TESTIMONY OF

STEPHEN W. HALL
LEGAL DIRECTOR AND SECURITIES SPECIALIST
BETTER MARKETS, INC.

BEFORE THE

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT OF THE U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

ON

"IMPROVING COMMUNITIES' AND BUSINESSES' ACCESS TO CAPITAL AND ECONOMIC DEVELOPMENT"

MAY 19, 2016

Introduction

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, thank you for the opportunity to testify today on behalf of Better Markets. Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. Its goal is to help establish a stronger, safer financial system that is less prone to crisis and the need for taxpayer bailouts. Better Markets seeks to achieve these goals through regulatory comment, public advocacy, independent research, and litigation. Through these channels, we serve as a counterweight to the financial industry to help ensure that policy makers and regulators prioritize the interests of hardworking Americans over special interests.

Better Markets supports the goal of promoting and protecting capital formation for the benefit of the real economy but has serious concerns about all three of the bills that are the subject of this hearing. They would remove or weaken regulations aimed at protecting investors and maintaining financial market stability in the areas of money markets funds, real estate securitizations, and business development companies.

In my testimony, I'll describe the perspective that Better Markets brings to these issues; offer a general assessment of the deregulatory approach reflected in these measures; and highlight specific provisions in each of these bills that we believe would be harmful.

The Better Markets Perspective

Better Markets firmly believes that vibrant, fair, and stable capital markets are crucial to generating economic growth and prosperity for all Americans. We also believe that achieving these goals requires a strong regulatory framework. That framework must be capable of protecting investors to sustain their confidence in our markets and preserve their willingness to participate in capital formation. And above all, our regulations must limit systemic risk in our markets to avoid a recurrence of the type of devastating financial crisis that nearly destroyed our economy in 2008.

That crisis was the worst financial disaster since the Great Crash of 1929, and it produced the worst economy our nation has seen since the Great Depression of the 1930s. It nearly destroyed our financial system, obliterating millions of jobs, triggering a tidal wave of home foreclosures, and wiping out the savings of countless American households. Small businesses were particularly hard hit. In 2008, for the first time in history, more businesses failed than were started. The costs have been staggering: tens of trillions of dollars in lost GDP and inestimable human suffering.[1]

And the crisis is still being felt today. Underemployment remains at almost 10%, 6.7 million homes are still underwater; median wages remain stagnant; and middle class Americans still struggle with $3.5 trillion in non-mortgage consumer debt.

---

1 BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING, (JULY 2015), *available at* http://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf

The lesson is clear: Without effective rules, our financial system is susceptible to financial crisis, and financial crisis poses the single greatest threat to capital formation and economic growth, especially among small businesses. Strong regulation is thus essential for protecting and promoting capital markets that support the real economy and ensure long term economic prosperity.

General Concerns

The deregulatory approach in these bills raises a number of concerns. First, we question whether these measures will really help businesses and municipalities access the capital they need to expand and contribute to economic growth. Throughout its history, members of the financial services industry have opposed regulation based on confident predictions that regulatory safeguards applied to their activities will limit access to capital and stifle economic growth. In fact, however, these claims tend to be speculative, anecdotal, and ultimately unfounded. In this case, we haven't seen credible evidence that these bills will materially benefit our financial system or the larger economy.

Second, if enacted, these bills will come with a heavy price. They will expose investors to an increased risk of loss. Inflicting harm on investors doesn't fuel the real economy, and it ultimately undermines the investor confidence that is so essential to a well-functioning capital market.

Of greatest concern, these bills would also lead us in the dangerous direction of increased systemic risk and a greater likelihood of financial crisis. For example, we know for a fact that money market funds and the securitization of real estate loans contributed heavily to the 2008 financial crisis. The floating net asset value (NAV) and the risk retention, or "skin in the game," requirements that will soon take effect are key regulatory reforms designed to reduce the risk that our financial system—and these markets in particular—will once again be thrown into chaos. The bills at the center of this hearing would repeal or weaken those reforms before they have been given a chance to work. As result, these bills would increase the prospects for another devastating financial crisis that would destroy our economic growth.

Perhaps the Financial Stability Oversight Counsel (FSOC) said it best when it issued its proposed recommendations on money market reform. At the top of their list was the floating NAV. The FSOC observed that by reducing the risk of runs on money market funds, their recommendations would decrease both the likelihood and severity of future financial crises.[2] It explained that because financial crises have such a profoundly damaging impact on economic activity and economic growth, "**reforms that even modestly reduce the probability or severity of a financial crisis would have considerable benefits in terms of greater expected economic activity and, therefore, higher expected economic growth**."[3]

---

2 Proposed Recommendations Regarding Money Market Fund Reform, 77 Fed. Reg. 69,455 (Nov. 19, 2012), at 69,481 (FSOC Release).

3 *Id.* at 69,482 (emphasis added)

The bills we're discussing today are at odds with this approach. They would weaken regulatory safeguards, thereby increasing the probability of another financial crisis, while putting investors needlessly at risk. We believe they would be counterproductive.

S. 1802 – Deregulation of Money Market Funds

S. 1802 would allow all money market funds (MMFs) to maintain a fixed net asset value. This provision would effectively repeal the SEC's 2014 rule requiring institutional prime and institutional municipal money market funds to adopt a floating NAV. But to ensure that money market funds remain stable, we actually need to apply more regulation in this area, not less. The bill is a step in the wrong direction.

MMFs Are Vulnerable to Destabilizing Runs.

MMFs are susceptible to runs and when they do occur, the financial system can experience major disruptions that cripple the short-term credit markets. MMFs do not come with any form of reliable capital buffer or government insurance that can mitigate the effect of a run. In addition, the MMF market is large, amounting to $2.7 trillion, and relatively concentrated. MMFs are highly interconnected with other financial institutions, and they are widely used by individuals, institutions, and businesses as cash management vehicles or as sources of credit. By virtue of these characteristics, MMFs present an ongoing risk of runs that can spread widely and rapidly throughout the financial system.

The financial crisis of 2008 made this threat painfully clear. In the most compelling example of run risk, the Reserve Primary Fund broke the buck on September 16, 2008 due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. Although that debt was only 1.2 percent of the fund's total assets, a run ensued when the fund sponsors declined to provide support. Within two days, investors sought to redeem $40 billion from the fund. This required the fund to dump tens of billions of dollars in assets immediately so that it could pay for the flood of shareholder redemptions. This fire sale in turn depressed asset values, further weakening the fund.

The run quickly spread to the entire prime MMF industry, and during the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) of prime MMF assets. This industry-wide run caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, falling asset prices, and mounting redemption requests. The run abated only after the Treasury, on September 19, 2008, established the Temporary Guarantee Program to guarantee money market funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis.[4] The entire $3.7 trillion money market fund industry was backstopped, putting taxpayers on the hook for any losses.

The collapse of the Reserve Primary Fund was not the first time—or the last—when MMFs faced significant stresses and potential collapse. During the crisis, other money market funds

[4] *See* SEC DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION, RESPONSE TO QUESTIONS POSED BY COMMISSIONERS AGUILAR, PAREDES, AND GALLAGHER, at 12 (Nov. 30, 2012), *available at* http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

experienced significant stress levels requiring their sponsors to provide support. Going further back in time, one study found 144 cases from 1989 to 2003 in which MMFs would have broken the buck had it not been for sponsor support.[5] Another survey revealed 78 instances between 2007 and 2011 in which sponsors provided support to their MMFs in the form of either cash contributions or purchases of securities from the fund at inflated prices.[6] Relying on sponsors to maintain a stable NAV is an unreliable approach, as we learned from the financial crisis.

As the SEC and the FSOC have concluded, requiring MMFs to maintain a floating NAV is one the most important reforms we can adopt to reduce this run risk. Under this approach, instead of being fixed artificially at $1.00, the price of shares fluctuate and reflect the actual market value of the assets in the fund portfolio.

<u>The Floating NAV Mitigates Run Risk.</u>

Floating the NAV offers several benefits. First and foremost, it reduces the incentive of any investor to expedite withdrawals from a stressed MMF in hopes of redeeming at the $1.00 price as opposed to something lower.[7] Investors who withdraw first no longer benefit from a "first mover advantage," since they receive the actual market-based value of their shares. Eliminating this first mover advantage substantially reduces run risk.

Second, the floating NAV also promotes greater fairness among investors.[8] As a result of the artificially stable NAV, an investor that succeeds in redeeming early in a downward spiral may receive more than they are due by liquidating at $1.00 per share even though the underlying assets are actually worth less. Without a sponsor contribution or other rescue, that differential in share value is paid by the shareholders remaining in the fund. Early redeemers receive a windfall and later redeemers pay the cost. The floating NAV eliminates this disparity and unfairness.

Finally, floating the NAV also enhances transparency. A fluctuating NAV helps correct the basic misconception among many investors that their MMF investment cannot lose value. Instead, investors see plainly that they bear the risk of loss as to MMFs, just as they do with other investment vehicles. Acclimating MMF investors to share price fluctuations would further mitigate their tendency to run in panic at the prospect that their MMF will "break the buck."[9]

---

5 MOODY'S INVESTORS SERVICE, SPECIAL COMMENT, SPONSOR SUPPORT KEY TO MONEY MARKET FUNDS (Aug. 9, 2010), *available at* http://www.alston.com/files/docs/Moody's_Report.pdf; *see also* Release at 69,462 n. 28.

6 *See* STEFFANIE A. BRADY, ET AL., FEDERAL RESERVE BANK OF BOSTON, RISK AND POLICY ANALYSIS UNIT, THE STABILITY OF PRIME MONEY MARKET MUTUAL FUNDS: SPONSOR SUPPORT FROM 2007 TO 2011, WORKING PAPER RPA 12-3, at 4 (Aug. 13, 2012), *available at* http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1203.pdf; *see also* SEC Press Release, *supra* note 10, at 4 (citing over 300 instances since the 1980s of sponsor support necessitated by the diminished value of holdings or extraordinary redemptions).

7 Money Market Fund Reform; Amendments to Form PF; Proposed Rule, 78 Fed. Reg. 36,834 (June 19, 2013), at 36,850.

8 *Id.*

9 *Id.* at 36,851.

Prospectus Disclosure Is Insufficient.

S. 1802 includes a provision apparently aimed at preserving the transparency benefits of the floating NAV. The bill would prohibit bailouts of money market funds and require prominent disclosure of that fact in all fund prospectuses and sales literature. It thus seeks to correct the widespread misimpression that MMFs cannot sustain losses or that they carry bank-like deposit insurance. However, we do not believe that disclosure alone would alter investors' inflated confidence in the stability of MMFs. Demonstrating the truly variable nature of MMFs on a day to day basis through transparent price fluctuations would be far more persuasive than simply stating the fact in fine print disclosure forms. More importantly, this provision in the bill would do nothing to mitigate the powerful incentive to redeem shares that arises directly from the fixed NAV. Nor would it eliminate the unfair advantage that some investors can gain by redeeming shares early in times of stress under a fixed NAV.

The concerns expressed by opponents of the floating NAV are understandable but not persuasive. The operational changes required by the SEC rule appear to be manageable, in part because the SEC established a two-year compliance period. Most of the large fund complexes have made the necessary adjustments to implement the rule. And Treasury and the IRS have addressed the tax and accounting concerns previously raised.

Loss of Institutional Investment Will Not Be Significant.

Perhaps the single greatest lingering concern is that institutional investors will migrate away from floating NAV Funds, especially the municipal MMFs, raising the cost of credit for local governments. Under the SEC rule, however, the impact is not expected to be significant. As it is, institutional investors account for a small percentage of municipal debt in the money market space, and at least some institutional investors will continue to seek the tax benefits that municipal funds provide. In addition, municipal MMFs that serve retail investors will not be subject to the floating NAV requirement, so the feared reduction in investment will not occur in that sector.

In any case, even if the cost of credit rises to some degree for businesses or municipalities, the gains in terms of systemic stability will be worth it. Policy makers responsible for mitigating systemic risks must at times face the need to "accept higher costs in normal times in order to significantly reduce the costs of financial crises."[10]

In short, repealing the SEC's rule requiring institutional prime and municipal MMFs to float their NAV is a step backward. In reality, we should be floating the NAV for all money market funds, not just institutional funds.[11] In addition, regulators should be weighing the need for additional safeguards, including capital buffers.[12] Rolling back the progress that the SEC has made in protecting MMFs from the potentially disastrous runs is unwise.

---

[10] FSOC Release, at 69480 n. 119.

[11] As Better Markets detailed in this comment letter: Letter from Better Markets to the SEC, Money Market Reform (Release No. 33-9408) (Sept. 17, 2013). In our letter, we also explain why the SEC's MMF reforms, while critically important, were still only half-measures. In addition to floating the NAV for all MMFs, the SEC must apply other safeguards, including capital buffers, especially where the fixed NAV is allowed to persist.

[12] *Id*. at 2.

H.R. 4620 – Risk Retention exemption for commercial real estate loans

H.R. 4620 would weaken the risk retention safeguards applicable to securitizations of commercial real estate loans. If properly regulated, the securitization markets can be an important source of affordable credit. However, when the securitization process is marked by recklessness or fraud in the origination and pooling of the underlying financial assets, coupled with a lack of transparency and disclosure, then securitized loans can inflict enormous harm on the entire financial system.

Regulatory Gaps in Securitization Contributed to the Crisis.

It was precisely this type of broken securitization market that contributed so heavily to the financial crisis. In the years leading up to the crisis, the "originate to distribute" model became pervasive in the residential mortgage market. Loans were originated for the express purpose of being sold into securitization pools, allowing lenders to reap enormous fees without bearing the credit risk of borrower default. This widespread practice ultimately led to the accumulation of massive amounts of high-risk mortgage-backed securities in the hands of financial institutions and investors of all types. The situation epitomized the very concept of systemic risk, and when the housing bubble burst, it took a huge toll on markets, investors, and the economy.

A similar pattern unfolded in the commercial real estate market, where underwriting standards sank to meet demand for loans that could be securitized. In fact, many banks that failed or were bailed out and rescued during the financial crisis did so in part because they held badly underwritten commercial real estate loans. The crisis devastated not only the residential mortgage backed securities market, but also the commercial mortgage backed securities market.

Risk retention requirements are among the most important reforms in this area. They are designed to align the interests of securitizers more closely with investors, thereby increasing the quality of assets in securitization pools and reducing the risk of loss. These requirements help protect investors and restore confidence in mortgage-backed securities. This in turn helps allocate capital to real estate development in a way that will support economic growth without threatening a financial crash. Diluting the risk retention requirements is the wrong approach.

The Bill Would Create a Blanket Exemption for Single or Related Loans.

H.R. 4620 would make two particularly worrisome changes in the risk retention rule. First, it would create a blanket exemption for the securitization of a single commercial real estate loan or groups of related loans. The exemption is unwarranted for several reasons. Even single loans and groups of related loans can represent large and complex transactions that present underwriting challenges. Moreover, securitizations of these types of loans can actually present heightened risks of default since the loan pools lack diversity and therefore concentrate risk. In addition, the securitization of a group of cross-collateralized loans poses greater risk, since the default of one loan triggers default of the entire pool. Therefore, the risk retention requirements still have an important role to play in incentivizing careful underwriting for a single loan or a group of related loans as these investments are assembled for sale to investors.

This exemption is also troubling because it is essentially unlimited. The bill would impose no boundary on the number, size, quality, or complexity of the loans that would fall within the exemption. Under the bill, groups could include any number of loans, provided that they have relatively tenuous connections through "related borrowers" and direct or indirect ownership of the underlying properties. Finally, the bill would leave no room for the agencies to impose any safeguards or objective risk-limiting requirements on such securitizations as a condition for the exemption. This restriction prevents the agencies from applying their expertise to the task of identifying commercial real estate loans that can be safely exempted from the risk retention requirement.

The Bill Would Weaken the Exemption for Qualified CREs.

The bill would also dilute the protections in the risk retention rule applicable to qualified commercial real estate loans. These loans are exempt from the risk retention requirement provided they have certain attributes that make them relatively low risk. The risk retention rule currently specifies the features of qualified commercial real estate loans that make them eligible for the exemption. However, the bill would eliminate some of those features and actually prohibit the agencies from taking them into account when defining the universe of qualified loans.

For example, the bill would permit interest-only loans to qualify, even though such loans can adversely affect repayment ability at maturity due to the absence of any principal reductions. In addition, the bill would prohibit minimum loan term requirements (now set at 10 years), and it would extend the maximum allowable amortization schedule to 30 years (now set at 25 years). It would also bar the application of separate loan-to-value caps to account for the risk associated with appraisals that use lower capitalization rates than other loans. Yet each of these loan characteristics is associated with weaker underwriting and heightened risk.

In short, this bill would create a new exemption from the risk retention requirements for all single commercial real estate loans and groups of related loans. It would also water down the qualified loan exemption, broadening it to encompass loans of lower quality. These changes are likely to harm investors and increase the chances for the accumulation of systemic risk in the securitization market for commercial real estate loans.

H.R. 3868 – Deregulation of Business Development Companies

H.R. 3868 would weaken multiple regulatory safeguards that govern the operation of BDCs. We have concerns, shared by the SEC, that the bill would expose investors to significantly greater risk, while diverting capital away from the companies they are intended to serve.

Congress established Business Development Companies in 1980 as a special type of closed-end investment company. Their principal mandate is to invest in small, growing, or financially troubled businesses, many of which cannot obtain credit through more mainstream banking channels. To help ensure that BDCs fulfill their underlying purpose, the Investment Company Act (ICA) requires BDCs to provide managerial assistance to its portfolio companies.

BDCs already present heightened levels of risk, due to the nature of their portfolio companies and the regulatory exemptions they enjoy under the ICA. For instance, BDCs are permitted to use more leverage than a traditional closed end fund, including a 1-to-1 debt-to equity ratio, as opposed to the more conservative 1-to-2 ratio applicable to other funds. And they can issue multiple classes of debt securities. However, even as it relaxed the regulatory requirements applicable to BDCs, Congress recognized that it was important "to avoid compromising needed protections for investors in the name of reducing regulatory burdens."[13]

The proposed bill changes the nature of BDCs by allowing them to increase their leverage; invest more money in financial companies rather than operating companies; and even purchase a registered investment adviser.

<u>The Bill Would Double Permitted Leverage.</u>

The bill would allow BDCs to borrow more and double their already preferential leverage level. Because leverage magnifies potential losses as well as gains, this change would expose investors to a substantially increased risk of loss. Such losses would fall largely on retail investors, as they hold most BDC securities.

The current trends in BDCs cast further doubt on the wisdom of this approach. The BDC universe has expanded rapidly over the last 15 years, both in terms of the number of BDCs in operation and their total assets. From 2003 to 2015, for example, BDC net assets rose ten-fold, from $5 billion to over $52 billion.[14] On the other hand, reports have recently emerged that BDCs are becoming overleveraged even under existing regulations.[15] Adding a new layer of leverage risk under these circumstances would seem to be especially unwise.

<u>BDCs Would Be Able To Divert Capital From Operating Companies to Financial Companies.</u>

H.R. 3868 would also allow BDCs to invest greater amounts in financial companies, thus diverting capital from the types of operating businesses they were intended to assist. Today, BDCs are required to invest 70% of their funds in small or medium size operating companies, referred to as "qualifying assets" or "eligible portfolio companies," which have often been rejected by ordinary funding institutions. Congress did allow BDCs to diversify their holdings by investing 30% of their funds in other securities, including financial firms. The 70% - 30% asset holding structure of BDCs was selected after careful consideration and it was "chosen by the [Senate Banking Committee] as a matter of compromise between the [SEC] and the business development industry."[16] The 70% requirement was clearly intended to direct BDC investments toward the small businesses that actually produce goods and services.

---

[13] *See* H.R. Rep. No. 1341, 96th Cong., 2d Sess. 20-23 (1980).
[14] SEC Chair Mary Jo White, Letter to Representatives Hensarling and Waters, Nov. 2, 2015.
[15] Fitch: BDC's Are Getting Overleveraged, Barron's (Apr. 25, 2016).
[16] S. Rep. No. 96-958, 96th Cong., 2d Sess. 23.

This bill would expand the definition of "qualifying assets" to include other types of securities, including those issued by banks, brokers, insurance companies, and consumer finance companies, subject to a limit of 20% of total assets. With this new provision in place, BDCs could actually invest up to 50% of their assets in non-eligible portfolio companies, including financial firms. Allowing such an increase in funding for financial firms would decrease the amount of funding directed to true operating companies by almost 30%. This approach conflicts with the basic rationale for the creation of BDCs: channeling capital to businesses in the real economy.

BDCs Would Be Able to Own a Registered Investment Adviser

Additionally, the bill would allow BDCs to own registered investment advisor firms. This too would divert capital away from the operating companies that BDCs were intended to serve. And it would enable a BDC, through control of its adviser, to circumvent various limits on BDC activities. For example, if the BDC's adviser were to manage a number of private funds, and invest BDC money in those funds, then it could exceed the BDC leverage limits as well as limits on a BDC's investment in financial companies. In addition, the adviser's clients would be exposed to conflicts of interest arising from the adviser's recommendation to invest in the parent BDC or its portfolio of companies.

In sum, these provisions in H.R. 3868 violate Congress's original admonition to avoid comprising necessary investor protections in the name of reducing regulatory burden.

Conclusion

Thank you again for the opportunity to appear at this hearing today. I look forward to your questions.