The Floating NAV Isn't Going to Hurt Municipal Financing

On August 14, 2014, the SEC published a final rule ("Rule") adopting a collection of reforms applicable to money market funds ("MMFs"). Although the Rule contained an incremental and incomplete set of measures, it nevertheless was a positive step forward. One of the most important components of the Rule was a requirement that all institutional prime and institutional municipal money market funds float their net asset value or "NAV."

The floating NAV has encountered strong opposition throughout the regulatory process, and has even inspired legislative proposals to roll it back. *See* S. 1802. Some of the most vocal critics include municipalities who claim that the Rule will drive institutional investors away from municipal money market funds, increasing the cost of financing for local governments.

The SEC addressed these concerns appropriately when it released the Rule, explaining that the impact of the floating NAV would be minimal because (1) institutional municipal MMFs supply only a small percentage of financing for municipalities; (2) those funds will continue to attract at least some institutional investors even with the floating NAV in place; and (3) any impact is a necessary cost of stabilizing our financial system and preventing future devastating financial crises. A look at more recent data confirms these points: The floating NAV is an important reform that is unlikely to have a significant impact on the cost of financing for municipalities.

RECENT DATA CONFIRM THAT THE FLOATING NAV WILL HAVE LITTLE IF ANY IMPACT ON MUNICIPAL FINANCING

Table 1 below sets forth information about the level of investment by institutional municipal MMFs in municipal debt. It confirms one of the key points that the SEC highlighted when it issued its rule implementing the floating NAV. In its 2014 release explaining the final rule, the SEC observed that the upcoming transition of institutional municipal MMFs to a floating NAV would likely have a minimal impact on municipal finance, because "institutional tax-exempt funds hold approximately 2% of the total municipal debt outstanding and thus **at most** 2% is at risk of leaving the municipal debt market." [1]

Recent data confirm this point and it is critical to a proper assessment of the impact of institutional municipal MMFs on municipalities' borrowing costs. As reflected in Table 1, institutional municipal MMFs currently hold even less of the total $3.7 trillion municipal debt market today than in 2014, now amounting to only 1.22% or $45.7 billion dollars. This means that the floating NAV will have an even more minimal potential impact on the borrowing cost of municipalities.

Table 1

Institutional Municipal MMF Investment in Municipal Debt (*in billions*)[2]	

[1] SEC: Money Market Fund Reform; Amendments to Form PF (pg. 255) (emphasis added).

[2] Data pulled from multiple publicly available sources are linked in this response.

Total Municipal Securities	$ 3,746.9
MMF Investment in Municipal Securities	$ 206.6
% of Institutional Municipal MMFs	$ 22.14%
Institutional Muni Investment in Municipal Securities	$ 45.74
% of Municipal Securities Held by Institutional Municipal MMFs	$ 1.22%

Recent trends in the level of investment in various types of MMFs support this conclusion. As reflected in Table 2 below, investment in **all** municipal MMFs has decreased somewhat over the last six months. However, the data suggest that this is not due to the floating NAV rule but is instead part of a broader trend. In fact, **retail municipal** MMFs have experienced a greater reduction in dollars invested than institutional municipal MMFs have experienced. *Compare* third and fourth columns in Table 2 (showing that nearly $3 billion more has been withdrawn from retail municipal MMFs than from institutional MMFs). Yet retail municipal MMFs will not be subject to the floating NAV, so the floating NAV cannot account for the decrease.

Furthermore, **retail prime** MMFs have also experienced a nearly 16% decline in investment dollars over the last six months. *See* sixth column of Table 2. They too will be exempt from the floating NAV, further indicating that any decrease in municipal MMF investment is actually part of a larger trend affecting non-governmental MMFs, unrelated to the floating NAV. Any number of factors may be contributing to this trend, including a shift in demand due to ultra-low risk in government MMFs or recent volatility in the yields offered by MMFs.

Table 2

Assets Under Management (*in millions)*[3]	*All Municipal MMFs*	*Institutional Municipal MMFs*	*Retail Municipal MMFs*	*Institutional Prime MMFs*	*Retail Prime MMFs*	*All MMFs*
01/20/2016	$ 255,267	$ 68,624	$ 186,643	$ 783,307	$ 466,136	$ 2,742,488
06/08/16	$ 206,600	$ 45,739	$ 160,861	$ 730,299	$ 391,934	$ 2,725,398
Change (in $)	-48,667	-22,885	-25,782	-53,008	-74,202	-17,090
% Change	-19.07%	-33.35%	-13.81%	-6.77%	-15.92%	-0.62%
% of All Muni MMFs (1/20)		26.88%	73.12%			

[3] ICI Research & Statistics: Release: Money Market Fund Assets June 9, 2016 and Summary: Money Market Fund Assets Data (xls).

% of All Muni MMFs (6/8)		22.14%	77.86%			
% of All MMFs (1/20)	9.31%	2.50%	6.81%	28.56%	17.00%	
% of All MMFs (6/8)	7.58%	1.68%	5.90%	26.80%	14.38%	

Even if the floating NAV were to have some dampening effect on the 1.22% invested in institutional municipal MMFs, it will not significantly reduce municipalities' access to financing. For example, even with the floating NAV in place, institutional investors will still have an incentive to seek out the beneficial tax exemptions associated with municipal MMFs. In addition, some investors may withdraw from institutional municipal MMFs but then migrate to retail municipal MMFs, causing no net change in funds invested in municipal MMFs. For example, as the SEC explained in the final rule, some retail investors currently invest in municipal MMFs through omnibus institutional accounts. Some estimates submitted to the SEC indicate that as much as 50% of the assets held in ostensibly institutional municipal MMFs are actually beneficially owned by institutions on behalf of investors.[4] To the extent the rule prompts them to withdraw from institutional funds, they are likely to reinvest in retail municipal MMFs, with no negative impact on municipal financing via MMFs.

Finally, any impact of the floating NAV must be viewed in a larger context. The reforms adopted by the SEC in its rule are necessary to help mitigate the risk of another devastating financial crisis.[5] In reality, as we explained in our testimony and in our comment letter to the SEC,[6] the SEC reforms are only a partial solution, and more needs to be done. But at least they begin to address the proven threat to financial stability posed by MMFs, as exemplified by the dramatic run on the Reserve Primary Fund during the 2008 financial crisis (see response to Question #2 below). The floating NAV is a critical element of those reforms. If it is rolled back, the risk of another devastating financial crisis, and its intensity, will increase. As we saw in 2008, such a crisis would throw **all** MMF markets into disarray, cause a massive and prolonged increase in unemployment, and ultimately devastate economic growth—to the detriment of local governments along with everyone else. The far wiser course is to allow all of the SEC reforms to go into effect, notwithstanding any minimal or speculative impact they may have on municipal financing obtained through MMFs.

THE 2008 FINANCIAL CRISIS CRIPPLED PRIME INSTITUTINOAL MMFs, AND A FUTURE CRISIS WOULD HAVE THE SAME DEVASTATING IMPACT

The financial crisis made it painfully clear that MMFs present a serious risk of systemically significant runs and that those runs can cripple the short-term credit markets, potentially tipping the entire financial system into chaos. In the most compelling example of MMF run risk, the Reserve Primary

[4] SEC: Money Market Fund Reform; Amendments to Form PF (pg. 247).

[5] Better Markets, The Cost of the Crisis: $20 Trillion and Counting (2015), *available at* www.bettermarkets.com/costofthecrisis (incorporated herein by reference as if fully set forth).

[6] Testimony of Stephen W. Hall, Better Markets, Inc., Before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Improving Communities' and Businesses' Access to Capital and Economic Development," May 19, 2016, at p. 6 & n.11; Comment Letter from Better Markets to the SEC, Money Market Reform (Release No. 33-9408) (Sept. 17, 2013).

Fund broke the buck on September 19, 2008 due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. This nearly unprecedented event happened even though Lehman-related assets comprised only 1.2 percent of the fund's total assets.

When the fund sponsors declined to provide support and priced its securities at $0.97 per share, a run immediately ensued. Within two days, investors sought to redeem $40 billion from the fund. This required the fund to sell 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.

That September, over 90% of the redemptions from prime MMFS were from institutional not retail funds. This caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, depressed prices, redemption requests, more asset fire sales, and rapidly evaporating liquidity. That month alone MMFs reduced their holdings of commercial paper by about $170 billion or 25%.[7] The run abated only after the Treasury, on September 19, 2008, established the Temporary Guarantee Program for Money Market Funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis.[8]

Notwithstanding this unprecedented and massive intervention in what was then a $3.7 trillion market, the September 2008 run resulted in large and rapid divestment by MMFs in short-term instruments, "which severely exacerbated stress in already strained financial markets."[9] The decline in outstanding commercial paper contributed to a sharp rise in borrowing costs for commercial paper issuers.[10] In addition, while the losses ultimately sustained by investors in the Reserve Primary Fund were modest, those investors suffered substantial liquidity damage, losing access to their money for an extended period pending the outcome of judicial proceedings.[11]

The buckling of MMFs contributed heavily to the financial crisis, and all sectors of the economy paid a heavy price: "Regardless of which metric you look at—long-term unemployment, number of foreclosures, small business growth, federal R&D spending—there is irrefutable evidence that the financial crisis of 2008 and the subsequent Great Recession have set the U.S. and tens of millions of Americans back like no other economic calamity since the Great Depression."[12] MMF reform is essential to prevent a recurrence. As stated by the SEC, "[w]ithout additional reforms to more fully mitigate the

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7 SEC: President's Working Group Report on Money Market Fund Reform, at 11-12 (Release No. IC-29497) (11/3/2010).

8 *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.

9 *See generally* FSOC, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. at 66,464 (Nov. 19, 2012) ("FSOC Proposal");

10 FSOC Proposal, at 69,455, 69,458, 69,464; *Perspectives on Money Market Mutual Fund Reforms, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs,* 112th Cong. 6 (June 21, 2012) (Testimony of Mary Schapiro, Chairman, SEC) *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=66f4ddb5-4823-4341-bad9-8f99cdf5fe9a ("Schapiro Testimony").

11 Schapiro Testimony, *supra* note 8, at 6-7.

12 Better Markets: The Cost of the Crisis, at 95.

risk of a run spreading among MMFs, the actions to support the MMF industry that the U.S. government took beginning in 2008 may create an expectation for similar government support during future financial crises, and the resulting moral hazard may make crises in the MMF industry more frequent than the historical record would suggest."[13]

TYPES OF COMPANIES THAT ARE THE TYPCIAL INVESTMENTS OF PRIME MMFs

The aggregated data from the SEC, reflected in Table 3 below, reveals that prime MMFs invest largely in private debt instruments but historically hold about 20% of assets in government issuances. The 80% is invested in two types of non-governmental obligations: certificates of deposits from banks and thrift institutions, and short term issuances including commercial paper and securities issued by financial institutions, securitizers, and non-financial institutions.

Table 3

Prime MMF Portfolio Composition (in millions)[14]	*Certificates of Deposit*	*Non-Financial CP and Other Short Term Securities*	*Gov't (Direct & Repo)*	*Financial Co. Commercial Paper*	*Asset Backed Commercial Paper*	*Total Amortized Cost*
4/30/2014	$ 615,826	$ 398,568	$ 366,015	$ 266,701	$ 100,270	$ 1,747,380
% of Total	**35.24%**	**22.81%**	**20.95%**	**15.26%**	**5.74%**	
4/30/2015	$ 564,264	$ 439,606	$ 350,540	$ 258,376	$ 90,277	$ 1,703,063
% of Total	**33.13%**	**25.81%**	**20.58%**	**15.17%**	**5.30%**	
4/30/2016	$ 633,856	$ 214,119	$ 296,882	$ 228,873	$ 93,903	$ 1,467,633
% of Total	**43.19%**	**14.59%**	**20.23%**	**15.59%**	**6.40%**	

[13] President's Working Group Report on Money Market Fund Reform, at 18 (Release No. IC-29497) (11/3/2010).

[14] SEC Division of Investment Management: Money Market Fund Statistics, at 13 (06/14/2016)