

July 25, 2012

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Geithner:

In its 2012 *Annual Report*, the Financial Stability Oversight Council regrettably endorses a narrative about money market funds' experience in the financial crisis that is inaccurate and unsubstantiated. Specifically, at page 11 of the *Report*, in the first of the "Annual Report Recommendations," the Council commends certain structural changes for money market funds (MMFs) currently under consideration at the Securities and Exchange Commission (SEC). It states that "these reforms are intended to address the structural features of MMFs that *caused a run on prime MMFs and the freezing of the short-term credit markets* after the Reserve Primary Fund was unable to maintain a stable net asset value (NAV) in September 2008." (Emphasis added.)

As detailed below, this characterization of the events of September 2008 is incorrect on at least three counts. First, it entirely disregards the nature and severity of the events of 2007–2008 leading up to the problems of the Reserve Primary Fund. Second, it does not comport with actual developments in the commercial paper and Treasury markets both before and after the collapse of Lehman Brothers. Finally, its general indictment of the "structure" of money market funds leaves unexplained the strong *inflows* into certain money market funds after the Reserve Primary Fund proved unable to maintain its \$1.00 per share value. I elaborate on each of these points below.

The Events of 2007–2008

The narrative endorsed in the *Annual Report*—that money market funds *caused* short-term credit markets to freeze—altogether ignores the context of what Federal Reserve Chairman Ben Bernanke has described as "the worst financial crisis in global history, including the Great Depression." This crisis had reached a critical stage well in advance of the problems of the Reserve Primary Fund. At least 13 major institutions had gone bankrupt, been taken over, or been rescued during the 12 months *before* Lehman Brothers was allowed to fail. The United States government's inconsistent policy on rescuing troubled institutions contributed significantly to confusion and uncertainty in the market. Not unreasonably, many participants had expected Lehman to be rescued, in line with the actions already taken by the government with respect to Bear Stearns, Fannie Mae, and Freddie Mac. Only one day after allowing Lehman to collapse, the government's decision to reverse field and rescue American International Group (AIG) deepened that confusion and uncertainty. Following the events of September 15–16, concerns rapidly spread in the financial markets that the debt of numerous other large investment and

commercial banks presented much greater risk than previously thought. In this environment, it is hardly credible simply to attribute problems in the short-term credit markets to money market funds.

As ICI has amply documented, most recently in my June 21 testimony before the Senate Banking Committee, money market funds did not cause the freeze in short-term credit markets that occurred during the week of September 15, 2008.¹ Rather, investors in prime money market funds, like investors everywhere, reacted to the widespread uncertainty over the stability of financial institutions and the lack of predictable government policy responses to a crisis gripping the global banking system. This uncertainty led to a general pullback by *all* participants in the money markets—including banks, which ceased to lend to one another. Money market funds and their investors were neither the first nor the largest of these retreating investors. Instead, they were simply among the most easily observable market participants.

Money Market Funds and the Commercial Paper Market

Data clearly demonstrate that money market funds were *not* the primary source of pressure in a critical segment of the short-term credit markets—the commercial paper market. During the month of September 2008, outstanding commercial paper declined by \$185 billion. ICI data show that money market funds reduced their holdings of commercial paper by \$164 billion in that month; however, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) program also held \$152 billion in commercial paper as of October 1, all of which arose from money market fund sales to commercial banks in September. Hence, money market funds' net reduction (after adjusting for sales to the AMLF program) amounted to \$12 billion, or about 6 percent of the \$185 billion decline in outstanding commercial paper. Other investors clearly were pulling back from commercial paper issuers in a stressed market. Data for other investors is not available specifically for September, but the Federal Reserve's Flow of Funds Accounts show that funding corporations, foreign investors, state and local governments, and the household sector (which includes hedge funds and nonprofit organizations) were significant sellers of commercial paper in the third quarter of 2008. It would appear that much of the selling by these investors occurred during September.

Apart from the commercial paper market, there is additional evidence that a variety of market participants were pulling back their exposures to financial institutions, particularly banks, during the fall of 2008. Borrowing from the Federal Reserve's discount window, excluding the commercial paper programs and lending associated with AIG and Bear Stearns, rose from \$170 billion as of September 10, 2008 to \$587 billion as of December 17, 2008 and remained at that level through the end of 2008.² Much of this increase was through the Term Auction Facility, which held biweekly auctions of term funds to depository institutions against collateral that could be used to secure loans at the discount window.

At the same time, interbank lending by commercial banks fell more than 30 percent or nearly \$145 billion on a seasonally adjusted basis. The stress in the banking industry was reflected in the spread between the 3-month

¹ My written statement to the Senate Banking Committee, available at http://www.ici.org/pdf/12_senate_pss_mmf_written.pdf, includes a detailed timeline of these events in Appendix A and analyzes the role of money market funds in greater depth in Section II (pages 3–10).

² See <http://www.federalreserve.gov/releases/h41/20080911/> and <http://www.federalreserve.gov/releases/h41/20081218/>.

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London Interbank Offered Rate (LIBOR) and the overnight index swap (OIS) rate, which jumped from less than 100 basis points on September 12 to nearly 370 basis points one month later. As you know, the LIBOR-OIS spread generally is viewed as an indicator of the banking industry's financial health; a widening of the spread can be interpreted as a reluctance or unwillingness on the part of banks to lend to other banks because of an increase in credit risk. Subsequent events suggest that, if anything, the LIBOR-OIS spread may understate the pressures then prevailing in the banking system, based on reports that funding costs were being under-reported by certain banks participating in the LIBOR survey.

Finally, reflective of the general flight by all investors to safety and liquidity and the widespread stresses in the money market, investors flooded into the short-term U.S. Treasury market. Yields on short-term Treasuries dropped sharply on September 15, 2008 and fluctuated widely in subsequent weeks as investors continued to evaluate developments and as the federal government introduced measures to support the financial sector.

The Structure of Money Market Funds

Even in the extreme conditions prevailing in fall 2008, investors demonstrated continuing high confidence in money market funds. About \$300 billion flowed out of prime money market funds, the holdings of which included securities issued by financial institutions. For every dollar that left these funds, however, 61 cents flowed into Treasury and government and agency money market funds. Investors did *not* abandon money market funds, nor did they perceive problems with the "structure" of these funds. Like virtually *all other* investors during this period, they reacted to pervasive concerns about the financial health of banks, about the U.S. government's unpredictable response to failing financial institutions, and about the state of the commercial paper market. In a classic "flight to quality" response, they moved to less risky assets—choosing money market funds as their vehicle.

Notably, the narrative of money market funds' experience in the financial crisis has become shriller in official commentary with the passage of time—even as memories of the events of 2008 recede and (as the latest *Annual Report* recognizes) the SEC's 2010 reforms of money funds have proved successful. The Council's 2011 *Annual Report*, for example, said that money market funds "added considerably to market stress during the financial crisis." The President's Working Group on Financial Markets, in its October 2010 *Money Market Reform Options* report, stated that "the cash needs of [money market funds] exacerbated strains in short-term funding markets." These prior statements at least implicitly acknowledge that there were other (if unidentified) stresses and strains on cash markets. The narrative now has evolved into a claim that money market funds "caused ... the freezing of the short-term credit markets." One looks in vain for any analysis supporting this new characterization.

In addition, as you are aware, scores of groups representing money market fund investors and money market issuers, in the business, governmental, nonprofit, and household sectors, have articulated their concerns about the consequences of the structural changes now endorsed by the Council. The record before the SEC leaves little doubt that such changes will destroy the utility of these funds for investors, deprive private and public issuers of an important source of funding, and in the process harm the nation's economy. There also is every reason to believe that such changes will give rise to additional risks to the financial system, impelling institutional investors

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to resort to unregistered or offshore funds lacking the regulation and transparency of money market funds. Regrettably, the Council addresses none of these concerns in its latest report.

With great respect, I would submit that sound policy is best achieved through meticulous analysis of the problems that the policy purports to address, in light of subsequent events. Here, we have seen that the far-reaching changes to money market funds adopted by the SEC more than two years ago have profoundly changed money market funds and helped them to weather subsequent crises, such as the U.S. debt ceiling impasse and the deteriorating conditions in the European debt markets. A thorough analysis would, I am certain, undercut the core premises upon which the case for these "structural reforms" is based.

With thanks for your consideration.

Sincerely,



Paul Schott Stevens
President & CEO
Investment Company Institute

cc: Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency
Richard Cordray, Director, Bureau of Consumer Financial Protection
Mary L. Schapiro, Chairman, Securities and Exchange Commission
Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Company
Gary Gensler, Chairman, Commodity Futures Trading Commission
Edward J. DeMarco, Acting Director, Federal Housing Finance Agency
Debbie Matz, Chairman, National Credit Union Administration
S. Roy Woodall, Jr., Independent Member with Insurance Expertise, Financial Stability Oversight Council
Mary J. Miller, Under Secretary for Domestic Finance, U.S. Department of the Treasury