BETTER MARKETS

BANKING REPORT

The Increasing Dangers of the Unregulated "Shadow Banking" Financial Sector: Money Market Funds

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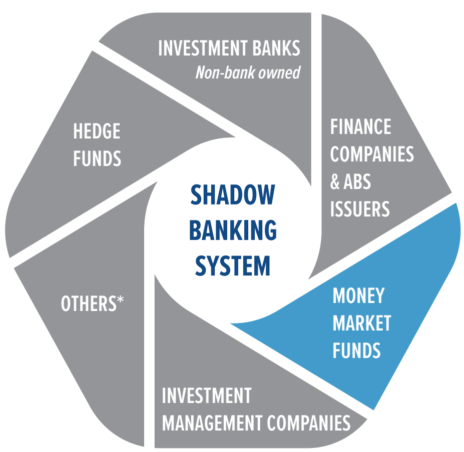
INTRODUCTION

A Bank-Like Product Without Bank-Like Protections Creates Systemic Risks

Since the first funds of this type were established in the 1970s, money market funds (MMFs) have been providing individuals and businesses with an alternative to traditional bank checking or savings deposit accounts. The basic structure is very similar between the two types of institutions. Both MMFs and banks serve an intermediary function in transferring funds from savers (i.e., those with excess cash) to borrowers while promising that the funds can be retrieved at any time. However, MMFs are not subject to the same regulations as banks that work to reduce the likelihood of runs by depositors in periods of stress. In both the 2008 Global Financial Crisis (2008 Crash) and the 2020 pandemic-caused market stress (2020 pandemic) this lack of sufficient regulations led to panic and massive runs by MMF investors that resulted in near-crippling turmoil in short-term funding markets.



* Not all shadow banking institutions are represented in this graphic.

MMFs invest in short-term corporate and government debt securities, making them a material source of the short-term funding that is heavily used by banks and other financial firms. This funding can become very expensive or even can shut down altogether when there is a stressed feedback loop of investor redemptions from and asset sales by MMFs. That is, worsening financial conditions and falling asset prices lead to redemptions by investors as they grow concerned about an MMF's solvency. The redemptions are funded with fire-sales of assets, which further depresses asset prices and sets off a cycle that threatens the MMF industry and overall financial stability.

To date, instead of internalizing the costs of the risks from their business models, the MMF industry has long relied on implicit government backstops that have put the burden on the taxpayer. Indeed, in both 2008 and 2020, the Federal Reserve (Fed) stepped in to provide support to the industry and reduce stress in short-term funding markets (which was also accompanied by a guarantee from the U.S. Treasury in 2008). After each event, the Securities and Exchange Commission (SEC)—who regulates MMFs—has sought to strengthen the regulatory framework, such as with its recently proposed enhancements. But even that framework would still be insufficient to reduce the incidence and severity of investor runs during periods of stress and would benefit greatly from two important additions:

1. Adding meaningful minimum capital requirements across all MMFs (in addition to the proposed liquidity requirements) to allow them to absorb losses on their assets; and
2. Requiring share values to vary for all MMF types and investor types, not only for the shares of Prime and Tax-Exempt MMFs that are owned by institutional investors.

Additionally, the spillover effects of stress in the industry on the firms that "sponsor" or manage MMFs are not currently being addressed. Historically, MMF sponsors repeatedly have stepped in to provide support through capital or liquidity injections when their MMFs have been in financial trouble, as evidenced most recently during the 2020 pandemic. One incentive for the provision of such support is that the failure of MMFs can result in substantial resolution costs for their sponsors. Perhaps even worse, if a sponsor does not step in, investors may question the financial condition of the sponsor itself, which can result in the sponsor facing issues obtaining funding.

Sponsorship of the MMF industry is roughly split between large banks and large investment management companies, which have both provided financial support for their MMFs over and over. This can deteriorate or strain the sponsor’s own financial condition, a troubling reality especially for bank sponsors whose capital buffers would be impacted. **Furthermore, banks are squeezed from both sides, providing support to their MMFs while facing additional pressure from filling gaps in the funding markets.** Therefore, capital requirements related to sponsor support must be in put place, especially since the SEC’s proposed regulations do not include capital requirements at the MMF level:

1. The federal banking agencies should require banks to capitalize for some amount of sponsor-related exposure through the supplementary leverage ratio and/ or the stress test-related capital requirements.
2. The SEC should add capital requirements for large investment management companies related to MMFs sponsorship.

This report is one in a series of reports about the "shadow banking" sector. It outlines the structure of the MMF industry, current and proposed regulations, the risks the industry has shown to pose to the financial system, and the policy adjustments that should be made to make the financial system more resilient under stress.

The Structure of MMFs, Their Special Treatment, and the Explosive Risks That Arise as a Result

Generally, there are three types of MMFs that are distinguished by the assets in which they invest:

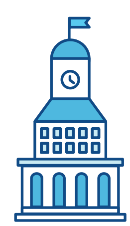
1

Government MMFs that invest in U.S. Treasury securities or repos that are backed by U.S. Treasury securities.

2

Prime MMFs that invest in short-term debt instruments issued by various types of corporations, namely commercial paper from all corporation types and certificates of deposit issued by banks.

3



Tax-exempt MMFs that invest in state and local government and municipal securities.

Money Market Funds (MMFs)—At a Glance

Similar in name, an MMF is not the same as a Money Market Account.

An MMF is a type of mutual fund that invests in high-quality, short-term debt instruments, cash, and cash equivalents.

Regulated by the SEC.

MMFs of all types—by types of investments and types of investors—are not required to have the same safeguards as banks that are designed to protect investors from losses and minimize financial stability issues.

Without appropriate safeguards in place to maintain a true guarantee to investors of a stable share value, this uncertainty turns to panic in periods of market stress that results in runs by investors on the funds.

Most funds service both individual retail investors and institutional investors. In the U.S. the share of retail investors is about 30% of the **over $4.5 trillion held in the MMF industry.**

As previously noted, the basic structure of MMFs appears to the depositor/investor to be pretty similar to a bank deposit account. Two of the most fundamental functions of banks are to take deposits and use those to make loans. Similarly, MMFs accept cash investments that essentially masquerade as deposits—based on the promise of allowing withdrawals of those investments at any time—and use them to invest in debt securities, which are a form of lending. That is, individuals and business with excess cash put it into an MMF under the expectation they can withdraw the same amount of funds at any time while the MMF turns around and invests that cash into debt securities.

However, functionally the model operates as an investment fund rather than as a checking or savings account. Investors are provided shares in an MMF for the funds they "deposit," and these shares are supposed to be able to be redeemed at any time at a fixed face value. Therefore, the value of the shares is supposed to be stable over time by design, which would allow investors to redeem them on a one-for-one basis similar to a bank deposit account.

This model, including its illusion that it is able to exist without significant risks, attracts investors seeking a higher-yielding alternative to bank deposit accounts and is what makes MMFs one of the key components of the financial system and one of the major players in the so-called "shadow banking" sector. These investments help fuel financial markets with short-term funding, which is used heavily by companies of all types, in particular banks, to meet their day-to-day cash needs. These companies also in turn invest excess cash with MMFs, creating a complicated inter-reliance between day-to-day corporate operations and MMFs.

As discussed in our report on shadow banking, the action of exchanging cash for securities results in maturity, credit, and liquidity transformations that each create a level of uncertainty and insecurity around whether investors will be able to retrieve the full amount of their original investment. Because MMFs do not have the appropriate safeguards in place to maintain a true guarantee to investors of a stable share value, this uncertainty turns to panic in periods of market stress that results in runs by investors on the funds.

The Faulty Assumptions Underpinning the Structure of MMFs Has Been Used to Provide Them with Special Treatment That Results in Significantly Under-Addressed Risks

Without appropriate safeguards in place, the safety and stability of an MMF and the value of its shares are based on the value of the assets they hold and investors' perception of safety and stability. The value of a debt security is dependent on whether it is held to maturity or is bought and sold in financial markets. If held to maturity, the value of a debt security can be represented by the "*amortized cost*" value, which is roughly equal to the amount of interest to be paid to the holder of the security plus the original amount loaned to the security's issuer, which is repaid to the holder of the security.

However, if securities are sold in financial markets, the amortized cost value likely will not be the market value. There are financial markets for debt securities in which their value is dependent on supply, demand, and the market's assessment of the likelihood of the security's issuer defaulting. Therefore, the market price of a debt security typically deviates from its amortized cost value, especially so in periods of market stress. This makes the constant share value more difficult to maintain when securities must be sold into distressed markets.

Therefore, successfully maintaining a stable share value over time, even during periods of stress, is dependent on two major and faulty assumptions that must hold true:

1. The amount of share redemptions by investors for cash is not materially in excess of the cash inflow from new investments and securities that are maturing.
2. If redemptions are in excess of the inflow of cash, and additional cash is needed, any securities that are sold to obtain that additional cash can be sold for a value that is not materially lower than the original amount paid for the securities. That is, MMFs will be able to obtain a price in the market that is sufficient to cover the excess share redemptions one-for-one based on the original investments.

These two assumptions underpin the special treatment that is afforded to MMFs, especially so in the case of individual retail investors. Retail MMFs are allowed to value the underlying debt securities they hold based on amortized cost value rather than the price of the securities in financial markets. Put another way, even though Retail MMFs might be required to sell their assets into financial markets at any time, an action which is likely to increase during periods of market stress, they do not value their assets according to the market price.

In a stressed market this would be similar to considering the value of a home to be equal to the original mortgage amount even if the actual market price is much lower. By using amortized cost value and ignoring the market price—a matter of accounting—Retail MMFs are able to "maintain" the stable share price that they promise to their customers. In the event the funds need to quickly liquidate assets into a declining market to meet withdrawal demands, that value is fictional. Additionally, although Institutional MMFs are required to have their share values fluctuate, these assumptions clearly influence the behavior of institutional investors as well.

Not only that, MMFs of all types—by types of investments and types of investors—are not required to have the same safeguards as banks that are designed to protect investors from losses and minimize financial stability issues. MMFs are not required to hold capital buffers that would allow them to absorb losses in periods of market stress when asset prices are declining, they have insufficient liquidity requirements (especially as compared to banks), and they do not have anything like deposit insurance. The absence of these safeguards substantially increases the likelihood investors will "run" to withdraw their money in times of stress—indeed, MMFs have repeatedly faced runs by investors during periods of market stress resulting in severe impacts to funding markets.

To attempt to ensure the assumptions are met, MMFs invest in short-term securities by design—indeed, as mandated by SEC regulations, discussed more below—including U.S. Treasury bills, repurchase agreements (or repos) backed by Treasuries, and so-called commercial paper. Both the Treasury bills and commercial paper that MMFs hold have an average maturity of 60 days, as required, but generally can have maturities up to a year. The markets in which these securities trade are known as money markets because they are used primarily to fulfill short-term cash needs—Treasuries for the needs of the U.S. government and repos and commercial paper for the needs of corporations of all types. MMFs also invest in certificates of deposits issued by banks, but these assets are not focused on in this report.

> *Without some safeguards (such as those required of banks) to protect investors against these risks, investors rationally will rush to protect their savings by redeeming their shares before their value is reduced or the MMF is insolvent.*

Shorter maturities more closely match the "on-demand" redemption feature of MMF shares, making it more likely that the first assumption above is fulfilled—i.e. that the cash inflow of securities maturing can cover expected redemptions during normal times. Also, the liquidity requirements imposed by the SEC require securities that can be sold more readily into financial markets, including in periods of stress. This helps keep their value higher, making it more likely that the second assumption is fulfilled—i.e., that the securities MMFs hold can be sold for an amount that is equal to or at least not materially lower than their original purchased amount.

That being said, despite these design features there are still risks that become particularly significant during periods of market stress. The maturity of the securities they hold—sixty days on average, as noted—is still longer than the on-demand nature of the shares in the fund. As such, MMFs still engage in maturity transformation by offering investors the ability to withdraw their cash at any time while investing in assets with fixed maturities. Therefore, if enough investors attempt to redeem their shares within a short period, funds will not have enough cash on hand to meet those redemptions and so will have to sell securities, often at distressed prices, starting off or exacerbating a cycle of market stress.

Additionally, there is credit transformation when investor cash that has no credit risk is used to purchase debt securities that carry the risk of the security issuers defaulting. Similarly, there is liquidity transformation from cash that maintains its value to securities that can lose value when sold into financial markets. These two risk types exacerbate the downward spiral. As securities are sold, funding costs increase and funding availability decreases, which makes it more likely companies will default, reducing debt security valuations, restricting funding availability, and increasing sales. And as there are more and more sellers and fewer buyers, liquidity is reduced and asset prices are further depressed.

Without some safeguards (such as those required of banks) to protect investors against these risks, investors rationally will rush to protect their savings by redeeming their shares before their value is reduced or the MMF is insolvent. Such runs by investors cause these risks to manifest in an explosive way, and they can rapidly impact all financial markets and banks as liquidity in the system disappears.

The MMF Industry Is Heavily Linked to Banks, Financial Markets, and the Economy, and So Stress in the Industry Threatens the Financial Sector and the Economy, and Puts Pressure on Banks

The investments made through MMFs make up a material portion of the markets for various assets—between one-fifth to one-quarter of the markets for commercial paper issued by financial and non-financial corporations and Treasury-backed repos. With such material portions of those markets, rapid and large-scale redemptions at MMFs can result in major disruptions in financial markets, which threaten the functioning of the real economy.

Commercial paper is utilized for short-term funding by companies of all types to fulfill day-to-day cash needs, maturing mostly in just one to four days but as long as over 80 days. The size of the commercial paper market is around $1 trillion, 80% of which is used by financial and non-financial firms.

Repos are short-term exchanges of cash for securities, usually for just a day. They are effectively a loan with securities as collateral, most often Treasuries or mortgage-backed securities. This market is a significant source of short-term funding primarily for financial companies. It is also used by the Fed to provide funding under market stress and manage the level of the federal funds rate. Trillions of dollars are lent and repaid through repo transactions each day.

Although runs on MMFs have more directly affected the market for commercial paper, shortages of supply and increased costs of funding in one market can increase demand and costs for funding in other markets, such as for repo funding. Banks, for example, are heavily reliant on the repo markets for their day-to-day funding needs, making up about 25% of repo markets volume.

Banks are especially affected in periods of stress and face multiple, simultaneous sources of financial pressure:

1. When funding in the commercial paper markets dries up, corporations turn to banks for loans.
2. Market stress is usually accompanied by stress in the repo markets, affecting the cost and availability of funding for banks.
3. Banks may provide (and many times have provided) financial support to the MMFs they sponsor (discussed more below).

In Periods of Market Stress, the Structure of MMFs and Insufficient Regulation Lead to Investor Panic and a Cycle of Redemptions, Asset Price Declines, and Funding Market Turmoil

In normal periods, MMFs serve as intermediaries between savers and borrowers in the massive short-term funding markets. And as shown above, they are a significant source of funding. However, in periods of heightened market stress, investors become concerned that the value of the assets in which their cash is invested could decline so significantly that the MMFs may not be able to return the cash they invested. During both the 2008 Crash and the 2020 Pandemic, this led to runs by investors and large-scale redemptions from Prime MMFs. These redemptions rapidly and materially reversed the intermediation process and thereby all but eliminated demand for commercial paper and threatened the functioning of that key funding market.

When market stress sets in, investor perceptions change rapidly. They seek to preserve as much of their wealth as possible, preferring cash and cash-like assets to riskier assets, such as a preference for government debt over corporate debt or cash over any other asset. Investors therefore sell their riskier assets and either hold onto their cash or reinvest it in safer assets. This drives down the prices of riskier assets as markets for those become one-sided with many more sellers than buyers. In addition, increased credit risk reduces the value investors attribute to debt securities, as noted above.

These factors can lead to significant redemptions from MMFs, which is exactly what occurred in the 2008 Crash and 2020 pandemic. The price of commercial paper started to decline as the perception of credit risk increased and investors had a preference for cash and safer assets. Investors in Prime MMFs sought to preserve their wealth against declines in the value of commercial paper by redeeming their shares for cash in massive quantities and, in some cases, reinvesting it in safer assets. For example, in March 2020, Prime MMFs experienced outflows of around $140 billion or almost 20% of their December 2019 assets, a percentage comparable to what we saw in the 2008 Crash. At the same time, inflows into Government MMFs—seen as a safer investment—were over 30% of assets in both periods.

Such large-scale redemptions are driven in large part by a “first mover” advantage – that is, investors that are able to redeem their shares sooner have a higher probability of getting all of their money out with no losses. This is true for MMFs with both fixed and market-variable share prices. In the case of fixed share prices, investors seek to redeem their shares quickly on a one-for-one basis before the MMF becomes short of funds, breaks the buck and thus offers less than a dollar per share, or reaches the point of insolvency. For MMFs with variable share prices, investors will try to redeem the shares at as high a value as possible.

In either case there is a very strong incentive to be “first in line,” resulting in rapid redemptions in significant quantities. This incentive seems to be stronger for institutional investors, who have shown to redeem at faster rates. In both the 2008 Crash and 2020 pandemic their redemptions were about a third of assets as opposed to about 10% for retail investors. Clearly, institutional investors rush to redeem their shares whether or not there is a variable share price, since the share price was fixed for them through the 2008 Crash but was changed to variable a few years later (this has been used as an argument against providing retail investors with this necessary protection—discussed more below).

In order to satisfy the redemptions, MMFs are required to sell assets in similarly substantial quantities, which leads to a feedback loop of redemptions and falling asset prices. In 2008 and 2020 sales of commercial paper exacerbated the already one-sided markets, further driving down market prices and increasing investor panic, which led to even further redemptions. Funding availability to companies through commercial paper all but dried up, leaving companies to seek other sources of funding. In fact, in March 2020 the use of corporate lines of credit held with banks increased at record weekly rates because companies were unable to obtain sufficient funding in the commercial paper markets. **This in turn increased the funding needs of banks, which contributed to pressure in other funding markets, in particular the repo markets.**

In both periods of stress, the feedback loop continued until the Federal Reserve stepped in with its Money Market Mutual Fund Liquidity Facility[1] and funneled billions of dollars of support to MMFs to bail out the industry and funneled billions of additional dollars into the markets more broadly to stave off complete collapse (accompanied by a guarantee from the U.S. Treasury in 2008). Without this intervention, the cycle would have continued and many MMFs likely would have collapsed into bankruptcy, causing huge investor losses as well as potentially major disruptions to funding markets. The facility was set up so that the Fed essentially served as a buyer of commercial paper from MMFs with a set price that was close to the amortized cost value of the securities so that Prime MMFs could obtain the necessary amount of cash to redeem investor shares. This bailout reduced investor panic and stopped large-scale investor redemptions.

Without a robust and effective regulatory framework, MMFs are just another investment product, but one that has potentially serious downside risks for their investors and for financial stability.

The Regulatory Framework for MMFs Has Always Been Insufficient and Must Be Strengthened

Regulatory Failures Have Led to Investor Runs and Market Turmoil

Without a robust and effective regulatory framework, MMFs are just another investment product, but one that has potentially serious downside risks for their investors and for financial stability. The true scale of these risks was first realized during the 2008 Crash when the Fed set up a facility to bail out the MMF industry in order to protect short-term funding markets. However, the SEC discussed the importance of these underlying risks as early as 1977:

> "The Commission is concerned that the amortized cost method…Investors purchasing or redeeming shares could pay or receive more or less than the actual value of their proportionate shares of the funds' current net assets. The effect of such sales or redemptions may therefore result in inappropriate dilution of the assets and returns of existing shareholders."

[1] The facility in the 2008 Crash was called the Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), which was very similar to the Money Market Mutual Fund Liquidity Facility. The major difference was that the AMLF accepted asset-backed commercial paper as collateral since the market for these securities was significantly larger in 2008.

Despite this the SEC yielded to industry lobbying and adopted a rule in the 1980s that first provided the special privilege for MMFs to maintain a fixed share price by using amortized cost accounting. This was allowed as long as certain conditions were met (known as rule 2a-7). Most significantly, the rule required the securities held by MMFs to have a dollar-weighted average maturity of no more than 60 days and the highest levels of credit ratings. As discussed above, these conditions were intended to limit maturity and credit transformation under the false assumption that would limit the overall amount of risk. This assumption repeatedly was shown to be mistaken in the early 2000s as multiple funds either failed or required substantial outside support to prevent failure. This assumption then was completely discredited when the industry blew up during the 2008 Crash.

In response to the apparent vulnerabilities, the SEC put in place two sets of post-2008 Crash rules that were intended to reduce the occurrence of investor runs and associated disruptions in funding markets. A rule was finalized in 2010 that required all MMFs to hold a minimum percentage of their total assets in liquid assets under the assumption that these requirements would provide sufficient liquidity from assets that would maintain their value even in periods of stress. Specifically, MMFs were required to hold:

- At least 10% of their assets in those considered to be able to be liquidated within one day, or “daily liquid assets” (such as U.S. Treasury securities) and
- At least 30% of their assets in those considered to be able to be liquidated within one week, or “weekly liquid assets.”

In 2014 the SEC expanded on this requirement to allow funds to charge fees on redemptions or impose restrictions on redemptions if the amount of liquid assets falls below the required amounts. Additionally, for Prime MMFs offered to institutional investors, the SEC required the value of shares to vary instead of holding a stable share price. Even with that floating share value, there was still an assumption the shares would in fact continue to hold their value because of the regulatory framework.

Notably, though, the change to a floating share value did not apply to shares held by retail investors, again a result of industry lobbying efforts to keep the illusion of a deposit-like product for retail investors. In fact, the SEC supported this decision with the absurd argument that run risk is lower for retail funds because retail investors are less inclined to monitor their funds closely, as evidenced by their lower rate of redemptions compared to institutional investors (discussed above)—essentially saying that because retail investors are less sophisticated, they deserve fewer protections.

These requirements did little to prevent mass runs on MMFs, which were repeated during the 2020 pandemic along with setting up another Fed emergency support facility that was needed to support the MMFs—and the financial markets more broadly—yet again. In fact, there is evidence that the ability to charge fees or impose restrictions on redemptions based on the liquidity requirements exacerbated the scale of investor runs, particularly by institutional investors. In other words, investors were also protecting against having to pay fees or even losing access to their cash altogether in addition to losses from share price declines, providing more incentive to rush to be the first in line for redemptions.

The SEC's 2022 Proposal Has Good Elements but Falls Short

Earlier this year the SEC proposed rule changes and published them for public comment to enhance MMF regulations, but the modifications still fall short of the meaningful reform that is necessary to prevent future crises in the industry. Three major proposed modifications from the proposal are:

- Removing the ability to charge fees or impose restrictions on redemptions when the liquidity requirements are breached;
- Increasing the liquidity requirements from 10% of daily liquid assets and 30% of weekly liquid assets to 30% and 50% respectively; and
- Imposing a swing pricing requirement for institutional Prime and Tax-exempt MMFs when the fund is experiencing net redemptions.

These modifications should serve to reduce the likelihood of liquidity crises at MMFs that spill over to the broader system. Removal of fees and restrictions on redemptions will remove the additional associated incentive to redeem shares even quicker, though it does nothing to protect the funds when runs do occur. Increasing the liquidity requirements will increase the ability of MMFs to weather redemption runs. Analysis included in the SEC's proposal showed that had the increased liquidity requirements been in place during the 2020 pandemic, they would have reduced a fund's chance of depleting its liquidity buffers from 32% to 9%.

Also, imposing swing pricing will allow the higher liquidation costs in periods of stress to be passed on to those redeeming their shares early and in large quantities, i.e., those investors that are redeeming their shares in a way that may threaten the value of the fund and the cost of funding in markets. This will protect the value of the fund for those investors that are not redeeming shares by passing along the costs to those that are redeeming instead of internalizing them, and would help to protect financial stability by discouraging runs by investors. However, swing pricing should be applied for all fund types and investor types.

The MMF Regulatory Framework Must Be Strengthened to Be Effective

However, more reforms are needed that were not included in the proposal because, as the SEC stated in its proposal, they "may reduce the attractiveness of affected money market funds to investors and may result in significant reductions in the size of the money market fund sector." In other words, they were not included due to—once again—industry lobbying efforts. In order to properly regulate the industry and protect investors and taxpayers from future crises, the SEC must finalize its rule with two important changes:

1. Adding meaningful minimum capital requirements across all MMFs (in addition to the liquidity requirements) to allow them to absorb losses on their assets, an aspect that is critically important when asset values are deteriorating rapidly; and
2. Requiring share values to vary for all MMF types, not only for Prime and Tax-Exempt MMF shares owned by institutional investors, as is currently the case.

Suggested SEC Regulatory Reforms

Adding Capital Buffers Higher than 3.9% — A capital buffer offers a number of benefits. In times of stress, it could allow MMFs to weather declines in asset values and to continue funding shareholder redemptions without resorting to fire sales that further depress share values.

Requiring share values to vary for all MMF types — A fixed share price fuels run risk, misleads investors into a false sense of security, and unfairly burdens investors who are late to redeem their investments when runs are underway in stressed market conditions. Therefore, the share value should be required to vary for all fund and investor types, including Government MMFs and those specifically for retail investors.

A capital buffer offers a number of benefits. In times of stress, it could allow MMFs to weather declines in asset values and to continue funding shareholder redemptions without resorting to fire sales that further depress share values. Critically, that in turn would help reduce the risk of investor runs by increasing investor confidence that an MMF could withstand adverse movements in the value of portfolio assets without causing a significant drop in their share price. The buffer would also reduce moral hazard and increase discipline in the management of MMFs by adding an incentive to manage the fund prudently not only to preserve investor confidence, but also to protect the buffer against depletion and costly replacement.

The buffer must be set at a level that is sufficient to cover multiple factors: projected and historical losses; additional costs in the form of liquidity damages or government backstops; and investor psychology in the face of possible financial shocks or crises. The Financial Stability Oversight Council has suggested a level of one or three percent, which would be insufficient to cover past cases of historical realized losses. As detailed in the SEC's recent proposal, MMF losses have been as high as 3.9 percent. This figure serves only as a floor regarding actual potential losses, which could indeed be higher, clearly indicating that the necessary buffer must actually be substantially higher than 3.9 percent. Without such a level, the buffer will do little to further mitigate run risk.

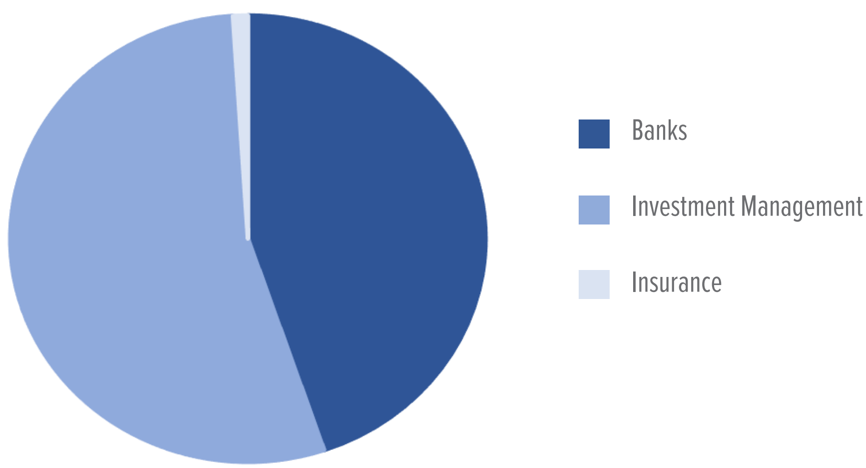
A varying share price is also critically important. A fixed share price fuels run risk, misleads investors into a false sense of security, and unfairly burdens investors who are late to redeem their investments when runs are underway in stressed market conditions, which fuels destabilizing runs as nobody wants to be the last one holding the bag. Although there is currently a varying share price for shares held by institutional investors in Prime and Tax-Exempt MMFs, these issues are the same and apply regardless of fund type or investor type. Therefore, the share value should be required to vary for all fund and investor types, including Government MMFs and those specifically for retail investors.

As the SEC has acknowledged in a previous proposal, government funds may be more stable than some other types of MMFs, but they are nevertheless susceptible to run risk. For example, during the summer of 2011, government MMFs experienced a surge in redemptions as concerns intensified over the U.S. debt ceiling impasse and the possibility of a downgrade in government securities. Additionally, government funds can hold up to 20% of their portfolios in non-government securities, which can trigger a run on the funds if there is a credit event in those securities. Furthermore, the SEC acknowledged that "a retail prime MMF generally is subject to the same credit and liquidity risk as an institutional prime MMF."

Sponsorship of MMFs, Especially by Banks, Can Result in a Secondary Source of Stress to the Financial System

Another channel of impact to the financial system is through sponsorship of MMFs. Sponsors provide the foundation for MMFs by using their institution's brand and credibility to raise funding as well as put forth an image of stability that is based on the assumption that sponsor support is likely to be provided in periods of severe market stress. There are various types of financial institutions that sponsor MMFs, but a significant portion of the industry is sponsored by banks. Just before the 2008 Crash, over 50% of Institutional Prime MMF shares were affiliated with bank sponsored MMFs. Currently, in the U.S. MMFs that are sponsored by banks hold about 45% of the industry's assets, with MMFs sponsored by large investment management companies holding almost all other industry assets. These relationships can create exposures, and even losses, to the sponsor in times of stress, which is especially concerning for the safety and soundness of the banking system.

MMF Assets by Industry of Fund Manager

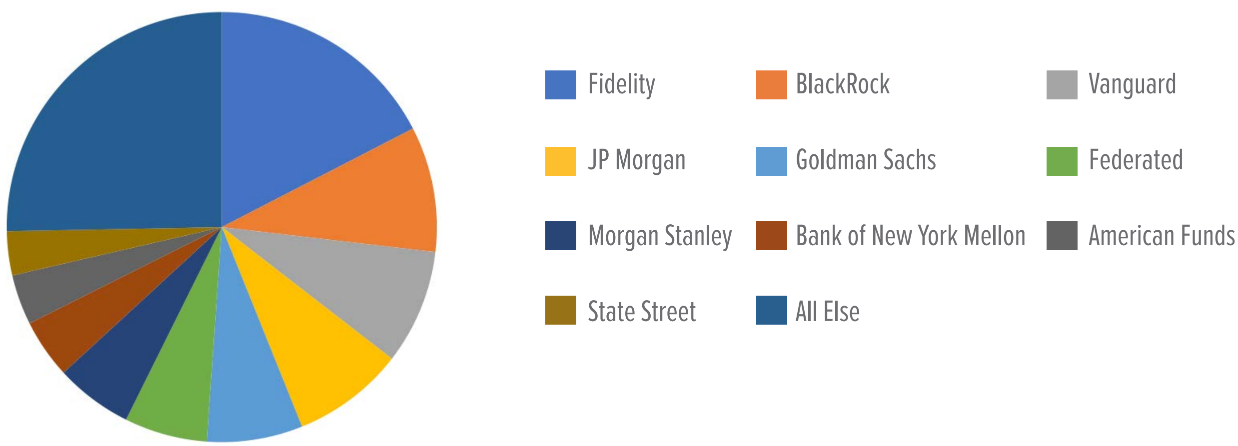


It is clear throughout the history of MMFs, especially in both the 2008 Crash and the 2020 pandemic, that the close affiliation between the sponsor and the MMF puts pressure on the sponsor to provide support in periods of severe market stress. That is, the sponsors become concerned that investors will start to question their own financial condition if they do not provide support to their MMFs that are in financial trouble. Additionally, the absence of support for one fund can create panic among investors around the possibility of other funds similarly not receiving support. In the U.S. between the mid-1980s and the 2008 Crash, sponsors provided support over 200 times to their MMFs.

Although support is not required, it is often necessary to prevent fund failure and the costs associated with fund liquidation, loss of future revenue, and knock-on impacts to other parts of the sponsor's business. When there is severe market stress, the expectation of these costs would be higher, and so sponsors will see more risk in doing too little rather than too much. Also, direct costs aside, the failure of a sponsored fund could have significant reputational harm to the sponsor, impacting a sponsor's ability to obtain affordable funding in financial markets.

Support is usually in the form of either providing liquidity so that the funds have cash to continue to meet investor redemptions even in the face of falling asset prices—for example, by purchasing the fund's assets above their market value—or capital injections that help the funds absorb losses on their assets. While the support can prevent a sponsor from bearing future costs, in providing support the sponsor is utilizing its own funding resources that it could be applying to other parts of its business. That diversion could strain its own financial condition. Considering the concentration in the industry—the MMFs of just 10 sponsors hold about 75% of the industry's assets—it is much more likely that one of the large sponsors would have to support one of its funds in times of stress.

MMF Assets by Fund Manager



Indeed, the apparent need for bank sponsors to provide support has not changed since the 2008 crash, even though they could suffer impacts to their capital and therefore affect their ability to meet capital requirements, distribute dividends, or repurchase shares. During the 2020 pandemic both Goldman Sachs and the Bank of New York Mellon provided support to some of their MMFs by purchasing large quantities of distressed assets. It was reported that $1 to $2 billion was provided to each fund. That is money that could have been used to fund other business, such as corporate lines of credit or margin loans, but was instead used by the bank to purchase assets that were losing value rapidly. Continued value declines in such assets on bank balance sheets are absorbed dollar-for-dollar by capital, eroding banks' capital cushions. Alternatively, if banks were to provide their MMFs with direct capital injections as opposed to liquidity, that would ultimately be funded by cash—whether cash on hand, from selling assets, or obtaining funding in markets that must be repaid—also directly impacting capital levels.

Despite the long history of banks supporting sponsored MMFs and the substantial proportion of the industry that is sponsored by banks, there are no bank capital requirements associated with potential sponsorship-related exposures. Typically, bank sponsorship is done through affiliated organizations that are considered "off balance sheet." In this model, a company is established for the special purpose of setting up a fund, but it is done so in a way that it is considered independent of the bank. The bank then funnels cash through this company and on to the fund. Because the bank does not directly own the special purpose company or the fund, they are not counted as part of the bank's assets. Additionally, there is no requirement for a MMF sponsor to provide support, making it difficult to define the exposure to the MMF.

How Banks & Large Investment Companies Can Reduce Stress

Capital Requirements — MMFs sponsors including banks and large investment management companies should have capital requirements to absorb potential losses from providing sponsor support.

There are ways in which the federal banking agencies could incorporate such exposures within capital requirements. First, the supplementary leverage ratio capital requirement could be adjusted to account for these potential exposures. The ratio is defined as the amount of capital relative to “total leverage exposure,” a concept that includes “off balance sheet” exposures, the definition of which could be modified to include some level of MMF exposure related to sponsorship. Second, the stress test—which is used to set the stress-related capital buffer requirement—could include a component that assumes support is provided to sponsored MMFs, which in the case of a distressed fund would contribute to capital ratio declines over the stress scenario.

However, banks are not the only MMF sponsors. Large investment management companies that act as sponsors (e.g., BlackRock, Vanguard, and Fidelity) face the same issues associated with providing capital or liquidity to their MMFs in periods of stress. MMFs that are managed by investment management companies hold nearly half the assets of the MMF industry, with the MMFs of just the top five investment management companies holding around 45% of the industry’s assets. Any support provided by these fund types equally deteriorates their financial condition just as with banks. Therefore, capital requirements should be in place for sponsors that are investment management companies—something that could be implemented by the SEC.

Conclusion

Ultimately, the Fed, and therefore the American public, effectively has served as the backstop sponsor to the entire MMF industry by bailing it out twice through special liquidity facilities in the 2008 Crash and 2020 pandemic. Considering this and the importance of MMF stability to the short-term funding markets, it is time regulations are put in place to create a stable MMF industry that is less susceptible to runs and more resilient to market stress.

Market stress will occur in the future no matter the regulatory framework in place. But it is the depth and scale of that stress that makes the difference between stress that can be absorbed by the MMF industry and the markets and stress that is catastrophic to both. Thus far, the structure of MMFs has only served to exacerbate market stress, and their regulatory framework has failed multiple times to protect against that stress, most explosively in both the 2008 Crash and the 2020 pandemic. Short-term funding markets are critical to the functioning of the real economy, and we cannot allow the illusion of stability of the MMF industry to cause us to keep in place an insufficient regulatory framework that fails to protect these markets, the economy, and the American taxpayer from the industry’s true instability.

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