

Money Market Mutual Funds and Financial Stability

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Overview

- Focus of my comments will be financial stability and prime money market mutual funds (MMFs)
- MMFs offer a fixed net asset value (fixed NAV) to investors for immediately available funds, hold no capital, and take credit risk
- Key buyers of short-term debt issued by banks and corporations
- Are these characteristics really consistent with financial stability? Or with potential to amplify financial problems?

MMF Structure Not Consistent with Financial Stability

- Some MMFs take significant credit risk, at times necessitating sponsor support
- Such risk is inconsistent with structure (e.g., no capital) and implicit promise of MMFs
- Despite reforms, the risk of amplifying financial shocks remains
- SEC proposals would mitigate concerns, particularly if credit risk was reduced

Credit Risk at MMFs

- Reserve Primary Fund buying Lehman paper was not a unique example of credit risk taking
- MMFs have held other defaulted securities...

Figure 1

Examples of Defaulted Issuers Held by Money Market Mutual Funds: 2007-2008

- Axon Financial Funding LLC
- Cheyne Finance LLC/Gryphon Funding LLC
- Lehman Brothers Holdings Inc
- Ottimo Funding Ltd./Issuer Entity LLC
- Thornburg Mortgage Capital Resources LLC/
Wickersham Entity LLC
- Victoria Finance LLC/Stanfield Victoria Funding LLC
- Whistlejacket Capital LLC

Credit Risk at MMFs, Continued

- At least 47 funds have received direct support from a parent/sponsor, either through cash contributions or purchase of distressed securities
- Publicly available sources suggest support was at least \$3.2 billion from 2007-2010

Figure 2

U.S. Money Market Mutual Fund Sponsor Support Sample: 2007 - 2010

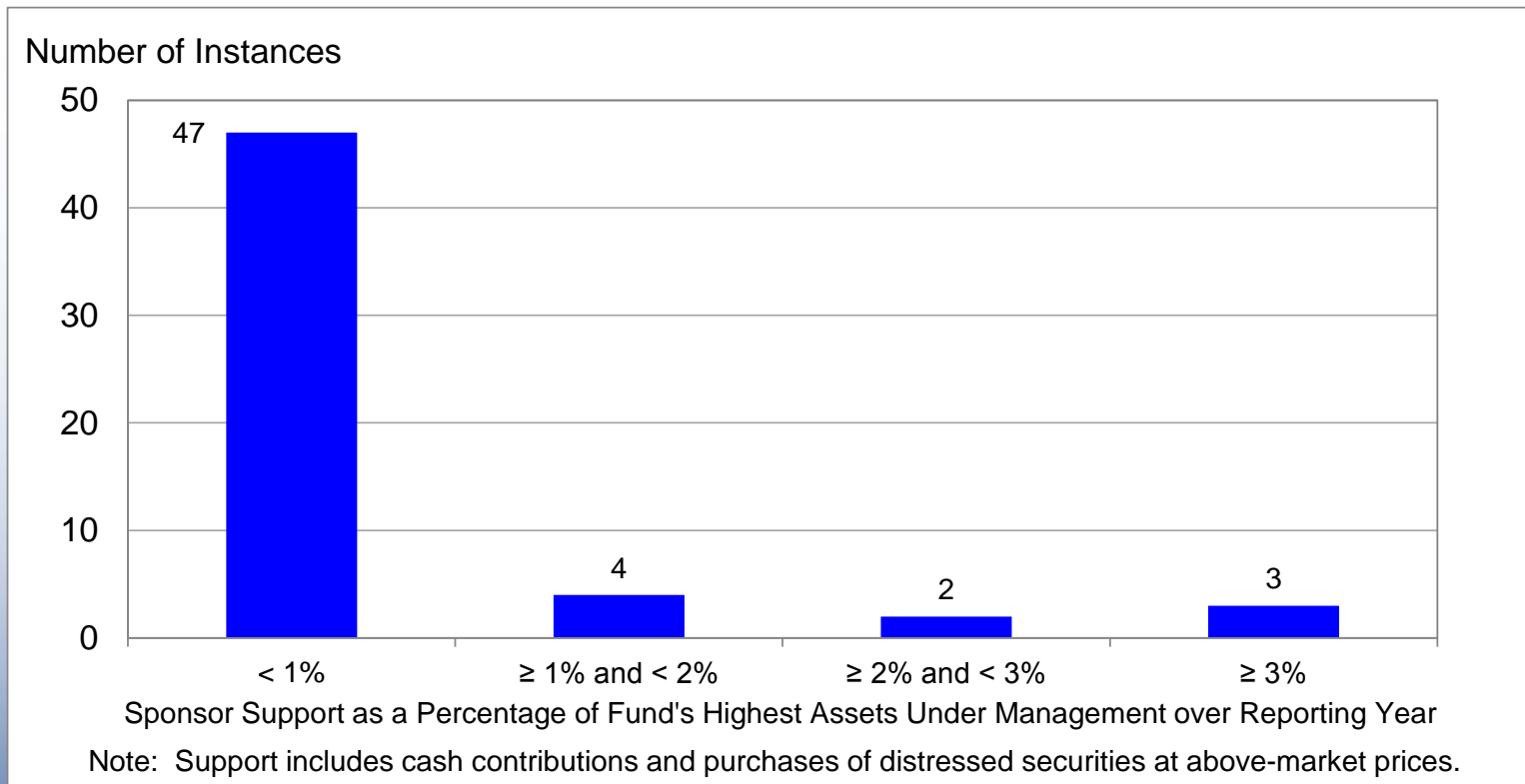
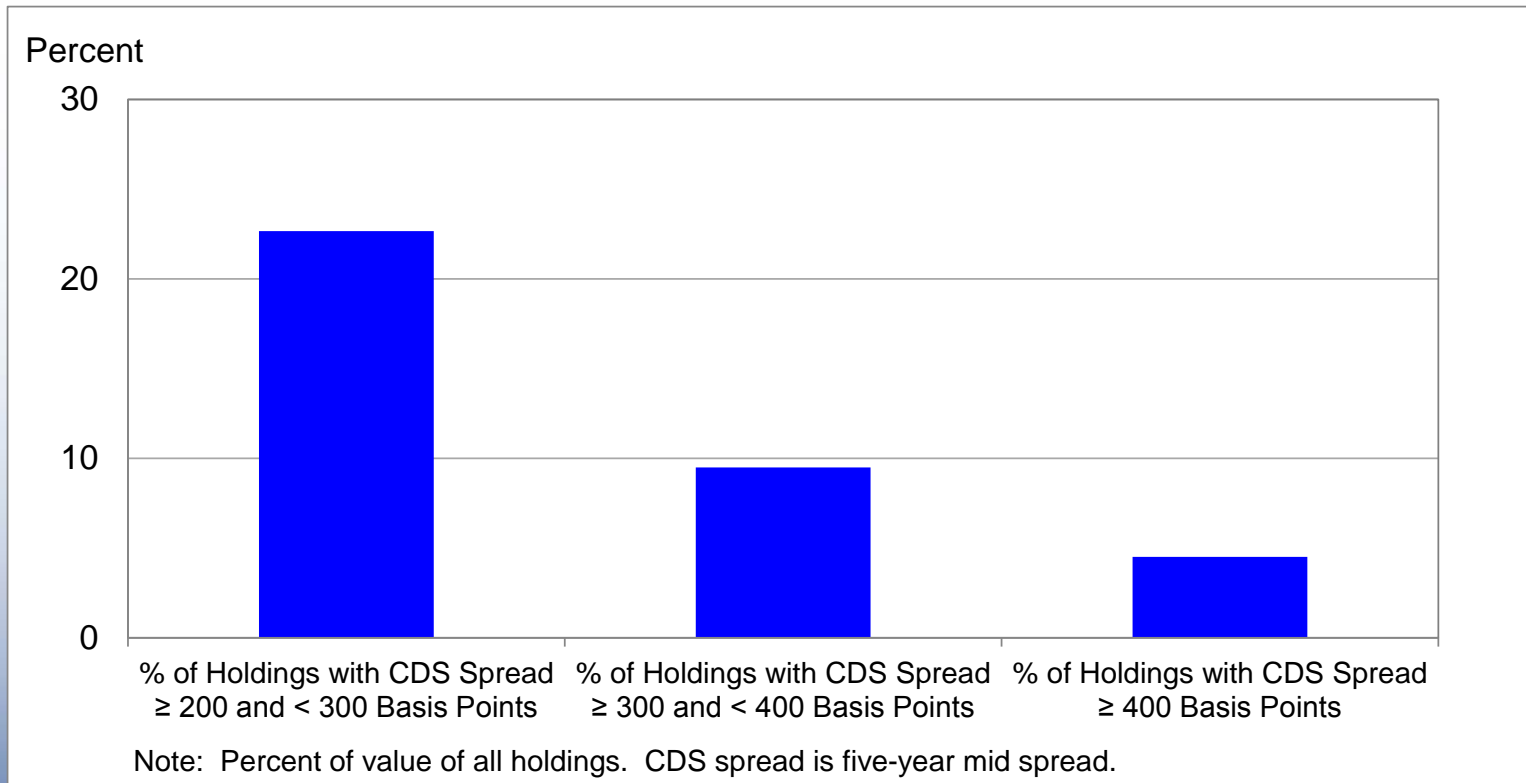


Figure 3

U.S. Prime Money Market Mutual Fund Holdings by CDS Spread of Issuer/Sponsor of Holdings

As of September 30, 2011



Source: Crane Data, Bloomberg, Mutual Fund Company Websites

Figure 4

Holdings of Two Prime Money Market Mutual Funds by CDS Spread of Issuer/Sponsor of Holdings

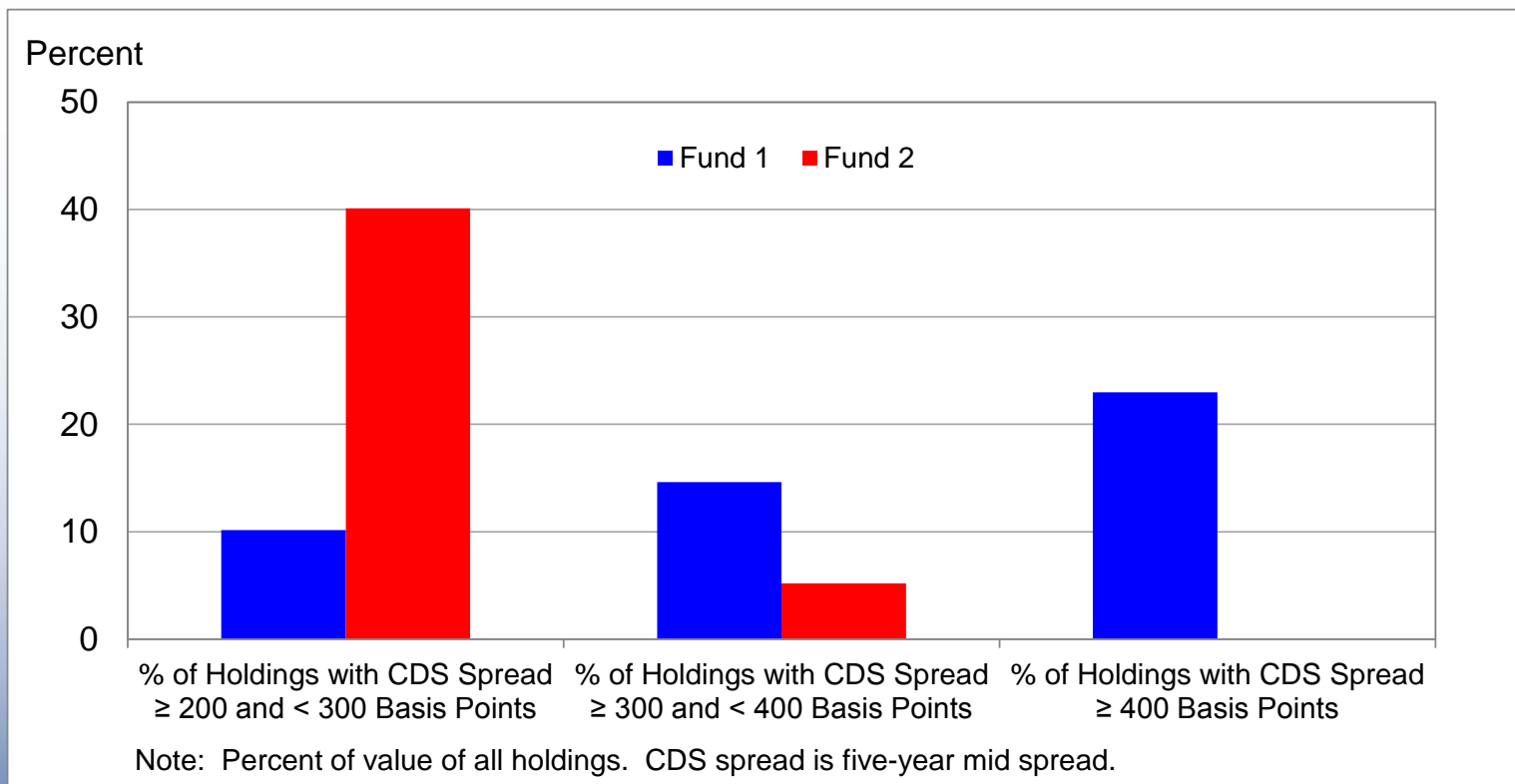
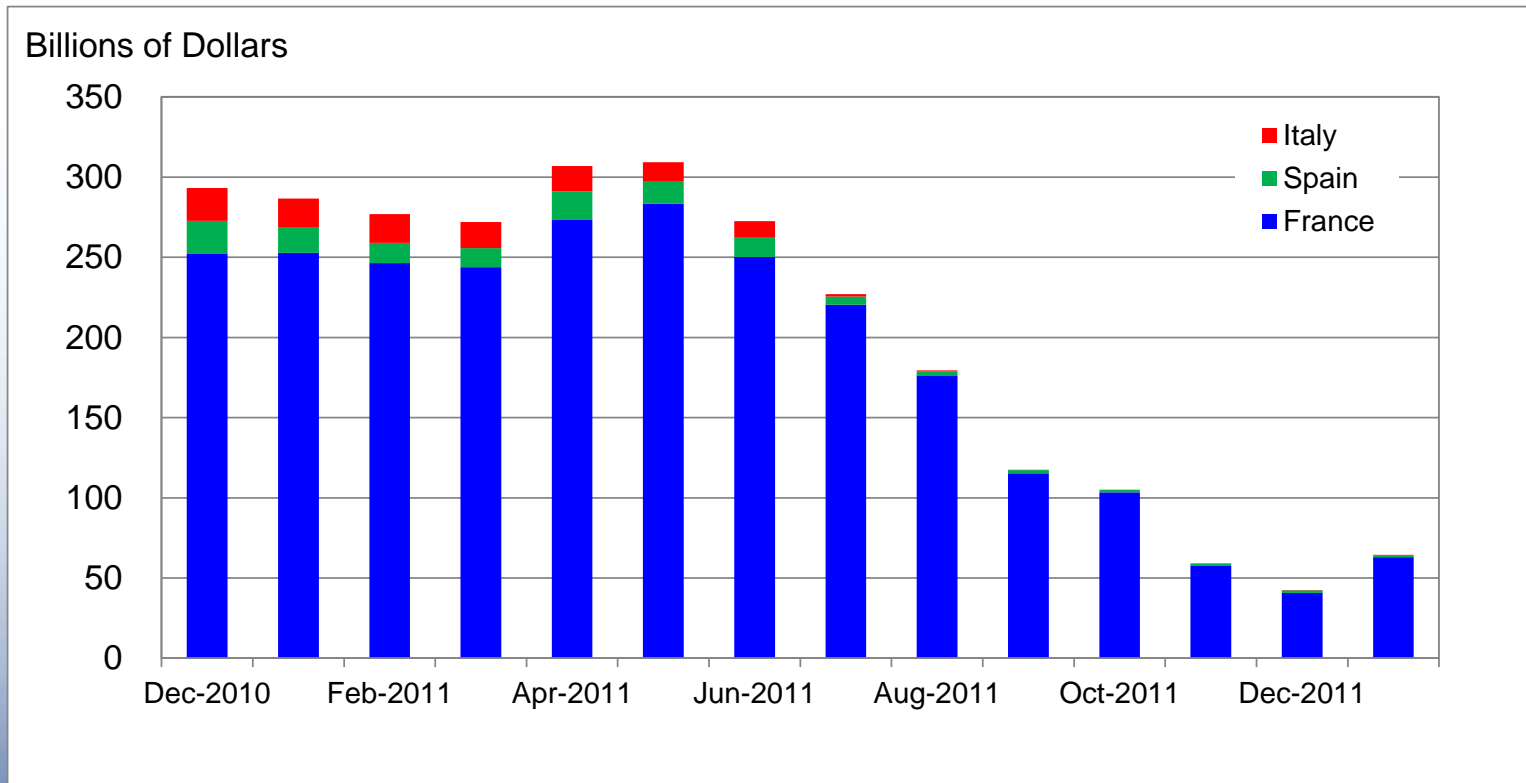


Figure 5

Selected Country Exposure of U.S. Prime Money Market Mutual Funds

December 2010 - January 2012

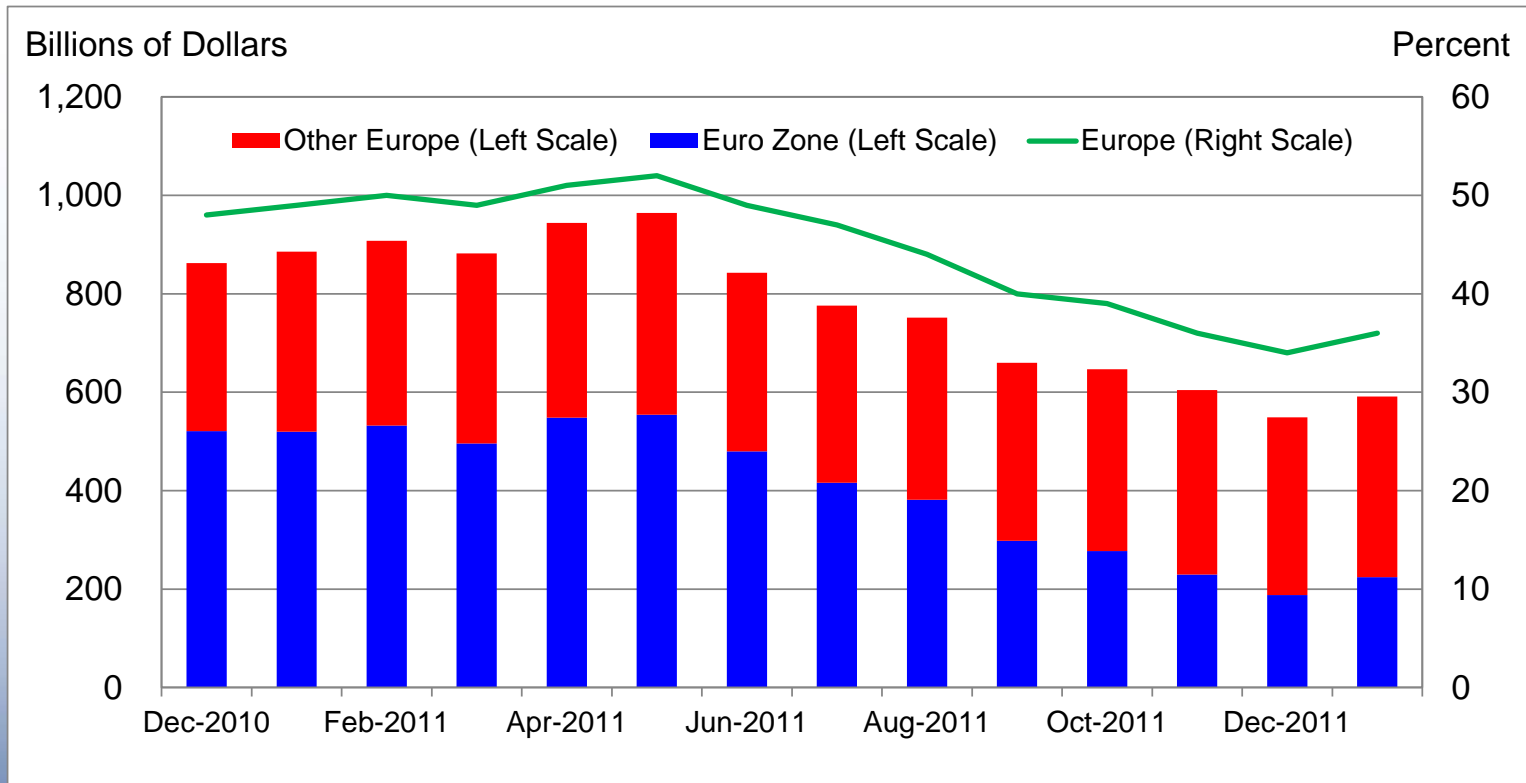


Source: SEC Form N-MFP, Federal Reserve Board Staff

Figure 6

European Exposure of U.S. Prime Money Market Mutual Funds

December 2010 - January 2012

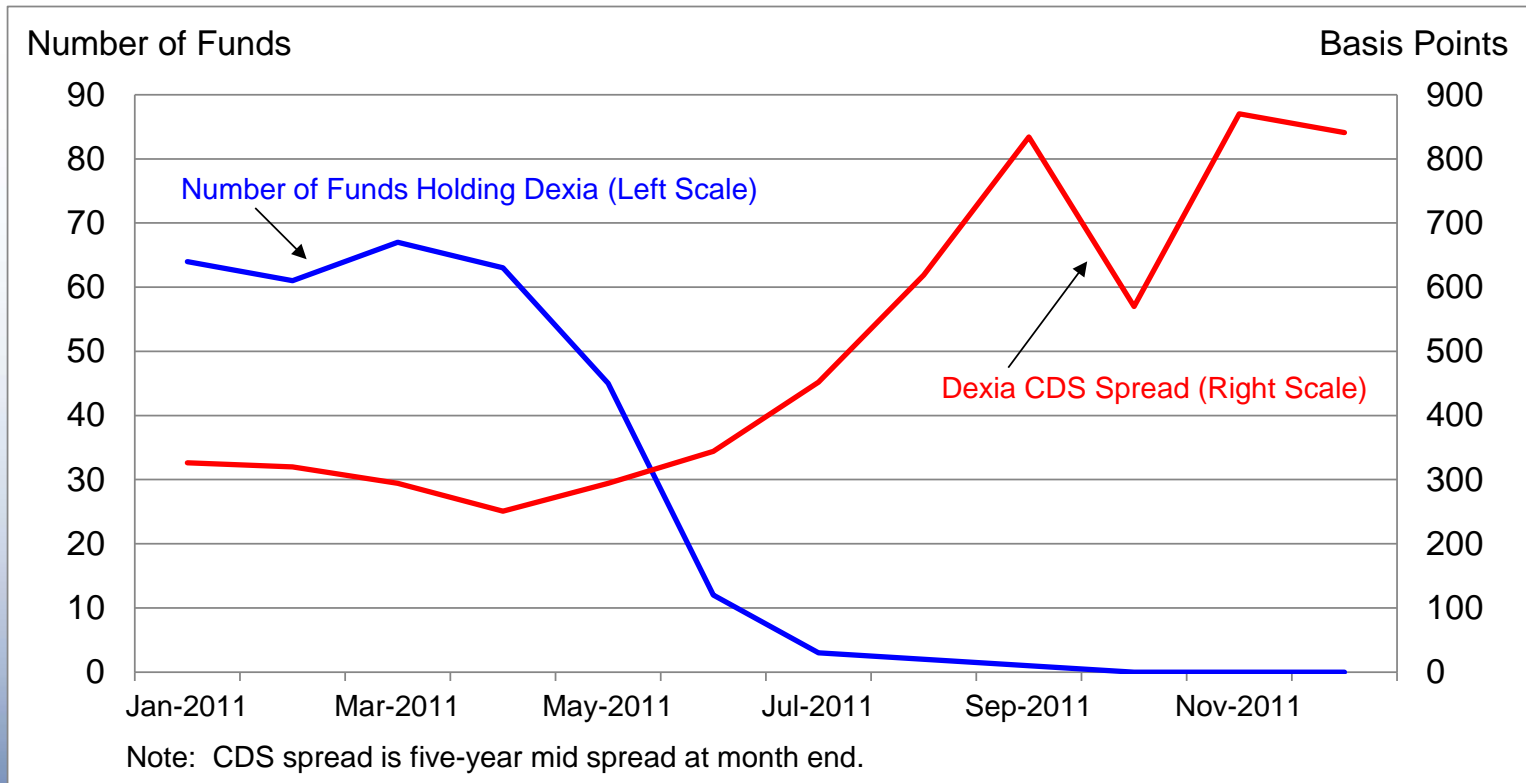


Source: SEC Form N-MFP, Federal Reserve Board Staff

Figure 7

U.S. Prime Money Market Mutual Funds Holding Dexia and Dexia CDS Spread

January 2011 - December 2011



Source: SEC Form N-MFP, Bloomberg, Federal Reserve Board Staff

Potential Mitigation Option: Floating NAV

- Avoids implicit promise to investors that may not be kept during stress – fixed NAV inconsistent with credit risk and no capital
- Investors are reminded prices can fluctuate
- But...
 - Changes the product for investor (taxable gains and losses)
 - Only partially mitigates threat of runs

Potential Mitigation Option: Holding Capital; Imposing Costs on Redemptions

- Increases the ability to pay fixed NAV, if credit risk is modest
- Mitigates risk of runs
- But...
 - Changes the product for investor
 - Difficult to build capital in current rate environment

Conclusion

- Strongly support additional reforms being proposed by SEC
- All reforms have costs
- There may be additional ways to address issues/ encourage reduction in credit risk
- Current structure not consistent with financial stability – cannot take credit risk and promise a fixed NAV to investors without capital backing the promise
- Need structure where sponsor or government support is not necessary, even in times of stress