The Systemic Risk Council

sponsored by CFA Institute

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

With copies to the United States Secretary of the Treasury, and the other members of the President's Working Group on Financial Markets

SUBMITTED VIA EMAIL

April 12, 2021

RE: File No. S7-01-21, Release No. IC-34188

Dear Commission:

This letter sets out a preliminary response of the Systemic Risk Council to the Securities and Exchange Commission's recent request for comments on the Report by the President's Working Group on Financial Markets on possible reforms to money market and other open-ended funds.[1]

A decade ago, after the federal government had rescued the money-fund industry, the Systemic Risk Council (SRC) strongly urged the Securities and Exchange Commission (SEC) to act to ensure money funds did not again jeopardize financial stability.[2] Some measures were taken. Within a decade,

---

[1] Securities and Exchange Commission, Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report, 86 Fed. Reg. 8,938 (Feb. 10, 2021).

[2] Letter from Sheila Bair, Chair, Systemic Risk Council to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission (Sept. 16, 2013), available at http://4atmuz3ab8k0glu2m35oem99.wpengine.netdna-cdn.com/wp-content/uploads/2013/09/Systemic-Risk-Council-Letter-on-Money-Market-Funds-Sep-16-13.pdf; Letter from Sheila Bair, Chair, Systemic Risk Council to the Financial Stability Oversight Council (Jan. 18, 2013), available at http://systemicrisk.wpengine.com/wp-content/uploads/2013/01/Systemic-Risk-Council-Letter-on-Money-Market-Funds-1-18-13.pdf.

along with other parts of finance, the industry has been rescued again --- this time during the market volatility and disorder of March 2020, when the implications of COVID-19 were suddenly grasped. It turns out that taxpayer bailouts were not a once in a lifetime event but, rather, twice in a generation, so far. This is not a sensible course if financial services are to find a sustainable, legitimate place in the market economy.

<u>Summary of analysis and options</u>

The Report by the President's Working Group (PWG) describes the state of the money-fund industry, the etiology of the March 2020 events, and the assistance provided by the Federal Reserve. For what it is worth, the SRC finds all this to be laid out clearly and professionally.

The PWG's Report airs the following possible reforms:

- Removing the current tie between money-fund liquidity and thresholds for imposing fees or gates on redemptions
- Altering the conditions for imposing redemption gates
- Requiring investors to hold a "minimum balance at risk" which would not be redeemable on demand
- Imposing new requirements on the liquidity management of money-funds
- Introducing a countercyclical element to the current weekly liquid-asset requirements
- Moving to a system of valuing investments on a fully floating net-asset value (NAV) basis for all prime and tax-exempt money funds
- Charging a greater discount for sudden, large redemptions so that investors bear some of the costs of liquidity (known as "swing pricing")
- Introducing requirements for funds to carry a capital buffer
- Requiring money funds to participate in a new central liquidity-exchange bank
- Strengthening requirements for asset-management businesses to stand behind the money funds they sponsor.

The Report assesses, and invites commentators to assess, the options against three criteria. Broadly, whether they would effectively reduce the structural vulnerabilities and dynamics among money funds, and in short-term funding markets; and whether, directly or indirectly, they would reduce the probability of liquidity assistance or taxpayer bailouts for money funds or other vehicles in the short-term money markets, and of the state having to substitute for market-based finance.[3]

SRC comments on the PWG analysis and specific options

The SRC welcomes the SEC consultation, and the study by the PWG on the March 2020 disorder. In particular, the PWG's Report makes clear that the money-fund industry is large enough, and its role in providing short-term finance to the economy significant enough, that if and when it or parts of it hit difficulties, the costs are not confined to the industry and its investors. The supply of credit to the economy can be adversely affected, and households and institutions are likely to become more cautious about spending because of worries about their own liquidity and/or net worth. In other words, the fault lines are not just a problem for Wall Street but for the American economy as a whole.

In the view of the SRC, the March 2020 disorder was an accident waiting to happen. Because it was triggered by a pandemic, the authorities enjoyed wide public support for their interventions even though they were in effect rescuing parts of finance that, at least formally, do not have access to the safety net.

This is part of the wider problem of shadow banking, which undermines the resilience of the financial system (see below). Without fundamental repairs, disorder will happen again, whether in the money-fund industry, or elsewhere. And after each rescue, the underlying incentives among both investors and intermediaries drive the system toward even bigger problems down the road.

Some comments on some of the options' mechanisms

At this stage, the SRC wishes to make only a few generic points on the specific options identified in the Report.

First, so long as investors treat their investments in money funds and some other open-ended funds as liquid and safe, the prospect of imposing gates will act to trigger runs. Even though gates obviously halt a run *ex post*, they can

[3] We have split the PWG Report's third test into the two parts that are implicit but not expressly stated. Crudely, the state can either rescue or substitute for distressed market intermediaries.

also signal that other vehicles or intermediaries might have similar problems. It is worth remembering that the world-wide liquidity crunch in the summer of 2007 was triggered when some European funds (invested in asset-backed securities) suspended redemptions.

Second, it would be much better for all such funds to be valued on a floating NAV basis, for them to have to value all of their underlying investments on a mark-to-market basis, and for investors in such funds to be precluded from valuing them at par in their own accounts. But it should be clear that that of itself would not cure the problem of runs. Runs for the exits are driven in part by the first-come, first-served feature of mutual funds; in circumstances where the sales required to meet redemptions might depress the price of the assets being sold and so the value of the fund, it is irrational not to redeem if others are expected to do so.[4]

Third, again so long as investors treat their fund investments as safe and liquid, it is important to introduce reforms that will cause both the investors themselves and the funds' sponsors to internalize some of the wider adverse financial and economic spillovers (social costs) of runs.

Fourth, we would not be inclined to put much weight on administrative costs for the industry in adapting to reforms, since at present sponsors and others do not pick up the costs of government rescues. Even where a central bank or finance ministry recovers its loans or investments, there are serious opportunity costs for the authorities (and hence the public) in having to act as fire fighters for flare ups that could be avoided.

Fifth, the SRC is broadly sympathetic to the proposition, explained in the PWG's Report, that liquid-asset requirements need to be framed in ways that do not impede funds drawing down on the liquidity when needed, and do not signal distress.

<u>More general comments on the underlying problem</u>

The current predicament arises through a combination of four issues. First, mutual funds are exposed to runs because of the first-come, first-served

---

[4] First-come, first-served redemptions are sufficient for disorder via runs, but do not exhaust possible threats to stability, which might be generated by fire sales of investments in and by closed-end funds of some kinds. Evaluating other possible systemic vulnerabilities is beyond the scope of this letter.

undertaking. Second, investors treat money funds as though they are safe. Third, to the extent that money funds hold assets that are even slightly risky, runs are more likely. The second and third issues together make money- and similar funds particularly brittle. Fourth, where runs and forced sales of assets occur, they inflict costs on the economy given the role of money funds and other similar funds in short-term financing markets.

That combination distinguishes such funds from other types of mutual fund. While equity mutual funds can suffer a dash for the exits, that does not automatically trigger a government safety net because no one remotely expects them to be safe.

Reforms will work only if they succeed either in signaling to potential investors that money funds and similar instruments are not, in fact, “safe assets” or, alternatively, in ensuring that they really are safe. In the former case, demand for money-market mutual funds would decline, and so a run for the exits would entail losses but would not violate investors’ reasonable expectations, or inflict wider economic damage. In the second case, relying entirely on banks and dealers for a liquidity backstop would put hope before experience. Indeed, our sense is that the dealer community is not suggesting that they could have coped in March 2020 without Federal Reserve assistance.

The need to confront the systemic problem of shadow banking

This prompts the SRC to offer a few comments on the nature of the underlying problem. Investors of many kinds —- people, municipal authorities, corporate treasurers, asset managers —- want to hold some proportion of their assets in safe instruments. The best description of a safe asset is that those investing and trading it do not need to think about whether it is safe, and so do not need to track information on it; economists call assets of this kind information-insensitive.[5]

Money is the classic information-insensitive asset, since it could not fulfill its core functions (as a unit of account, means of exchange, and store of value) if holders were frequently thinking about its value. Many money-market instruments are treated, in financial markets and by investors, in a similar way, including money-market-fund units, higher tranches of some asset-backed securities, and repurchase agreements (repo) in various instruments. The

[5] Bengt Holmstrom, “Understanding the Role of Debt in the Financial System,” BIS Working Paper No. 479, 2015, https://www.bis.org/publ/work479.pdf.

description “shadow banking” is apt for those and other vehicles and structures, because commercial banks issue some liabilities (insured deposits) that are guaranteed by the state and so safe.

Once framed that way, it is obvious that money funds and other types of shadow banking can suffer two kinds of problem when investors are relying on them being safe. First, they might suffer a liquidity run, triggering forced sales of assets which, in turn, depress asset prices, inducing further redemptions, and adversely affecting the economy. Where a vehicle having liquidity difficulties is fundamentally sound, only liquidity provision of some kind can break that vicious circle. Second, a money fund, other open-ended fund or other shadow-banking vehicle might suffer such significant losses on their investments that they simply cannot honor their obligations at par; a solvency impairment.

A permanent solution will, therefore, have the following two features: it will be clear about which instruments of which entities should be treated as “safe”, and it will include a policy to structure and sustain the dividing line.

First, then, there has to be a decision on whether or not any particular manifestation of shadow banking should be regarded as viably safe by the authorities, and in particular by the monetary authorities. Where not, it is absolutely vital that that is understood by investors, so that they do not mistakenly treat that particular type of investment as though it were in fact safe --- behavior which when pervasive is effectively self-fulfilling. But those binary judgments must be credible, which is the central task of a decent policy in this area.

Second, instruments or vehicle-types deemed to be “safe” need formally to have access to liquidity insurance from the Federal Reserve, whether directly or indirectly (which we assume is the point of the PWG Report’s liquidity-exchange-bank idea). It is a costly mistake for such liquidity to be available in practice ex post, as it has been, without recognizing up front that there will be such access. Facing up to this reality will make it much easier to take measures to address the perverse incentives created.

Since insuring the liquidity of fundamentally sound funds or vehicles should absolutely not imply access to taxpayer solvency support, which would be highly distortive, funds and other vehicles with access to Federal Reserve liquidity insurance need to be required to issue capital instruments of some kind that will absorb losses ahead of those investor claims that rely upon being liquid and safe. In the case of money market mutual funds, that could be subordinated instruments which absorb losses ahead of regular unit holders, or the kind of "minimum balance at risk" for investors identified in the Report, or both.[6]

It should be underlined, however, that a capital buffer of some kind does not necessarily deter runs. It would not head off a pure panic run. It might in some circumstances deter runs based on perceptions of deteriorating fundamentals; namely, where the existence of a capital buffer convinces holders of runnable claims that their investment is not going to be impaired. But that relies on the capital-like instrument being held by third parties, not by the investors in the "safe" instruments. For that reason, the minimum-balance-at-risk feature might induce runs.

Separately, if capital-type instruments are contemplated, it will need to be completely clear, and beyond doubt, whether they can absorb losses smoothly in a going concern, or only via some kind of bankruptcy process. If the latter (or if investors suddenly perceive that), then the capital-type instrument does not help to keep the issuing vehicle alive. That was painfully apparent from 2007/8 banks failures, when subordinated-debt liabilities could not keep them afloat. While money funds are of course legally distinct, the same broad legal issue would need to be resolved.

More generally, the underlying principles should be that:

- Liquidity insurance will be better designed if accepted that it is there in practice
- Intermediaries not given access to such liquidity insurance should not be allowed to promise or imply safety and liquidity for their investors, because that leads to self-fulfilling disaster
- Liquidity insurance should not be a back door to taxpayer solvency bailouts
- Liquidity insurance entails regulation of capital structure in order to incentivize some investors, sponsors, and managers to internalize some of the social costs of their own actions.

[6] For earlier proposals of this broad kind, Samuel G. Hanson, David S. Scharfstein and Adi Sunderam, "An Evaluation of Money Market Fund Reform," IMF Economic Review, Vol. 63(4), 2015.

While those principles are valid for shadow banking in general, they are particularly apt for U.S. money funds and other open-ended funds invested in credit instruments, given the latest averted collapse followed so quickly after the systemic run in late 2008.

Summary

Warnings of the kind rehearsed here have been recurrent since the 1980s, not least from our late colleague Paul Volcker. Up to now it has seemed as if an obvious fault line in the financial system did not matter so long as no one fell through it. That is the opposite of a sensible policy regime.

The SEC's consultation, and the PWG focus, is highly welcome, offering the prospect of a deeper debate than has been possible hitherto, and suggesting that the key agencies are working together on this issue. The protests from parts of the industry underline not the validity of their criticisms but the strength of the desire for safe assets. But it is not possible for purely private vehicles to combine safety, liquidity, and a return that is a little better than government-backed instruments, so the federal safety net lurks in the background of such protests. It is time to face up to that fundamental truth of finance.

Summing up, after the federal government has rescued the money fund industry -- and others -- twice in little over a decade, albeit for understandable reasons, it is time to confront the difficult and costly problem of shadow banking. Failure to do so would jeopardize not only the stability of the financial system, but the role of the dollar in global finance.

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

Systemic Risk Council Membership

Chair: Sir Paul Tucker, Fellow, Harvard Kennedy School and Former Deputy Governor of the Bank of England

Chair Emerita: Sheila Bair, Former Chair of the Federal Deposit Insurance Corporation

Senior Advisor: Jean-Claude Trichet, Former President of the European Central Bank

Members:

Brooksley Born, Former Chair of the Commodity Futures Trading Commission

Baroness Sharon Bowles, Former Member of European Parliament and Former Chair of the Parliament's Economic and Monetary Affairs Committee

Bill Bradley, Former U.S. Senator

William Donaldson, Former Chair of the Securities and Exchange Commission

Darrell Duffie, Dean Witter Distinguished Professor of Finance at Stanford University Graduate School of Business

Peter Fisher, Tuck School of Business at Dartmouth, Former Under Secretary of the Treasury for Domestic Finance

Jeremy Grantham, Co-Founder and Chief Investment Strategist, Grantham May Van Otterloo

Richard Herring, The Wharton School, University of Pennsylvania

Simon Johnson, Massachusetts Institute of Technology, Sloan School of Management

Jan Pieter Krahnen, Chair of Corporate Finance at Goethe-Universität in Frankfurt and Director of the Centre for Financial Studies

Sallie Krawcheck, Chair, Ellevate, Former Senior Executive, Citi and Bank of America Wealth Management

Erkki Liikanen, Chairman of the IFRS Foundation Board of Trustees

Lord John McFall, Former Chair, UK House of Commons Treasury Committee

Ira Millstein, Senior Partner, Weil Gotshal & Manges LLP

John Reed, Former Chairman and CEO, Citicorp and Citibank

Kurt Schacht, Managing Director, Standards and Advocacy Division, CFA Institute

Chester Spatt, Tepper School of Business, Carnegie Mellon University, Former Chief Economist, Securities and Exchange Commission

Jeremy Stein, Moise Y. Safra Professor of Economics and Chairman of the Department of Economics at Harvard University

Lord Adair Turner, Former Chair of the UK Financial Services Authority and Former Chair of the Financial Stability Board's Standing Committee on Supervisory and Regulatory Cooperation

Nout Wellink, Former President of the Netherlands Central Bank and Former Chair of the Basel Committee on Banking Supervision

* Affiliations are for identification purposes only. SRC members participate as individuals and any SRC statement reflects their own views and not those of the organizations with which they are affiliated.