank Act Progress Report, http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

[51] Some of the Reserve Banks, including Boston and New York, featured the Reserve Bank letter to the SEC on their home webpage and their presidents have targeted MMFs in speeches and other public forums.

institution's size and activities. The standards must include risk-based capital surcharges, leverage limits, enhanced liquidity requirements, overall risk management requirements, resolution and credit exposure requirements, single-counterparty credit limits, and stress tests, among other provisions.

As of this writing, however, the Board has not adopted any final regulations to implement section 165. The Board issued proposed regulations in 2011 and in 2012 reopened the comment period, but has not agreed on any final rules.[52] A review of the public comment file reveals no comment letter by the twelve Reserve Banks, jointly or otherwise, advocating any position on the section 165 rules.

C. Short-Term Debt Limits for Banks

The Dodd-Frank Act authorized the Board of Governors to impose limits on the use of short-term credit by large banking organizations "in order to mitigate the risks that an over-accumulation of short-term debt could pose to financial companies and to the stability of the United States financial system."[53] The Board has not yet proposed any regulations for this purpose, which would directly address the financial stability risks the Reserve Bank presidents complain of. Board officials have said they are in the process of thinking about whether to seek public comment on possible approaches to address the problem, including the imposition of an additional capital requirement on banks that excessively rely on the short-term markets.[54] However, no such proposal has emerged as of this writing.

Why the Board of Governors has not pursued a more vigorous process of implementing short-term debt limits is unclear given statements by Board members concerning the urgency of the problem.[55] One reason might be that the Board and Reserve Banks have deluded themselves into thinking the problem is caused by MMFs rather than banks.

The Reserve Banks collectively have been silent on short-term debt limits, which would directly address the problem they aim to solve by eliminating MMFs' $1.00 NAV. Instead of trying to get the SEC to solve the problem, they should publicly demand that the Board delay no further in adopting prudential limits on the use of short-term funding by large banks.

[52] See 77 Fed. Reg. 593 (Jan. 5, 2012).

[53] Dodd-Frank Act § 165(g).

[54] Governor Tarullo recently stated, "staff is currently working on a recommendation for an advance notice of proposed rulemaking to seek comment on possible approaches to requiring additional measures that would directly address risks related to short-term wholesale funding, including a requirement that large firms substantially dependent on such funding hold additional capital." Statement by Daniel K. Tarullo, Federal Reserve Board, July 2, 2013, http://www.federalreserve.gov/newsevents/press/bcreg/tarullo20130702a.htm.

[55] See Daniel K. Tarullo, Governor, Federal Reserve Board, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Feb. 14, 2013.

D. **Liquidity Requirements for Large Banks**

Bank liquidity is another area where pending reforms would address Reserve Bank concerns about large bank stability. The Board of Governors has acknowledged that weaknesses in bank liquidity structures were a destabilizing factor during the financial crisis.[56] The Board has stated that many of the liquidity problems encountered by banking organizations were due to "lapses in basic principles of liquidity risk management."[57]

Yet, the Board has not yet adopted liquidity enhancements for large banking organizations as required by the Dodd-Frank Act. Only within the past month has the Board, along with other banking regulators, proposed a quantitative liquidity requirement for banking organizations and developed an agenda for implementing the Basel III liquidity framework. A central feature of the Basel framework and the Board's proposal is a "liquidity coverage ratio" that will "improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy."[58] Board Chairman Bernanke has emphasized the importance of the new liquidity proposal:

> Liquidity is essential to a bank's viability and central to the smooth functioning of the financial system. The proposed rule would, for the first time in the United States, put in place a quantitative liquidity requirement that would foster a more resilient and safer financial system in conjunction with other reforms.[59]

The Board's proposal for enhanced prudential standards under the Dodd-Frank Act would improve bank liquidity by requiring large bank holding companies to conduct internal stress tests at least monthly to measure their liquidity needs at 30-day, 90-day and one-year intervals during times of instability in the financial markets. The proposal also would require such institutions to maintain a liquidity buffer of liquid assets sufficient to cover 30-day stressed net cash outflows under their internal stress scenarios.[60]

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[56] See 74 Fed. Reg. 32035, 32038 (July 6, 2009) (Proposed Interagency Guidance on Funding and Liquidity Risk Management) ("Recent events illustrate that liquidity risk management at many financial institutions is in need of improvement. Deficiencies include insufficient holdings of liquid assets, funding risky or illiquid asset portfolios with potentially volatile short-term liabilities, and a lack of meaningful cash flow projections and liquidity contingency plans.").

[57] 77 Fed. Reg. 594, 604 (Jan. 5, 2012) (Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; proposed rule).

[58] Bank for International Settlements, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, Jan. 2013, http://www.bis.org/publ/bcbs238.htm.

[59] Statement by Ben S. Bernanke, Oct. 24, 2013, available at http://www.federalreserve.gov/newsevents/press/bcreg/bernanke20131024a.htm.

[60] Large bank holding companies also would be required to meet specified corporate governance requirements for liquidity risk management, to project cash flow needs over

The Board's proposal, however, does not include an essential element of the Basel liquidity framework—the "net stable funding ratio" which is designed to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items on a longer term basis.[61]

A joint letter from the Reserve Bank presidents urging the Board to move forward with these proposals might encourage more timely Board action to minimize the risks to financial stability posed by excessive bank reliance on short-term funding and lapses in liquidity management.

E. **Too-Big-To-Fail Banks**

The Reserve Banks also could do much to minimize risks to financial stability by jointly developing and recommending a unified proposal to reform too-big-to-fail banking organizations. The Board of Governors has acknowledged that too-big-to-fail banks are a threat to the financial system:

> The market perception that some companies are "too big to fail" poses threats to the financial system. First, it reduces the incentives of shareholders, creditors and counterparties of these companies to discipline excessive risk-taking. Second, it produces competitive distortions because companies perceived as "too big to fail" can often fund themselves at a lower cost than other companies. This distortion is unfair to smaller companies, damaging to competition, and tends to artificially encourage further consolidation and concentration in the financial system.[62]

Yet the Board has not suggested any plan to restructure too-big-to-fail banking organizations that pose these risks.

The president of the Federal Reserve Bank of Dallas has put forth a proposal that would limit access to federal subsidies for too-big-to-fail banking organizations.[63] Yet, none of the other Reserve Bank presidents has publicly

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various time horizons, to establish internal limits on certain liquidity metrics, and to maintain a contingency funding plan that identifies potential sources of liquidity strain and alternative sources of funding when usual sources of liquidity are unavailable.

[61] See Basel Committee, Basel III: International framework for liquidity risk measurement, standards and monitoring (December 2010) at 25.

[62] 77 Fed. Reg. 593 (Jan. 5, 2012).

[63] Richard W. Fisher, President, Federal Reserve Bank of Dallas, Ending Too Big to Fail: A Proposal for Reform Before It's Too Late, Remarks before the Committee for the Republic, Washington, D.C., Jan. 16, 2013. See also Richard W. Fisher, Correcting 'Dodd–Frank' to Actually End 'Too Big to Fail', Statement before the House Committee on Financial Services, June 26, 2013 ("Our proposal is simple and easy to understand. . . . It calls first for rolling back the federal safety net to apply only to basic, traditional

endorsed or supported this initiative or developed alternative proposals to address the problem of too-big-to-fail banks.

The president of the Federal Reserve Bank of Boston has made more than a dozen speeches discussing "financial stability" issues during the past two years. In none of them has he addressed what to do about too-big-to-fail banking organizations. Indeed, most of his speeches fail to even mention the word "bank." Rather, he refers opaquely to "financial institutions" or "large financial intermediaries" as if to obscure the role of banks and bank holding companies in the problems that caused the financial crisis.[64] Instead of using his public speaking forums to address the problem of too-big-to-fail banks, he has used nearly every such occasion to castigate MMFs for not providing a guaranteed supply of credit to the short-term funding markets which, he fails to note, primarily benefits banks and their affiliates. At least six of his recent speeches have been devoted entirely or almost entirely to MMFs,[65] suggesting his Reserve Bank is migrating away from its core duties into areas of financial regulatory policy where the Dodd-Frank Act dictates it should not go.[66]

F. **Better Banking Supervision**

Instead of criticizing MMFs and lobbying the SEC to solve bank regulatory problems, the Reserve Bank presidents need to attend more fully to the job of supervising banking organizations within their responsibility. Banking organizations under Reserve Bank supervision have been charged with numerous compliance failures, violations of law, and unsafe and unsound practices both during and since the financial crisis.

The SEC and United States Department of Justice recently brought a civil action against a large banking organization supervised by the Federal Reserve alleging that more than 40 percent of the mortgages placed in its securitized collateral pools backing its commercial paper did not comply with the bank's own

commercial banking. This two-part step should begin to remove the implicit TBTF subsidy provided to BHCs and their shadow banking operations.").

[64] See, e.g., Eric S. Rosengren, President, Federal Reserve Bank of Boston, Defining Financial Instability, and Some Policy Implications of Applying the Definition, Keynote Remarks at the Stanford Finance Forum, Graduate School of Business, June 3, 2011.

[65] See Eric S. Rosengren, President Federal Reserve Bank of Boston, Towards Greater Financial Stability in Short-Term Credit Markets, Sept. 29, 2011; Avoiding Complacency: The U.S. Economic Outlook, and Financial Stability, March 27, 2012; Money Market Mutual Funds and Financial Stability; April 11, 2012; Our Financial Structures – Are They Prepared for Financial Instability?, June 29, 2012; Risk of Financial Runs – Implications for Financial Stability, April 17, 2013; Money Market Mutual Funds and Stable Funding, Sept. 27, 2013; Defining Financial Stability, and Some Policy Implications of Applying the Definition, June 3, 2011.

[66] As previously noted, the Dodd-Frank Act significantly curtailed the Reserve Banks' role in bank regulatory policy. The Boston Reserve Bank had only 17 mostly small state member banks to supervise as of 2011.

underwriting standards.[67] The SEC has brought similar actions against other banking organizations under Federal Reserve supervision.[68] These cases suggest that rampant violations of bank credit underwriting standards—the most basic banking function—were a significant factor in the financial crisis and may continue without close supervision.

The Federal Reserve Bank of New York in particular can ill afford to be distracted from bank supervisory matters by illusory threats to financial stability from MMFs. The Bank supervises the largest bank holding companies, a number of which are too-big-to-fail and played a leading role in the financial crisis. The Reserve Bank's biggest bank supervisory client was the recent recipient of $920 million in civil money penalties stemming from lapses in risk management occurring just last year.[69] That penalty came on the heels of a $410 million penalty imposed on the firm for energy market manipulation.[70] An unprecedented penalty of $11 billion or more reportedly is about to be levied on the institution by the U.S. Department of Justice for fraud in the mortgage markets.[71]

Banking organizations operating under Reserve Bank supervision have been the subject of enforcement actions and ongoing investigations by a host of federal and state enforcement agencies in recent years involving allegations of:

- fraudulent, deceptive and improper conduct in the provision of financial services
- misleading investors in the market for residential mortgage-backed securities
- misleading investors in the market for auction rate securities
- management deficiencies resulting in $6 billion of derivatives trading losses
- manipulation of LIBOR
- big-rigging in the market for government securities

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[67] See U.S. Department of Justice, Press Release dated Aug. 6, 2013, "Department of Justice Sues Bank of America for Defrauding Investors in Connection with Sale of Over $850 Million of Residential Mortgage-Backed Securities." See also SEC Press Release 2013-148, Aug. 6, 2013 ("The Securities and Exchange Commission today charged Bank of America and two subsidiaries with defrauding investors in an offering of residential mortgage-backed securities (RMBS) by failing to disclose key risks and misrepresenting facts about the underlying mortgages.").

[68] See, e.g., SEC Press Release 2012-233, Nov. 16, 2012, ("SEC Charges J.P. Morgan and Credit Suisse With Misleading Investors in RMBS Offerings"). See also In Re Citigroup Inc. Securities Litigation, Master File No. 07 Civ. 990 1 (SHS), Consolidated Class Action Complaint, S.D.N.Y., $590 million settlement against Citigroup.

[69] See Securities and Exchange Commission, Press Release 2013-187, Sept. 19, 2013 ("JPMorgan will pay a total of approximately $920 million in penalties in these actions by the SEC and the other agencies.").

[70] Federal Energy Regulatory Commission, Press Release dated July 30, 2013.

[71] Wash. Post, Sept. 25, 2013 ("JPMorgan in talks to settle government cases for $11 billion, source says.").

- manipulation of energy markets
- illegal activities in the credit default swaps market
- anti-money laundering deficiencies
- deficiencies in mortgage loan servicing and foreclosure practices
- failure to supervise misconduct of employees
- negligence in the role of indenture trustee
- structuring fraudulent transactions for Enron
- rendering biased investment advice to clients,
- breach of fiduciary duty and aiding and abetting fraud in the Madoff Ponzi scheme,
- improper transfers of customer funds in connection with the bankruptcy of MF Global, and
- other violations of securities, banking and consumer laws.

These kinds of infractions are absent from MMFs. The scope and scale of enforcement actions involving institutions under Federal Reserve supervision is staggering and suggests the Reserve Banks should not be worrying about MMFs.

V. RESERVE BANKS SHOULD ABANDON THEIR MMF MYTHS

The Reserve Bank letter is not supported by any policy justified by the Dodd-Frank Act that will further the interests of financial stability. The letter rather appears to be based on what has become embedded Federal Reserve mythology regarding MMFs.

The mythology is based on two myths that Federal Reserve officials began propagating shortly after the 2008 financial crisis—that MMFs caused the crisis and are part of a "shadow banking system" that threatens another crisis. These myths are an outgrowth of the Federal Reserve's long-standing hostility to MMFs dating from the 1980s when the growing popularity of MMFs as an alternative to bank deposits exposed the absurdity of antiquated Federal Reserve regulatory policies.[72]

The MMF myths have remained a central part of the Federal Reserve's dogma of what went wrong with the financial system and what needs to be done to avoid a future crisis. Neither myth is supported by facts or evidence. Both myths are harmful because they deceive policymakers toward misguided solutions that not only fail to address the true threats to financial stability but create potential new ones.[73]

[72] MMFs enabled consumers to earn a market rate of return on their liquid assets at a time when the Federal Reserve's Regulation Q prohibited banks from paying any interest on checking accounts. Regulation Q also imposed a ceiling on the amount of interest payable on savings deposits, ostensibly to protect savings and loan associations and prevent ruinous competition but which deprived bank depositors of a market return on their money.

[73] See generally Fein, Melanie L., Shooting the Messenger: The Fed and Money Market Funds (March 30, 2012). Available at SSRN: http://ssrn.com/abstract=2021652.

A. **MMFs Did Not Cause the Financial Crisis**

The first myth—that MMFs caused the financial crisis—has been disproven by almost every unbiased committee or commission that has examined the origins and causes of the financial crisis. No evidence has shown that MMFs caused the crisis. What has been shown is that the financial institutions most directly implicated in the origins of the crisis were banking organizations, their affiliates, and their sponsored entities engaged in so-called "shadow banking" activities through securitization and other highly-leveraged off-balance sheet activities.[74] Banking regulators also were a cause of the financial crisis to the extent they allowed banks to conduct such activities with insufficient capital and liquidity, and even adopted regulatory exemptions that incentivized banks to increase their involvement in activities that ultimately proved devastating.[75] Banking regulators tolerated weak risk management and excessive reliance on short-term funding, and failed to adequately supervise shadow banking activities by banks and their affiliates.[76]

One of the most exhaustive inquiries into the causes of the financial crisis was that of the Financial Crisis Inquiry Commission, an independent bi-partisan commission created by Congress with subpoena power to investigate and examine the causes of the crisis. The Commission's report heavily blames the Federal Reserve for failing to stem the flow of toxic mortgages into the financial system, for not curbing excesses of large banking organizations, and for instilling panic in the financial markets by its chaotic management of the financial crisis once it began. Notably, the report does not conclude that money market funds were a cause of the financial crisis. Excerpts from the Commission's conclusions follow:

> We conclude this financial crisis was avoidable....Despite the expressed view of many on Wall Street and in Washington that the crisis could not have been foreseen or avoided, there were warning signs. The tragedy was that they were ignored or discounted. There was an explosion in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of egregious and predatory lending practices, dramatic increases in household mortgage debt, and exponential growth in

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[74] Researchers at the Federal Reserve Bank of New York have shown that banks were "by far the predominant force in the securitization market." Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012, at 58. See also Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008, Oct. 21, 2009, highlighting the involvement of banking organizations in overleveraged "shadow banking" activities without adequate liquidity, capital, or risk-management.

[75] See, e.g., Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez, Securitization Without Risk Transfer, Aug. 8, 2011.

[76] See Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008, Oct. 21, 2009.

financial firms' trading activities, unregulated derivatives, and short-term "repo" lending markets, among many other red flags. Yet there was pervasive permissiveness; little meaningful action was taken to quell the threats in a timely manner. The prime example is the **Federal Reserve's pivotal failure to stem the flow of toxic mortgages**, which it could have done by setting prudent mortgage-lending standards. The **Federal Reserve was the one entity empowered to do so and it did not**….

We conclude **widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets**. The sentries were not at their posts.…[W]e do not accept the view that regulators lacked the power to protect the financial system. They had ample power in many arenas and they chose not to use it. To give just three examples: the Securities and Exchange Commission could have required more capital and halted risky practices at the big investment banks. It did not. The **Federal Reserve Bank of New York and other regulators could have clamped down on Citigroup's excesses** in the run-up to the crisis. They did not. Policy makers and regulators could have stopped the runaway mortgage securitization train. They did not. **In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound** even in the face of mounting troubles, often downgrading them just before their collapse…**Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding**….[T]he large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products….

We conclude the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets. As part of our charge, it was appropriate to review government actions taken in response to the developing crisis, not just those policies or actions that preceded it, to determine if any of those responses contributed to or exacerbated the crisis. As our report shows, **key policy makers—the Treasury Department, the Federal Reserve Board, and**

> **the Federal Reserve Bank of New York—who were best positioned to watch over our markets were ill prepared for the events of 2007 and 2008**….In addition, **the government's inconsistent handling of major financial institutions during the crisis—**the decision to rescue Bear Stearns and then to place Fannie Mae and Freddie Mac into conservatorship, followed by its decision not to save Lehman Brothers and then to save AIG**—increased uncertainty and panic** in the market….**We conclude collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis**….These trends were not secret. As irresponsible lending, including predatory and fraudulent practices, became more prevalent, **the Federal Reserve and other regulators and authorities heard warnings** from many quarters. Yet **the Federal Reserve neglected its mission** "to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers." ….Witness again the **failure of the Federal Reserve and other regulators to rein in irresponsible lending**.[77]

Among the information relied on by the Commission was a case study by Federal Reserve examiners of the failure of Wachovia Bank.[78] According to the study, the $812 billion bank was weakened by subprime mortgage losses in its SIVs and ABCP conduits in 2007 and faced liquidity pressures and depositor outflows during 2008, resulting in credit rating downgrades. The bank was able to raise deposits in a deposit-promotion campaign in the summer of 2008 and, according to Reserve Bank examiners, the parent holding company appeared to have a "strong liquidity" position as of September 11, 2008, although capital-

[77] The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Authorized Edition (Jan. 2011), xvii-xxiii. A report published by the European Commission also concluded that the source of risks that led to the financial crisis was not MMFs: "The activities of money market funds were not the underlying causes of financial instability during the financial crisis per se. . . .[I]n the context of the financial crisis, it must be noted that **the underlying cause of risks to financial stability operating through money market funds did not originate in money markets**. **In particular, risks arose within the banking sector** (due to securitised loan assets). . . . Moreover, the impact on MMF investors in terms of realised losses were either zero or very small." European Commission, Nonbank Financial Institutions: Assessment of Their Impact on the Stability of the Financial System, Economic Paper 472, Nov. 2012, 64-66. The report found that MMFs were nevertheless affected by the crisis and became part of a "feedback loop."

[78] See Federal Reserve Board, "Wachovia Case Study", available at Financial Crisis Inquiry Commission web archive at:

http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-11-12%20Federal%20Reserve%20Board,%20Wachovia%20Case%20Study.pdf.

raising was problematic. After the Federal Reserve allowed Lehman Brothers to declare bankruptcy on September 15, 2008, however, followed by the announcement of an $85 billion bailout of AIG the next day, Wachovia's uninsured deposits began to plummet, although it maintained good collateral and cash at the holding company level. On September 25, 2008, banking regulators seized Washington Mutual in what was then the largest bank failure in history due to that institution's subprime mortgage lending activities. In a major miscalculation, the FDIC refused to pay WaMu's bondholders, creating panic among bondholders of other banking organizations. On September 26, 2008, bondholders demanded repayment of $65 billion in bonds from Wachovia—half of its outstanding notes and bonds. Wachovia's stock price plunged, the FDIC threatened to auction off the bank's assets, and the bank was sold off to Citigroup and later Wells Fargo, wiping out shareholders. The Federal Reserve case study concluded that the bank and its supervisors underestimated the impact of reputation risk incurred by the bank, data gaps masked the outflow of deposits, and the bank waited too long to access the Fed's discount window for liquidity (not until September 26). But the catalyst that brought down the bank was the failure of the FDIC to pay WaMu bondholders, preceded by the panic caused by the failure of Lehman and AIG.[79] The case study provides no basis to conclude that MMFs were a cause of Wachovia's failure. Similar case studies do not implicate MMFs in the failure of any bank.

It is unlikely that all twelve of the Reserve Bank presidents actually subscribe to a contrary narrative that blames MMFs for causing the crisis. The Reserve Banks have had ample time to study the crisis and see that the Federal Reserve's myth-based narrative is unsupported by the facts, does not explain what happened, and misleads policymakers. Nevertheless, the fact that all twelve Reserve Bank presidents signed the letter to the SEC recommending debilitating changes to MMFs indicates that they have been enlisted to perpetuate the myth whether they believe it or not.

B. MMFs Are Not "Shadow Banks"

The second Federal Reserve myth about MMFs—that they are part of an unregulated "shadow banking system"—is equally flawed. The shadow banking myth claims that highly leveraged, unregulated entities and activities operating outside the traditional regulated banking framework caused the financial crisis by spreading hidden risks. These entities and activities, which allegedly operate "in the shadows" out of the view of regulators, include asset-backed commercial paper conduits (ABCP), structured investment vehicles (SIVs), credit default swaps, repurchase agreements, securities lending, broker-dealers, mortgage brokers and, it is alleged, money market funds. According to the myth, all of these entities and activities contributed to the financial crisis by proliferating the

[79] Id. at 27 ("non-support for WaMu bondholders was catalyst that brought down WB.").

risks of subprime mortgages, evading regulatory restrictions, and creating runs that destabilized the financial system.[80]

MMFs do not meet the definition of shadow banks because they are completely unleveraged, have no ability to originate subprime mortgages or other unsafe assets, and are highly regulated under the Investment Company Act of 1940. The Act imposes strict requirements on MMFs for credit quality, liquidity, diversification, and transparency, among other requirements. MMFs invest only in high-quality, short-term instruments and do not proliferate risks in the way that leveraged entities such as banks and bank holding companies do.

The shadow banking myth fails to recognize that regulated banking organizations in fact are the largest shadow banks. Banks and their affiliates—including Wachovia—issued vast amounts of asset-backed commercial paper prior to the crisis and were among the largest issuers and sponsors of ABCP and SIVs that imploded. They originated and bought subprime mortgages that they then pooled, guaranteed, and sold to investors, including MMFs. They funded their shadow banking activities with short-term commercial paper and repurchase agreements. Regulated banking organizations were at the center of the shadow banking system and today remain the largest shadow banks.

The shadow banking myth falsely links MMFs to the causes of the financial crisis, diverts attention away from the real causes, and provides no justification for structural changes to MMFs of the type recommended by the twelve Reserve Bank presidents.

C. MMFs Did Not "Run Repo"

The Federal Reserve's MMF mythology is based in large part on research by two Yale economics professors who, in a series of widely acclaimed (but later discredited) papers, asserted that a run on the market for repurchase agreements caused the banking system to become insolvent and led to the financial crisis.[81] MMFs are key lenders in the repo market and, as theorized by Professors Gorton and Metrick, played a leading role in the "run on repo" and ensuing financial collapse.

In their papers, Gorton and Metrick identified the repo market as a key part of the "shadow banking system" and estimated its size in 2007-08 to be between $10 and $12 trillion—exceeding the size of the banking system. They

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[80] See generally Fein, Melanie L., The Shadow Banking Charade (Feb. 15, 2013). Available at SSRN: http://ssrn.com/abstract=2218812.

[81] Gary B. Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007; Gary Gorton and Andrew Metrick, The Run on Repo and the Panic of 2007-2008, March 9, 2009; Gorton and Metrick, Haircuts, Federal Reserve Bank of St. Louis Review, Nov.-Dec. 2010; Gorton and Metrick, Securitized Banking and the Run on Repo, Nov. 9, 2010; Gorton and Metrick, Regulating the Shadow Banking System, Brookings Papers on Economic Activity, Fall 2010.

postulated that a dramatic increase in "haircuts" on repo collateral by repo investors (i.e., MMFs) caused a "run on repo" which in turn caused the entire banking system to become insolvent:

> How did a breakdown in one part of the housing market lead to a systemic crisis in the whole financial sector? In this paper, we provide some evidence on . . . how the financial crisis spread from the subprime housing market sector to the broad panic that we had by the end of 2008. We argue that the crisis is "systemic" because it was a run on the sale and repurchase market (the "repo" market), which stopped functioning, leading to massive deleveraging of participants. In effect, the banking system became insolvent. * * * * Our answer is that there was a run in the repo market. . . .[by MMFs and other investors].[82]

To prevent a similar danger in the future, Gorton and Metrick recommended, among other things, that MMFs be subjected to bank-like regulation.[83]

Federal Reserve officials latched onto the work of Gorton and Metrick as a basis for their narrative of the financial crisis and the role of MMFs as a key causal element.[84] The "run on repo" theory of the financial crisis, however, was subsequently challenged by other academics and proven wrong in its conclusions regarding MMFs.

In 2012, economists at Northwestern and Stanford Universities published a paper refuting the conclusions of Gorton and Metrick. In contrast to the latter's

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[82] Gorton and Metrick, Securitized Banking and the Run on Repo, supra.

[83] Gorton and Metrick, Regulating the Shadow Banking System, supra.

[84] See Federal Reserve Board Governor Daniel K. Tarullo, Regulating the Shadow Banking System, Remarks at the Brookings Panel on Economic Activity, Washington, D.C., Sept. 17, 2010 ("Gary Gorton and Andrew Metrick have, in setting forth this proposal, continued to shape our understanding of the role and risks of the shadow banking system, as well as to add a specific proposal to our menu of possible responses."). Fed Chairman Bernanke repeatedly has cited Professor Gorton's work and recommended it as required reading. See Michael Corkery, Ben Bernanke's Reading List, Wall Street Journal, Sept. 3, 2010; David Ignatius, Ben Bernanke, Quiet Tiger at the Fed, Washington Post, May 28, 2009 ("Bernanke recommended studies by Gary Gorton, a Yale economist who has analyzed the ways the recent panic resembled those of the late 19th century. . . his latest paper, 'Slapped in the Face by the Invisible Hand'."). See also "Reflections on a Year of Crisis," Remarks of Ben S. Bernanke at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming, Aug. 21, 2009; Statement by Ben S. Bernanke, Chairman, Federal Reserve Board, before the Financial Crisis Inquiry Commission, Sept. 2, 2010; Remarks by Ben S. Bernanke at the New York University Law School, April 11, 2007, Financial Regulation and the Invisible Hand.

sweeping claims concerning the role of repo, they found that repo played "only a small role" in funding subprime mortgages and transmitting risks.[85] Moreover, these economists found that only three percent of outstanding asset-backed securities were financed with repo from MMFs and that most of the repo funding extended by MMFs was collateralized by government securities—a finding that undercut the "haircut" theory of Gorton and Metrick. Researchers at the Federal Reserve Bank of New York also in 2012 published a paper contradicting the findings of Gorton and Metrick.[86] Other researchers reached a similar conclusion.[87]

It turns out that the data used by Gorton and Metrick as a basis for their heralded "run on repo" hypothesis were drawn from a sliver of the bi-lateral repo market not representative of the market as a whole. In particular, Gorton and Metrick did not properly account for the tri-party repo market, which forms a large part of the repo market and relies on safe government securities rather than mortgage-backed securities as collateral.

In light of the subsequent research undermining their theory, Gorton and Metrick reassessed their broad claims concerning the role of MMFs in the financial crisis. In a major admission of academic error, in 2012 they recanted their earlier conclusion, stating:

> As it turns out, MMFs were not at all representative during the crisis, with repo assets actually increasing for MMFs by

[85] Arvind Krishnamurthy, Stefan Nagel, and Dmitry Orlov, Sizing Up Repo, Centre for Economic Policy Research, Discussion Paper No. 8795, Feb. 2012 at 50 ("repo accounts for only a small fraction of the short-term funding of securitized assets…prior to the crisis. This finding does not support [the] broad brush picture painted by Gorton and Metrick...."). These professors analyzed an SEC database of 15,000 separate transactions by the 20 largest money market fund families, covering some 80 percent of the assets in the industry.

[86] Adam Copeland, Antoine Martin, Michael Walker, Repo Runs: Evidence from the Tri-Party Repo Market, Federal Reserve Bank of New York Staff Report no. 506, July 2011, rev. March 2012 ("We study the behavior of haircuts and values of collateral posted over this period and document the surprising result that securities dealers' funding was remarkably stable. Strikingly, even around times when a securities dealer experienced adverse shocks, we show the affected dealer is able to maintain its funding without changes in haircuts. . . . This paper provides a detailed description of the U.S. tri-party repurchase market. . . .We document that the level of haircuts and the amount of funding were surprisingly stable in this market, even for securities dealers who suffered adverse shocks."

[87] See, e.g., Richard Comotto, Haircuts and Initial Margin in the Repo Market, European Rep Council, Feb. 8, 2012 ("They [Gorton and Metrick] are therefore simply incorrect to attribute the entire deleveraging of the US financial system and loss of liquidity in the US money market to the dynamics of the repo market in form of deepening haircuts.").

> more than $100 billion at the same time that overall repo liabilities were falling by $1.3 trillion.[88]

Thus, the academic research shows that MMFs actually counter-balanced the run on repo rather than causing it and contributed important liquidity to the financial system during the crisis.

Federal Reserve officials likewise should admit that they erred in their initial view of the financial crisis and dispense with their myths. They should stop harassing the MMF industry with threats of ill-conceived regulatory proposals that do nothing to improve financial stability but would destroy an investment product valued by millions of investors that contributes important liquidity to the financial system.

VI. CONCLUSION

The core duties of the Federal Reserve Banks in check clearing, banking supervision, and monetary policy have diminished in recent years. The Reserve Banks appear to be looking for other areas to take up the slack. The regulation of money market funds is not an area they should be looking at. The Dodd-Frank Act sought to limit their role in financial regulatory policy matters. The floating NAV idea they advocate would worsen the problem they say they seek to solve. MMFs did not cause the financial crisis and do not pose a risk to U.S. financial stability. The Reserve Bank focus on MMFs is misplaced.

The floating NAV idea is not a substitute for regulations that curb inappropriate reliance on short-term credit by banks and strengthen bank liquidity and capital. Destroying MMFs will not solve the problem of too-big-to-fail banking organizations but will result in them becoming bigger. Eliminating the $1.00 NAV would deprive investors of a safe and efficient cash management tool not available from banks. It would diminish MMFs as efficient suppliers of short-term credit for banking organizations as well as other borrowers, including municipalities that rely on MMFs for short-term credit to fund a wide range of public projects.

The Reserve Banks have an important role to play in advising the Board of Governors on bank regulatory and supervisory matters. Whether twelve of them are needed for this purpose is unclear. What is clear is that twelve of them are *not* needed to advise the SEC on how it should regulate MMFs. Rather than lobby the SEC to resolve what in reality are *bank* financial stability issues, the Reserve Bank presidents should focus their joint advocacy efforts on encouraging the

[88] Gary Gorton and Andrew Metrick, Who Ran Repo? Oct. 4, 2012. Gorton and Metrick admitted that their data was flawed and their interpretation of the data misleading: "Our analysis demonstrates the danger of relying exclusively on official sources of data for repo markets. While it is tempting to focus where the data are strongest, such analyses can be misleading.").

Board of Governors complete its unfinished agenda of bank supervisory reforms mandated by the Dodd-Frank Act.