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MONEY MARKET FUNDS IN 2013

FSOC's Economic Analysis: Exaggerated Benefits, Underestimated Costs to Long-Term Economic Growth

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, to propose changes to money market fund regulation, the Financial Stability Oversight Council (FSOC) must "take costs to long-term economic growth into account." In its January 24 comment letter, ICI explains the significant shortcomings in FSOC's economic analysis. In short, the FSOC analysis exaggerates the potential benefits of its proposed reforms and may significantly underestimate their costs to the economy. (See page 89 of ICI's comment letter for a detailed discussion.)

The estimated benefits of FSOC's proposed changes for money market funds are illusory.

FSOC argues that its recommendations would significantly reduce the risk and severity of future financial crises. That, in turn, "would imply a sizable net benefit in terms of higher expected economic growth, given the very large costs of financial crises on economic output." But FSOC fails to show that the regulatory changes that it advocates would reduce those risks.

Flaws in FSOC's analysis include:

- The "baseline" in the economic analysis for the alleged risks of money market funds is the 2007–2008 financial crisis, totally ignoring the effects of the U.S. Securities and Exchange Commission's 2010 reforms to Rule 2a-7. These reforms already have made money market funds far more resilient. The FSOC analysis thus significantly overstates any risks money market funds might pose in a future crisis.
- FSOC exaggerates the effect that its proposals could have on investor behavior in a future financial crisis. Its economic analysis implicitly assumes that the regulatory system can ensure that investors in short-term markets will not react to vast, systemic financial events.
- The Council's benchmark for achieving more resilience in money market funds appears to be the creation of a product where investors and portfolio managers never react to unfavorable financial developments. That's an unrealistic basis for financial regulation.

FSOC's economic analysis fails to consider the likelihood that its proposals would drive investors into less-regulated, less-transparent products, thus *increasing* systemic risk.

The Council's recommended regulatory changes impose clear and substantial costs and burdens on money market fund investors. The floating net asset value (NAV) would eliminate the stability, cash equivalency, and tax and operational convenience that investors currently enjoy. The minimum balance at risk (MBR) would the limit the ability of shareholders to fully redeem their money fund investments under all market conditions, no matter how placid. Capital buffers would significantly reduce investor returns.

By ignoring these realities, FSOC also ignores the fact that its proposals will drive many investors to money market fund alternatives:

- FSOC's analysis assumes that money market funds can compel fund investors and issuers of short-term debt to bear the costs and burdens of the Council's proposed reforms. Given the wide range of alternatives available to cash investors, this assumption is unrealistic.
- The Council fails to evaluate how its proposals likely would drive investors into less-regulated, less-transparent products and *increase* the risks and severity of a future financial crisis. FSOC simply mentions this possibility in passing, suggesting that the Council and its members can address this possibility through further regulation "where appropriate and within their jurisdictions." That ignores the fact that many of these alternative products lie beyond the jurisdiction of FSOC regulators, either because they are not regulated or they are domiciled outside the United States.

The Council's cost analysis is narrow—and highly speculative.

The Council's cost analysis focuses only on the cost to long-term growth of requiring funds to hold a capital buffer. It does not even attempt to analyze the costs of requiring funds to adopt floating NAVs or MBRs—even though those concepts are central to FSOC's recommendations.

FSOC maintains that the cost of its proposals to long-term economic growth is "very small." It reaches that conclusion, however, by relying on economic models that generally assume financial activity has little or no impact on long-term economic growth.

Curiously, this minimal estimate of the cost to long-term economic growth appears to contradict the Council's own comments that money market funds "provide an economically significant service by acting as intermediaries between investors who desire low-risk, liquid investments and borrowers that issue short-term funding instruments."

FSOC gave only the most perfunctory nod to its legal obligation under Dodd-Frank to assess the cost of its proposals on long-run economic growth.

FSOC ignores alternative economic models that demonstrate the great uncertainty surrounding its "very small" estimate of the economic cost of its proposals. Other readily available estimates show that the potential costs could be seven or eight times as great. Given the failure of the Report to provide any kind of sensitivity analysis, despite the ready available of alternative models, one must assume the Council sought only to produce the lowest possible cost estimate at the least expenditure of its time.

In light of the untested nature of the proposed recommendations and the cursory analysis of any benefits and costs, FSOC's proposed experiment with a core sector of our financial system is untenable.

For more information on money market funds, their role in the economy, ICI's efforts to make these funds more resilient in the face of adverse market conditions, and the significant risk of undermining money market funds' value to investors and the economy, please see www.ici.org/mmfs or www.PreserveMoneyMarketFunds.org.