The Future of Money Market Fund Regulation

Money Market Funds (MMFs) are an important part of the Canadian investment landscape. According to the Investment Funds Institute of Canada[1], assets held by MMFs totaled $73.1-billion at the end of May 2009; an increase of over 50% since May 2007. MMFs were the biggest selling class of mutual fund in nine of the past thirteen rolling thirteen-month periods.

The MMF total of $73.1-billion may be compared to the $503.7-billion in total liquid deposits in Canadian banks reported by the Bank of Canada for April 2009.[2] Clearly, MMFs are an important part of the Canadian economy, although not as important as they are in the US, where MMF assets of $4-trillion compare with bank deposits of $8.7-trillion.[3] In the US, sales of MMFs have been encouraged by the reserve requirements of the Federal Reserve; in order to minimize their mandatory reserve balances (which did not pay interest until very recently), many banks offer "sweep" programmes to their depositors, whereby excess funds in chequing accounts are automatically used to purchase MMFs on an overnight basis.[4]

In my essay published in the December, 2007, edition of AER, *A Collateral Proposal,* I argued that:

- Investors had a strong expectation of zero loss from MMF investments
- That banks would be forced, due to reputational concerns, to cover credit losses incurred in their MMFs
- Therefore, the credit risk of the commercial paper held by bank-sponsored MMFs should be included in their Risk-Weighted Assets for capital ratio calculations.

Concern regarding reputational risk is not simply a reaction to the extreme events of the Credit Crunch. The implicit guarantee has been tested before: there were fifteen near failures of MMFs in 1993-94 which cost sponsors around USD 600-million.[5]

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[1] IFIC, *Final Statistics for May 2009,* via https://www.ific.ca/Content/Content.aspx?id=2212 (accessed 2009-07-02)

[2] Bank of Canada, *Banking and Financial Statistics, June 2009,* on-line at http://www.bankofcanada.ca/pdf/bfs.pdf. The figure is taken as the sum of series V41552775, V36822, V41552774 and V36828

[3] Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance*, available on-line at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1351987 (accessed 2009-7-13)

[4] Federal Reserve Bank of Atlanta, *Sweep Accounts Lower Reserve Balances, Complicate Fed Funds Targeting,* available on-line at http://www.frbatlanta.org/invoke.cfm?objectid=5AC8E645-B0FE-11D5-898400508BB89A83&method=display (accessed 2009-7-13)

[5] Robert N. Gordon, *Say Goodbye to Money Market Funds,* available on-line at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090215/REG/902139987/1011 (accessed 2009-7-13)

The effect of breaking the implicit guarantee was tested last September by Reserve Primary Fund which announced that it had "broken the buck" after writing off an investment of $785-million in commercial paper issued by Lehman[6].

Shocked at the sudden revelation that no investment is risk-free, investors placed MMF redemption orders totaling $169-billion in the two days following the announcement, after two weeks bank sponsored funds found their assets under management reduced by 30%.[7] This posed a huge risk to the world financial system, as European banks are highly dependent upon US MMFs as a buyer of their short-term USD paper. Extraordinary measures by Central Banks were required to limit the damage.

To avoid future crises policy makers are now considering alternative methods of MMF regulation. Paul Volcker, chairman of the White House Economic Recovery Advisory Board, headed a group that concluded that because of the "dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk" two revisions to policy[8] are required:

- MMFs seeking to offer bank-like services such as maintenance of a stable NAV should reorganize as special-purpose banks, with all the regulatory and capital implications that bank status implies
- Other MMFs should not be permitted to use amortized cost pricing of their assets and would therefore carry a fluctuating NAV.

These proposals, endorsed by the Bank of England[9] and currently being reviewed by the President's Working Group on Financial Markets[10], caused immediate howls of anguish. The President and CEO of the Investment Company Institute (ICI) stated "If the recommendations are implemented, there will be no more money-market funds, period".[11]

In order to protect their franchise, the ICI prepared a report that suggested that credit risk in MMFs could be eliminated via increased box-ticking.[12] The proposals that apply to credit risk are:

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[6] Christopher Condon, Bloomberg, *Reserve Primary Money Fund Falls Below $1 a Share,* available on-line at http://www.bloomberg.com/apps/news?pid=20601087&sid=a5O2y1go1GRU (accessed 2009-7-13)
[7] Naohiko Baba, Robert N. McCauley & Srichander Ramaswamy, BIS, *US dollar money market funds and non-US banks,* available on-line at http://www.bis.org/publ/qtrpdf/r_qt0903g.pdf (accessed 2009-7-13)
[8] Group of 30, *Financial Reform: A Framework for Financial Stability,* available on-line at http://www.group30.org/pubs/reformreport.pdf (accessed 2009-7-13)
[9] Bank of England, *Financial Stability Report,* June 2009, available on-line at http://www.bankofengland.co.uk/publications/fsr/2009/fsrfull0906.pdf (accessed 2009-7-21)
[10] Department of the Treasury, *Financial Regulatory Reform: A New Foundation,* available on-line at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (accessed 2009-7-16)
[11] Paul Schott Stevens quoted by John Morgan, *Money Funds Seen as Endangered Species,* available on-line at http://www.financial-planning.com/news/Money_Funds_Endangered-2661075-1.html (accessed 2009-7-13)
[12] Investment Company Institute, *Report of the Money Market Working Group*, March 2009, available on-line at http://www.ici.org/pdf/ppr_09_mmwg.pdf (accessed 2009-7-15)

- Make it illegal to purchase "non-prime" commercial paper. These lower-grade credits are currently[13] limited to 5% of investments, with a maximum of 1% exposure to a single name
- Require that all money market fund advisers establish a "new products" or similar committee.
- Encourage money market funds and their advisers to follow best practices for determining minimal credit risks.
- Retain references to credit ratings in SEC rules as an important "floor" on investments.
- Require advisers to money market funds to designate and publicly disclose a minimum of three credit rating agencies that the adviser will monitor, to encourage credit rating agencies to compete for this designation by improving their ratings systems for short-term debt.

The emphasis on Credit Rating Agencies in the ICI's proposals is simply an abnegation of the sponsors' role as trustee of the fund. It should be very clear to all participants that the Portfolio Manager designated by the trustees is solely responsible for determination of credit quality; he may take advice from his analytical support team, from the Credit Rating Agencies, or even from his barber, if he wants to; but he must not be permitted to delegate a shred of his responsibility for determining the suitability of investments. Further, any revision of the SEC's rules must include the aim of providing a legal basis for the frustration of any attempts to encroach on his authority, such as is envisaged by the establishment of a "new products committee".

The ICI report's rebuttal to the Volcker proposals is simply laughable: *Imposing capital requirements on money market funds poses significant accounting and tax challenges and would provide little protection against the market-wide credit and liquidity events that can lead to widespread redemptions.*

Somehow I feel that an industry that touts its competence to manage $4-trillion in money market funds alone should be able to handle the unspecified accounting and tax challenges involved in adding to the 8,000+ banks currently operating in the United States! As for the protection against credit events: credit events can happen anywhere, at any time.

However, on June 24[14] the SEC responded to a directive from Treasury[15] and released a set of rule changes titled *Money Market Fund Reform*[16] incorporating most of the ICI

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[13] Similar rules apply in Canada. See OSC, *National Policy 81-102* available on-line at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_19970627_81-102_pni.jsp (accessed 2009-7-15)

[14] SEC Press Release 2009-142, *SEC Proposes Rule Amendments to Strengthen Rugulatory Framework for Money Market Funds,* available on-line at http://www.sec.gov/news/press/2009/2009-142.htm (accessed 2009-7-15)

[15] US Department of the Treasury, *Financial Regulatory Reform: A New Foundation,* available on-line at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (accessed 2009-7-16)

proposals. The approach to credit quality risk simply replaces the judgment of the portfolio with that of a committee which includes the credit rating agencies. Amusingly, the SEC has accepted the ICI's contention that requiring a MMF to designate in advance at least three credit rating agencies for determination of investment suitability "may promote competition among NRSROs to produce the most reliable ratings". Evidently, the SEC is not fully aware of events involving Commercial Mortgage-Backed Securities, the US regulator of insurance companies (National Association of Insurance Commissioners, "NAIC") and the ratings agencies: after S&P announced that it was considering reducing its ratings for these securities *en masse*, there was an immediate move to have another agency, Realpoint (which has a rosier outlook for the asset class) approved as a source of credit ratings by NAIC.[17] As Dr. Joseph Mason emphasizes, "The regulatory use of ratings thus has changed the constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one."[18]

It is all very well to have box-ticking procedures in place that will absorb some blame for disasters; but ultimately nothing concentrates the mind like having your own money on the line. It should also be apparent that while the credit risk of any company might be extremely low, it is never zero.

The SEC's statement of allegations against Reserve Management Company and others[19] claims that Reserve Primary's ability to maintain a stable NAV relied exclusively on the controlling shareholder's (the Bent family) ability and willingness to absorb losses. The SEC alleges that the Bent family made assurances of such support to ratings agencies, unitholders and others, without any intention of doing so. The response of American MMF investors, and the world-wide repercussions that resulted from the lack of support for a single fund mean that the current system of nods, winks and understandings is simply not good enough.

Breaking the buck for a MMF is a strong indication that the financial system is already strained; since only the highest quality and largest companies are able to issue commercial paper in the first place. The *laissez-faire* attitude toward MMF sponsors' credit guarantees may be contrasted with the demonization of AIG that culminated with Senator Grassley's famous exhortation[20] that AIG executives should "resign or go

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[16] SEC, *Release No. IC-28807; File No. S7-11-09,* available on-line at http://www.sec.gov/rules/proposed/2009/ic-28807.pdf (accessed 2009-7-15)
[17] Al Yoon, Reuters, *Realpoint seeks to disarm S&P CMBS rating blows,* available on-line at http://www.reuters.com/article/bondsNews/idUSN1151302620090611 (accessed 2009-7-15)
[18] E.g. Charles Calomiris and Joseph Mason, *Reclaim power from the ratings agencies,* available on-line at http://www.aei.org/docLib/20071114_JosephMason4.pdf (accessed 2009-7-15)
[19] SEC Statement of Allegations, May 5, 2009, available on-line at http://www.sec.gov/litigation/complaints/2009/comp21025.pdf (accessed 2009-7-16)
[20] Fox News, transcript, *Senator Grassley on Controversial AIG Comments,* available on-line at http://www.foxnews.com/story/0,2933,509665,00.html (accessed 2009-7-16)

commit suicide" and harassment of employees[21] after AIG that made contractual obligations of credit support (via Credit Default Swaps) that it couldn't back up.

In order to ensure that – unlike AIG – a willing sponsor will (probably!) have the ability to bail out a MMF, explicit credit support should be accounted for when assessing the capital quality of the sponsor. Currently the reputational risk is almost as trustworthy as a contract; the Bank for International Settlements has adopted as a matter of policy[22] that supervisors must assess the degree of implicit support for MMFs, but have stopped short of including this off-balance-sheet implied credit guarantee as a factor when computing risk-weighted assets.

Canadian MMFs have seldom required sponsor support, but in August 2007 (following the ABCP collapse) National Bank announced[23] that it would acquire all the ABCP held through its mutual funds; the National Bank Money Market Fund had about half its value invested in these instruments in March 2007. The total value of ABCP acquired by National Bank from various sources was $2.1-billion.[24] Since the provision of this credit support, National Bank has recognized $739-million in impairment charges while the cost of financing this positions totaled $84-million.

National Bank's Risk-Weighted Assets at the end of third quarter of 2007 totalled about $51.2-billion; hence, the charge due to ABCP represented about 1.6% of Risk-Weighted Assets. This is a manageable amount; the credit support and its effects may be described as a legitimately unexpected loss and it is the purpose of bank capital to absorb such unexpected losses. National Bank is a relatively small player, however: TD Asset Management was reported by BIS to have USD 22.6-billion in MMF assets as of August 31, 2008.[25] TDAM provided support to its MMFs; they were not alone in this as about one-third of the top 100 US MMFs received support of some kind throughout the depths of the crisis.

It is outrageous that unexpected losses to this degree arose from credit risks that are not recognized at all in the determination of the credit risk borne by a bank. We may consider ourselves lucky that in Canada we have avoided the worst direct effects of the Credit Crunch; but we should be taking action to ensure that next time it won't be a matter of luck. Credit support must be made explicit and the credit risk inherent in this support should be incorporated in the calculation of the sponsor's Risk Weighted Assets.

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[21] James Barron and Russ Buettner, New York Times, *Scorn Trails A.I.G. Executives, Even in Their Driveways,* available on-line at http://www.nytimes.com/2009/03/20/nyregion/20siege.html (accessed 2009-7-16)

[22] Bank for International Settlements, *Enhancements to the Basel II framework,* July 2009, available on-line at http://www.bis.org/publ/bcbs157.pdf?noframes=1 (accessed 2009-7-16)

[23] National Bank Press Release, *National Bank to aquire all asset-backed commercial paper (ABCP) of National Bank Mutual Funds,* available on-line at http://www.nbc.ca/bnc/cda/newsdetail/0,2714,articleCode-14601_divId-2_langId-1_navCode-6100_viewFilter-2007,00.html (accessed 2009-7-16)

[24] National Bank, *Annual Report 2008,* available on-line at http://www.nbc.ca/bnc/files/bncpdf/en/2/e_ri_QGJqbrZtpRlM.pdf (accessed 2009-7-16)

[25] Naohiko B, *et al.*