THE IMPACT OF REGULATIONS ON SHORT-TERM FINANCING

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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CONTENTS

THE IMPACT OF REGULATIONS ON SHORT-TERM FINANCING

Thursday, December 8, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Royce, Neugebauer, Huizenga, Duffy, Hultgren, Wagner, Messer, Schweikert, Poliquin, Hill; Maloney, Scott, Foster, and Carney.

Ex officio present: Representative Hensarling.

Also present: Representative Rothfus.

Chairman GARRETT. Good morning. The Subcommittee on Capital Markets and Government Sponsored Enterprises will now come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Also, without objection, any members of the full Financial Services Committee who are not members of the subcommittee are authorized to participate in today's hearing, although I am not sure we will have that.

With that said, I will recognize myself for 2 minutes with regard to this committee meeting and, before I do that, actually, just to say we have been notified that there will be votes right in the middle of things, as is often the case here. So, in reality, what we will probably be doing is doing our opening statements by the members, a couple of members, and then going to opening statements from the panel. And I bet that will be just about when votes will interfere with us. So we will go on, take a break, go on recess, and then come back for the deep and penetrating questions that will enliven the discussion for the next 3 or 4 hours. Well, maybe not.

So let me just address the matter before us as far as the hearing today. During the last couple of years, this subcommittee and the full committee have comprehensively sought to facilitate capital formation by considering some 40 pieces of legislation, many of them bipartisan legislation—actually, the majority of them I think bipartisan legislation. In doing so, we examined the activities of the SEC's major divisions and offices and conducted oversight of the many self-regulatory organizations that oversee different pieces of capital markets.

And, today, the subcommittee meets to examine the impact of regulations on short-term financing in the U.S. capital markets. The Federal securities laws, which are the bedrock of our capital markets, were put in place eight decades ago to promote the transparency of security offerings and to mitigate and enforce against fraud in the markets. And it created the SEC to carry out this important mission.

As this subcommittee is well aware, the SEC's mission is what? It is threefold: to protect investors; maintain fair and orderly and efficient markets; and to facilitate capital formation. Congress and market participants have long understood the SEC's mission as such and have recognized that the securities laws were not created and were never intended to be a roadblock to access to capital.

If you want to revitalize the economy, Congress needs to promote investment to reduce red tape and to do so by making it easier for investors and businesses across the country to access capital and to grow. New rules must not be duplicative nor contradictory nor counterproductive or inspired by regulatory regimes designed for wholly different entities.

And so it is clear that Main Street is feeling the impact of nearly hundreds of new rules heaped upon our economy over the last few years. And so this hearing is yet another opportunity to examine the impact of the Volcker rule, Basel liquidity, and capital rules, and other financial crisis actions are having on the capital markets and, specifically what we are looking at here, short-term financing.

And so, with that, I do thank each member of the panel for coming today, and I will recognize you shortly. But at this point—

Chairman HENSARLING. Mr. Chairman, I ask unanimous consent to speak out of order for 2 minutes.

Chairman GARRETT. So ordered.

Chairman HENSARLING. I thank the gentleman for yielding. But as he yields, I feel a heavy heart, but I also feel pride. I am proud that the chairman of this subcommittee has been my friend and colleague for 14 years, as has the gentleman from Texas, Mr. Neugebauer. And my heart is heavy in that this will be their last hearing with us and the last hearing that Mr. Garrett will preside over. Both of these fine gentlemen have fought for the cause of freedom and free enterprise and prosperity. They have acted with dignity and principles and courage. They have commanded respect on both sides of the aisle. With their departure, this will be a lesser committee and Congress will be a lesser institution. No one can fill their shoes or, in the case of the gentleman from Texas, no one can fill his boots. But people will at least follow in their footsteps. So I did not wish to have the moment pass without recording for the record the contribution of the gentleman from Texas, Mr. Neugebauer, and the contribution of the gentleman from New Jersey, Mr. Garrett, to this committee.

And whatever the future holds for Chairman Neugebauer and Dana, and whatever the future holds for Chairman Garrett and Mary Ellen, know that you go with our respect, and you go with our blessing. You will always have permanent friends here. And anything that we achieve in this broader committee, please know it is based upon your work. We stand on your shoulders and you will never, ever be forgotten among this group of friends. Godspeed and thank you.

And I yield back.

Chairman GARRETT. I thank the chairman and a unanimous consent to speak out of order as well at this point. But we will get to the panel.

I very much appreciate that, and I echo the comments that the gentleman makes to our colleague and friend and leader from Texas. We came in about the same time, worked together with the chairman.

You know, the chairman has been most gracious and has done something that I don't know happens that often, has had multiple sort of going-away events, and so you hear nice things said each time. I am hoping that he is—Randy and I are both hoping that he is planning at least three or four more of those going-away things because I know, once I leave D.C., I will not hear any of those nice things anymore. I certainly didn't hear them over the last year and a half of the campaign, so this makes up for it—sort of.

But thank you very much. It is—I wasn't going—I was going to go right into the meeting, actually. But I said to someone the other night at one of the going-away events—and I said it in jest toward one Member—I said: It has been an honor and a privilege to work with some of the most dedicated, smart, intelligent in a different way, committed to trying to do all they can for the people of this country, to lift people up in all walks of life, regardless of whether they support them or not in their districts, trying to do it for this generation and for the next generation. We have been on the same page for so many issues in that regard. And throughout that time, we have had some battles that we won, and that was fun; and we had some battles that we lost, and we just marked it up to what we had to do the next time. But we just kept on going forward. And I looked at my colleagues and my friends as well, knowing that, through it all, as scripture tells us, that you run the race, you stay the course, and you keep the faith. And I could not have chosen a better group of people to be with during these last 14 years than the people right here and the people who didn't show up as well. And we are taking down names.

Mr. NEUGEBAUER. Mr. Chairman?

Chairman GARRETT. I yield to the gentleman from Texas.

Mr. NEUGEBAUER. May I speak out of order?

Chairman GARRETT. Absolutely. No objection.

Mr. NEUGEBAUER. I thank the gentleman from Texas for his kind words as well the gentleman from New Jersey. It has been an honor and a privilege to serve with these two great guys and the ladies and gentlemen who are on the committee as well. You know, Scott and I have had some—heard some nice things said about us. And one of the things I keep regretting, though, is that my mother-in-law is not here to hear those.

But, anyway, Scott has provided great leadership on this subcommittee, and I have enjoyed serving on it with you and also the other projects that we worked on.

And to my colleagues on the other side of the aisle, I see several there that we have worked together on some issues, and so I thank you for the opportunity to hang out with you for a few years.

Chairman GARRETT. And now we will have time to hang out even more.

The gentleman yields.

Mrs. MALONEY. I also ask to speak out of order.

Chairman GARRETT. The gentlewoman is recognized.

Mrs. MALONEY. I would like to be associated with the comments of the chairman and Mr. Neugebauer and in speaking about all the fine things about our chairman. The chairman and Mary Ellen have been friends of mine on a personal level. He has been a friend and an outstanding, dedicated, and effective public servant. We did not always agree, but it was never personal. And it was always an honest and, in some cases, fun debate. And he is devoted to his constituents and to serving this body. I will miss him. He is a fine Representative. It has been an honor for me to work with him in every way. And we did some work together. We passed some bills together.

And I just feel sad that you are leaving. And I appreciate your friendship and your support, particularly when my husband passed away. I will never forget how nice you were to me. In any event, you have been an outstanding chairman, and it has been a privilege to work with you. I will miss you.

Mr. SCOTT. Mr. Chairman, over here.

Chairman GARRETT. The gentleman is recognized.

Mr. SCOTT. We all are going to really miss you. And as you know, we both came in together 14 years ago, and it has been a pleasure working with you. I want you to know that you have made some very sterling contributions to the financial stability of our great country. It has been a pleasure serving with you as the chairman. I have served on this Capital Markets Subcommittee with you for all these years, and I really appreciate the great opportunities we had to cosponsor some bills together, work on amendments, and debates on the floor. And I will tell you: there is not a more acute mind of knowledge to understand the basic fabric and the foundation of our finance system as you. And I want you to go away knowing that, not only the people of New Jersey, but the people of this Nation are really grateful for your service. Thank you very much for our working together.

Chairman GARRETT. Thank you. It has been an honor and a pleasure.

And, with that, we can focus—oh. Opening statement. With that, I turn to the gentlelady from New York, who I will be looking forward to for now personal invitations to events in New York City.

Mrs. MALONEY. You will get them.

Chairman GARRETT. There we go. The gentlelady from New York is now recognized.

Mrs. MALONEY. Thank you so much, Mr. Chairman.

The title of this hearing is, "The Impact of Regulations on Short-Term Financing," and for once, we can agree: regulation definitely has had an impact on short-term financing markets. But this was entirely intended. The financial crisis revealed huge problems with many short-term financing markets, some of which completely broke down during the crisis. We discovered that the largest banks have become overly reliant on short-term wholesale financing markets, such as the repo market, which can dry up in a heartbeat and suffered a massive run during the crisis.

The point of many postcrisis regulations has been to reduce the banks' reliance on unstable short-term financing, which has significantly improved the stability of the largest banks. A reduction in short-term financing markets was an intended consequence of financial reform. Now we have an ongoing debate about whether certain postcrisis regulations have had unintended consequences for some short-term financing markets, but that debate is far from settled. And I believe we need to seek compelling evidence of harm before we roll back core postcrisis protections.

There has also been a lively debate about the SEC's money market fund reforms, which took effect in October. These reforms were intended to make the pricing of money market funds more transparent and to reduce the first-mover advantage that can lead to devastating runs. The reforms also provided funds with tools to manage large-scale investor redemptions in an orderly fashion.

In anticipation of the reforms taking effect in October, many investors moved their cash out of prime and municipal money market funds and into government money market funds, which we were less affected by the SEC's reforms. It is true that short-term borrowing costs for corporations and municipalities have increased recently. And some commentators have attributed this entirely to the SEC's rules. Most market participants believe that this increase has been driven primarily by the expectation of a Fed interest rate hike this December. In fact, the data clearly shows that corporate borrowing rates first started to increase shortly before the Fed raised rates the first time last year, which is exactly what you would expect if the increase was driven primarily by the Fed's monetary policy, rather than the SEC's rules.

Moreover, while one bill has been introduced that would repeal the requirement in the SEC's rule that certain funds are at floating net asset value or NAV, my understanding is that most investors who have taken their money out of prime funds have done so because of the mandatory gates and fees, not the floating NAV. Therefore, it is not clear to me that simply repealing the SEC's floating NAV requirement would actually accomplish anything. Once investors get comfortable with the new rules, I believe at least some of this money will return to prime funds. Much of it will never come back, but again this was an intended consequence of reform. It would be very strange if the SEC's reforms, which were among the most important postcrisis reforms, produced no change at all in the money market funds.

So, therefore, I look very much forward to the hearing today and what our witnesses have to say. Thank you very much.

I yield back, and I will miss you.

Chairman GARRETT. Thank you, the gentlelady yields back. We now go to the witnesses and hopefully the message from leadership was wrong as far as when they are going on to a break for the votes.

So we will begin—for the witnesses, you will each be recognized for 5 minutes. Your full testimony will be made part of the record.

There should be little lights or something in front of you to indicate your time. Green is for 5 minutes. Yellow, it means you have 1 minute left remaining. And red is at the end, saying your time is up.

So, at the very beginning, Mr. Carfang, welcome and you are recognized for 5 minutes.

STATEMENT OF ANTHONY J. CARFANG, MANAGING DIRECTOR, TREASURY STRATEGIES, A DIVISION OF NOVANTAS, INC.

Mr. CARFANG. Thank you, Chairman Garrett, Ranking Member Maloney. I am pleased to be here today.

My name is Tony Carfang, and I am a managing director with Treasury Strategies. We are a division of Novantas. We are a consulting firm specializing in Treasury payments and liquidity. And we work with hundreds of corporations, municipalities, healthcare organizations, and financial institutions around the country.

The issues we are talking about today are very important to our clients, and there are three—when I say the big three regulations that have come out of the financial crisis, are Basel III, Dodd-Frank, and money market fund reform. These are bold experiments. And as we all learned in high school chemistry, when you do an experiment, you pour the chemicals in slowly and carefully. What has happened in this case is all the experiments went into the test tube at the same time. And that test tube is America's businesses and America's consumers.

We are now seeing the reaction and, in some cases, the uncontrolled reaction of that. For example, in the 5 years since the postcrisis regulation has been going into effect, there are 1,500 fewer banks in the United States. That is more than a 20-percent decrease. America used to create about 150 to 170 new banks per year. That is an 80-year average. Since 2010, only two new banks have been formed in the United States. I think that gives you a sense of how crushing the regulations have been.

What I would like to do today is focus on money market mutual funds and point out first that, in 2010, the SEC introduced a set of reforms to improve transparency and liquidity, and those regulations were very successful in terms of providing safety and soundness to not only money market funds but the entire financial system without impairing the utility of those funds to investors. Unfortunately, in 2014, the SEC again came out with an extended set of regulations that, in effect, prohibited what they called non-natural persons from investing in stable net asset value prime and municipal money market funds. The result of that has been for investors to exit those funds. And what we have seen is in prime funds—and by the way, prime funds are private sector funds; they invest in the commercial paper or other debt of corporations and financial institutions providing the day-to-day working capital for those organizations—assets have fallen almost 75 percent, from $1.4 trillion down to about $380 billion. That is hardly a scaling back. They have been crushed. They have been decimated. And the borrowers who rely on those funds for financing, where they are able to find credit elsewhere, have a much higher cost to that credit.

On the municipal funds, here the impact is particularly profound. We have seen a decrease of 50 percent from about $260 billion down to $130 billion in assets. These are the funds that finance municipalities, schools, hospitals, and universities.

To give you some examples, the State of New York has seen, just this year, a decrease in funding from $39 billion down to $19 billion; California healthcare finance from $2 billion down to 1.3. The total decline has been $1.2 trillion. Let me point out: this money has moved from the private sector to the public sector. And to put that in perspective, the $1.2 trillion is more than the entire TARP program several years ago. It is more than the stimulus program, and it is several times more than the amount of cash we expect to get back from overseas if we can get corporations to repatriate. These are huge numbers.

In addition to States losing financing, let me just point out the Metropolitan Transit Authority in New York City has seen its financing fall from $2.34 billion down to $800 million. They have lost a billion and a half that municipal money funds used to finance. Harris County, Texas, educational facilities have lost—they have gone from $1.1 billion down to $580 million. These are very real consequences.

H.R. 4216 is designed to provide a simple fix to allow non-natural persons to again invest in stable value money market funds. This will restore funding—it is the stable value that is the threshold issue that makes this money funds a cash-management tool for corporate treasurers. Without that stable value as a source of financing, we lose a couple trillion dollars. This is all about preserving money market funds as an effective financing tool.

Mr. Chairman, thank you very much.

[The prepared statement of Mr. Carfang can be found on page 34 of the appendix.]

Chairman GARRETT. And I thank you. That is interesting.

Next, speaking on behalf of the U.S. Chamber of Commerce, Mr. Deas, welcome, and you are recognized for 5 minutes.

STATEMENT OF THOMAS C. DEAS, JR., CHAIRMAN, NATIONAL ASSOCIATION OF CORPORATE TREASURERS, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. DEAS. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I am Tom Deas. Today, I am testifying on behalf of the U.S. Chamber of Commerce and its Center for Capital Markets Competitiveness. I am also the chairman of the National Association of Corporate Treasurers. These organizations are fully supportive of the bipartisan efforts of the chairman, ranking member, and other distinguished members of this subcommittee to protect Main Street companies from regulations that, however well-intended, place an undue burden on job creators at the heart of our economy as they work every day to finance their businesses, safeguard their cash and other assets, and hedge risk in their day-to-day operations in the most efficient and effective ways as possible.

When it comes to the needs of Main Street businesses, the Members of the House have worked together to get things done. In this 114th Congress, you have led the charge in enacting both the enduser margin bill and the centralized Treasury unit bill benefitting directly the enduser community. We appreciate your efforts, thank you.

We support the overall goals to increase the financial markets' transparency, safety, liquidity, and efficiency. However, there are areas where conflicting regulations compel endusers to appeal for relief. We are seeing compounded adverse effects from the elaborate web of new regulations imposed and so urge a study of the cumulative effects of how these rules interact to produce a greater impact than an analysis of them taken individually would predict.

In the area of money market fund reform, in mid-October new rules affecting these money markets came into force that had the effect not only of taking $1 trillion out of the market that has long provided treasurers with a diversification away from bank time deposits for investments of temporary excess cash balances but which also diminished an important source of funding for treasurers seeking to issue commercial paper to fund their day-to-day needs.

Conflicting with the importance of diversification, the Treasury's rule for simplifying the tax consequences of investors having to track money market fund investments and share prices to the nearest hundredth of a cent now, along with liquidity fees and redemption gates, we instead have greater concentration, fewer funds as alternative, purchasing less nonfinancial enduser commercial paper, resulting in higher borrowing costs and greater risks of less liquid funding sources.

We believe that the net stable funding ratio, also a rule proposed by banking regulators, must have higher—result in higher short-term funding costs for Main Street companies. For example, it requires banks buying a company's overnight commercial paper to hold reserves against that purchase in the form of significantly higher long-term funding for 85 percent of the balance. As an example of the need for a cumulative impact study, consider the interaction of money market fund reforms and the NSFR rule. The money fund reforms' drive for greater liquidity has driven funds holdings maturing in less than a week, including bank certificates of deposits and commercial paper, to increase from 54 percent at June 30 to 68 percent at the end of November. However, the very structure of the NSFR is to force banks to issue their funding not at 1 week or less, but on a far longer term basis with higher costs passed on to their borrowers, Main Street companies.

These conflicting regulatory company conflict—these conflicting regulatory forces will tend to increase our costs. The rules were adopted without an economic analysis of their implications and ultimate costs.

To summarize, Congress was instrumental in clarifying that nonfinancial endusers should not divert capital from investments in their businesses to unproductive regulatory set-asides, such as the daily posting of cash margin for their derivative positions. However, the banking regulators have implemented rules on capital that banks must hold against derivative positions as well as against loans to endusers and other advances to them that have the same economic effects.

These capital and liquidity rules create real impacts and costs on endusers' ability to manage risk and access capital. This is why we support undertaking a cumulative assessment of the impact of these rules on endusers. The imposition of unnecessary burdens on endusers, businesses, restricts job growth, decreases investment, and undermines our ability to meet and beat our foreign competition, leading to material cumulative impacts on corporate endusers and the U.S. economy.

Thank you again for your attention to the needs of Main Street companies.

[The prepared statement of Mr. Deas can be found on page 77 of the appendix.]

Chairman GARRETT. Great, I appreciate your testimony.

Next, Mr. Konczal, you are recognized for 5 minutes and welcome to the panel.

STATEMENT OF MIKE KONCZAL, FELLOW, ROOSEVELT INSTITUTE

Mr. KONCZAL. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank for the opportunity to testify.

My name is Michael Konczal. I am a research fellow at the Roosevelt Institute. Previously, I was a financial engineer at Moody's KMV, a provider of credit analysis tools to lenders and investors.

The 2010 Dodd-Frank Act has many important accomplishments, one of which is reducing the regulatory arbitrage that characterizes shadow banking. Here I will refer to the financial activity that follows the functions of traditional banking without exclusive banking regulations or access to deposit insurance or emergency lending. The sector is often regulated through securities law, which emphasizes disclosure over prudential regulation. One of the primary elements of shadow banking is money market funds, whose collapse in the aftermath of the failure of Lehman Brothers was the defining moment of the panic.

As a legal matter, money market funds function as mutual funds and are regulated as such. But as an economic matter, money market funds share functions identical to bank deposits. They allow for investments to be liquidated at any time at par with the expectation that they will return the capital amount invested plus interest. This exposes them to runs. This has been covered up previously because of the ability of sponsor funds to provide capital injections. Yet they blur the line between these two regulatory worlds of securities and banking law. The history of these funds has always been tied to this regulatory blurring, as former Federal Reserve Chairman Paul Volcker recently noted: I was there at the Federal Reserve Board when these funds were born. It was obvious at the time that these products were created to skirt banking regulations, end quote.

Since the crisis, the SEC has imposed several regulations on money market funds designed to increase their stability and reduce the likelihood of runs. The most important requires the use of a floating net asset value for prime institutional funds. As SEC Commissioner Daniel Gallagher noted at the time, quote: This will address the three decade old error in a nuanced and tailored manor to reinstate market-based pricing, end quote.

With this change, there is less of an incentive for mass withdrawal under stress conditions. There's no cliff effect of breaking the buck, and it reduces the first-mover incentive. There is also an issue of transparency that gives investors a better understanding of the risk they face.

It is worth noting previous efforts to educate investors that these instruments do not function as deposits and could break the buck had they not worked. This was attempted in both 1991 and 1996 by the SEC with language provided in my written testimony.

Disclosures are not a sufficient substitute for proper regulation and market-based pricing. Beyond this, Dodd-Frank provides for the graduated, consolidated level liquidity and leverage requirements from the largest financial players. These are essential for risk management. By itself, risk-weighted requirements are procyclical and can be subject to unexpected assetwide downgrades. Leverage requirements provide a backstop and an important complement to other regulatory capital tools. Just as equity is regulated, debt should be regulated too and ensure that the term structure of debt of a firm ensures sufficient liquidity to survive a panic without massive capital lender of last resort backstops.

There are concerns that this is affecting the real economy. It is difficult to see actions in the real economy that would indicate this negative effect. According to analysts at the New York Fed, "price-based liquidity measures—bid-ask spreads and price impacts—are very low by historical standards, indicating ample liquidity in corporate bond markets."

We did not see this in the survey data either. In surveys conducted just this month in—monthly by the National Federation of Independent Business, only 4 percent of small businesses indicate that their borrowing needs were not satisfied in the past 3 months. This number is down over the past several years. Instead, the National Federation of Independent Business' researchers find that a "record number of firms remain on the credit sidelines, seeing no good reason to borrow."

This is mirrored in the Federal Reserve survey of loan offices, which indicate declining credit spreads over the past several years. We also do not see this financing constraining corporate governance decisionmaking. If Dodd-Frank was reducing the ability of corporations to borrow to invest, we would expect firms to retain more earnings, substituting against other types of capital streams capable of sustaining investment.

However, total shareholder returns on the S&P 500 set a 12-month record high in 2016. 2014 spending on buybacks and dividends across the nonfinancial corporate sector was larger than the combined net income across all publicly traded, nonfinancial U.S. companies for the first time out of recession. We do not see, certainly as a macro economic effect, the shifts associated with reduced financing for investments.

Even with all this work done, experts rightfully remain concerned about destabilizing elements in the shadow banking market. Efforts should go further. There are several avenues that could be investigated.

More broadly, important reforms remain in establishing a system of minimum haircuts for securities financing transitions, and revisiting the Bankruptcy Code's carving out of derivatives and other financing contracts can help provide stability and reduce the potential to runs. These risks are real, and they still remain. I think it is important to be diligent to them as we go forward as the crisis recedes into the background.

Thank you and I look forward to your questions.

[The prepared statement of Mr. Konczal can be found on page 89 of the appendix.]

Chairman GARRETT. Thank you. The gentleman yields back.

And last, but not least, from SIFMA, Mr. Toomey is recognized for 5 minutes.

STATEMENT OF ROBERT TOOMEY, MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. TOOMEY. I thank you, Mr. Chairman. Chairman Garrett, Ranking Member Maloney, and the distinguished members of the subcommittee. Thank you for providing me the opportunity to testify on behalf of SIFMA and to share our member firms' perspective on the impact of regulation on the capital markets.

Before turning to my opening statement, though, I want to take a brief moment on behalf of SIFMA to thank Chairman Garrett for his years of service on this committee and years of leadership of the Capital Markets Subcommittee. We always appreciated the thoughtfulness with which you approached an issue. Thank you.

Regarding the topic of today's hearing, let me start by applauding your focus on ensuring that an appropriate balance is struck between regulation and growth. We believe it is time for an evaluation of the intended and unintended consequences of postcrisis reforms. Much of the regulation that has been implemented seeks to address key contributors to the financial crisis and has made both banks and the system safer and sounder.

Recently, however, market participants have raised concerns that the reforms have resulted in reductions in market liquidity beyond what was intended, particularly for the high-quality liquid assets that underpin the financial system and our economy. We see the resiliency and depth of market liquidity as a critical objective for policymakers to consider. If market participants' ability to access liquidity is impaired, particularly during stress periods, it will negatively impact functioning of financial markets with broad ramifications for the economy. Regulations that are risk-insensitive and regulations that target the same risk multiple times through overlapping rules may weigh particularly heavily on vital market functions. As such, we believe now is an appropriate time to assess the existing framework. Specifically, we recommended an assessment of coherence and cumulative impacts on a forward-looking basis to identify cases where there may be unnecessary duplication or conflicts between specific regulatory requirements and broader policy goals.

A recent effort undertaken by the European Commission provides an example of the type of call for evidence or review that we think is both warranted and timely. The Commission specifically sought feedback on the impact of financial regulation on the ability of the economy to finance itself, and growth, unnecessary regulatory burdens, and interactions, inconsistencies, gaps, and unintended consequences. These are exactly the right areas of inquiry.

For any review undertaken domestically, we would note a few areas for consideration. First, in looking at the full rule set in place today and what we expect to come on line in the near future, we find potential conflicts between the rules that together could have negative impacts.

Second, the treatment of low-risk, high-quality assets like cash and cash equivalents varies depending on the rule and often does not reflect their low-risk or risk-free status.

Finally, the assessment should examine the calibration of specific rules that are designed to serve as backstops but that actually operate as binding constraints.

Turning to the specific focus of the hearing, I would highlight the importance of the short-term funding markets in the financial system. In particular, repo markets provide the necessary grease that allows the U.S. capital markets to remain the most efficient and liquid in the world. This facilitates lower cost credit to businesses, municipalities, and the Federal Government.

Several significant regulations, some of which are not fully in place yet, have been proposed and are adopted that have a direct impact on the repo market and other short-term funding markets. While some of these impacts are clearly intentional and reflect the policy concern for overreliance by financial institutions on short-term funding. SIFMA believes that the cumulative impact of these regulations reflect neither the risk to the financial system nor individual firms. Rules, including the supplemental leverage ratio, the liquidity coverage ratio, the net stable funding ratio, may impact short-term funding in different ways, but the overall interaction of these regulations is unclear. Our concern is that these potential conflicts will become evident during stressed environments.

In conclusion, the time is right to provide a wholesale review of the impact and coherence of these requirements with a view toward a better balance of safety and soundness on the one hand and efficiency, liquidity, and capital availability on the other. As liquidity diminishes or becomes more brittle in these markets, higher costs of capital may be inevitable for both the government and Main Street.

I thank you for your interest in this important topic and look forward to your questions.

[The prepared statement of Mr. Toomey can be found on page 104 of the appendix]

Chairman GARRETT. Great. Thanks. So the Floor has called, but we will have time to do a couple of questions. I will start with myself.

So it appears that there is some uniformity in most of the testimony as far as, to use your words, Mr. Toomey, some brittleness of the market and the tightening of liquidity. One aspect of that is there was a study done—I forget if it was in the testimony or not—by Deutsche Bank saying it estimated that dealers have cut down their inventory by something like 80-some odd percent, right—you are nodding your head—which to me, I think, in layman's terms, that is like, in manufacturing or retail, that you are getting into it just in time—you are hoping to have a just-in-time delivery at that point if what is on the shelf is way down. What is the reaction to the marketplace to that, as I coined it, just-in-time delivery? Are they able to deal with that?

Mr. CARFANG. Well, the just-in-time inventory means bids and ask spreads are wider, which means costs go up for everyone participating.

Chairman GARRETT. So what does that mean to the layman that the bids are wider to Main Street as far as my borrowing costs?

Mr. CARFANG. It means, when you are borrowing, you pay a slightly higher price; when you are lending, you get a slightly lower yield.

Chairman GARRETT. Right. So what does that mean as far as me as a local small business or as a medium-sized business as far as my ability to expand or what have you in that marketplace?

Mr. CARFANG. Well, at the margin, funding becomes more expensive, and at some point, you are going to decide not to do the project or hire the employee.

Chairman GARRETT. And so that was not the intention, obviously, in legislation that Congress passed.

I go to Mr. Deas on this as far as you were referring to something—oh, I know. It was on the endusers, and the intention of Congress here was not to have the higher requirements, reserves requirements there, right, to the specific endusers in that category. But you point out what I would sort of—I would coin a phrase an end run, if you will, by the banking regulators saying: Well, if Congress is saying we are not going to be able to propose those requirements over here, we are going to do it, how? As you were suggesting, over here through the banks, right, through the banking regulators. Do you want to speak on that again? I have 30 seconds.

Mr. DEAS. Yes, sir. This committee was very clear in directing the banking regulators that they should not require endusers to set aside cash to margin their derivative positions. And yet, in the regulations they have imposed, they are essentially requiring the banks to do that. And what we focus on as endusers is the banks; the way we look at them, they are mere intermediaries in the system. In the end, we are the productive economy. They get the money from where it is generated to where it is needed. And if an extra cost is put on them, it is ultimately borne by us, the productive manufacturing companies of this country.

Chairman GARRETT. I got it. So you add that to what Mr. Carfang was talking about this other problem, what Mr. Toomey was talking about as well as far as using the word "brittleness" to it and the expansion of the spreads and the cost to the system, right? So what is the result of that?

Well, besides result, because we have heard the result. You are seeing that in the marketplace, right?

Mr. DEAS. Yes, sir.

Chairman GARRETT. And we are seeing occasional exasperations of that through the flash crash and that sort of thing, right? But we don't hear that from the regulators. Treasury Secretary, the Fed Chair reject any notion. They have been here a number of times in the past. We would throw these questions out to them, and we say: Gee, is there a problem here? Is there a liquidity problem here? And they see no evil in that area.

Why is that you are seeing something—and I throw this to the panel—that the regulators can't seem to be seeing?

Mr. DEAS. Well, sir, we will see it when it comes to a tightened or a stressed financial market. When this kind of capital flows out of the market for endusers, when a trillion dollars that was in prime money funds, much of which—in April of 2012, money funds bought 40 percent of commercial paper, nonfinancial commercial paper. It is now, at the end of November, down to 5 percent. So the supply-demand has been imbalanced. When in these times, where markets are steady, we are not seeing so much of an effect; we are seeing the numbers, as I have demonstrated in my testimony. But when we get into more strained conditions, we will see it very much.

Chairman GARRETT. And give credit as credit is due, as my dad always said, to the Fed Chair because—I mean to the SEC Chair, that she recognized this and saw it but would not attribute actually what the cause was. And I think, from most the panel here, part of reason why they are not attributing and she is not attributing the cause is because of why? We haven't done a full study to see exactly what the cumulative effect was of all of these regulations. I know we have had all the Fed Chair and others and Treasury Secretary here as well, and we have always asked them: What is it really costing the system what you are doing? What are you really costing the system of Dodd-Frank and the 400 regulations? And to a man or to a woman, they can't give an answer to that, correct?

Mr. DEAS. Yes, sir. We would very much urge that these interactions be studied. The regulations have been looked at individually, but they don't see the compound effect.

Chairman GARRETT. Cumulative effect. Yes.

Mr. DEAS. Money market funds are not just a source of short-term investing opportunity for treasurers, but they buy our commercial paper. They finance our businesses. And when a trillion dollars flows out of them, we pay more to finance day-to-day operations.

Mr. TOOMEY. So these new regulations, though, should be rolled back while the study is going on so that they don't continue to do ongoing damage.

Chairman GARRETT. First, do no harm.

With that, I yield now to the gentlelady of New York.

Mrs. MALONEY. Thank you everyone for your testimony.

I would like to ask Mr. Konczal and Mr. Carfang a question and get both of your perspective on it. I was, quite frankly, struck by the decline of money—municipal money market funds in New York, the city that I represent. But my office is telling me they called the city and they don't see this as a big problem, which is hard for me to understand. If you have a 50-percent decline, that is a pretty serious thing in my mind.

So I would like to say that, obviously, we have seen investors pull out a substantial amount of money from the money market funds this year, and some claim that this is all due to the floating NAV requirement in the SEC's rule, but the bill only deals with the floating NAV. But some of the investors that I have talked to say that the bigger problem is the gates and fees aspect of this SEC rule, which gives funds the ability to suspend withdrawals in times of stress. Many people use their money market fund as a liquidity access point, and they don't like the point that they may not be able to pull their money out so that is why they are pulling it out.

So I would like to ask both of you: Do you think that, if we did away with just the floating NAV requirement, that that would cause investors to put all their money back into the money market funds, or are the gates and fees the bigger problem here?

Mr. TOOMEY. You make an excellent point: gates and fees as well as the floating NAVs are all problems. I have testified to that in the past. The floating NAV is the threshold issue, however, because NAVs started to float beginning October 14. Corporate treasurers would have needed to change their investment policies, get board approval, implement systems, change their tax reporting. That was the threshold issue that caused the problem. Gates and fees are clearly a longer run problem. In a black swan event, the possibility of a gate clearly is a problem. We think that, if we can change that threshold issue on the FNAV for non-natural persons, that can begin the process of at least bank sweep accounts going back into money market funds as well as institutional investors.

Longer term, the Commission itself I believe needs to address the fees and gates issue of that. But we need to get—4216 sends a signal to the Commission that this committee wants to keep money market funds in business, reinstitute the floating NAV, and the Commission itself can deal with the regulatory aspects of fees and gates.

Mrs. MALONEY. Mr. Konczal?

Mr. KONCZAL. A quick point, on the previous question, there is still very little evidence right now of increased bid-ask spreads in the corporate bond market. Research differs on this, but it is important to remember there is a distinction between what is happening right now and what could happen in a crisis. In a crisis, we have already seen $400 billion of institutional prime money market funds flow into Treasurys essentially in a very short period of time, in essentially less than a week. So we know what it looks like already stressed under a fixed NAV market. I do think there are some concerns about removing the floating NAV with keeping the gates and fees. I think there is an additional incentive, increased incentive to run under those conditions.

We should distinguish also between an evolving credit market, where it is going to look a lot more like the stock market, a just-in-time, as people brought up—as the chairman brought up. And, also, we should distinguish between liquidity and Treasury markets, which function a lot more like the stock market at this point with algorithmic training, where you could see some things like a flash crisis, but that has less to do with bid-ask spreads and a lot more to do with just algorithms.

Mrs. MALONEY. Would anyone else like to comment on this question?

Listen, we have a vote. So I have 55 seconds left, but I am going to yield back my time and run to make sure I don't miss my vote.

Thank you all for your testimony. I will be back.

Chairman GARRETT. The gentlelady yields back.

We do have a minute left—or we have 45 seconds left in our vote, so we will call recess for this committee and reconvene immediately after the floor votes.

The committee is in recess.

[recess]

Chairman GARRETT. Thank you, gentlemen.

The meeting is called back into order, and the gentlelady from Missouri is recognized for 5 minutes.

Mrs. WAGNER. Thank you very, very much, Mr. Chairman. And thank everyone for appearing today to discuss the impact of Dodd-Frank regulations as well as actions by FSOC and the Basel Committee have had on short-term financing and the U.S. capital markets.

As Mr. Deas noted in his testimony, "liquidity is the lifeblood of any business," and that, as I go on, "Without having ample liquidity, production comes to a halt, inventories run low, and bills are not paid on time." I appreciate those words.

Treasury Secretary Lew has continually refused to acknowledge the possibility that regulations such as the Volcker rule as well as other post-crisis regulations are contributing to illiquidity in certain segments of the fixed income markets. However, other government officials, including Federal Reserve Board of Governors, had acknowledged that these regulations may in fact be a factor.

Mr. Deas, do you believe that Dodd-Frank, Basel III, and other regulations, are a contributing cause of diminished fixed income liquidity?

Mr. DEAS. Congresswoman, yes, I certainly—it certainly is the case that when $1 trillion has flowed out of prime money market funds, which went from a position of buying 40 percent of manufacturing and other nonfinancial companies' commercial paper in April of 2012, to now at the end of November, only 5 percent of their commercial paper, and that source has dried up, that has been a direct result of these changes. And it has increased the cost. For instance, the cost of prime money fund, the yield that they are paying now is 22 basis points higher than equivalent government money market funds for the same maturity, for 1-week maturity.

Mrs. WAGNER. Twenty-two basis points higher.

Mr. DEAS. Yes, ma'am.

Mrs. WAGNER. Outrageous. What are the real world consequences besides that of reduced liquidity in the corporate bond markets for U.S. companies, their employees, and individuals that are saving for retirement, to send their kids to college?

Mr. DEAS. Well, we have all supported the goal of greater price transparency. And when there is no liquidity in the corporate bond market, then when an industrial company comes to the market to issue its bonds, it doesn't know, nor do its underwriters know, what is the right price. And in order to assure that they get the issue off successfully and there isn't an embarrassing withdrawal of the issue from the market, they may well overprice it. And so they will price it to clear the market.

And sometimes you get the effect of selling your house and the real estate agent tells you they have sold it in 1 day, you may wonder how that was priced, and that is what happens in the corporate bond market. And that is a burden that you have to pay for the remaining 10 years or 30 years of the corporate bond issue.

Mrs. WAGNER. Good analogy. What resources is the SEC or FSOC devoting to understanding or combatting this problem?

Mr. DEAS. Well, we think not enough resources when it comes to analyzing the effect through a cumulative impact study of the interaction of all these forces. In some cases, they have analyzed the individual effects, but there is a cumulative effect and an interaction, as I demonstrated in my comments on how money funds relate to commercial paper borrowing costs for companies. And they haven't studied that. And we think it would be important for this committee and for Congress to mandate that these regulators conduct such a study.

Mrs. WAGNER. Thank you. And in my limited time, the EU recently undertook a call for evidence to analyze the cumulative impact of post-crisis financial regulations to identify areas where they have interacted in ways harmful to economic growth. In your testimony, you noted several times the need to study the effects of all of these rules and their interactions with one another. Do you think a similar initiative as the EU's call for evidence would be valuable here in the U.S. as we transition into a new administration, sir?

Mr. DEAS. Yes. I think it very much would be, as well—I mean, in the European community, they have specifically exempted end users. They have recognized that end users' participation in these markets is for productive purposes, that they are not engaged in speculative activity. And so the burden that would be placed on a trader maintaining an open book for financial speculative purposes should not be placed on end users. And we have been much less consistent in the implementation of that philosophy here. So studying the actual costs would be what we would highly recommend.

Mrs. WAGNER. Absolutely. Thank you for your testimony, for your presence here today.

Mr. Chairman, thank you. I yield back. And I thank you for my time serving with you on this committee.

Chairman GARRETT. I thank you. Thank the gentlelady.

Mr. Carney.

Oh, I am sorry. Mr. Scott.

Mr. SCOTT. Thank you. Thank you.

Panel, I was very seriously concerned about the health of the market for money market funds, when, as you know, during the financial crisis we saw funds breaking the buck. And I think you know what I am talking about there. Sort of money market funds seek to maintain a stable net asset value, or called NAV, so that each share in the fund is worth one dollar. But during a catastrophic event like the financial crisis, when shareholders in the fund all redeemed very quickly, the fund's NAV can drop below one dollar, which is why they call it breaking the buck.

Now, recently the FSOC took notice of this and the Securities and Exchange Commission adopted the floating NAV rule, applying it to non-retail investors and tax-exempt funds. The theory was that those funds mostly catered to the retail investor and the impact would be minimal. But it is my understanding, however, that the impact has been anything but stable. And what we are seeing today is that tax-exempt funds have been very negatively impacted, regardless of whether those funds are serving retail or institutional investors.

So I would like to ask the panel, if you all would respond and comment on whether you think that the Securities and Exchange Commission did a sufficient job at understanding the impact of this rule and the impact it might have on the market, or if there are other factors outside of the Securities and Exchange rule that may be contributing to rising short-term borrowing costs.

Mr. CARFANG. Thank you, sir.

Mr. SCOTT. You're welcome. Mr. Carfang.

Mr. CARFANG. I don't think anyone, including the Securities and Exchange Commission, imagined that $1.2 trillion was going to leave. I think that exceeds everyone's wildest worst-case scenario. And in that regard, you know, I think it is important to step back and understand what factors took place.

In my testimony, when I talk about rates rising, I am looking at spreads. So the Fed rate hike, for example, last December impacted the markets. But what—if you look at the spread of LIBOR, which is the basic business borrowing costs over treasuries, that spread has widened. Market rate changes impact both of those identically. So we are actually seeing evidence of about a 25 or 30 basis point increase in borrowing costs over and above what the Fed rate changes have done.

Mr. SCOTT. Okay.

Mr. KONCZAL. I would—

Mr. SCOTT. Yes, Mr. Konczal.

Mr. KONCZAL. I would just like to—like us to remember that the SEC came to this decision slowly and carefully. You know, immediately after the crisis, it instituted certain kinds of reserving in liquidity issues to deal with the immediate aftermath. But then in conjunction with FSOC, in conjunction with international regulators, and in conjunction with many studies of the market as a whole, in 2014, only after those many years of study, that it did take this action.

We do want to remember that we are in an environment of general increasing interest rates. You know, Goldman Sachs has predicted, you know, large deficits in the near future and which will obviously lead to a more quicker than normal normalization of Federal Reserve policy. So it is very difficult to disjoint what has happened in the past month from the broader macroeconomic condition, which has certainly changed. But, you know, SEC came to this decision very slowly and carefully after considering whether its initial actions were sufficient and broad agreement through FSOC that it was not.

Mr. SCOTT. Do any of you feel, as some suggest, that the investors are overreacting in pulling their short-term cash out of money market funds that do not offer a stable NAV? That suggests that once investors understand floating NAV funds better, they will flock back in. Do you agree with this?

Mr. DEAS. Congressman, we—the practicalities of this rule change requiring now to keep track of investments in money market funds down to the nearest hundredth of a cent, and to do so for both Federal and State income tax purposes, and to record gains and losses if an investment is made on Tuesday and the company needs to liquidate part of that investment on Thursday to meet its payroll, then that is a recordkeeping burden that we warned the SEC companies are not prepared to fulfill.

And within a company there are—is a competition for resources between departments that are engaged in profit-making activities and those that are engaged in compliance, and profit-making usually wins. So what happened was, money was pulled from these investments requiring this kind of recordkeeping and to the tune of $1.2 trillion.

Mr. SCOTT. That is right. Very good.

Thank you very much, Mr. Chairman.

Chairman GARRETT. The gentleman is out of time.

Mr. Messer.

Mr. SCOTT. Oh, Chairman, I am sorry.

Chairman GARRETT. Yes, sir.

Mr. SCOTT. Thank you, Tanner.

I would like to ask unanimous consent to include this letter to Ms. Moore in the record.

Chairman GARRETT. Without objection, it is so ordered.

Mr. MESSER. I would like to follow up on those questions. And I am going to start with Mr. Deas. You know, we often talk about it here in this committee. But in life and in public service, we are not just accountable for our intentions, we are also accountable for our results. And that's actually—if you ask the American people, the results matter a lot more than our intentions. Sometimes things done with the best of intentions can end up with results that are maybe unintended but catastrophic.

And following up on the money market reform debate we were just having, the floating net asset value rule, I just want to ask you a very direct question, again to Mr. Deas, do you think the economic benefit of the rule is worth the cost?

Mr. DEAS. Sir, thank you for that question. I think, just to reiterate what my colleague Tony Carfang has said, we have measured the cost. So it is upwards of 25 or so—20 to 25 or 30 basis points in higher cost. We view, from the point of view of manufacturing company treasurers, that the financial system is a mere intermediary getting the money from where it is generated to where we need it. And that is an extra burden that we now have to cut some other costs or decrease employment in order to overcome.

Mr. MESSER. I think that the answer is no, you don't think it is worth the cost.

Mr. DEAS. Yes, sir. I agree.

Mr. MESSER. Mr. Carfang, I don't know if you want to add anything to that.

Mr. CARFANG. Well, and the increased cost that is 25 or 30 basis points is against $10 trillion of debt keyed off of the LIBOR rate. So we are talking about an increase of $30 billion of cost. And, you know, companies like FMC where Tom was treasurer, you know, aren't even going to consider that and obviously exit.

Mr. MESSER. Mr. Carfang, I wanted to follow up with you and ask this question: Do you believe—you talked about this imbalance. Do you think it is going to get worse in the coming months or better?

Mr. CARFANG. Well, it looks like the decline out of prime funds has stabilized. But as one of my colleagues told me, you know, falling off a cliff and hitting a rock and calling your fall stabilized is not necessarily what you want to—

Mr. MESSER. That's not a laughing matter, but, I mean—

Mr. CARFANG. No, it is not happy. I don't think it can turn around until we get relief on the fluctuating net asset value short term and then fees engaged in—

Mr. MESSER. And once again, I think the followup is fairly common sense but still would ask you to articulate, could you expand on—I mean, what is the answer here? What do we need to do in response to this trillion dollar drop?

Mr. CARFANG. Well, I think, first of all, you know H.R. 4216 will restore the floating NAV for non-natural persons. And that sends a message to the commission that Congress really wants to protect and defend the money market fund as a primary investment vehicle, as it has been for 40 years and several trillions of dollars.

Getting the fluctuating NAV fixed for non-natural persons will remove the administrative barriers to corporate treasurers investing in these funds. It will also allow banks who sweep into money market funds, and by definition then must sweep into a constant net asset value fund, to pull some of their assets back in, as well as Roth management groups and brokers who sweep on behalf of both retail and corporate clients. So that begins to open the door for some of the money to come back. And then that would allow the commission, then, to go back and alter the fees and gates part of this.

Mr. MESSER. Thanks.

Mr. Deas, you look like you might have something to add. No?

Mr. DEAS. No, sir.

Mr. MESSER. Okay. Great.

With that, I yield back the balance of my time, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

The gentleman is recognized, Mr. Carney.

Mr. CARNEY. Thank you, Mr. Chairman. Let's just continue this conversation, if we may. And I would like someone, maybe you, Mr. Konczal, to remind us why we got to the point of considering a floating NAV and what the issue there was and—so we can evaluate the action that has been taken and the costs that you question in terms of 20, 25 basis points. Could you remind us of how we got to this point?

Mr. KONCZAL. Absolutely. The cost of the financial crisis, for instance, from the Federal Reserve Bank of Dallas, is about 10 or $15 trillion. So money market—

Mr. CARNEY. That is a little bit higher than what we have been talking about in terms of the effect of this move, which you would argue is, in part, just a movement of interest rates on the way up kind of naturally.

Mr. KONCZAL. Absolutely. And if money market funds contributed 3 percent of that crisis, which I think would be a low estimate, suddenly you are talking about a really big wave of cost-benefit analysis.

Mr. CARNEY. And what was the issue there with respect to the money markets and how they performed or didn't perform, the concerns that were raised vis--vis the breaking the buck, if you will?

Mr. KONCZAL. Absolutely. So as economists across the spectrum have agreed, that the way money market funds were legislated and regulated as fixed NAVs is indistinguishable from bank deposits. So it encourages runs, encourages first mover advantage to remove those funds, and it—

Mr. CARNEY. Is that actually true, though? Does that actually happen? Do we have the kind of runs that were—that were theorized? Does the data suggest that?

Mr. KONCZAL. Absolutely. We saw $400 billion leave money market funds to go to treasuries, a safe asset, within—within weeks in the aftermath of the Lehman Brothers failure. The failure of Lehman caused the Reserve fund bank to break the buck. But the contagion was not limited to money market funds with exposure to Lehman. I think that is very important to remember. If it was an issue of just due diligence against the credit risk of one firm, we would have a different conversation. But the panic that spread across the funds as a whole led to a complete contraction, a complete collapse of commercial paper in a way far beyond anything we are talking about at the margins here.

You know, there has been an express—expressed interest of Congress to avoid future bailouts. And I believe that floating NAV provides a market-based transparency and a market-based price for what the actual risk of these investments are when treasurers in other companies take them on.

Mr. CARNEY. What about the point, I think a good one, that there ought to be some analysis of the effect of these regulations and how they interact with one another in decision-making? Do you think that has been done effectively or does there need to be more done there?

Mr. KONCZAL. I can't comment to the extent that there needs to be a formal review. But I would say that it is by—the capital requirements that we are discussing separately here, leverage ratio, risk-weighted assets, LCR liquidity, and TLAC, are designed to work together. They complement each other in very powerful and important ways, where risk weighting—

Mr. CARNEY. Do they also provide more of a burden, if you will, a regulatory burden?

Mr. KONCZAL. I don't know if—

Mr. CARNEY. In combination as opposed to on their own.

Mr. KONCZAL. No. I believe together they actually amplify and make each other work better from a systemic risk point of view. For instance, we know risk-weighting assets are pro-cyclical. They—you know, they are less binding and less—less important in times of credit booms and credit expansions, where leverage requirements are not. You know, if you have the safest assets but you are funded overnight, if there is a little bit of a problem, you can suddenly end up in big trouble if you don't have the liquidity needed to survive 2 months—or to survive 1 month as per the Bear Stearns rule. So I feel we want to—we do want to understand them as overlapping in a good way because they were designed to do that.

Mr. CARNEY. So what about the argument that, again sounds compelling to me, that there is a significant administrative burden, you know, in terms of keeping track of this and that, that otherwise those resources could be used for something else in a firm?

Mr. KONCZAL. And, you know, there perhaps is low-hanging fruit—

Mr. CARNEY. I mean, is there a better way to do it, I guess, is ultimately the question.

Mr. KONCZAL. The issue of tax law I can't speak to. I know the IRS has worked with the SEC and they can talk more. But the actual issue of the floating NAV, I think, is the crucial component, and it is what really defines the market-based pricing of these things. And it prevents the runs and dynamics that we saw in the crisis and we absolutely must prevent in future crises.

Mr. CARNEY. I don't have much time left, but, Mr. Deas, do you—you obviously have a different view of that. What would you highlight as the difference—the important differences?

Mr. DEAS. Yes, sir. Just on the last point you made, the Treasury Department—or my colleague made, the Treasury Department did come out with rules to simplify the tax recordkeeping. The effect of those rules is to force a corporate treasurer to invest all the company's money in a single money market fund which increases concentration and creates much higher systemic risk.

Mr. CARNEY. So you think there—there is a better way to accomplish the same thing?

Mr. DEAS. Well, a fixed NAV would do that.

Mr. CARNEY. Well—

Mr. DEAS. And it would be offset by greater reporting, visibility, transparency of what the fund's holdings are so that investors can look at that on a daily basis and make their own choices. Some of these were instituted in 2010 reforms, and we think that sunshine is the best medicine.

Mr. CARNEY. So with the chairman's indulgence, so assuming a floating NAV. Right? So is there a better way to do that or is this the best way to do it, in your view? I mean, I understand you would go back to a fixed NAV. But I am talking about given a floating NAV, are there things that can be done to make it less administratively burdensome?

Mr. DEAS. Well, the reality is with corporate systems and cash management systems, it takes literally months to modify those systems to keep track down to the nearest hundredth of a cent of investing the company's funds at a floating NAV. And when we are asked is there an alternative to spending this money for information technology changes, the answer is, well, yes. I can buy a government money market fund. And enough yes answers were made so that $1 trillion left. And that money is not available for productive purposes. It is available to funds government entities being financed through these government money market funds.

Mr. CARNEY. I tell you, I am sympathetic to the argument with respect to administrative costs. You know, the question gets to be, you know, what are the tradeoffs, you know. And I think it is every—it should be everybody's objective to keep your borrowing costs as low as possible so that you can keep people working. And that is what is really most important to me and I know my colleagues on both sides of the aisle. And it would be nice if we could kind of work together and find the best way to do that, to address some of the issues and concerns that came out of the financial crisis and move forward in a way that is productive for job creation and administratively not as burdensome for firms that create those jobs.

Thank you, Mr. Chairman, for your indulgence. I yield back.

Chairman GARRETT. That was a good question. Good questions.

The gentleman from Pennsylvania, recognized for maybe the last word.

Mr. ROTHFUS. Mr. Chairman, I thank you for holding this hearing and I thank you for giving me the opportunity to join the committee just for the day to ask some questions. And I also want to thank you for your service and your friendship on the committee, your friendship to us. And you will be sorely missed.

I am glad we are having this hearing because I have become concerned about the significant dislocation that we are seeing as a result of the regulatory changes that went into effect in October. This rule which forces institutional prime and tax-exempt money market funds to have floating NAVs has effectively nationalized the money market industry. One point two trillion dollars has left institutional prime and tax-exempt funds, and much of it has migrated to government funds and treasuries. The rule thwarts investor preference and effectively, in my opinion, subsidizes Fannie and Freddie and the Federal Government. Municipalities, universities, hospitals, and corporations are seeing their borrowing costs go up, and we can trace this directly to the dislocation caused by this rule.

That is why I am a strong supporter of H.R. 4216 which corrects this problem. I understand the concerns that some members of this committee have raised, but in addition to the fact that money market funds are historically very secure investments, this bill makes clear that taxpayers will not be on the hook to bail out a failing fund. There is an express prohibition on that.

Mr. Carfang, as you know, I asked Treasury Secretary Jack Lew about this issue at a full committee hearing in September. His response surprised me. At that point, nearly $1 trillion had moved in anticipation of the rule's implementation, yet Secretary Lew said that we were, "not seeing dislocations in the marketplace on a broad basis." He went on to add that, "We are not seeing problems arising in the market where funding needs can't be met."

I am wondering if you could respond to Secretary Lew's comments.

Mr. CARFANG. Well, I would be concerned if he did see a dislocation that—this change had been telegraphed for 2 years, and the Treasury itself announced it was watching and stood ready for greater debt issuance if the markets needed the Fed to—the Treasury to step in.

These dislocations are real. Companies are paying higher interest rates. Municipalities are losing funding from tax-exempt funds and having to turn to other—

Mr. ROTHFUS. When he says funding needs can't be met, I mean, is that necessarily the question? I mean, that is one of the questions. But there is also a cost associated with that.

Mr. CARFANG. Well, sure.

Mr. ROTHFUS. You might—

Mr. CARFANG. But there are funds available in the market but at a cost. I can go to my father-in-law to borrow money, but I certainly wouldn't want to do that at his price. You know, I would rather borrow from, you know—you know, corporate treasurers need to borrow from the most deep and efficient markets, like the commercial paper market and the bank markets.

Mr. ROTHFUS. In looking at the municipal context where I think you testified that assets and taxable funds and prime funds have fallen—well, let's look at tax-exempt—fallen roughly by half.

Mr. CARFANG. Right.

Mr. ROTHFUS. This is funding used by municipalities, schools, hospitals. It stands to reason that this rule is to blame for driving some of the money out of these assets. Yes?

Mr. CARFANG. That is correct. Well, as a matter of fact, the fluctuating NAV and the non-natural person restriction almost makes it impossible for a bank trust department to now invest in a tax-exempt fund. Because a bank trust department has no way of seeing down through into the natural person/non-natural person question.

Mr. ROTHFUS. But a natural person still gets to invest in a fixed—a natural person would still be able to invest in a fixed.

Mr. CARFANG. Well, except a natural person and non-natural person is kind of a fiction. You know, it gets down to the question of who is making the investment decision deep down inside of an omnibus account. And the banks simply have no way of knowing that.

Mr. ROTHFUS. If I could quickly go to Mr. Deas. In your testimony you wrote that the SEC's rules raises heightened concerns about money market funds' liquidity, stability, and overall utility. Can you elaborate a little bit more on the systemic risks that you see as a result of the rule?

Mr. DEAS. Yes, sir. We have focused on the amount of money that is left, and we pointed out to the SEC several times that when you change the rules affecting this investment vehicle known as money market funds, remember that it also has been a significant source of financing for Main Street companies. And we have seen the amount of non-financial commercial paper that money funds buy decline from 40 percent in April of 2012 to just 5 percent at the end of last month. And that supply/demand imbalance has resulted in higher costs for Main Street companies. And when we get into a time of heightened financial crisis, then it will dry up, because money funds not only have their amounts gone down, but the actual number of funds has declined from 600 funds to 400 funds. So it is not going to be there and it will become more evident when we get into strained conditions.

Mr. ROTHFUS. Mr. Chairman, I see my time has expired. If I could offer to the record a letter from the State Financial Officers dated December 1st to Speaker Ryan, and from the Coalition for Investor Choice to you and to the ranking member.

Chairman GARRETT. Without objection, it is so ordered.

And your last word apparently sparked other interest. And so now we turn to the gentleman from California. And Ed is recognized for 5.

Mr. ROYCE. Well, Mr. Chairman, thank you. Thank you very much. And I thank the witnesses on the panel for being with us today.

So we are home to capital markets that are unmatched in terms of the size of our markets, the transparency in it, the depth, the resiliency, as we have seen. And they provide, really, the fuel that keep the largest economy in the world moving and allow for investment and development and ultimately allow for job growth. Because at the end of the day, wages per worker are dependent upon productivity per worker. That is dependent upon investment per worker, and that is dependent upon the capital markets and getting everybody into the capital markets. So it is interesting.

The European Commission recently engaged in what they called a call for evidence. And that was a request that the—to the public for feedback on interactions, inconsistencies, and gaps, and unintended consequences created by Europe's regulatory framework, created by their bureaucracy. And I was going to ask should, and maybe of Mr. Toomey, should U.S. regulators engage in a similar project as the EU's call for evidence and maybe ask what the benefits would be of such an undertaking?

Mr. TOOMEY. Yes. Thank you. And I think as we mentioned in our opening remarks, European Commission effort and the call for evidence provides a framework for doing this cumulative analysis on the effects of all these different and overlapping regulations. And we think particularly the parameters that the European Commission outlined, the impact on economic growth, we think is key. Obviously, the interactions and the inconsistencies is key to understand. And I think the ultimate output from a domestic standpoint is understanding how all these dispirit rules attacking and addressing different types risks, whether they are overshooting their policy goals to the detriment ultimately of the economy.

So I think, basically, when we look at the European Commission effort, the parameters they outline are very similar to what we believe should be done. And now is a good time to do it, given that the rules have been in place for some time. At least some of them have.

Mr. ROYCE. Well, I would also ask Mr. Deas, on the testimony that you submitted focused on the impact of bank capital and liquidity rules on end users and on corporate treasurers. This argument, less liquidity, can mean production comes to a halt. Less liquidity means often that the inventories run low, that the payroll isn't made on time. All of which, of course, harm the people that rely upon these businesses and harm the economy. And I would just ask what could we do in Congress here to address exactly these concerns.

Mr. DEAS. Congressman, thank you very much for that question. I would say that for you to mandate that the banking regulators undertake an analysis of both the individual effects but equally as important the cumulative effects based on their interactions of these different rules as they affect Main Street companies. We made the point and got bipartisan agreement that, for instance, requiring end users to margin their derivative positions with cash, which was a direct dollar-for-dollar diversion from funds that would otherwise be invested to grow inventory, to conduct research and development, to buy new plant and equipment, and otherwise to sustain and we hope grow jobs, was something that should be done. And in this Congress that was done.

But the banking regulators have taken steps that put that capital burden instead on the banks, I think, without fully appreciating that, in the end, they are intermediaries and we bear—we the end users and the manufacturing companies of this country bear those costs.

Mr. ROYCE. You know, our chairman of this committee has a firm grasp on history as well as economics. And I would just, Mr. Chairman, quote Aristotle on this, "Balance in all things that are unbalanced." And my fear here is that we have tipped the scales too much towards bureaucracy. Collective action really is needed at this point, because at the end of the day, bureaucracy can't take all risk and regulate it out of the market. And the facts are that we have to keep our eye on the main function of the market and drive that job growth.

But with that I will yield. And I thank you, Mr. Chairman, for your good leadership of this subcommittee.

Chairman GARRETT. And I thank the gentleman from California.

Moving up north to—oop. The gentleman from California has arrived. Then we shall—the gentleman from Maine.

Mr. POLIQUIN. Thank you, Mr. Chairman, very much. Those of us that—or those of you who are here today probably don't know that with the chairman's moving on, he will be spending more time in the great State of Maine that I represent. And I would like to make it public that, Mr. Chairman, you would be so welcomed up in Maine with your family. You have no idea. Just bring as much money as you can. We need the business. And February is a wonderful time go to Maine, Mr. Chairman. And I know you know that.

With that, you know, I am scratching my head here a little bit, folks. Here we have a product, money market fund product, that has been around for decades. And it has been used very effectively by not only individual investors but by institutional investors to manage their cash, to make sure that there is a way to finance expansion. And, of course, when businesses grow, they hire more people and they pay them more money.

I was a State treasurer for a couple years up in Maine. And we used money market funds effectively, different types of funds, to manage our cash such that we could build a new sewage treatment plant in Auburn or a new bridge over the Penobscot River in Bangor, for example. So there are all kinds of opportunities to use this product. Now, all of a sudden, you know, government comes along and we have a new regulation and we see money flying from this product that has worked for decades well. We see players leaving the space. We see costs going up. And there is less liquidity in the market and less opportunity to grow our economy and do what we want and have more opportunity and more jobs for our kids.

So my question is, Mr. Toomey, to you, please, my first question, is one of the concerns the SEC has and others have in this—that have been dealing with this issue is a run on the bank, accelerated redemptions. And do you have any evidence or do the folks that you work with have any evidence that this new rule dealing with market to market or floating NAV or whatever you want to call it would have an impact in slowing down or stopping accelerated redemptions at a tough time?

Mr. TOOMEY. I am actually not the best person in my shop to answer that question. But we can get back to you on that one.

Mr. POLIQUIN. Thank you.

Anybody else on the panel like to take a shot at that?

Mr. CARFANG. Well—

Mr. POLIQUIN. Mr. Carfang, you look like you are ready to say something.

Mr. CARFANG. Well, sure. It will not stop a run. And, in fact, if you go back and look at what happened during the financial crisis, while the reserve fund broke a buck and investors fled, i.e., a run, that was on the Monday morning that Lehman went bankrupt. The run didn't spread until it hit the entire capital market on the Wednesday, which was after the Federal Reserve announced a bailout of AIG. It wasn't the reserve fund that spread to other prime funds. It was when the entire market collapsed.

Mr. POLIQUIN. So what I am hearing you say, sir, is that market conditions, whether it be economic or capital market conditions, really determine investor behavior.

Mr. CARFANG. Exactly.

Mr. POLIQUIN. Okay.

Mr. KONCZAL. I would like to also respond to that, Congressman.

Mr. POLIQUIN. Please.

Mr. KONCZAL. To the historical stability of the money market fund, that it is worth noting that there has been over 200 capital injections by sponsor funds going back to the early 1980s. These sponsor capital injections are, basically, the only way to handle a lot of the failures of these and—of these funds. And crucially, they are ad hoc and they are opaque to investors. So they are not even sure when they happen. You know, they can't be anticipated in the way that it happens.

And so, you know, if you want to talk about reducing bureaucracy of these kinds of things, market pricing strikes me as the best way to ensure that these funds are properly matched to investors' expectations and to also decrease the possibility of a bailout.

Mr. POLIQUIN. Mr. Konczal, let's stick with you, if you don't mind, and ask my final question in the time I have remaining here. We have a change in administration that is underway now. It will be effective as of noontime on January 20. Presumably, there will be a couple new commissioners on the SEC and Chair White is moving on at the end of the current administration. Doesn't it make sense to you that we let the new SEC commissioners deal with this issue?

Mr. KONCZAL. Well, the SEC has already dealt with this issue in 2014 through a very long process of international coordination, coordination with FSOC and other regulators. There is an important reason they put this in. They were initially reluctant to do it, and they had to think about it and do a significant amount of analysis to do it. So it was not entered into lightly and it was not entered into carelessly. I feel it really does reflect something that went wrong in the crisis that is widely acknowledged to have gone wrong in the crisis. And if this is not the appropriate regulation, going back to the regulatory environment of 2007 strikes me as a step backwards, not a step forward.

Mr. POLIQUIN. Mr. Deas, would you like to comment on that with respect to the new administration coming in and how they will be populating the SEC?

Mr. DEAS. Yes, sir. I think it should be undertaken along the lines of this cumulative impact study that I mentioned. And we have always said that sunshine is the best medicine.

Prior to the financial crisis, money market funds did not report their underlying holdings except on a very infrequent basis. I think it was every 60 days and—or with a delay. And one of the improvements that the SEC has made is more frequent reporting of even daily positions. And we think this provides market participants enough information that they can make their own decisions when to trade out of a fund that is becoming more risky based on their analysis of that underlying data.

Mr. POLIQUIN. Thank you all very much.

Mr. Chairman, again, I salute you, congratulate you, and I thank you for your service to the great State of New Jersey, and to our country. Thank you, sir.

Chairman GARRETT. And I will see you in February.

The gentleman from California. Actually, I may be in California in February. That sounds like a better place to be.

Mr. SHERMAN. That was my point. If the gentleman from Maine is going to convince you that that is the place you want to be in February, you are more gullible than I previously thought.

Chairman GARRETT. The gentleman is recognized.

Mr. SHERMAN. Shadow banking is an interesting phrase. Can't imagine anybody being in favor of shadow banking. We want transparency and light. Shadow banking sounds dangerous. Is this term accurate? Where does it derive from? And is there a less pejorative term that would be more accurate? I will ask the gentleman from the Roosevelt Institute.

Mr. KONCZAL. I will give you a little bit of a history. It comes out of analysis of the crisis by PIMCO and other—particularly on the bond side. The economist Gary Gorton wrote several books about it in 2009, 2010.

Mr. SHERMAN. Well, if I was going to sell a book, I would want something hard hitting like Shadow Banking or the Monsters of Shadow Banking, the Vampires of Shadow Banking. But is this an accurate—

Mr. KONCZAL. Like so many things in finance, it is tough to find a catchy term for it. But it is absolutely accurate. It refers to banking activities that occur outside the formal prudential banking activity. Credit lending through things that have redemption at par. And as such, you know, it is—evolves out of the capital markets historically. But basically, securities industries and—

Mr. SHERMAN. You are saying it is limited to those circumstances where you are not going to a regulated depository institution but you expect to redeem at par.

Mr. KONCZAL. Exactly. And I don't want to say there is no regulations because, you know, for instance—

Mr. SHERMAN. It is not a regulated depository institution.

Mr. KONCZAL. Absolutely. And does not have contacts for deposit insurance or other kinds of insurance, prevent runs, and it doesn't have lender of last resort access. Those aren't necessarily the right tools to deal with things like shadow banking. But it gives you a sense of how it has emerged in a way that creates systemic risk, creates panics and contagion, but doesn't have the tools around it to help prevent the systemic risk.

Mr. SHERMAN. Now, investors want to redeem at par. But, in fact, they are the owners of shares in a mutual fund where assets may be worth slightly more or might be slightly less. Now, one way to deal with this is to simply disguise this and tell people that their shares are always worth a dollar when, in fact, they are worth a mil more or a mil less.

Another way for the private market to deal with this is some sort of insurance where a private sector entity, instead of disguising the fact that your investment may be worth less than par, would come in and guarantee that your investment would be less than par—would be worth full par in return for a premium that might take away from investors some of the up side when their investment is worth more than par.

Why do we need to tell investors it is worth par when it isn't instead of having a private sector insurance so that it really is worth par? I will go to—I don't know which of you would like to respond.

Mr. Carfang.

Mr. CARFANG. Sure. Daily liquidity is the fundamental cash management need of corporations. And money market mutual funds have provided that since their institution over 40 years ago and—

Mr. SHERMAN. I get daily liquidity on my S&P 500 fund too. But it may not be minute liquidity, but it is daily liquidity. But nobody is going to tell me that it is worth par.

Mr. CARFANG. But what you have are ultra short investments in the funds that can be amortized to maturity and actually provide that daily liquidity of par. And, you know, this is the same way that Treasury and government funds operate. So, you know, this whole argument about separating out the private—the funds that deal with the private sector and municipalities from government funds, well, government funds operate under the same accounting rules as well. So it seems to me that that is a red herring and—

Mr. SHERMAN. That may be a red herring, but it is not relevant to the question I asked. Why have mutual funds that cater to investors who want to make sure they get absolute par to the last mil, why have they not simply acquired insurance so that their assets are never less—worth less than par? Mr. Konczal. Oh, Mr. Deas, then—

Mr. DEAS. Yes, sir. Well, I think in the declared policy of zero interest rates, which we have lifted off from very gradually, the cost of the insurance compared to the margin that is available after all the other expenses to pay for that insurance is just not going to be there. And so the—

Mr. SHERMAN. Well, you do also have the up side. I mean, the—

Mr. DEAS. But the cure will—

Mr. SHERMAN. Just as likely to be worth a mil more than a mil less than par.

Mr. DEAS. But the cure will kill the patient. And the patient is already $1 trillion in worse shape than when this effort started, however well intentioned. And I agree that it would have the beneficial effect that you say, but I am questioning the cost versus that benefit.

Mr. SHERMAN. So our way to assure people of par is just tell them it is worth par whether it is or not—

Mr. DEAS. No, sir. What I have testified to is that to provide them with greater information, with daily information, and that sunshine is the best medicine. And corporate treasurers are paid every day to protect the company's funds and will look at that information and make a wise decision on behalf of their shareholders.

Mr. SHERMAN. I believe my time has expired.

Chairman GARRETT. Mr. Hultgren is recognized for perhaps the last word.

Mr. HULTGREN. Thank you, Mr. Chairman. And, again, I just want to thank you so much for your service, Chairman Garrett. You have been such a help to me and so many others. I just want to let you know that I appreciate you. I appreciate your family so much, and wish you all the best. And I am, again, just very grateful for your friendship and your mentoring to folks like me. So thank you so much. And, again, all the best to you.

Thank you to our witnesses. Grateful that you are here.

Mr. Carfang, I want to address my at least initial questions to you if I may. On page 7 of your testimony, you stated, Tax-exempt funds, a key source of funding for municipalities, universities, and hospitals, have experienced a 51 percent, or $132 billion decline from $260 billion to $128 billion. How much of this decline is directly attributable to the SEC's new rules? Do you think there could be other factors in that?

And then continuing on with my questions, some of my constituents have raised concerns that the imposition of a floating NAV is increasing the cost for tax-exempt financing. However, I have also heard that the liquidity fees and redemption gates are a bigger issue. What has your research shown on that?

And then last, during a November hearing before the Financial Services Committee, SEC Chair Mary Jo White noted that the recent movements in the money market fund occurred consistent with their economic analysis. Chair White also testified that she expects that the institutional prime funds will stabilize and see a return of funds sometime after the October effective date. Do you agree with this assessment?

That is a lot of questions. I apologize.

Mr. CARFANG. That was a lot of questions.

Well, the first one is what percent of the decline in tax-exempt funds was due to the SEC regulations? All of it. That is no question about it. Banks had to, for technical reasons, pull out of it because they simply couldn't sweep and they couldn't identify non-natural persons.

Let's see. The second part of your question—

Mr. HULTGREN. Well, it was about some constituents raised concern about imposition of a floating NAV is increasing costs for tax-exempt financing. But also, I have heard that liquidity fees and redemption gates are a bigger issue. What has your research shown on that?

Mr. CARFANG. What we have testified, and we have spoken to the commission as well, that both the floating NAV and the fees and gates are key issues. And that—that should not have been imposed the way they have been. The floating NAV is the threshold issue, though, because there are a number of mechanical and administrative reasons why a number of organizations have to move their money out.

So, you know, with the 4216, that actually informs the SEC that it is the intention of Congress to protect and defend and restore money market funds. That can be an immediate fix. And then the fees and gates, which are an issue, can be dealt with longer term.

Mr. HULTGREN. Okay. Let me ask you quickly here. Do you believe the SEC and other members of FSOC should conduct an analysis and see what systemic risk could be posed by the decrease of liquidity in our bond market? To your knowledge, has the FSOC or any member agency conducted any analysis of the systemic risk that could result from a lack of liquidity in the corporate bond market due to misguided regulatory initiatives like the Volcker rule or Basel III?

Mr. CARFANG. Oh, I—I think the rules what—they dry up liquidity in the market. They depress trading. They reduce dealer inventories. So as a result, there is less price discovery and there is less economic efficiency all the way around. And, you know, a theme I am hearing is that, you know, the investors in these prime funds don't understand the valuation or what is going on in the daily liquidity. Frankly, that is an insult to corporate treasurers all over America. These are sophisticated folks who know exactly what is in these funds and understand the risks and make their judgments based on that.

Mr. HULTGREN. Okay. Thank you.

Quickly in my last minute, Mr. Toomey, you note in your testimony that repo transactions play a vital role within the financial system and underpin the functioning of the capital markets. You further describe the repo market as the grease that allows the U.S. capital markets to remain the most efficient and liquid in the world so that businesses, municipalities, and the Federal Government can access needed credit at a lower cost over time.

There seems to be a great deal of misunderstanding about the repo market by prudential regulators and others. I wonder if you could explain quickly further the importance of the repo market.

Mr. TOOMEY. Thank you. And quickly on the repo market, it indeed—it manages to move securities and cash around the system quickly and safely. In particular, take the example of a market maker. It allows a market maker to both source securities to service its clients, as well as provide a venue for short-term cash that may need to be invested on a short-term basis. So all of that provides grease, lubricant for the overall financial system. Allows liquidity to thrive in the cash markets because cash market participants can always source securities in the repo market. So I think that important piece is sometimes missed, and it really does underlie all our cash markets.

Mr. HULTGREN. Thank you. Thank you all.

Chairman, again, thank you so much. And I yield back.

Chairman GARRETT. The gentleman yields back.

And with that, seeing no other speakers, I guess I will just conclude with two things.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And on a personal note, I guess this is my last hearing, my last speaking and what have you. So I will end—and it is apropos that I come in on a hearing where the hearing topic is the impact of regulations on the economy, which I guess is why I came to—one of the reasons why I came to Washington in the first place, to figure out why we were doing so many regulations in Washington and the negative effect that it has on people back at home.

So it has been an honor to be able to be here in this House of Representatives and to be in this committee, and to be actually a chairman of a subcommittee that is so interesting and so significant to this country. It has been an honor to know all the folks who are on this committee, to both now and have left the committee over the years, that we should remember them as well. It has been an honor to have all the folks behind me and next to me, my committee designee. But a member of our committee, Brian and Kevin, and then all the rest here who have been working with us assigned to the committee over the years have been really—I will say the appropriate word, it has been neat working with all of you, and it is really fun on the sometime very—what some people might say boring issues. But I think the members of this committee find them fascinating and extremely important and profoundly significant to this country.

So I guess I will just say: Wish you all well, as people say to me. As they don't know what I am doing in the future, I don't know what you guys are all going to be doing in the future either. So I wish you well in what is going to be an exciting time for this country where I see in the public opinion polls there is a huge wave of optimism going forward. So I am optimistic for all of you folks as well, both here, behind me, next to me, and in front of me, the people who come and testify before this committee as well. Optimistic for the future, what we can do—what you all can do for the country.

And I am also pleased—and she didn't want me to introduce her or anything else—that my wife Mary Ellen could be with me on this last day as well.

Thank you, and the committee is adjourned. Thank you, and God bless.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

APPENDIX

December 8, 2016

Testimony of Anthony J. Carfang, Managing Director
Treasury Strategies, a division of Novantas, Inc.
December 8, 2016

U.S. House Subcommittee on Capital Markets
and Government-Sponsored Enterprises.

Good morning Chairman Garrett, Ranking Member Maloney, and members of the Committee. It is an honor to be invited to testify at today's hearing: ***The Impact of Regulations on Short-Term Financing***. This is a timely hearing that goes to the heart of the health of the U.S. economy and I am pleased to be able to contribute to the discussion.

I am Anthony J. Carfang, a managing director of Treasury Strategies, a division of Novantas, Inc. We are a leading consultancy in the area of treasury management, banking, payments and liquidity. Our clients include large and medium-sized corporations, and financial institutions as well as state and local governments, hospitals and universities.

I am here today on behalf of the hundreds of businesses, state and local governments and financial institutions to whom we consult.

Overview

Let me first state that Treasury Strategies and our clients fully support well-thought-out efforts to improve economic efficiency and to reduce the likelihood of another systemic failure. We advocate pro-growth measures that stabilize and strengthen the financial system. The regulatory objectives of improving accountability and transparency, reducing systemic risk, ending "too big to fail," protecting consumers and putting an end to taxpayer-funded bailouts are laudable. We applaud you for tackling such important issues.

However, we feel strongly that several recent financial regulations such as Dodd-Frank, Basel III, Money Market Fund regulations and many more, both alone and in concert with each other, have triggered **regulatory and compliance cost burdens** that radiate through the economy. Ultimately, this is choking the U.S. economy and paralyzing American businesses and financial companies that had nothing at all to do with the financial crisis.

It is in this context that I frame my testimony today.

Adverse Impact of Post-Crisis Regulations

The rollouts of Dodd-Frank and its Volcker Rule, Basel III, and Money Fund Regulations are still ongoing. Most are in the midst of a phased implementation, so the full impacts and chain reactions of unintended consequences are only beginning to be felt. Yet we are already seeing a contraction in the availability of financial services and transaction services. Below is a partial listing of dislocations we at Treasury Strategies are already seeing; we learn of new restrictions and prohibitions almost weekly:

- **There are 1,489 fewer banks today** than when Dodd-Frank was passed. U.S. banks have decreased from 6,829 to 5,340 since 2010. The loss of nearly 1,500 commercial banks over six years has numerous consequences, some of which are less consumer and business choice, higher borrowing costs and less access to credit.

- **Only two new banks have been chartered in the six years since 2010.** In the ten years prior to the 2008 crisis, the FDIC averaged 157 new bank charters per year. Going back to the earliest FDIC statistics in 1934, there was never a year in which the FDIC chartered fewer than 15 new commercial banks. That is, until 2010, when it chartered only five and only two since then. Again, this dearth of new banks stifles innovation as well as reduces choice and competition for businesses and consumers.

- SEC regulations that went into effect in October 2016 have crippled the market for private sector and municipal money market mutual funds (MMFs). The regulations contain a number of provisions which make these funds less attractive to investors. The result has been a **$1.1 trillion dollar shift of capital out of the private sector and into government funds**, limiting capital availability and raising borrowing costs for America's businesses and municipalities.

- Basel III is changing the profit and balance sheet dynamics of banks, essentially penalizing deposits. To comply, some banks must **discourage deposits by charging higher fees or paying lower interest.**

- Basel III is also requiring banks to hold a much higher proportion of government securities instead of traditional business loans. Many are **restricting credit to all but the highest quality borrowers**. As a result, many companies and municipalities are faced with higher borrowing costs or unable to borrow at all. The really perverse consequence is that such borrowers go "off the grid" entirely to unregulated or underground lenders.

- Many banks, to comply with Basel III's liquidity plank, are **cutting back on issuing lines of credit** to their customers. Since most companies rely on these backup lines for emergency liquidity, their alternative is simply to hold more idle cash on their balance sheet. That sidelines productive capital and also impairs economic efficiency.

- The combination of the Volcker Rule and increased capital requirements results in financial institutions scaling back their market making activities. This results in wider bid/ask spreads and ultimately less liquidity in the market. There have been sporadic **liquidity black holes in which markets completely freeze up** or prices gyrate wildly such as the U.S. Treasury flash crash. A study by Deutsche Bank estimates that dealers have cut their inventories by as much as 80%.

- The **higher costs of hedging risk** because of the Volcker Rule and other Dodd-Frank provisions are leading some businesses to not hedge at all. This means some businesses no longer have protection from cost gyrations in their supply chain and actually **take on more risk.** All that has been accomplished is to shift risk and made it less visible.

- Virtually all regulations discussed in this testimony require financial institutions and businesses to hold more government securities. These requirements hide under names like "collateral," "high quality liquid assets," "liquidity buffers," "segregated funds," "risk retention" and other euphemisms. The net effect, however, is to **remove productive capital out of the real economy and leave it stranded in government securities**. A recent Treasury Strategies report, Collateral Scarcity: An Approach To Preventing Market Stress From Becoming Contagion, actually warns of a pending collateral shortage that could seriously exacerbate risk in times of financial stress.

Money Market Funds (MMFs)

A significant case in point

Our paper, "Dissecting the Financial Crisis, a Two Year Flight to Quality," dispels the myth that MMFs were a primary culprit in the 2008 financial crisis. We show that a rolling crisis unfolded beginning in 2007 in the real estate and asset backed commercial paper markets. Later that year it spread to the enhanced cash funds market and made its way to the auction rate securities market. Finally, several GSEs required support. In all these cases, assets fled those markets and went into Prime MMFs as the last bastion of safety. On September 15, after the Reserve Primary Fund 'broke the buck', asset outflows were contained. Not until September 17, the morning after the NY Federal Reserve Bank announced its shocking $85 billion rescue AIG, did the panic begin in all financial markets. Even then, Prime MMF assets did not drop below their mid-2007 pre-crisis levels. Rather than a cause of the financial crisis, Prime MMFs were actually a shock absorber. See Attachment A.

In 2010, as part of its overall response to the financial crisis, the SEC successfully enacted liquidity and transparency requirements for money market mutual funds (MMFs). These requirements improved resiliency through several subsequent market stress events such as the European debt crisis and the U.S. debt downgrade of 2011 and the debt-ceiling impasse of 2013.

However, despite this success, the commission went much further and proposed extensive additional rules in 2014 for implementation in October 2016. Unfortunately, some of the additional regulations significantly reduced utility for investors who are not "natural persons" and have crippled Prime and Municipal MMFs.

Under the new regulations, "non-natural persons" such as corporate treasurers and institutional investors are prohibited from investing in Prime or Municipal MMFs that have a stable net asset value. Instead, to receive a stable net asset value, they would have to invest in Government or Treasury funds. That $1 stable net asset value (NAV) has been the primary driver of investor utility since MMF inception over 40 years ago. The "floating" NAV effectively kills the money market fund as a cash management vehicle.

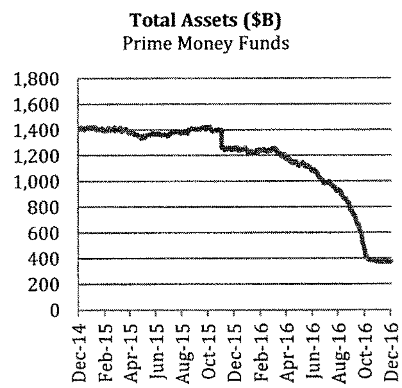
- The new regulations make impractical and non-operational distinctions between "natural persons" and "non-natural persons" which push large investors out of Prime and Municipal MMFs and into Government/Treasury MMFs, thereby taking capital out of the private sector.
- The new regulations impose onerous accounting and recordkeeping activities on *de minimis* daily fluctuations for corporations and institutional investors, but exempt their investments in Government/Treasury MMFs.

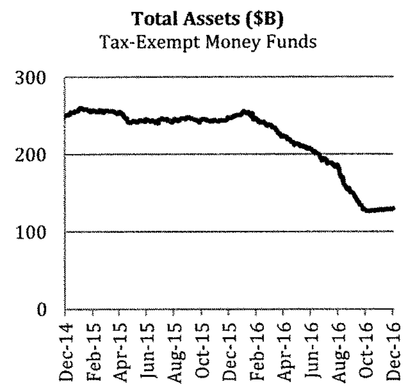
Thus, all investors other than "natural persons" are forced to leave any stable value, dollar per share, Prime or Tax-Exempt money market fund. The resulting exodus is now more $1.1 trillion.

In addition to the floating NAV, the new regulations also stipulate that all Prime and Municipal money funds impose liquidity fees or exit gates under certain high market stress scenarios. These two restrictions also greatly diminish investor utility.

Consider the following Treasury Strategies analysis:

- Prime funds, a key source of funding for corporations and banks, have seen a **74% or $1.04 trillion decline**, since January 2015, from $1.41 trillion to $0.37 trillion on December 1, 2016.
- Tax exempt funds, a key source of funding for municipalities, universities and hospitals, have experienced a **51% or $132 billion decline**, from $260 billion to $128 billion.
- These assets have moved into Government and Treasury money funds, which combined have **grown by $1.16 trillion in assets** since January 2015. This amount is almost identical to the amount that has exited Prime and Tax Exempt funds.





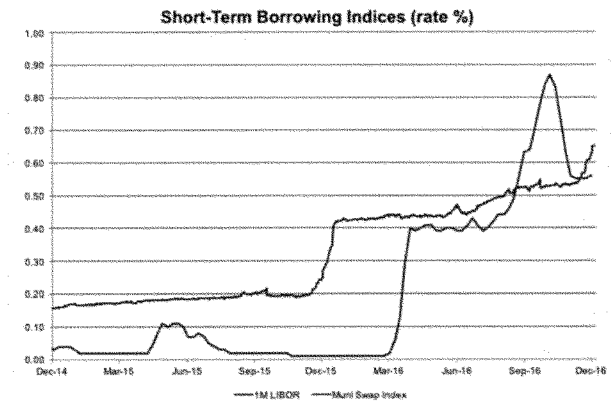
To put that in perspective, the $1.1 trillion that has left the private sector in the past several months is:

- More than the expected increase in **infrastructure spending** now being proposed in Washington
- Much more than the several hundred billion dollars **of overseas U.S. corporate** cash that is targeted for repatriation
- Greater than the entire **TARP** program of 2008
- More than the **stimulus** program of 2009

Simply stated, the new SEC regulations on MMFs have created a drag on the U.S. economy as large as any of the highest profile economic stimulus programs to date. Reversing some elements of these regulations as proposed in the bipartisan H.R.4216, The Consumer Financial Choice and Capital Markets Protection Act, cosponsored by Rep. Gwen Moore (D-WI), Steve Stivers (R-OH), and many others, could have a profound economic impact exceeding all those listed above.

Municipal MMFs and Infrastructure Investments

The problem is particularly acute in the municipal market where MMFs have historically provided 70% - 80% of the short-term funding needs of state and local governments, hospitals, secondary schools and universities. Borrowing costs have skyrocketed as fund assets have been halved. Municipalities recently borrowing at less than 0.05% are now paying ten times as much (0.50%) since the beginning of 2016, even though there have been no Federal Reserve rate increases this year. Alternatives such as bank borrowing, if available, are even more expensive.

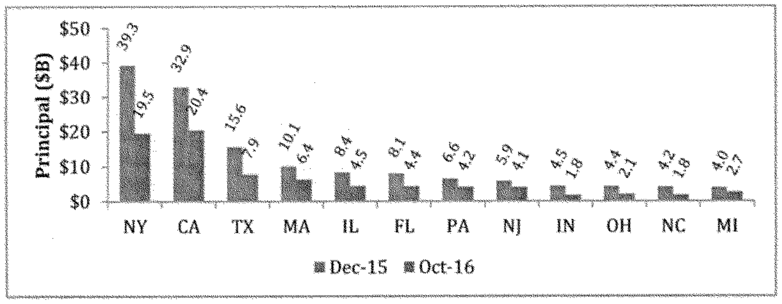


This raises the costs for infrastructure projects and eliminates some projects at the margin. Current federal plans to expand **infrastructure investments** will require state and local governments to seek funding from the capital markets. Yet the pool of available capital has been halved. H.R.4216 will help increase that pool of available funding.

Attachment B (Maintaining Municipal Funding Access) describes the specific impact of these most recent MMF regulations on municipal finance. Municipalities in almost all states are impacted. For example, as of the end of 2015, Municipal MMFs were providing $39.3 billion in funding for NY municipalities. By October 31, 2016, that number plunged by 50%. $19.8 billion in funding dried up for NY municipalities, who had to replace that debt at higher rates, if indeed it could be replaced.

The states shown below have experienced the largest drop in funding from Municipal MMFs.

Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt – Top 12 States ($B), Source: CraneData.com, December 2016



II. Change in Assets Held by Tax Exempt MMFs, Top 15 by Impact ($MM)

State	Principal - 12/31/15	Principal - 10/31/16	$$$ Change	% Change
NY	39,263	19,500	(19,763)	-50%
CA	32,910	20,443	(12,467)	-38%
TX	15,633	7,861	(7,773)	-50%
IL	8,439	4,541	(3,898)	-46%
MA	10,123	6,394	(3,729)	-37%
FL	8,093	4,392	(3,701)	-46%
IN	4,491	1,787	(2,703)	-60%
NC	4,204	1,787	(2,416)	-57%
PA	6,576	4,180	(2,396)	-36%
OH	4,362	2,083	(2,279)	-52%
NJ	5,900	4,135	(1,765)	-30%
WI	3,184	1,512	(1,672)	-53%
MN	2,696	1,040	(1,656)	-61%
MS	2,169	585	(1,584)	-73%
CT	3,125	1,592	(1,533)	-49%
VA	2,891	1,462	(1,430)	-49%

At the local level, hundreds of issuers have seen their funding from Municipal MMFs evaporate. They have likely replaced that funding with higher cost debt from banks or other sources. In some cases, infrastructure projects may have been delayed or cancelled.

I. Changes in Debt Held by TE MMFs, (Select Entities, $MM)

Municipal Entity	Principal - 12/31/15	Principal - 10/31/16	Change	% Change
New York				
Metropolitan Transportation Authority	$2,324	$847	($1,477)	-64%
Port Authority Transportation	$1,207	$852	($355)	-29%
Nassau Healthcare	$157	$55	($102)	-65%
California				
California Health Facilities	$2,048	$1,279	($769)	-38%
Bay Area Toll Authority	$421	$166	($256)	-61%
California Infrastructure and Econ. Dev.	$374	$196	($178)	-48%
Texas				
Harris County Cultural and Educational Faciliti	$1,103	$579	($524)	-48%
Lower Neches Industrial Development	$414	$74	($340)	-82%
Dallas Area Rapid Transit	$133	$73	($60)	-45%

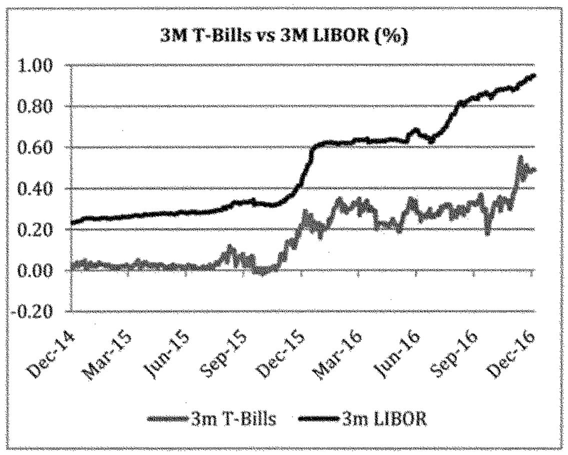
Capital Markets Impact of MMF regulations

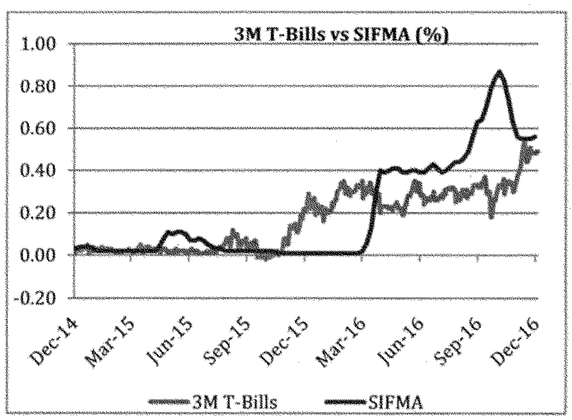
As stated earlier, Prime MMF assets have declined by over $1 trillion since the regulations were announced. Prime funds invest in corporate commercial paper, asset backed securities and short-term bank debt. Since assets in Prime MMFs have been decimated, corporate borrowers have had to look elsewhere to fund working capital, payroll and capital investments. This has put enormous pressure on the entire global debt market.

LIBOR is the global reference interest rate. Approximately $7-10 trillion of mortgages, auto loans, business loans and other debt is based on LIBOR.

As assets moved out of Prime and Municipal funds and borrowers sought funding elsewhere, LIBOR increased by 25 basis points over its historical spread against U.S. treasury securities. This increased the borrowing costs for businesses and consumers by a similar amount, which translates to $25 billion per year in additional interest cost. Clearly, this is a drag on economic growth.

Furthermore, the International Swaps and Derivatives Association estimates that over $300 trillion of derivatives are indexed off LIBOR. Business who thought they were hedged against interest rate risk and currency risk learned that some of their hedges were ineffective. Simply put, the $1 trillion flow from private sector funds to government funds has the **double barreled negative impact of increasing borrowing costs and increasing business risk.**





Impact of MMF regulations on repatriation of overseas cash

U.S. corporations currently hold significant amounts of cash overseas. Plans are being made to invite that cash back onshore to spur economic growth. Cash that could be repatriated is estimated at several hundred billion dollars.

Clearly, businesses will be encouraged to deploy that cash into U.S. growth and expansion. However, the most efficient channel for immediate private sector investment, Prime MMFs, is unattractive to investors because of the new regulations. Corporate treasurers are likely to sideline that cash in Government/Treasury MMFs until their expansion plans roll out.

It is quite ironic that the economic growth objective of repatriating corporate cash should be constrained by these new regulations. Money that was stranded in foreign jurisdictions will now be stranded in government securities. Either way, the U.S. businesses and consumers lose.

Impact of MMF regulations on systemic risk

The rationale of the 2010 MMF reforms was to improve the safety and soundness of the financial system – which they did. Prime and Municipal MMFs proved themselves quite resilient by successfully weathering the European debt crisis and the U.S. Treasury debt downgrade in 2011, the debt ceiling impasse of 2013, the U.S. Treasury and Swiss Franc flash crashes of 2014, and 2015 and Brexit in 2016. The 2010 MMF reforms passed the test with flying colors over and over again.

Yet the additional MMF regulations implemented in October 2016 have proven to be a bridge too far. $1.18 trillion has fled the market. Another way to view this is that the market has lost a $1+ trillion shock absorber. This is yet another irony in which over-regulation to limit systemic risk has actually increased it.

Summary

Recent financial regulations such as Dodd-Frank, Basel III, Money Market Fund regulations and many more, both alone and in concert with each other, have triggered **regulatory and compliance cost burdens** that radiate through the economy. Ultimately, this is choking the U.S. economy and paralyzing American businesses and financial companies that had nothing at all to do with the financial crisis.

Some of the unintended consequences include:

- Impaired market liquidity
- Higher costs and less certainty for borrowers
- Reduced access to credit for businesses
- Reduced access to capital for state and local governments
- Reduced capacity for economic growth

Well-thought-out efforts to mitigate the adverse consequences of these regulations and restore the smooth flow of capital in the U.S. economy are essential.

We strongly encourage Congress to put America's businesses back on the right track by allowing/restoring the free flow of capital. That means instituting protection for those businesses, municipalities and financial institutions that had nothing to do with causing the crisis.

One place to start is to dial back the most recent MMF regulations, which have caused $1.1 trillion in assets to flee the private sector. Legislative proposals such as the bipartisan H.R.4216, The Consumer Financial Choice and Capital Markets Protection Act, cosponsored by Rep. Gwen Moore (D-WI), Steve Stivers (R-OH), and many more are required to restore the efficient flow of capital that makes America's capital markets the broadest and deepest in the world. These are small but important steps to ensure that Main Street businesses, municipalities and banks have access to the growth capital that they and their customers require.

I appreciate the opportunity to appear today on behalf of Treasury Strategies and our hundreds of business, municipal and financial services clients.

Respectfully,

Anthony J. Carfang, Managing Director
Treasury Strategies, a division of Novantas Inc.
312-443-0840
tony_carfang@treasurystrategies.com

Appendix A

Dissecting The Financial Collapse of 2007-2008

A Two-Year Flight to Quality

Dissecting The Financial Collapse of 2007-2008

A Two-Year Flight to Quality
May 2012

Considerable resources are being expended to develop new regulations to prevent a repeat of the 2008 financial crisis. It is vital these new regulations are appropriately focused to encourage liquid money markets during any future period of financial stress. In support of that aim, Treasury Strategies (TSI) has prepared this analysis of the money markets prior to, during, and following the financial crisis that peaked in mid-September 2008.

Much of the analysis of the financial crisis repeats the myth that a run on money market mutual funds (MMFs) was a proximate cause of the financial crisis. We believe this is incorrect and misdirects focus away from more significant causal factors. In fact, a $1.2 trillion run on *non*-MMF asset classes had already occurred during the 15 months preceding the chaos of mid-September 2008.

Close examination of asset flows for the week of September 15 shows the firestorm was not triggered by the failure of MMFs, as is being widely cited. The firestorm was actually triggered by the surprise, late-night $85 billion government rescue of AIG.

On the morning of September 15, Lehman Brothers declared bankruptcy. That evening, aware of AIG's Lehman exposure, all three major rating agencies nonetheless issued investment grade ratings on AIG. Thus the 9 p.m.
September 16 surprise $85B rescue of AIG sent global markets into a tailspin. Investors were shocked, not only by the sudden collapse of AIG but also by the fact that all three rating agencies had been completely wrong, just 24 hours earlier. Hence, they assumed problems lurked around every corner.

That AIG rescue announcement panicked investors around the world, who then immediately fled all non-government guaranteed asset classes for the safety of government securities/government guarantees.

To further illustrate the distortions perpetuated by current conventional "wisdom," we note that the U.S. government guarantee of MMF holdings was capped at September 19, 2008 levels. Yet over the following weeks, investors poured $250 billion additional, non-guaranteed assets into MMFs, including $170 billion into prime funds. Thus, at a time the government was insuring virtually all corporate bank deposits, investors were choosing non-guaranteed prime MMFs instead![1]

Given the failures of various other asset classes, the widespread market chaos during this period, the flight to quality *into* MMFs, and the fact that 2010 MMF regulatory changes have already strengthened an already strong asset class, we must certainly question the fixation on pillorying MMFs and demanding they be further overhauled. In fact, MMFs have proved to be one of the most resilient asset classes throughout the financial breakdown.

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[1] In light of the flows into MMFs at this time, it is worth noting that MMF sponsors did not ask for or want the government guarantees. See ICI's commentary "MONEY MARKET FUNDS IN 2012", February 27, 2012.

Background

The collapsed housing bubble triggered a tsunami that hit the shores of the general money markets in early 2007. From that time until markets were calmed by massive government intervention in late 2008, most money market asset classes experienced considerable stress. Investors sought progressively higher ground as problems escalated, with hundreds of billions of dollars fleeing riskier assets and moving to safer territory.

By the time the markets calmed at the end of 2008, several asset classes were decimated. The asset-backed commercial paper market experienced outflows of $487 billion, structured investment vehicles declined $400 billion, enhanced cash funds declined $225 billion, and financial commercial paper fell $49 billion. In addition, $330 billion was frozen in illiquid auction rate securities.

By December 2008, investors seeking the higher ground had moved $1.05 trillion into government and treasury MMFs, $170 billion into prime MMFs, $225 billion into insured bank demand deposits, and $176 billion into bank time deposits.

In evaluating how the crisis unfolded, it is helpful to dissect the collapse into three time periods, to consider significant market events and their impacts on money market instruments and asset movements.

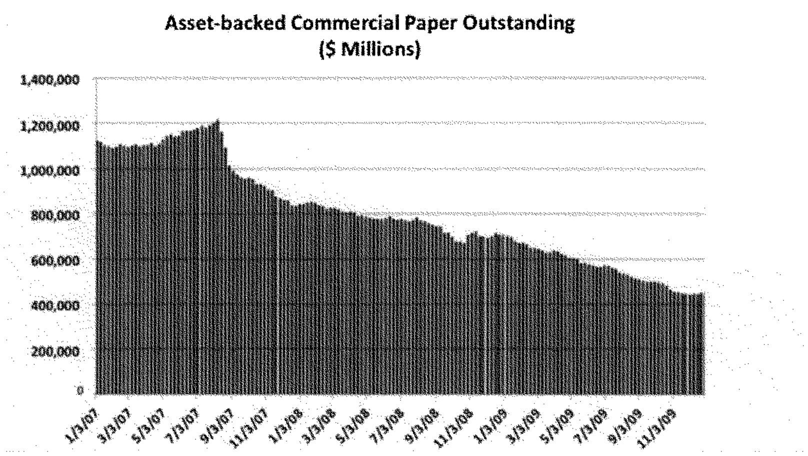
- Phase 1: Pre-Crisis (June 2007 – early September 2008)
- Phase 2: Collapse (mid-September 2008 – mid-October 2008)
- Phase 3: Stabilization (late October 2008 – December 2008)

Phase 1: Pre-Crisis (June 2007 – September 2008)

This time period was bookended by stress in the asset-backed commercial paper (ABCP) market, which started in June 2007, and the failures of Fannie Mae and Freddie Mac in September 2008.

Aggressive lending practices and the collapse of the housing bubble began to manifest themselves in the general money markets during this period. Most of the defining events were well-telegraphed credit events. They played out in the form of prolonged runs from the impacted asset classes, which were primarily commercial paper and enhanced cash funds[2]. In addition, there was an unanticipated liquidity-driven freeze of the auction rate securities market.

Asset-Backed Commercial Paper
As the housing crisis spread, in June 2007 the ABCP market faltered and experienced a prolonged run. This market peaked at $1.2 trillion in assets on August 8, 2007. Following major asset downgrades, assets declined by $432 billion (-37%) during the first phase of the crisis.



Source: Federal Reserve

Structured Investment Vehicles (SIVs)
These complex debt instruments provided very high returns by making highly leveraged investments. Many SIVs ultimately defaulted, were repurchased by their sponsors, or simply unwound. According to the Financial Times[3], total assets fell from a high of $400 billion in July 2007 to virtually zero (-100%) by early 2009.

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[2] For a description of the three types and two durations of runs, see Appendix A.

[3] Hughes, Jennifer. "Completion of SIV asset disposal near." *Financial Times,* 7 July 2009

Enhanced Cash Funds
Enhanced cash funds (also called ultra-short bond funds) peaked at $250 billion in November 2007 and experienced a prolonged run down to $25 billion (-90%) during this first phase of the crisis. The run in this asset class was triggered when a GE-managed fund went from a fixed to floating NAV in November 2007 and then subsequently failed to maintain a $1 NAV.

Auction Rate Securities
Auction rate securities (ARS) gathered assets up to a peak of $330 billion in February 2008. Then, following several failed auctions, the entire $330 billion ARS market froze (-100%) and has been slowly liquidating since that time.

Other Events
Several market events contributed to the prolonged run on various money market categories in this timeframe.

- Failure of a Bear Stearns real estate hedge fund (6/2007)
- Countrywide Financial rescue (1/2008)
- Bear Stearns rescue (3/16/2008)
- Indy Mac Bank failure (7/13/2008)
- Fannie Mae and Freddie Mac failure (9/8/2008)

It is important to recognize that these failures developed over time, with their underlying credit difficulties having been clearly understood by the market. With the exception of the unanticipated ARS freeze, market participants were well aware of impending problems at Bear Stearns, Countrywide, Fannie Mae, etc.

Phase 1: Summary

	Assets as of 6/27/07 ($B)	Assets as of 9/10/08 ($B)	Change ($B)	% Change
Inst. MMFs				
Prime MMFs	1,705	2,153	447	26%
Treas/Gov MMFs	427	906	478	112%
Commercial Paper				
ABCP	1,173	742	(432)	(37%)
Bank/Finance CP	763	810	47	6%
Non Financial CP	196	205	9	5%
Bank Deposits				
Demand Deposits	326	292	(34)	(10%)
Large Time Deposits	1,743	2,121	378	22%
Other Instruments				
Enhanced Cash	250	25	(225)	(90%)
Auction Rate Sec.	330	0*	(330)*	(100%)
SIVs	400	0	(400)	(100%)

*$330 billion in assets were frozen/illiquid.

Phase 2: Collapse (September 2008 – October 2008)

The market events and failures of multiple asset classes during Phase 1 culminated in collapse during the week of September 15, 2008.

The prolonged run, already underway for some time, built and accelerated until it became a firestorm run across the whole financial system – a flight to quality. This continued until October 14, 2008 when the government intervened with an unlimited guarantee on all non-interest-bearing bank deposits.

Market Events Accelerate
One week following the bailout of Fannie and Freddie, rapid-fire shocks roiled the markets:

- Bank of America bailed out Merrill Lynch (9/14/2008)
- Lehman Brothers declared bankruptcy (9/15/2008)
- Federal Reserve lent JPMorgan $138 billion to assist Lehman (9/15/2008)
- Washington Mutual was downgraded and experienced a $16 billion run (9/15/2008)
- Reserve Fund lost $785 million on Lehman CP, broke the buck (9/15-16/2008)
- Unexpected Federal Reserve $85 billion bailout of AIG (9/16/2008, 9 p.m. EST)

Market Surprises and Flight to Quality
The first phase of the crisis was characterized by prolonged runs on asset classes that were experiencing widely known credit-quality distress. The market digested these difficulties with equanimity. However, this second phase was distinctly different, and far more dangerous, because it was essentially the result of two seismic surprises:

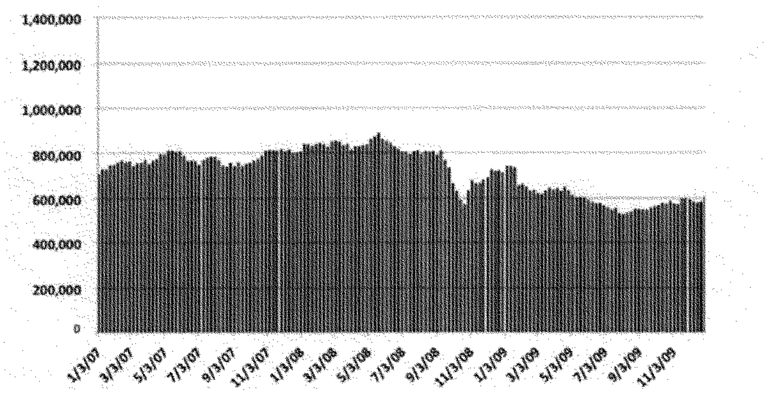
- The government's decision to **not** rescue Lehman Brothers
- The shocking late-night bailout of AIG at 9 p.m. EST Tuesday, which was not anticipated by the marketplace.

Indeed, the panic-fueled firestorm run out of virtually all non-government-insured asset classes and into insured deposits and securities reached a momentous stage on Wednesday, September 17, 2008.

The Federal Reserve's announcement of the $85 billion AIG bailout completely blindsided the market. Although there had been market rumors of AIG problems, on Monday evening Standard & Poor's issued an "A-" long-term rating and an "A2" short-term rating on AIG. On Tuesday evening, the Fed initiated the first of three AIG bailouts or restructurings. That bailout announcement shattered the markets, shaking investor confidence in virtually all investments. They continued their flight to quality by moving into government securities and government-guaranteed instruments.

The "Run" on Bank/Financial Commercial Paper
Events during this phase, such as the collapse of Merrill Lynch, Washington Mutual, Lehman Brothers and AIG, led to a run on financial commercial paper of $221 billion.

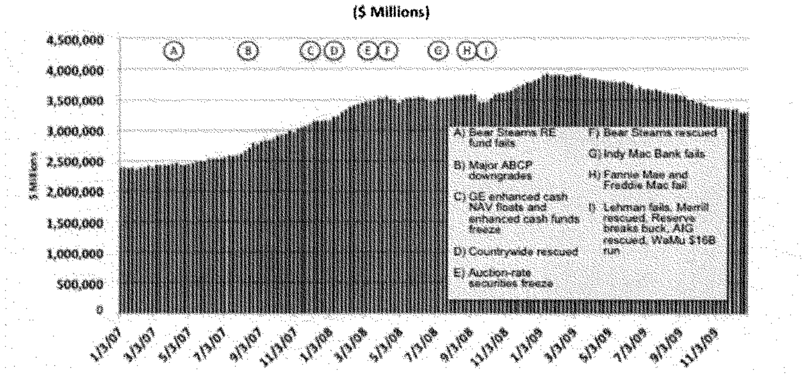
Financial Commercial Paper Outstanding
($ Millions)



Source: Federal Reserve

The "Run" on MMFs
There has been much spirited debate on the role of MMFs in the crisis. Specifically, it has become conventional wisdom that MMFs are susceptible to runs as evidenced by their asset levels during this time period. However, the data tell a different story.

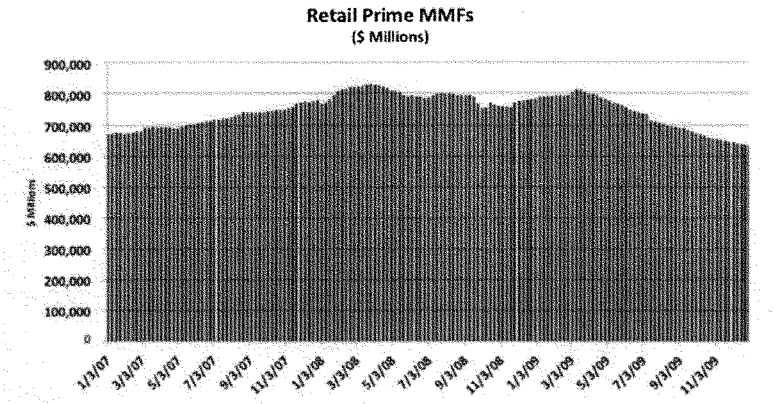
Market Total Assets of MMFs
($ Millions)



Source: The Investment Company Institute

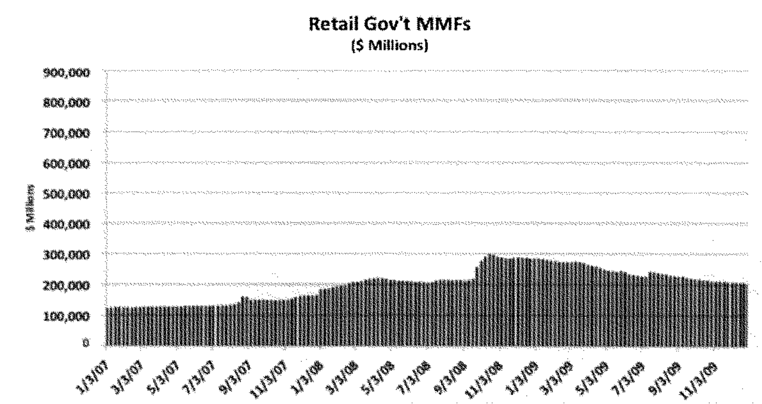
It is a challenge to find any widespread run occurring on the MMF asset class during any time period. That being said, there are different subclasses of MMFs for both retail and institutional investors, primarily prime MMFs and treasury/government MMFs. Prime MMFs invest largely in short-term commercial paper and other instruments. Treasury/government MMFs invest solely in T-bills and government securities.

Of these subclasses, the data reflect the flight to quality that was underway within MMFs during this time period.



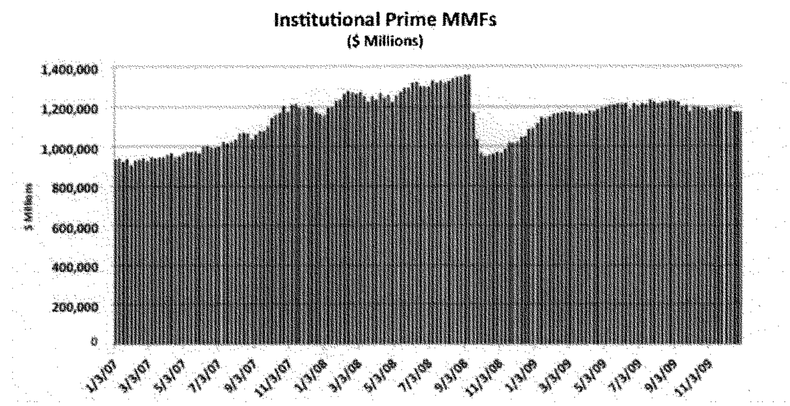
Source: The Investment Company Institute

As shown above, retail prime MMFs saw a slight 3% reduction in assets during this time period. Meanwhile, retail government MMFs experienced the flight to quality and increased assets of 40% during this same period.



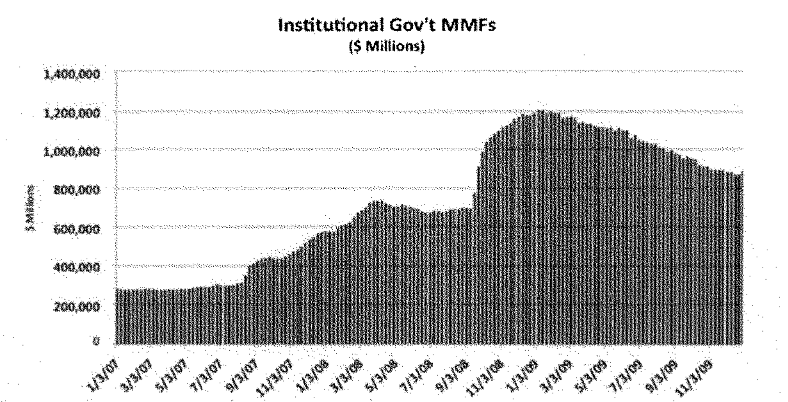
Source: The Investment Company Institute

The sophisticated investors within the institutional segment undertook a similar, albeit more pronounced, flight to quality.



Source: The Investment Company Institute

In the above graph, we see the Phase 1 *inflow* of assets followed by the pronounced reduction of assets as investors fled to quality during the week of September 15, 2008 fueled by the panic of the AIG bailout. This flight to quality is apparent in the graph below. Investors did not reject MMFs as an asset class, but rather sought the highest ground possible and moved into government MMFs.



Source: The Investment Company Institute

A detailed breakdown of the events of the week of September 15 provides further evidence that panic due to the *unexpected* bailout of AIG was the trigger for investors to flee to the highest quality instruments available (those instruments with implied or explicit government guarantee).

As the following table clearly illustrates, on September 15 and 16, institutional prime MMFs had total outflows of just over $50 billion from the Reserve Fund and $50 billion from all other prime funds. This was a fairly well-contained, credit-driven event. Some prime funds experienced no net redemptions at all over these two days.

However, financial markets skidded into a total liquidity collapse after the surprise AIG failure. Over the next two days following the failure of AIG, prime MMFs saw more than $200 billion of outflows.

Institutional Prime MMF Assets

Dates (2008)	Change In Inst. Prime MMF Assets ($B)	Market Events
8/28 – 9/12	(1)	Fannie & Freddie fail – estimated cost $200B
9/15	(61)*	Merrill Lynch rescued Run on WaMu of $16.4B Lehman Brothers fails as Fed guarantees $138B Reserve Primary Fund halts redemptions S&P rates AIG "A-" long-term and "A2" short-term
9/16	(37)*	Reserve Primary Fund "officially" breaks the buck with $785M loss on Lehman After the market closes, AIG requires $85B bailout
9/17	(130)	
9/18	(94)	
9/19	(25)	Several government safety nets implemented include commercial paper support and a temporary, limited MMF guarantee program Goldman Sachs and Morgan Stanley apply to convert into bank holding companies
9/22 – 12/31	+132	Cash inflows above the guarantee level

*Includes approximately $54B in redemptions from investors in the Reserve Primary Fund

The climactic week of September 15 ended with the government instituting several measures to support the commercial paper market. It also instituted the Temporary Guarantee Program, temporarily insuring money fund investors at their September 19 investment levels. MMF investments beyond investors' September 19 levels were excluded from the guarantee program.[4]

Phase 2 Summary
Market events catapulted the prolonged run on the financial system to a firestorm run, as investors continued their flight to quality.

	Assets as of 9/10/08 ($B)	Assets as of 10/15/08 ($B)	Change ($B)	% Change
Inst. MMFs				
Prime MMFs	2,153	1,725	(428)	(20%)
Treas/Gov MMFs	906	1,359	454	50%
Commercial Paper				
ABCP	742	677	(65)	(9%)
Bank/Finance CP	810	588	(221)	(27%)
Non-Financial CP	205	188	(18)	(8%)
Bank Deposits				
Demand Deposits	292	321	30	10%
Large Time Deposits	2,121	2,066	(55)	(3%)
Other Instruments				
Enhanced Cash	25	25	-	0%
Auction Rate Sec.	*0	*0	-	0%
SIVs	0	0	-	0%

*$330 billion in assets were frozen/illiquid.

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[4] Commercial paper support measures and the Temporary Guarantee Program had a single identical aim, according to M. L. Fein, which was not to shore up a "run" in MMFs. Fein argues, "The Fed's liquidity facilities and related regulatory actions that ostensibly benefited MMFs in reality were designed to support banks and the bank commercial paper market and that the bank commercial paper market was the source of systemic risk, not MMFs." See "SHOOTING THE MESSENGER: THE FED AND MONEY MARKET FUNDS," April 2, 2012.

Phase 3: Stabilization (October 2008 – December 2008)

The depth of the Phase 2 panic is underscored by the number of ways the government actively intervened in the markets. Some of the many programs instituted in the fall of 2008 include[5]:

- Fed lends JPMorgan $138 billion to assist with Lehman Brothers debt (September 15)
- Fed rescues AIG with $85 billion loan (September 16)
- Fed increases swap lines with other central banks by $180 billion (September 18)
- Fed establishes ALMF program to support money fund purchases of asset-backed commercial paper (September 19)
- Washington Mutual closed, assets acquired by JPMorgan (September 25)
- Treasury institutes TGP which guaranteed investor holdings of MMFs at September 19 levels (September 19)
- Goldman Sachs and Morgan Stanley convert to bank holding companies with discount window access (September 21)
- Fed doubles currency swap lines to $620 billion (September 29)
- SEC eases accounting mark-to-market rules for banks (October 3)
- TAF, the collateralized lending program, expanded to $900 billion (October 6)
- Fed begins CPFF for CP (October 7)
- IRS declares a cash repatriation tax holiday (October 7)
- Federal Reserve begins paying banks interest on their reserve balances (October 8)
- Second AIG bailout $37.8 billion (October 8)
- Wells Fargo purchases Wachovia (October 12)
- Fed removes all caps and provides unlimited currency swap lines to the Bank of England, the ECB and the Swiss National Bank (October 13)
- FDIC guarantees all demand deposits, without limitation (October 14)
- Fed removes all caps and provides unlimited currency swap lines to the Bank of Japan (October 14)
- Initial $250 billion of the $700 billion TARP program rolled out (October 14)
- FDIC guarantees all senior debt of U.S. banks and bank holding companies (October 14)
- MMIFF established for direct purchase of up to $540 billion of commercial paper and bank CDs to prop up those markets. This amount greatly exceeds total withdrawals from commercial paper-based money market funds (October 19)
- New York Fed lends $50B to two foreign banks, Irish-German Depfa Bank and Belgium's Dexia Bank (November 4)
- Third AIG bailout, an additional $40 billion (November 10)
- Second round of Citigroup support at $20 billion (November 24)
- TALF provides $200 billion to support retail and small business asset-backed commercial paper (November 25). Increased to $1,000 billion on February 10, 2009
- Fed announces program to purchase direct obligations of housing-related GSEs (November 25)
- General Motors and Chrysler bailouts announced (December 19)

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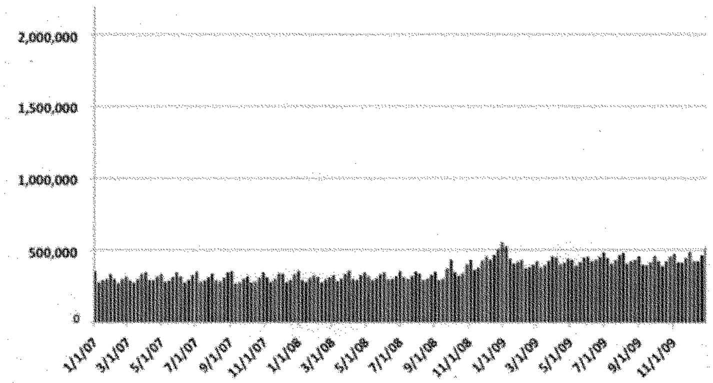
[5] See Appendix B for acronym definitions.

During this period of dramatic rescues and bailouts, hundreds of billions *flowed into* several asset classes, including prime MMFs, Treasury/government MMFs, insured bank deposits and financial commercial paper.

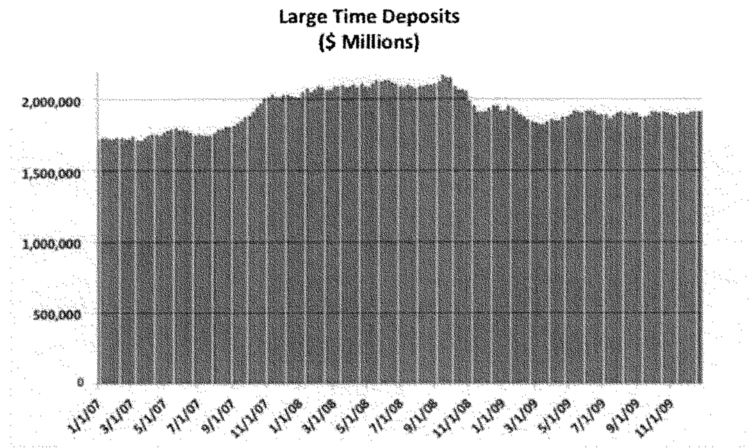
Inflow of Assets to Guaranteed Bank Deposits
On October 14, the FDIC expanded its insurance guarantee to cover *unlimited* non-interest-bearing bank deposits. During this phase, bank demand deposits grew by $230 billion (72%) to a total of $551 billion.

Demand Deposits
($ Millions)



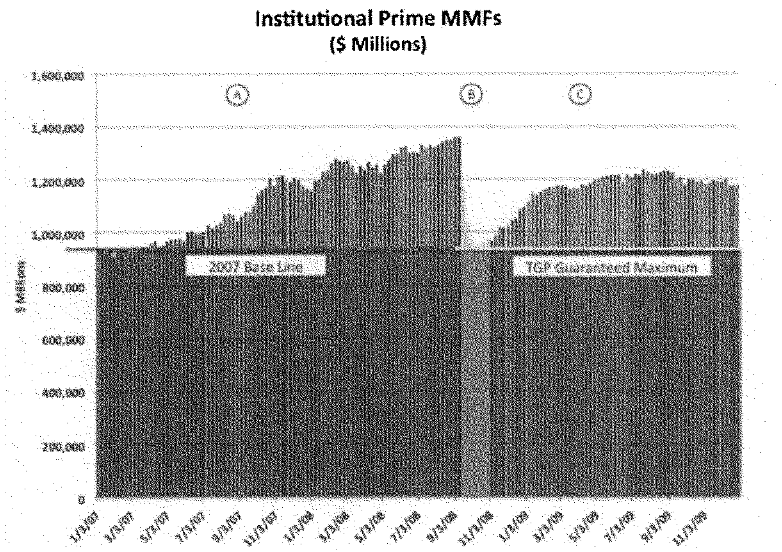
Source: Federal Reserve

The inflow into demand deposits was somewhat offset by an outflow of large time deposits, which decreased by $148 billion during this period.



Source: Federal Reserve

Inflow of Non-Guaranteed Assets into Institutional Prime MMFs
As one reaction to the market panic of Phase 2, the Treasury established the Temporary Guarantee Program (TGP) for MMFs. TGP guaranteed any investments in MMFs at September 19, 2008 levels. New assets invested after this date were excluded from this program and therefore not guaranteed.



A = Phase 1   B = Phase 2   C = Phase 3

Source: The Investment Company Institute, Treasury Strategies

Despite the fact that incremental investments were not guaranteed, institutional investors increased their holdings in prime MMFs. These sophisticated investors were fully aware that new MMF investments were not guaranteed, and that other fully guaranteed options were available (i.e., bank demand deposits). This testifies to the value investors place on MMF instruments.

Phase 3 Summary

	Assets as of 10/15/08 ($B)	Assets as of 12/30/08 ($B)	Change ($B)	% Change
Inst. MMFs				
Prime MMFs	1,725	1,875	151	9%
Treas/Gov MMFs	1,359	1,473	114	8%
Commercial Paper				
ABCP	677	705	28	4%
Bank/Finance CP	588	714	125	21%
Non-Financial CP	188	181	(7)	(4%)
Bank Deposits				
Demand Deposits	321	551	230	72%
Large Time Deposits	2,066	1,919	(148)	(7%)
Other Instruments				
Enhanced Cash	25	25	-	0%
Auction Rate Sec.	*0	*0	-	0%
SIVs	0	0	-	0%

*$330 billion in assets were frozen/illiquid.

Conclusion

The financial crisis fueled by the housing market collapse reverberated throughout the overall money markets. The failure of some very prominent institutions was widely felt and many asset classes experienced runs or failed altogether as a result.

A prolonged, credit-driven run took hold in mid-2007 as the housing tsunami cascaded across all asset classes. During this first phase, investors moved deliberately but without panic to higher ground. Excepting the surprise auction rate securities freeze,[6] major events of this period unfolded slowly, and problem institutions were well recognized in advance of their ultimate failures.

Then, two unanticipated shocks hit on successive days and triggered a firestorm run on all non-government guaranteed asset classes. First, the U.S. government abruptly reversed its very visible policy of supporting large distressed financial institutions. In a move that stunned the markets, it allowed Lehman Brothers to fail.[7]

Secondly, on the following evening while the markets were closed, the U.S. government reversed course again. While Lehman Brothers had been allowed to fail days earlier, the NY Fed that night announced an $85 billion bailout of AIG. This unexpected failure and its unprecedented magnitude shook the very foundations of the markets.

The next morning, investors ran for the high ground en masse, moving hundreds of billions of dollars into government and treasury MMFs, insured bank deposits, and government securities. They sold virtually everything else.

By year-end, with a mind-boggling list of support programs, bailouts, and guarantees, markets began to calm. When the dust settled, the crises that had begun in June 2007 had led to huge shifts of liquid assets. The ABCP, SIV, enhanced cash and auction rate securities markets were decimated. More than $1 trillion flowed *into* treasury/government MMFs during this time. An additional $600 billion flowed into government-guaranteed bank demand deposits, non-guaranteed prime MMFs, and large time deposits.

[6] Treasury Strategies long insisted these should not be classed as cash or cash equivalents. The freeze was a surprise to investors, yet this was recognized as an asset class deserving close scrutiny.
[7] The Reserve Fund, with 1.2% of its assets in A-rated Lehman commercial paper, was collateral damage to this policy change. Although Reserve "broke the buck", every other MMF holding Lehman paper maintained their $1 NAV.

Overall Crisis Summary

*$330 billion in assets were frozen/illiquid.

	Assets as of 6/27/07 ($B)	Assets as of 12/30/08 ($B)	Total Change ($B)	% Change
Inst. MMFs:				
Prime MMFs	1,705	1,875	170	10%
Treas/Gov MMFs	427	1,473	1,046	245%
Commercial Paper:				
ABCP	1,173	705	(469)	(40%)
Bank/Finance CP	763	714	(49)	(6%)
Non-Financial CP	196	181	(15)	(8%)
Bank Deposits:				
Demand Deposits	326	551	226	69%
Large Time Deposits	1,743	1,919	176	10%
Other Instruments:				
Enhanced Cash	250	25	(225)	(90%)
Auction Rate Sec.	330	0*	(330)*	(100%)
SIVs	400	0	(400)	(100%)

Recommendation

We encourage regulators to carefully consider the precise sequence of events as the crisis unfolded. This time period reveals a great deal about how much stress the markets could systematically digest and at which point the cumulative impacts became overwhelming. One point in particular stands out: the unprecedented and unanticipated AIG collapse, triggered by losses on Lehman credit default swaps, is the single proximate event that triggered a firestorm run on all money market asset classes. For all intents and purposes, that event divided the markets into just two asset classes: anything guaranteed by the U.S. government and anything that was not. During September 2008, investors wanted out of the latter and in to the former.

This point – along with the failures of various other asset classes, the widespread market chaos during this period, the flight to quality *into* MMFs, and the fact that 2010 MMF regulatory changes have already strengthened one of the most resilient asset classes throughout the financial breakdown – should guide regulators in their evaluations of asset classes and considerations of regulatory change.

Appendix B

Maintaining Public Sector Funding Access

Maintaining Public Sector Funding Access:

The Importance of Preserving Money Market Mutual Funds (MMFs)

New MMF regulations that were implemented in October of this year are having major negative consequences for issuers and borrowers of debt held by money market funds. Specifically, Tax-Exempt MMFs (TE MMFs) are closing and assets are leaving. This is drying up a very important municipal financing conduit.

As TE MMF close (or shorten their maturities), municipalities have fewer buyers for their debt. Even when they are able to place issues with the remaining TE funds, due to the shortened maturity structure, they are less able to lock in rates and more subject to weekly rate resets. This increases volatility and adds to their borrowing costs. If they are not able to place their issues with TE MMFs, only two options are available. They must turn to other lenders that have higher transaction costs or charge higher rates or they must defer or cancel infrastructure, educational/healthcare facilities or other municipal projects.

This paper will show the following, all of which demonstrate the negative impacts on municipal financing of new MMF regulation:

- Massive amounts of assets are leaving from Tax-Exempt MMFs
- Borrowing rates for Municipal borrowers have increased dramatically
- Managers that use TE funds on behalf of their customers are exiting those funds

Between December 2016 and December 2016 around $120 billion left TE MMFs, a decline of nearly 50%. Since TE MMFs provide a significant amount of financing to municipal borrowers, the short-term market for municipal debt is significantly smaller. This has led to a massive spike in borrowing rates – from less than 0.05% to 0.50%. Without Tax-Exempt MMFs, municipalities will be forced to seek even higher cost borrowing like bank credit, or reduce their short-term capital consumption. Projects in infrastructure, healthcare, education and government services will be impacted.

I. TE MMF assets declined by 50% in the months leading up to implementation of new regulations

MMFs have historically been an important holder of short-term municipal debt. As of December 2015, they provided over $250 billion of short-term funding to municipalities by purchasing their short-term debt instruments. By December 2016, TE MMFs were just barely half of that number and a quarter of pre-crisis levels in June 2008. Figure 1 shows the precipitous decline in TE MMF assets in 2016 prior to the implementation of new regulations in October.

Figure 1.Tax-Exempt Money Fund Asset Levels ($B),
Source: CraneData.com, Treasury Strategies (December 2016)

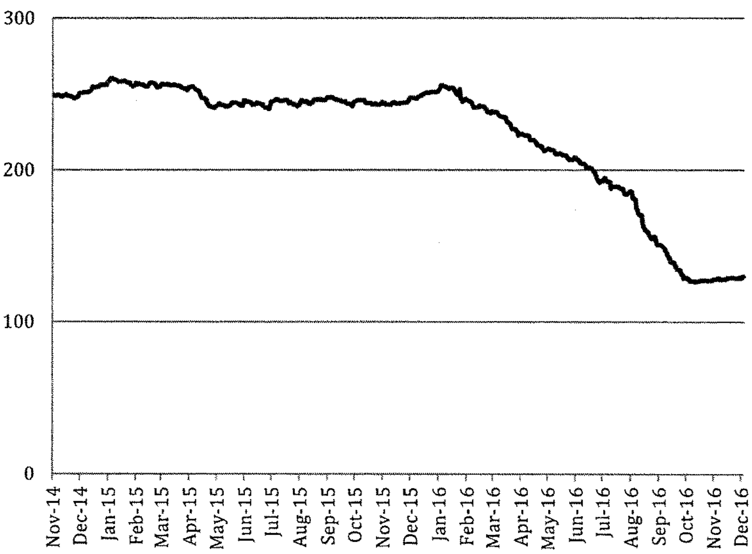
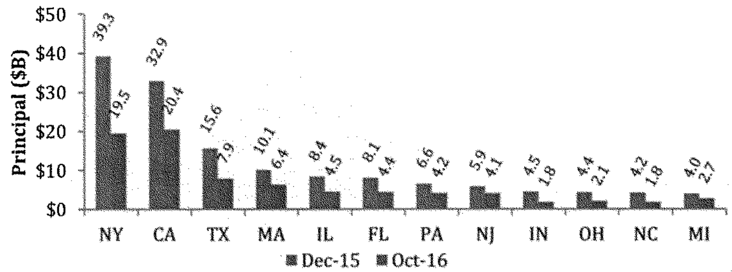


Figure 2 shows the large Tax-Exempt MMF investments in municipal debt of highly populated industrial and economic centers including New York, California, Texas, Massachusetts, Illinois, and Florida. It also shows the severe decline in these investments in 2016, with each of those states experiencing a 35% to 50% decline in the months leading up to the new regulations.

Figure 2. Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt – Top 12 States ($B), Source: CraneData.com, Treasury Strategies (November 2016)



The reach of TE MMFs is even more striking when viewed in light of population. These funds represented over $700 for every man, woman and child in the U.S in December 2015, or up to $2,000 per household. The asset losses in TE MMFs translate to a decline of up to $700 to $1,000 per capita in the states that were most impacted.

The impact of these declines is geographically diverse. The per capita effects are just as pronounced in Alaska, Wyoming and Missouri as they are in New York and California, as shown in Figure 3.

Figure 3. Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt – Top 12 States by Assets Per Capita, Source: CraneData.com, U.S. Census (November 2016)

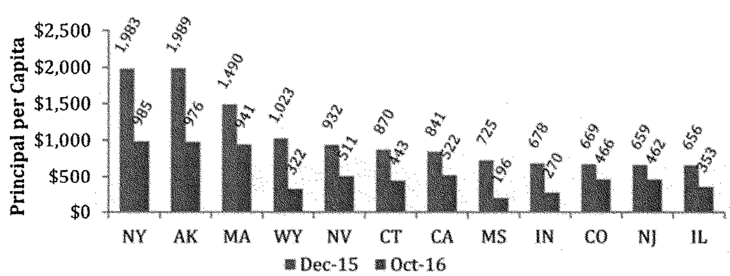


Figure 4 shows the impact of these asset outflows to important municipal issuers in the states of Texas, California, and New York. Many of these specific issuers have seen a decline in their debt held by TE MMFs over 50%, and some have seen much higher declines. Combined, the MTA and Port Authority in New York City have seen declines in excess of $1.8 billion.

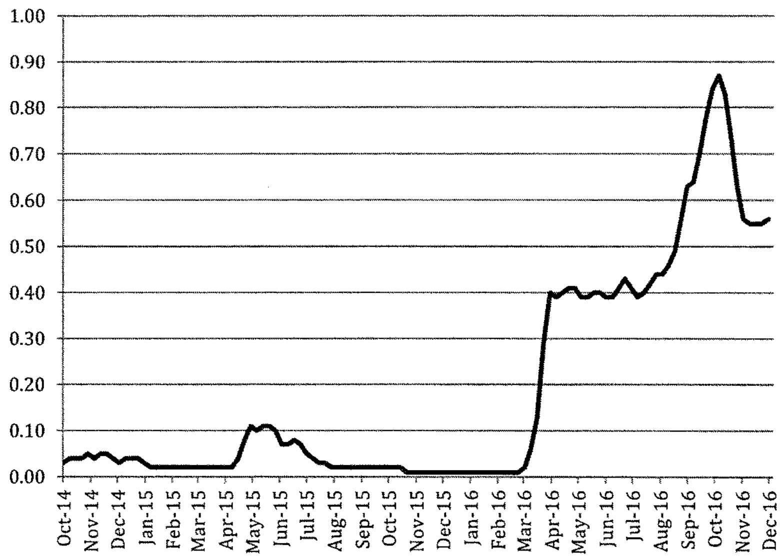
Figure 4. Impacts to Tax-Exempt Money Fund issuers in TX, CA and NY ($MM)
Source: Cranedata.com, Treasury Strategies (November 2016)

TE MMF Issuer	Principal - 12/31/15	Principal - 10/31/16	Change	% Change
Texas				
Texas Transportation Commission	$230	$104	($126)	-55%
Lower Neches Industrial Development	$414	$74	($340)	-82%
Dallas Area Rapid Transit	$133	$73	($60)	-45%
California				
California Health Facilities	$2,048	$1,279	($769)	-38%
California Infrastructure and Economic Development	$374	$196	($178)	-48%
Bay Area Toll Authority	$421	$166	($256)	-61%
New York				
Metropolitan Transportation Authority	$2,324	$847	($1,477)	-64%
Port Authority Transportation	$1,207	$852	($355)	-29%
Nassau Healthcare	$157	$55	($102)	-65%

II. Municipal borrowing rates have increased dramatically

As TE MMFs assets have diminished and waves of funds have closed, municipal borrowers have had to pay increasingly high rates to secure financing. Figure 5 shows that the SIFMA Index of municipal short term borrowing has jumped from under 5 basis points at the beginning of 2016 to over 50 basis points at the end of October. This greatly increases the borrowing costs for municipalities, university and hospitals. Since most debt resets on a weekly basis, borrowing costs on existing debt has increased by over ten-fold for many borrowers.

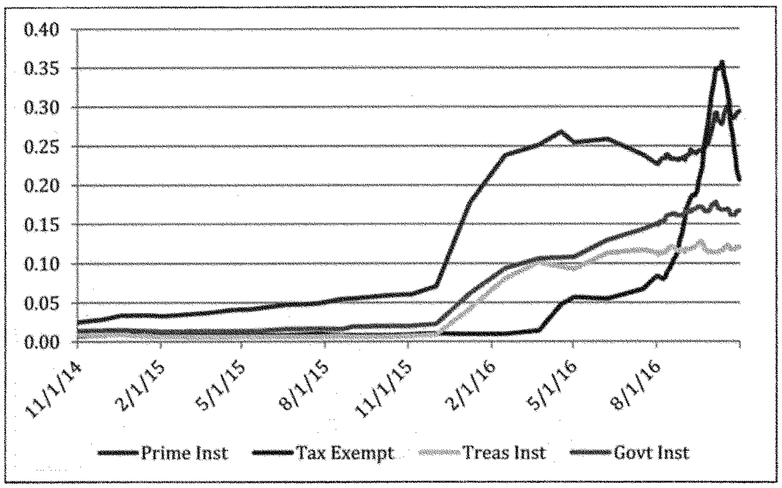
Figure 5. SIFMA Municipal Swap Index Rates (%).
Source: SIFMA (December 2016)



Municipal borrowing rates have also jumped from being significantly lower than other short-term rates to being positioned in-between one-month and three-month LIBOR. This represents a significant market disruption because many municipal debt instruments have traditionally been closer to over-night and seven-day rates due to weekly rate resets.

Another sign of this disruption is the yields that yields on TE MMFs have also increased significantly in this period compared to other money fund types. TE MMFs are traditionally the lowest yielding money fund due to their tax advantages, credit quality and short portfolios. Figure 6 shows that in the second half of 2016, TE MMF yields increased dramatically to be the highest yielding fund type for a brief period of time. As of October 31, 2016, only Prime Institutional funds offered higher yields.

Figure 6. Seven-day Money Fund Yields (%),
Source: Cranedata.com, Treasury Strategies, December 2016



III. Managers using TE funds on behalf of their customers are exiting

As they formulated the new MMF rules, regulators believed Tax-Exempt MMFs were held almost exclusively by retail investors. This was important, because the new rules were aimed at what are commonly called institutional funds – those used by corporates, institutions and trusts (called non-natural persons). [8]

The thinking was that if these non-natural persons did not invest in Tax-Exempt MMFs, then TE funds would see little impact, and municipal finance would be unharmed. However, this key assumption is incorrect. Not only are **significant portions of Tax-Exempt MMFs held by non-natural persons**, but the business is already adjusting in ways that will hurt municipal borrowers.

To delve into this issue, we conducted a two-part examination:

- First, we had discussions with managers from six of the largest U.S. tax-exempt fund companies that collectively represent 60% of all such assets.

- Second, to validate those findings, we surveyed 21 financial intermediaries that invest in TE MMFs, including nine of the 50 largest U.S. banks.

Fund Managers
From discussions with fund managers, we have estimated that non-natural persons hold a material portion – at least 30% to 50% – of TE MMF assets. Only one manager thought its fund had less than 30% institutional ownership.

Fund managers tell us they expect that virtually all such non-natural person investors in Tax-Exempt funds to leave. Reasons given range from operational difficulties to investment policy restrictions, driven primarily by the new regulations. As the new rules force such investors to exit, Tax-Exempt MMF asset levels will shrink and many funds will close.

Figure 11. Estimated TE MMF Assets Held by Institutional Investors, Source: Treasury Strategies Interviews of Top Fund Managers, February 2016

Fund Manager	Estimated % of TE MMF Assets Owned by Institutional Investors
# 1	30%
# 2	35%
# 3	15%
# 4	45%
# 5	50%
# 6	30%

[8] Non-natural persons include entities such as partnerships, LLCs, irrevocable trusts, corporations, and institutions

Financial Intermediaries
Information from Financial Intermediaries (FIs), who direct customer investments into Tax-Exempt MMFs, also paints a troubling picture for the future of these funds. Tax-Exempt MMF usage by FIs is likely to plummet.

According to FIs, non-natural persons account for almost two-thirds of the assets that they place in Tax-Exempt MMFs. Many FIs plan to cease offering Tax-Exempt Funds to any client, due to the complexity, difficulty and risk of determining which clients are natural versus non-natural investors. For others, the new rules make it impossible to continue offering Tax-Exempt funds to customers as an option on their sweep platforms. Accordingly, FIs will fully or substantially eliminate their use of Tax-Exempt MMFs on behalf of their customers.

This is a double-edged sword for municipal finance. First, lower investment in Tax-Exempt MMFs translates directly to reduced outlets for municipal borrowing. Secondly, at these significant levels of asset reduction, many TE funds will fall below efficient operating levels, and will close entirely – a trend we have already noted is underway.

IV. Conclusion

New SEC rules that change how MMFs function are having many unintended consequences. One such consequence now manifesting itself is a material reduction in the short-term credit available to municipal borrowers whose debt is held by Tax-Exempt MMFs. As recently as December 2015, Tax-Exempt MMF assets exceeded $250B. As of December 5, 2016, they are now under $130B.

These changes have also lead to a dramatic increase in the borrowing costs. Many municipalities have seen borrowing rates increase by ten-fold in 2016. They are also 30-day and 90-day rates for debt that resets on a weekly basis and is 100% callable on demand.

Without Tax-Exempt MMFs, municipalities will be forced to seek even higher cost borrowing options like bank credit, or reduce their short-term capital consumption. Neither of these options bode well for the US economy and tax payer.

Statement of the U.S. Chamber of Commerce

ON: The Impact of Regulations on Short-Term Financing

TO: House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Thomas C. Deas, Chairman, National Association of Corporate Treasurers on behalf of the U.S. Chamber of Commerce Center for Capital Markets Competitiveness

DATE: December 8, 2016

1615 H Street NW | Washington, DC | 20062

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House Committee on Financial Services
"The Impact of Regulations on Short-Term Financing"
Thomas C. Deas, Jr.
U.S. Chamber of Commerce Center for Capital Markets Competitiveness
December 8, 2016

Chairman Garrett, Ranking Member Maloney, and members of the subcommittee:

Thank you for the opportunity to testify at this important hearing focusing on financial regulation and its impact on short-term financing. I am Thomas C. Deas, Jr., recently retired vice president and treasurer of FMC Corporation and current Chairman of the National Association of Corporate Treasurers ("NACT"), an organization of treasury professionals from several hundred of the largest public and private companies in the country. I am testifying today on behalf of the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions. NACT fully supports the Chamber's many important efforts to assure that financial regulations do not unduly burden Main Street companies whose treasurers are working every day to finance their businesses, safeguard their cash and other assets, and hedge risks in their day-to-day operations in the most efficient and effective ways possible.

There is no question that liquidity is the lifeblood of any business. Without having ample liquidity, production comes to halt, inventories run low, and bills are not paid on time. The cyclical nature of many businesses places significant importance on the availability of short-term financing so that they can operate efficiently and without disruption. For decades, the U.S. commercial paper market has been the most efficient, cost-effective short-term financial market utilized by corporate treasurers to meet their day-to-day funding requirements. In addition, access to short-term lines of credit from financial institutions and healthy capital markets for corporate debt continues to play an important role in helping corporations of all sizes manage their expected and unexpected financing needs.

We have been clear in our support of the important legislative and regulatory objectives to increase transparency in financial markets and to strengthen their safety, liquidity, and efficiency. Unfortunately, with the onslaught of new financial regulations since the financial crisis, we have seen the implementation of requirements affecting Main Street companies that often conflict with those objectives. The markets for short-term borrowing have tightened, resulting in more volatility, wider spreads, and higher rates. Corporate treasurers have faced increasing difficulty managing liquidity without tying up productive capital or incurring additional substantial financing and hedging costs.

Several regulatory initiatives have or will have significant negative effects on short-term financing. In many cases these regulations interact in ways not fully understood at inception, producing a greater negative effect than might be predicted from an analysis of the rules individually. In some cases, an economic analysis was not done during the rulemaking process leaving stakeholders with an inability to provide informed commentary. Additionally, we believe that the interaction of bank capital and liquidity rules with other rules, like money market mutual fund reform, calls for an analysis for how these rules interact amongst each other and what the collective and individual unforeseen consequences are. We reiterate our call that agencies follow the Administrative Procedure Act and similar statutes, like the Riegle Community Development and Regulatory Improvement Act, to publish an economic analysis during the rulemaking process and allow stakeholders to comment on that analysis. Additionally, in this case, we also believe that there must be a careful analysis of the cumulative effect these rules have on the financial markets when taken together to assure they meet the cost-benefit tests required under present law. To highlight two areas critical to short-term financing, let us consider money market fund reform that has contracted the commercial paper market and the proposed net stable funding ratio rule affecting the amount of capital banks are required to hold aside against loans and other advances they make to Main Street companies.

Money Market Fund Reform

In July 2014, the Securities and Exchange Commission ("SEC") finalized new rules for money market mutual funds that came into force October 14, 2016. The Chamber together with many corporate treasurers expressed significant concerns during the rulemaking process that these changes would have far-reaching consequences on the ability of corporate treasurers to raise short-term capital and manage cash. As we—and others—exhaustively detailed during the rulemaking's comment period to the SEC, the requirement for the net asset value ("NAV") to float and be reported to the nearest hundredth of a cent significantly complicates investments in prime money market funds by corporate treasurers and government finance officers. It introduces an element of uncertainty and recordkeeping complications that are not present in stable NAV funds.

The floating NAV requires treasurers to keep track of gains and losses for federal and state income tax purposes whenever they buy money market fund shares at one price and sell them at another in the routine redemption of their investment. The Department of the Treasury issued a regulation permitting investors in a single money market fund to simplify calculation of their gains and losses.[1] However, as has often happened amid the post-financial crisis flood of regulations, an unintended, and indeed undesirable, consequence ensued. The financial crisis certainly highlighted the need for treasurers to assure, as an absolute requirement, diversification of funding sources, as well as investment alternatives. The tax simplification for money market fund floating NAV investments, however, is only available for investments in a single fund—tending to increase the concentration of investments, producing consequently higher risk.

Of perhaps even greater consequence, however, are the new rule's liquidity fee and redemption gate provisions, which represent significant deterrents for corporate treasurers and other institutional investors from participating in institutional prime funds. There is significant concern that redemption gates may limit liquidity during periods of market stress. As discussed earlier, ensuring liquidity is an absolute requirement for corporate treasurers. Additionally, the potential imposition of liquidity fees also presents uncertainty and a potential loss of principal, a great risk to a treasurer's responsibility to assure adequate funding of day-to-day operations and to safeguard the corporation's assets. Thus, this provision, which is inherent in institutional prime funds, is a major deterrent for corporate cash being invested in prime funds. Instead of stabilizing money funds against a potential run, the application of the SEC's final rule seems to be raising heightened concerns about MMF's liquidity, stability, and overall utility.

Prime funds are important for corporate treasurers not only as a flexible alternative to bank time deposits for investments of temporary excess cash balances, but also because they have been important providers of short-term funding by buying commercial paper notes issued by many corporations to meet their daily funding requirements. However, as the graph below shows, in the year running up to the October 14, 2016, implementation of the new MMF regulations, fund purchases of corporate CP declined significantly.

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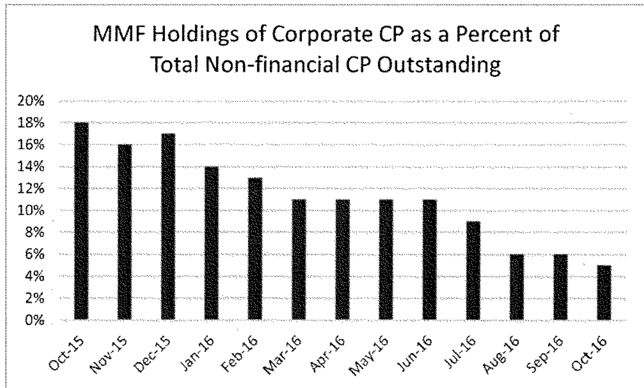
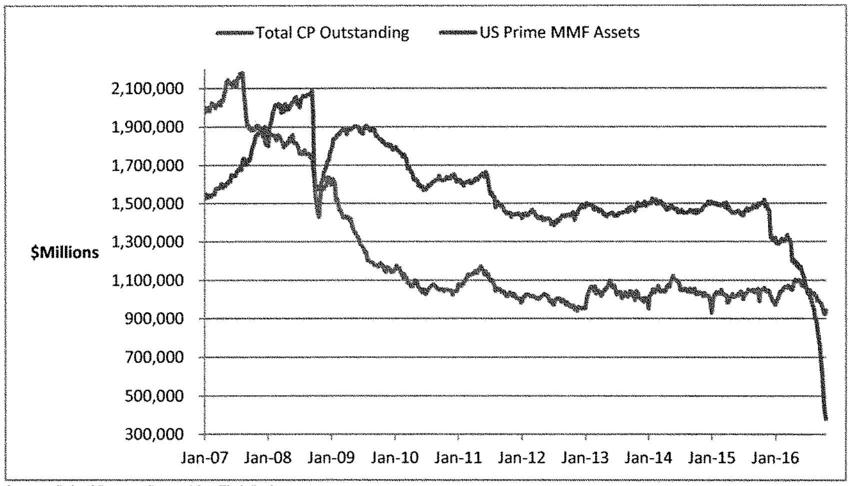
[1] *See* Department of the Treasury, Internal Revenue Service; Method of Accounting for Gains and Losses on Shares in Money Market Funds; Broker Returns with Respect to Sales of Shares in Money Market Funds, 91 Fed. Reg. 44,508 (Jul. 8, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-07-08/pdf/2016-16149.pdf.



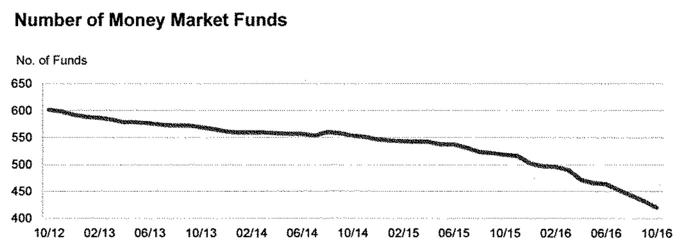
Source: Fitch Ratings and Crane Data

Concerns about investors fleeing prime money market funds have proven true. Assets in prime money market funds have fallen over $1 trillion to a mere $376 billion[2] since the rule was finalized. The outflow of funds accelerated over the summer in anticipation of the implementation in October, which led prime funds to invest in instruments that had a shorter duration (see chart below). The increasing reluctance to hold instruments such as commercial paper and municipal debt that matured beyond the October 14, 2016, compliance deadline resulted in a significant drop in demand for high-quality, short-term debt instruments. Additionally, the outflow of funds from prime money market funds has resulted in spreads widening by 20 to 25 basis points for prime funds compared to government funds. This quantifies the penalty for Main Street companies at the expense of relatively lower government funding costs.

[2] *See* "Money Market Fund Assets—Dec. 1, 2016," Investment Company Institute, *available at* https://www.ici.org/research/stats/mmf/mm_12_01_16.

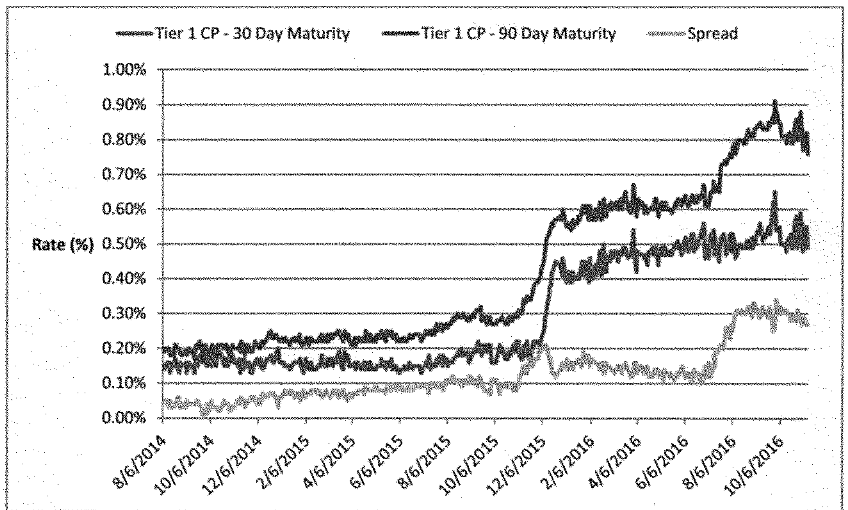


Source: Federal Reserve, iMoneyNet, Fitch Ratings



Source: SEC

The supply-demand imbalance, as well as the continued closing of institutional prime funds (see chart above) has forced companies and municipalities to pay higher borrowing rates to fund working capital and other short-term needs. This has been especially true for treasurers issuing 90-day commercial paper in October to obtain funding beyond the year end, faced with the October 14th MMF new rules implementation (see chart below).



Source: Bloomberg, Fitch Ratings

Money market fund reform has indeed added additional burdens to corporate treasurers to manage liquidity efficiently. Thus, we support legislative efforts that ease the economic burden on Main Street businesses to manage liquidity through affordable short-term financing and unrestricted access to cash investments and commend the sponsors of H.R. 4216 that have taken a step forward in this regard.

Net Stable Funding Ratio

The Chamber believes that the Federal banking regulators' proposed net stable funding ratio ("NSFR") rule does not take into account its dramatic impacts on corporate end-users. Specifically, the NSFR structurally discourages banks from investing in corporate debt and further restricts end-users' ability to hedge by increasing the cost of risk management, thus impacting the short-term financing markets and sidelining productive uses of capital.

The NSFR's treatment of corporate debt could hinder end-user capital raising efforts. The NSFR does not adjust for the maturity of end-user-issued debt when determining a dealer's required stable funding and would restrict liquidity in the corporate debt markets by requiring dealers to raise 50-85% long-term funding to support their inventory, which would discourage market making. End-users rely on market-based funding and the liquid markets for corporate bonds and commercial paper. As we prepare for the Federal Reserve's move to increase short-term rates and the yield curve moves up and steepens in anticipation of higher future short- and long-term interest rates, these effects will be exacerbated.

To cite a real-world example of the costs and diminished liquidity from these rules, corporate treasurers issuing commercial paper to balance their daily funding requirements at times are faced with a same-day payment that they identify too late in the day to place with an end-investor in the market. Often their bank commercial paper dealer will take the paper overnight for its own account and fund-out the requirement the next day. The NSFR rules require the bank to hold 85% of that overnight funding as long-term funding—at a cost over ten times the overnight amount. Ultimately this liquidity will no longer be available to end-user treasury departments. Accordingly, the federal banking regulators should carefully consider the impact of the NSFR's 50-85% long-term funding requirements on end-users.

Additionally, we also have concerns related to the add-on costs associated with derivative liabilities. For example, requiring dealer counterparties to provide required stable funding for 20% of the negative replacement cost of derivative liabilities (before deducting even for variation margin posted in cash) is a clear example of the direct burdens affecting end-users' ability to mitigate risk efficiently. The costs to hedge are likely to be passed on to end-user companies in the form of increased fees or transaction costs, less favorable terms, and collateral requirements.[3] Moreover, many have questioned why this 20% "add-on" is necessary and how it was developed, as it was not included in previous proposals from the Basel Committee on Banking Supervision. In fact, the European Union ("EU") has moved forward with a lower charge to reflect these concerns, placing U.S. companies and the U.S. financial institutions supporting them at a disadvantage relative to their EU competitors.

We believe that the Federal banking regulators would have avoided this unfair penalization of corporate treasurers and potential damage to our economy had they conducted and published economic analysis for public review and comment, as required under the Administrative Procedure Act and other similar statutes. In particular, the federal banking regulators are required under the Regulatory Flexibility Act ("RFA") and the Paperwork Reduction Act ("PRA") to conduct an assessment of the economic effect of regulations on small business and consideration of less burdensome alternatives. The PRA requires assessment of the paperwork burden on small entities and ways to reduce or mitigate it. In addition, those regulators are subject to the Small Business Regulatory Enforcement Fairness Act ("SBREFA").

[3] A January 2015 study of the OTC derivatives market by Oliver Wyman concluded that the NSFR's treatment of OTC derivatives would require an additional $500 billion in long-term funding, generating $5-8 billion in incremental costs to the industry, with a cost increase of 10-15% for derivatives transactions.

Among other things, the portion of SBREFA known as the Congressional Review Act states that rulemaking agencies must submit to GAO, and make available to each house of Congress, "a complete copy" of any cost-benefit analysis prepared for a final rule for which such an analysis is performed.[4] Other statutes, like the Unfunded Mandates Reform Act ("UMRA"), require the OCC to conduct economic analysis, and the Federal Reserve has vowed to abide by similar requirements under Executive Order 13563.[5]

Finally, and as we have repeatedly noted in our comment letters to the Federal banking regulators, the Riegle Community Development and Regulatory Improvement Act ("Riegle Act," 12 U.S.C. §4802(a)) requires a rigorous economic analysis that has not been performed here. In particular, the Riegle Act mandates that "[i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest—(1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations."

Need for Cumulative Impact Study

An inherent conflict of regulatory objectives further demonstrating the need for an analysis of cumulative impacts can be seen in money market fund regulations and the NSFR Proposed Rule as they affect bank funding and ultimately the cost for funding of Main Street companies. The SEC's rules aiming for greater liquidity for money market funds to meet short-term redemptions drove their investment holdings maturing in a week or less at November 28, 2016, to 68%, up from 54% at June 30, 2016. Many of these MMF investments have been bank certificates of deposit and bank commercial paper. Additionally, the NSFR rules force much greater reliance on long-term funding for banks. Taken together, the decline in money market prime funds' ability to buy short-term bank paper, and the NSFR rules mandating higher cost long-term funding for banks, must in the end result in higher short-term funding costs for Main Street companies. The costs compared to the benefits of these moves have not yet been fully determined.

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[4] 5 U.S.C. 801(a)(1)(b)(i))

[5] *See* Board of Governors of the Federal Reserve System, Statement of Policy Regarding Expanded Rulemaking procedures, 44 Fed. Reg. 3957 (1979) *and* letter from Scott Alvarez, General Counsel of the Federal Reserve, to Nicole Clowers, Director of Financial Markets and Community Investment of the General Accountability Office.

A bipartisan effort by Congress, supported by a majority of the members of this committee, clarified that end-users should be exempted from clearing any uncleared margin requirements to preserve end-users' ability to hedge their commercial risks effectively.[6] The Federal banking regulators should respect Congressional intent and modify the NSFR Proposed Rule to eliminate any potential impact on nonfinancial corporates to the extent that the Proposed Rule contradicts the value of congressionally mandated exemptions. While the Proposed Rule does not undo these exemptions, the consequences of the proposal would not be isolated to covered companies, which would pass on costs of the funding requirements to end-users.

Conclusion

We believe the legislative intent of the Dodd-Frank Act was not to make it exceedingly difficult for corporations to manage their short-term financing and liquidity needs. In fact, Congress specifically exempted nonfinancial corporations from having to use their own capital for unproductive purposes in other contexts, such as the mandatory margining of derivatives transactions. Sidelining productive capital through regulatory requirements diverts funding from investment in business expansion and ultimately costs jobs. Moreover, Congress felt it unnecessary to include additional reforms for money market funds in the Dodd-Frank Act as the SEC had already enhanced regulations under its Rule 2a-7 in 2010.

As a result, we strongly urge you to direct financial regulators to conduct a study of major regulatory initiatives for cumulative impacts on all financial institutions, their customers, and economic growth, which is a key recommendation in our 2017 agenda *Restarting the Growth Engine: A Plan to Reform America's Capital Markets*.

In fact, a recent survey from the U.S. Chamber of Commerce underscores the need to examine our financial services regulatory structure. The Chamber's *Financing Growth: The Impact of Financial Regulation* report asked more than 300 corporate finance professionals, including CFOs and treasurers, to report on the impact of financial services regulatory reform on the availability and cost of the products and services most crucial to the growth of Main Street businesses.

One key finding from the report includes the fact that access to credit remains their top concern. However, more than three-quarters of American companies of all sizes believe that the cumulative effect of financial regulations adopted over the past six years is making it harder for them to access the financial services they need. In

[6] *See* 7 U.S.C. § 2(h)(7); 7 U.S.C. § 6s(e)(4).

addition, 79% of respondents indicate that they are affected by changes in financial services regulation, resulting in 39% of respondents absorbing higher costs and 19% delaying or cancelling planned investments.

Consequently, the larger point, which I know this Subcommittee appreciates, is that the new money market mutual fund and bank structural and capital regulation threatens to impose undue burdens on corporate end-users. The indirect but potentially even more onerous regulation of end-users through bank capital and liquidity requirements serves to pass on substantial new costs to corporate end-users.

In sum, without a robust financial services system that can provide short-term financing, our nation cannot sustain adequate economic growth. Regulatory efforts to ensure financial stability must be accompanied by equally vigorous, data-driven analysis to make certain that Main Street companies continue to have access to the financial services they need. And, as in the case with the NSFR, a failure to conduct rigorous economic analysis as required by law can result in unfair and harmful penalization of regular activities by nonfinancial corporations and other end users outside of the financial system. As a result, Congress must examine the consequences stemming from regulatory initiatives, like money market mutual fund reform and the NSFR, and ensure that there continues to be affordable access to short-term credit and other financing needs.

Thank you and I am happy to address any questions you may have.

TESTIMONY OF

MICHAEL KONCZAL

ROOSEVELT INSTITUTE FELLOW

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES COMMITTEE ON FINANCIAL SERVICES

ON

"THE IMPACT OF REGULATIONS ON SHORT-TERM FINANCING"
DECEMBER 8th, 2016

ROOSEVELT INSTITUTE
REIMAGINE THE RULES

Introduction

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee, thank you for the opportunity to testify. My name is Michael Konczal, and I'm a research fellow at the Roosevelt Institute, where I lead our project on reforming the financial sector. Previously, I was a financial engineer at Moody's KMV, a leading provider of quantitative credit analysis tools to lenders, investors, and corporations. The Roosevelt Institute is the non-profit partner of the Franklin Roosevelt Presidential Library. Inspired by the legacy of Franklin and Eleanor Roosevelt, the Roosevelt Institute reimagines America as it should be: a place where hard work is rewarded, everyone participates, and everyone enjoys a fair share of our collective prosperity. We believe that when the rules work against this vision, it's our responsibility to recreate them.

The financial crisis showed us that the rules of the financial system weren't sufficient to prevent a crisis. It also showed us that while the financial system had become bigger and more profitable, making a greater contribution to inequality, it had also become less efficient than it was 100 years ago. Our goal is to identify the rules that will create a financial system that works for everyone in the economy.

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, the primary legislative response to the 2008 financial crisis, is the first step toward this goal, and has had many important accomplishments in this regard. It has increased stability among the major banks, with risk-weighted capital at the largest banks doubling since the crisis, alongside major improvements in liquidity, leverage, and stress-testing requirements. Advancements in single-point-of-entry technique by the FDIC will help ensure a failing financial firm can be eliminated without extensive panic and contagion. Dodd-Frank has also brought transparency and competition to the derivatives markets, where 75 percent of index credit default swaps and 53 percent of interest rate derivatives now trade through swap execution facilities.[1] And it has centralized consumer protection functions, previously dispersed among nearly a dozen different agencies, in the Consumer Financial Protection Bureau, whose supervision and enforcement work has brought $11.7 billion in relief to consumers.[2]

One of the major drivers of the financial crisis was a panic in short-term capital lending markets, a group of entities known as "shadow banking." Here we refer to shadow banking as financial activity that follows the function of traditional banking, especially creating credit by funding long-term and illiquid assets with short-term, runnable, liquid debt that acts like deposits. What distinguishes these activities is that they do not have explicit banking regulations or access to deposit insurance or emergency lending from the Federal Reserve. Often they are regulated through securities law, which emphasizes disclosures and enforcement over systemic, prudential regulations.[3]

[1] Financial Stability Oversight Council. "2016 Annual Report." 2016.
[2] Consumer Financial Protection Bureau. "Consumer Financial Protection Bureau: Enforcing federal consumer protection laws." July 2016.
[3] Gorton, Gary B. *Slapped by the invisible hand: The panic of 2007.* Oxford University Press, 2010.

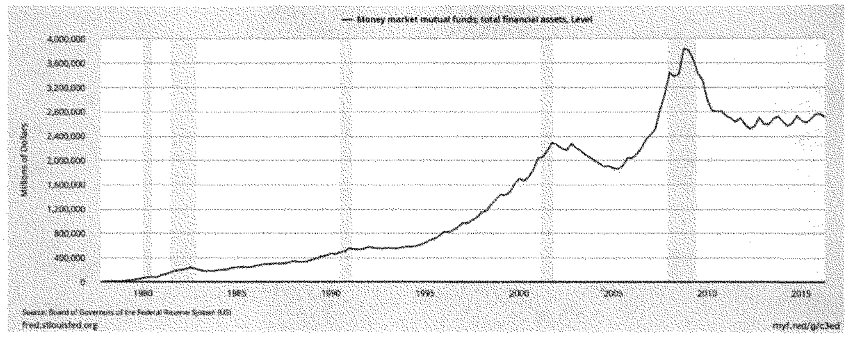
One of the primary elements of the shadow banking market is money market mutual funds, or money market funds (MMFs), whose collapse in the aftermath of the failure of Lehman Brothers was a defining moment for the panic. The reform of MMFs is thus an essential part of Dodd-Frank. Substantial progress has been made so far, but reforms to the short-term lending markets can and should go further.

Money Market Funds

Money market mutual funds are a class of mutual funds that invest in short-term debt instruments, including commercial paper, Treasuries, repurchase agreements, federal funds, and certificates of deposits. They are registered under the Investment Company Act and regulated pursuant to rule 2a-7 under the Act. They pay a dividend reflecting short-term interest rates, are redeemable on demand (considered a cash equivalent on bank balance sheets), and seek to maintain a stable net asset value (NAV). These features of MMFs stem from two important exemptions the SEC introduced in 1983. MMFs are allowed to value their securities using "amortized cost," which allows them to value their securities at cost plus premiums and discounts, as well as the "penny-rounding" method of pricing, which allows them to absorb normal volatility by rounding to the nearest 1 percent (I.e. one penny of a dollar). This combination of liquidity, stability, and payments makes them an attractive investment vehicle, but it also subjects them to destabilizing runs.[4]

The growth of MMFs since the late 1970s has been rapid. Their size peaked at $3.8 trillion immediately before the crisis before falling rapidly and leveling off at $2.7 trillion now.

[4] For background see: Securities, U. S., and Exchange Commission. "Money Market Fund Reform; Amendments to Form PF." (2013).



The features that distinguish MMFs from other investment vehicles also make them act just like commercial banks prone to runs, as we experienced during the financial crisis. However, they are not regulated like banks. Indeed, regulatory arbitrage has been built into MMFs since the beginning.

Money Market Funds as Regulatory Arbitrage

As a legal matter, MMFs function as mutual funds and are regulated as such. But as an economic matter, MMFs share functions identically to bank deposits. They allow for investments to be liquidated at any time at par, with the expectation that they will return the capital amount invested plus interest. They also invest in wholesale credit markets, and have no ability to recover value lost through defaults by retaining earnings. They blur the line between these two regulatory worlds of securities and banking law.[5]

The history of MMFs has always been tied to this regulatory arbitrage. They originated as a way of working around Regulation Q, a Depression-era limitation

[5] Armour, John, et al. "Principles of Financial Regulations." Oxford University Press, 2016.

on the interest rates banks could charge. As former Federal Reserve Chairman Paul Volcker has recently noted, "I was at the Federal Reserve [Board] when [MMFs] were born. It was obvious at the time that these products were created to skirt banking regulations. The first of these Funds to require a bailout by a corporate parent in order to avoid 'breaking the buck' was in 1980."[6]

Others noted that MMFs potentially violated the then-active Glass-Steagall prohibition on securities firms engaging in banking activities. Glass-Steagall prohibited securities firms, such as a MMFs, from engaging "at the same time to any extent whatever in the business of receiving deposits subject to check." Researchers at the time noted this “crack” between securities firms and deposit banking, though Congress and regulators ultimately took a passive stance toward the growth of MMFs.[7]

Congress and regulators did not take it upon themselves to regulate MMFs under a prudential regulatory umbrella suitable for banking activities, but instead left the SEC as their primary regulator. The SEC’s tools primarily consisted of mandates and disclosures, yet these tools turned out to be insufficient to deal with runs and the financial crisis.

History of Runs in Money Market Funds

This institutional setup created the conditions for massive runs on MMFs during the financial crisis. This risk had been covered up previously because of the ability of MMFs’ sponsor funds to provide funds to backstop losses, amounting to a de facto capital injection and backstop.

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[6] Paul Volcker, Comment Letter to the SEC 2-3, Feb. 11th, 2011.

[7] John A. Adams, Money Market Mutual Funds: Has Glass-Steagall Been Cracked?, 99 BANKING L.J. 4, 11 (1982): 4.

This backstop has been a consistent feature of the MMF landscape since their growth, unique among mutual funds. There have been at least 11 financial events that have required fund sponsors to provide support, occurring in 1989, 1990, 1991, 1994, 1997, 1999, and 2001, with researchers recording over 200 instances of such support.[8]

It was only a matter of time until there was a loss significant enough that MMFs' sponsors funds couldn't backstop the losses. When Lehman declared bankruptcy on September 15, 2008, the MMF Reserve Primary Fund held 1.2 percent of the fund's total $62.4 billion assets in Lehman. That morning the fund had $10.8 billion in redemption requests. State Street, the custodial bank, stopped an existing overdraft facility previously designed to help meet those requests, within hours. Investors requested an additional $29 billion throughout the rest of that day and the next.

After the Primary Fund "broke the buck," MMFs with no known Lehman exposure experienced runs. This interconnectedness and contagious panic spread rapidly across MMFs. Within a week, investors in prime MMFs withdrew $349 billion, with that headed for funds invested in Treasuries. Those funds had to turn people away. This panic, in turn, dramatically increased the costs of short-term borrowing, which disrupted payments and companies dependent on commercial paper markets.[9]

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[8] See: Securities, U. S., and Exchange Commission. "Money Market Fund Reform; Amendments to Form PF." (2013), and Financial Stability Oversight Council. Proposed Recommendations Regarding Money Market Mutual Fund Reform. 2012.
[9] Financial Crisis Inquiry Commission, and United States. Financial Crisis Inquiry Commission. *The financial crisis inquiry report: Final report of the national commission on the causes of the financial and economic crisis in the United States.* PublicAffairs, 2011.

Removing Floating NAV Would Increase Systemic Risk and Reduce Transparency

In subsequent years, the SEC has imposed several regulations on MMFs designed to increase their stability and reduce their likelihood of runs. The most important rule, imposed in 2014, requires prime institutional MMFs to use a floating NAV instead of a stable one.

H.R. 4312 would remove the floating NAV requirement required of both institutional prime and institutional municipal MMFs that emerged out of the SEC's 2014 rule-writing. This is a move in the wrong direction, reducing transparency and increasing the threat of a systemic panic by returning to the regulatory regime that existed before the crisis.

First, it's important to understand why a floating NAV will help reduce the risks of a financial panic. With a floating NAV, there is less incentive for mass withdrawals under stressed conditions. There is no "cliff effect" of breaking the buck that comes from the penny-rounding rule. A floating NAV greatly reduces the first-mover incentive, as there is no moment at which investments are redeemable at par and then they are not. Indeed, regular, small fluctuations would make investors less likely to panic. A floating NAV also increases fairness: Losses are mutualized, rather than concentrated among late movers while first-movers receive their investments at par.

There is also an issue of transparency. A floating NAV will give investors a clearer understanding of the risks they face and the movements in the MMF's portfolio. Investors have an opaque understanding of both the assets themselves as well as the support they could receive from their sponsors, leading to an expectation of stability and at-par withdrawal that may be unfounded. A floating

NAV makes it clear that investors will bear losses, rather than hope for ad hoc capital interjections by the sponsoring funds or bailouts from the government.[10]

Redemption Gates and Fees Aren't a Sufficient Reform

There is also the issue of retaining liquidity fees and redemption gates without a floating NAV. While the fees and gates structure can help mitigate risks faced in times of stress with a floating NAV, without one they are just as likely to increase the incentives to run. Knowing that gates on redemptions are potentially in play, investors could run even faster to remove their funding in times of stress. These important tools for preventing runs work best alongside, rather than as a replacement for, a floating NAV.

Disclosures Won't Work to Prevent Money Market Systemic Risk

H.R. 4216 has a provision that tries to educate investors that these instruments do not function as deposits and their investments are subject to losses. H.R. 4216 requires that "[n]o principal underwriter of a redeemable security issued by a money market fund nor any dealer shall offer or sell any such security to any person unless the prospectus of the money market fund and any advertising or sales literature for such fund prominently discloses such prohibition against direct covered federal assistance."

This approach defined much of the SEC's regulatory response to MMFs in the 1990s. The SEC has, at several times, adopted rule-making that emphasized that depositors remain at risk for runs and losses.

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[10] Financial Stability Oversight Council. Proposed Recommendations Regarding Money Market Mutual Fund Reform. 2012.

In 1991, the SEC "[r]equire[d] the cover page of [MMF] prospectuses, and fund advertisements and sales literature, to disclose prominently that an investment in a [MMF] is neither insured nor guaranteed by the U.S. Government and that there is no assurance that the fund will be able to maintain a stable per share [NAV]."

In a 1996 amendment, the SEC "acknowledges that none of its rules can eliminate completely the risk that a [MMF] will break a dollar as a result of a decrease in value of one or more of its portfolio securities. Thus, in adopting these amendments, the [SEC] is prescribing minimum standards designed not to ensure that a fund will not break a dollar, but rather to require the management of funds in a manner consistent with the investment objective of maintaining a stable [NAV]."[11]

Neither of these measures were sufficient to prevent the crisis of 2008, either in exposure to Lehman or in the panic that followed across MMFs immediately afterward. Disclosures are not a sufficient substitute for prudential banking regulations.

Liquidity is Not Stopping the Economy

There are many concerns about capital market liquidity weakening the economy and future growth. However we do not see this in bond market liquidity measures. According to analysts at the New York Fed, "price-based liquidity measures—bid-ask spreads and price impact—are very low by historical standards, indicating ample liquidity in corporate bond markets." It is not clear whether or not there is a liquidity problem within the capital market in general.

[11] 56 Fed. Reg. 8113 (Feb. 27, 1991) and Release 21,837 (Mar. 28, 1996), at *25*, as reprinted in Barr, Michael S., et al. "Financial Regulation: Law and Policy." Foundation Press. (2016)

Experts disagree on how the capital markets are evolving in response to the trauma of the crisis. Also the relationship between reduced liquidity in bond markets and overall corporate investment is complicated and not straightforward. However these do not matter for the real economy, because any potential reduced liquidity isn't showing up in measures that would affect corporate decision-making.[12]

Access to Finance Is Not Stopping the Economy

Part of the reason for these new measures and other concerns about short-term funding is the idea that lack of finance is holding back the recovery and further expansion of the economy. This lack of finance is understood to be the result of Dodd-Frank, especially its requirements on capital and liquidity. Yet there is no indication that financing is a constraint on the economy.

We do not see this in the survey data. In surveys conducted by the National Federation of Independent Business (NFIB), only 2 percent of small businesses indicate financing and interest rates are the single most important problem they face. Only 4 percent of small businesses indicate their borrowing needs were not satisfied in the past three months, a number that has trended downward since 2011. Instead, the NFIB's researchers find that "record number of firms remain on the 'credit sidelines', seeing no good reason to borrow."[13] This is mirrored in the Federal Reserve's Senior Loan Office Survey on Bank Lending Practices; there has been a continued reduction of overall spreads in recent years in commercial and industrial loans.[14]

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[12] Adrian, Tobias, et al. "Has US Corporate Bond Market Liquidity Deteriorated?." *Liberty Street Economics* (2015).
[13] NFIB Small Business Economic Trends, William C. Dunkelberg, Holly Wade, October 2016
[14] "Senior Loan Officer Opinion Survey on Bank Lending Practices Chart Data." Federal Reserve Board. Accessed 6 Dec. 2016.

We also do not see this financial constraint in corporate governance decision-making. The corporate governance literature gives us a hierarchy of substitutable funding options for businesses looking to expand, usually a range from retained earnings to borrowing to issuing equity. If Dodd-Frank were reducing the ability to borrow, we would expect firms to retain more earnings. However, total shareholder returns for the S&P 500 set a 12-month record high in March 2016 at $974.6 billion, with those companies also sitting on a record $1.347 trillion in cash.[15] In 2014, spending on buybacks and dividends was larger than combined net income among all publicly traded non-financial U.S. companies for the first time outside of a recession.[16] Total shareholder payouts in 2014 were more than $1.2 trillion, while money moving from investors to businesses in the form of IPOs and venture capital was less than $200 billion. As a result, for every dollar invested in the real economy by finance, six dollars are taken out.[17]

Estimates by Goldman Sachs also indicate that that if $200 billion were repatriated as part of a corporate tax holiday, $150 billion would be used for stock buybacks. Jim McCaughan of Principal Global Investors notes, "I don't think availability of funds has been a jar issue for U.S. capital investment."[18] Whether or not we should be worried about these trends, they clearly indicate that financing is not blocking expansion.

This also isn't relevant for declining rates of entrepreneurship and small-business formation. The trend toward declining entrepreneurship is a decades-long phenomenon, going back to 2000 and perhaps even the 1980s. Rates of

[15] Mahmudova, Anora. "U.S. companies spent record amount on buybacks over past 12 months." *Marketwatch*, 22 June 2016.
[16] Brettell, Karen, et al. "The Cannibalized Company." *Reuters*, 16 Nov. 2015.
[17] Mason, J. W. "Understanding Short-Termism." Roosevelt Institute. (2015)
[18] Wigglesworth, Robin. "Where will corporate America's overseas cash pile go?" *Financial Times*, 5 Dec. 2016.

entrepreneurship are closely linked with business cycles; studies have found that unemployment leads to weaker labor market fluidity,[19] while areas with the weakest labor market fluidity correlate with the weakest wage growth, pushing towards demand-side, rather than supply-side, factors.[20] Newer research shows recessions cause fewer business formations that also have lower rates of survival, yet capital intensity is not associated with startup firm survival, implying access to capital is not the driver.[21]

Money Market Mutual Funds: What More Can Be Done?

Even with the work done, experts rightfully remain concerned about the destabilizing elements in the shadow banking markets, with MMFs remaining a specific concern going forward. The floating NAV is a step in the right direction to bring greater transparency and resilience to this market, but policymakers must consider additional efforts to ensure that MMFs don't precipitate or amplify a future crisis. Avenues for future reforms of MMFs that require future investigation include:

- Require all MMFs and their close substitutes to publish a floating NAV and be subject to appropriate liquidity buffers. This incremental recommendation of the Volcker Alliance also suggests eliminating the ability of assets with less than 60 days to be accounted with amortized cost.[22]

[19] Molloy, Raven and Smith, Christopher L. and Trezzi, Riccardo and Wozniak, Abigail, Understanding Declining Fluidity in the U.S. Labor Market. *FEDS Working Paper No. 2016-15.* (2016)
[20] Konczal, Mike, and Marshall Steinbaum. "Declining Entrepreneurship, Labor Mobility, and Business Dynamism: A Demand-Side Approach." *Roosevelt Institute.* (2016)
[21] Moreira, Sara. "Firm Dynamics, Persistent Effects of Entry Conditions, and Business Cycles." (2015)
[22] "Unfinished Business: Banking in the Shadows." *The Volcker Alliance*, Dec. 2016.

- Regulate all MMFs as specialized "narrow banks." MMFs engage in all the activities of credit intermediation, yet do not have the same regulatory umbrella as traditional banking. MMFs that wish to continue offering bank deposit services, such as withdrawals on demand at par and a stable NAV, should reorganize as special-purpose banks, with prudential regulations as well as some level of basic insurance and access to lender-of-last resort facilities to prevent runs.[23]

Meanwhile, further regulations and actions are needed to ensure shadow banking overall poses less systemic risk to the financial markets. Such potential actions include:

- Establishing a system of "minimum haircuts" for securities financing transactions, such as repos, reverse repos, securities lending and borrowing, and securities margin lending. These transactions are important for capital markets, but they also hold the danger of creating panics and fire sales. These haircuts would require the posting of additional margins to lenders, which in turn would reduce leverage across the shadow banking sector.[24]

- Reform the bankruptcy code to revoke the repurchase agreement safe harbor rule. Currently, bankruptcy carves out repurchase agreements and derivative contracts from the Chapter 11 bankruptcy process, making them not subject to the automatic stay that normally prevents runs. Many academics believe this carve-out, established in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, was a major driver of the growth of these financial instruments and played a role in the sudden collapse of Lehman Brothers.[25]

[23] Gorton, Gary, and Andrew Metrick. "Regulating the shadow banking system." *Brookings Papers on Economic Activity* 2010.2 (2010): 261-297.
[24] Tarullo, Daniel K. Thinking Critically about Nonbank Financial Intermediation: a speech at the Brookings Institution, Washington, DC, November 17, 2015. No. 879. 2015.
[25] Kathryn Milani. "Reining in the Shadow Banking System." *Roosevelt Institute*. 2016.

- More aggressively use the Federal Reserve's balance sheet to crowd out private-sector maturity transformation. As Robin Greenwood, Samuel Hanson, and Jeremy Stein argue, "a plentiful supply of central-bank liabilities—e.g., interest-bearing reserves or overnight reverse repurchase agreements (RRP)—can reduce the economic incentives for private-sector intermediaries to engage in excessive amounts of maturity transformation." Much of shadow banking is dependent on institutional needs for short-term, informationally-insensitive, money-like instruments, and the Federal Reserve is better positioned than the shadow banking sector to provide this market need.[26]

Conclusion

Thank you for the opportunity to appear at this hearing. I look forward to your questions.

[26] Greenwood, Robin, Samuel G. Hanson, and Jeremy C. Stein. "The Federal Reserve's balance sheet as a financial-stability tool." *Designing Resilient Monetary Policy Frameworks for the Future," Jackson Hole Symposium: Federal Reserve Bank of Kansas City*. 2016

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Written Testimony of Mr. Robert Toomey

On behalf of the Securities Industry and Financial Markets Association

before the U.S. House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets

Hearing entitled "The Impact of Regulations on Short-Term Financing"

December 8, 2016

Chairman Garrett, Ranking Member Maloney, and distinguished members of the Subcommittee, thank you for providing me the opportunity to testify on behalf of the Securities Industry and Financial Markets Association (SIFMA)[1] and to share our members' perspective on the impact of regulations on the capital markets broadly and the short-term funding markets more specifically. SIFMA applauds this Committee's focus on ensuring that an appropriate balance is struck between regulation and growth through an evaluation of the intended and unintended consequences of the post-crisis reforms. Much of the regulation that has been implemented seeks to address key contributors to the financial crisis and has made both banks and the broader financial system safer and sounder through new heightened prudential standards and higher and better quality capital, leverage and funding rules. In addition, the Basel Committee, the Financial Stability Board, and several U.S. regulators continue to seek additional reforms that have yet to be fully implemented and whose effects are not yet baked into the system or the cost of capital.

It is often noted by this Committee that the U.S. financial markets are characterized by their unparalleled size, depth, dynamism, diversification, and resiliency. Our capital markets allow the Federal government, state and local governments, corporations and investors quick and efficient access to financing. Moreover, the depth and liquidity of U.S. secondary markets, particularly the fixed income markets, permit those entities to access capital and credit with greater availability at a lower cost over time.

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $20 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

Policymakers have clearly stated that many of the post-crisis reforms were designed to solve for what they saw as too little capital, lax underwriting standards and excess market liquidity that was insufficient during periods of credit stress. But recently, market participants and observers have raised concerns that the reforms may have resulted in reductions in market liquidity beyond what was intended, particularly for the high-quality liquid assets that underpin the financial system and our economy.

We see the resiliency and depth of market liquidity as a critical objective for policymakers and market participants alike. Again, the depth and liquidity of U.S. capital markets is among the primary reasons it leads the world in size and use, and to great benefit to the broader economy. If market participants' ability to access liquidity is impaired, particularly during stress periods, it will negatively impact functioning of financial markets with broad ramifications for the general economy. Indeed, this is what we experienced in 2007-2008 when markets froze, particularly short-term markets, putting severe funding pressure on both the private and public sector. Regulations that are risk-insensitive, and regulations that target the same risk multiple times through multiple rules, weigh particularly heavily on low-risk assets. While the broad contours of the new capital and liquidity rules have been known for some time, the implementation phase is just gathering force and indeed, some rules remain to be proposed and finalized.

Assessment of the Regulatory Framework Needed

As such, we believe now is an appropriate time to assess the coherence of the existing framework, and the degree to which overlapping rules target the same risks. We are thus recommending an assessment of coherence and cumulative impacts, on a forward-looking basis, to identify cases where there may be unnecessary duplication or conflicts between specific regulatory requirements and broader policy goals. Such an assessment could identify opportunities to add liquidity back to the market without adversely affecting the safety and soundness of individual banks or of the overall financial system. In this testimony, we identify potential, but not exhaustive, areas of concern.

First, we believe that the impact of risk-insensitive rules on client trades that are designed to reduce risk is inconsistent with the policy objectives of capital and prudential regulations.

Second, in looking at the full rule-set in place today and what we expect to come online in the near future, we find duplications and inconsistencies between the rules that together could have negative effects.

Third, and related to our first point, the treatment of low-risk, high-quality assets like cash and cash equivalents varies depending on the rule and often does not reflect their low-risk or risk-free status.

Finally, the assessment should examine the calibration of specific rules that are designed to serve as backstops but that actually operate as binding constraints.

Where new regulations such as the leverage ratio and Net Stable Funding Ratio (NSFR) interact with other rules and changes in market structure to further reduce market liquidity, users of financial services could be prevented from achieving their investing, capital-raising or risk-management goals, undermining the critical role of capital markets in the economy. While it has been observed that the average size of trades has shrunk during the implementation of the post-crisis regulatory reform package, indicating less immediacy of execution and higher execution costs in most asset classes, investors have shown an ability to absorb some of the execution risks in day-to-day markets. However, under the new rules they may not be able to transact effectively in stressed markets, when the need to sell is acute and delays can drive sharper price dislocations.

Impact of Regulation on the Repo Market

Short-term funding markets play an essential function in the financial system. Indeed, as we have noted most recently in our comment letter on the proposed Net Stable Funding Ratio, "[r]epo transactions play a vital role within the financial system and underpin the functioning of the capital markets, including the market for U.S. Treasury securities, collateral management and money markets."[2] Repo markets provide the necessary grease that allows the U.S. capital markets to remain the most efficient and liquid in the world so that businesses, municipalities and the Federal government can access needed credit at the lowest cost over time. A well-functioning repo market decreases the overall cost of borrowing and provides a mechanism for the efficient management of short-term cash and collateral requirements.[3]

Investors rely on the repo market as an essential part of their activities. Reverse repos are a safe way to invest cash, while repos allow investors to finance inventory, enhance yield in a safe and proven manner and quickly generate cash needed for redemptions.

Several significant regulations, some of which are not fully in place yet, have been proposed and/or adopted that have a direct impact on the repo market and other short-term funding markets. While some of these impacts are clearly intentional and reflect a policy concern for overreliance by financial institutions on short-term funding, we believe that as a result of the cumulative impact of these regulations, the repo market is being impacted in ways that do not reflect either the risk to the financial system or to individual firms.

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[2] SIFMA with other trade associations comment letter on NSFR Proposed Rule, August 5, 2016, available at http://www.sifma.org/issues/item.aspx?id=8589961839

[3] A robust repo market aids in limiting settlement fails by providing a ready supply of securities to market participants to alleviate short supplies or operational issues that may occur from time to time.

Given the overall importance of the repo markets to the cash markets, particularly the markets in fixed income securities, as a source of securities and as a repository for short-term investable cash, constraints on the liquidity in the repo market constrain liquidity in the cash markets to the ultimate detriment of the users of capital markets—the Federal government, municipalities and businesses both large and small.

Other rules, while not directly targeting the reliance of firms on short-term funding, will also have an impact on these markets by creating demand for a liquid repo market at the same time regulations are causing market participants to limit repo intermediation. Each of these rules may impact the short-term funding markets in different ways but the overall interaction of these regulations—and thus any unintended consequences for efficient capital formation—is unclear. Indeed, the aggregate impact of these reforms can be far greater than the intended impact of the individual reforms. These aggregate impacts can result in less access to credit, and higher costs for corporates, governments, and investors, impeding economic growth.

Within the short-term funding markets, and in response to the financial crisis, much has been done to improve resilience and lessen systemic risk. Reforms in the tri-party repo market, for example, eliminated over 95% of the significant intraday credit that was being extended by the clearing banks to dealer firms. This development lessens the risk that the market poses to the broader financial system. Individual firms, heeding the lessons of the financial crisis, improved risk management practices and recognized the need to diversify funding sources and to provide for a variety of maturities for repo transactions, thus lessening reliance on overnight funding.

Publicly available data illustrates the changing size and profile of the repo market, both in reaction to changes in prudential regulation and through the adoption of changed risk management practices.

Aggregate repo volumes in the U.S. have contracted significantly since 2008: Federal Reserve data shows that aggregate daily repo volumes in the U.S. have contracted from $3.9 trillion in 2008 to $2.4 trillion in 2014.[4] In addition, the mix of collateral subject to outstanding repos has changed, with a larger portion of non-Treasury securities now making up the collateral mix.[5]

Supplementary Leverage Ratio

The financial crisis of 2008-2009 revealed weaknesses in the prudential framework for banks. As previously noted, international and U.S. bank regulators along with the Congress have sought to strengthen this framework through a number of initiatives. There is widespread agreement that prudential reforms put in place following the financial crisis, aimed at both capital and liquidity, have helped create a system that is now more resilient and better able to withstand shocks.

While addressing some of these weaknesses through a revision to the risk-based prudential framework, policymakers also focused on strengthening the leverage ratio. The Supplementary Leverage Ratio (SLR) was first proposed in the U.S. in 2012 and finalized in 2013. U.S. banks subject to the SLR began disclosing and reporting ratios in 2015, and must be compliant by 2018.

Broadly speaking, the SLR seeks to create a prudential back-stop to the enhanced risk-based capital requirements. The ratio, in summary, contains two measures: a numerator that represents the tier 1 capital of the institution and a denominator that represents total exposures. Total exposures for purposes of the SLR includes on-balance and off-balance sheet assets, including repo-style

[4] See Global financial markets liquidity study, PwC, (August 2015), available at http://www.pwc.com/gx/en/financial-services/publications/assets/global-financial-market-liquidity-study.pdf

[5] See OFR Working Paper, "Do Higher Capital Standards Always Reduce Bank Risk? The Impact of the Basel Leverage Ratio on the U.S. Triparty Repo Market," Meraj Allahrakha, Jill Cetina and Benjamin Munyan (November 2016) (OFR Paper): "…[F]ollowing the 2012 introduction of the [SLR], broker-dealer affiliates of [bank holding companies] decreased their repo borrowing but increased their use of repo backed by more price-volatile collateral."

transactions. Notably, the SLR does not risk weight the assets in the exposure measure. Thus, the measure included in the exposure denominator treats all assets the same for SLR requirements. For instance, Treasury securities and cash are treated the same as unsecured loans and other more volatile securities.

While the SLR is intended to be a backstop measure to risk-based requirements, for many institutions it may become the binding constraint. This has implications for the smooth functioning of the short-term funding markets, particularly the repo market for U.S. government securities. As noted, the SLR is not risk-based and the calculation includes exposures for all repo transactions and makes no distinction between repos (and other financings) involving U.S. Treasury securities and those involving other assets. This creates two significant issues for the repo market: (1) it results in higher capital costs for dealer intermediation in the Treasury repo market; and (2) incentivizes for the substitution of Treasury repos with repos using collateral with a higher risk profile.

The SLR has sharply increased the cost for use of a bank's balance sheet in a traditional matched-book repo arrangement. On a typical repo trade, a bank/dealer may lend cash to a counterparty who secures the loan with Treasuries. The Treasuries may then be financed by the bank/dealer through another repo at a, usually, lower financing rate. If a counterparty fails, the position can be liquidated with very low risk to the bank/dealer because it is almost fully secured or over-secured by cash or safe Treasuries. The SLR makes this important sequence of transactions significantly more expensive from a capital perspective. For the largest U.S. banks, the SLR now requires 6% capital for all assets regardless of risk.[6] Safe Treasuries and cash are subject to the same capital treatment as less safe assets. As a result, intermediaries in the repo market for Treasuries -- generally a low

[6] We include the impact of the U.S. G-SIB surcharge as implemented in the U.S. which also measures reliance of short-term wholesale funding such that a banking organization that engages in a large number of matched-book repos which have a higher G-SIB surcharge.

margin business -- would have to require profits for Treasury repo that would be comparable to transactions in riskier assets. Dealers associated with banks subject to the SLR thus have hard balance sheet constraints that may limit the ability to intermediate some repo classes.[7]

Liquidity Coverage Ratio

The Liquidity Coverage Ratio (LCR) has led to an additional stress on liquidity in the repo market by imposing requirements on subject institutions to have on hand sufficient high quality liquid assets (HQLA) to weather a short-term (30 days) liquidity stress event. Thus, demands for HQLA, in particular U.S. Treasury securities, will increase because of the LCR. Further, during a market stress firms can be expected to hoard HQLA to meet liquidity requirements and not make such securities available in the repo market, adding additional liquidity pressures. Finally, demand for HQLA from banks and dealers will compete with money market funds, particularly government-only funds. These funds have increased significantly in size since the implementation of recent money market reforms and will add to demand pressures in an environment where, due to other requirements, repo supply may be diminishing.

Net Stable Funding Ratio

The proposed NSFR would further unduly add costs to safe matched-book activities. Under the NSFR proposal, repos and reverse repos would be subject to asymmetric treatment in that short-term funding from financial sector entities received by a subject entity is assigned 0 percent Available Stable Funding (ASF), whereas short-term lending to financial sector entities by a subject entity is assigned a 10 or 15 percent Required Stable Funding (RSF) factor (depending on the quality of the assets underlying the repo transaction and whether the subject entity has rights of

[7] See OFR Paper

rehypothecation with respect to the underlying assets). Thus, the proposed rule would require a subject entity to hold stable funding against a repo book that is perfectly matched, effectively imposing yet another tax on these transactions, even though the repo market for U.S. Treasuries and related assets should be considered low risk. Elimination of the asymmetrical treatment of the two legs of the matched transactions would alleviate this additional pressure on this low risk activity.

Volcker Rule

Finally, the Volcker Rule, with its limits on proprietary trading, exerts further liquidity pressure in the cash markets. SIFMA has long held the position that the Volcker Rule was a solution in search of a problem and that it did not address issues identified in the financial crisis. SIFMA members have implemented the Volcker Rule requirements, including the restrictions on proprietary trading, over the last several years. Implementation challenges remain as firms continue to put in place policies and procedures that would recognize the distinction between prohibited prop trading and permitted market making activities. We believe the approach to market making adopted by the Final Rule is complex and may make it difficult for firms to distinguish between permitted and proscribed activities. Thus, firms may limit their intermediary activities even more to ensure overall compliance with the prop trading restrictions.

In addition, implementation of the Volcker Rule over the last few years has indicated the need for a more coordinated approach to regulatory cooperation, particularly with respect to regulatory interpretations and supervision. A more transparent and cooperative regulatory/interpretive oversight regime would aid firms as they become compliant and limit the doubts that may cause further pull back from needed customer activity.

Conclusion

The short-term funding markets remain vitally important to the efficient functioning of our capital markets. In response to lessons learned from the financial crisis and regulatory prescriptions, the repo market has shrunk and firms' reliance on short-term wholesale funding has been reduced. However, through overlapping and non-risk sensitive rules regulators may be impinging on valuable liquidity and efficiencies this market provides and lessening liquidity in the cash markets. That is why it is essential that an assessment of the cumulative impact and interaction of these rules is undertaken to ensure harm is not being done to this crucial market.

Through the leverage ratio requirements firms are facing clear and rigid limits on the size of their balance sheets and this inelasticity, particularly with respect to safe U.S. Treasury securities and cash, will limit important dealer intermediation. Indeed, we are seeing these impacts now as the size of the repo market decreases and the mix of collateral changes. Further pressures on Treasury repo include requirements to hold HQLA -- a requirement which will create further significant pressures during stressed situations -- recent changes to the money market rules which create more demand for U.S. Treasury repo, and the proposed NSFR which imposes yet another tax on safe matched book Treasury repo activity.

We believe that given the experience and market data from the introduction of these new approaches, the time is right to provide a wholesale review of the impact and coherence of these requirements with a view towards moving towards a better balance of safety and soundness with efficiency, liquidity and capital availability. As liquidity diminishes or becomes more brittle in these markets, higher costs of capital may be inevitable for both the government and Main Street.

COALITION
FOR INVESTOR CHOICE INC.
Preserving Money Market Funds for Public Infrastructure Investment and Economic Growth

December 8, 2016

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Washington, DC 20515

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Maloney:

On behalf of the Coalition for Investor Choice, I ask that the following comments be submitted for the record of today's Subcommittee hearing entitled "The Impact of Regulations on Short-Term Financing." Thank you for your willingness to hold this hearing, which covers a topic that is critical to economic growth, job creation and the efficient functioning of our capital markets.

The Coalition for Investor Choice represents the interests of nearly 250 national, state and local entities and financial professionals who are issuers, borrowers and investors that support bipartisan legislation in Congress that will allow all investors to continue to use money market funds on a stable net asset value (NAV) basis. A list of those entities and financial professionals is attached, and their letters of support can be found at www.protectinvestorchoice.com/participants.

While my comments are focused narrowly on an amendment adopted by the Securities and Exchange Commission (SEC) to rule 2a-7 regarding the regulation of money market funds, the impact of that amendment has reverberated broadly throughout the short-term funding markets.

As you know, among the amendments to rule 2a-7 adopted by the SEC in July 2014 is a requirement that any money market fund, other than a fund investing only in U.S. government securities, which is available to investors who are so-called "non-natural persons" must transact using a fluctuating, or "floating" net asset value (NAV) instead of a stable $1 per share. During the rulemaking process, many of the organizations represented in our coalition expressed concerns that the rule would have far reaching consequences on the ability of non-financial businesses to raise short-term capital and manage cash. In particular, they warned the SEC that a floating NAV would not provide an incremental benefit to market stability but would, instead, do irreparable harm to money market fund investors, issuers and borrowers. That is exactly what has come to pass.

As of the rule's October 14, 2016 implementation date, over $1.15 trillion has exited non-government money market funds, leaving the private sector and moving into Treasury and Government funds. As a result, LIBOR has spiked to its highest level since the financial market

Coalition For Investor Choice, Inc. ~ 1025 Connecticut Ave., NW, Suite 1000, Washington, DC 20036
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crisis, as have rates on short-term municipal debt. Prime funds, a key source of funding for corporations and banks, have seen a 72% drop from January 2015 while tax-exempt funds, a key source of funding for municipalities, universities and hospitals, have experienced a more than 50% decline over the same period. In turn, private sector borrowing costs have risen by tens of billions of dollars, and municipal short-term borrowing has increased on average from under five basis points at the beginning of the year to as high as 75 basis points today.

In its July 2014 final rule, the SEC argued that applying a floating NAV to just a subset of money market funds was needed to address an "incremental incentive to redeem" as a result of a first mover advantage inherent in a stable NAV fund, and to reduce the potential for unfair investor dilution. But nowhere in the release did the SEC cite or provide an analysis suggesting that this "incremental" benefit was worth the cost of destroying the utility of prime and tax-exempt money market funds for institutional investors and with it, nearly $1.2 trillion in private sector capital and tens of billions more in lost interest income as businesses and other institutions are unable to benefit from market rates of return on their short-term cash investments. In essence, the SEC's effort to prevent a run on money market funds actually resulted in the largest run on prime and tax-exempt funds since those products were created over 40 years ago.

There are those who rightfully point out that virtually all of the assets that have left prime and tax-exempt funds have moved into Government and Treasury funds, thereby maintaining this important cash management tool for institutional investors. It is heartening for the money fund industry, which has expended significant resources to meet the new requirements by the implementation date, that investors did not convert their prime and tax-exempt money market fund investments into bank deposits, and the fund companies will continue to earn the management fees needed to recoup those costs. But this is of little consolation to the public and private sector users of money market funds that no longer have access to low cost financing provided by money market funds, or a convenient and safe tool for obtaining market returns on the short-term management of money.

H.R. 4216 would preserve the stable net asset value (NAV) for all money market fund investors, and restore an investment and short-term financing option that has been indispensable to economic growth and public infrastructure investment. It holds the SEC accountable for conducting realistic cost-benefit analysis by codifying Congress' intent that the SEC engage in appropriate day-to-day regulation while maintaining the utility of this important product to the investor. We urge the Members of the Subcommittee to support this important legislation.

Thank you for the opportunity to provide the perspective of issuers, borrowers and investors on this important issue.

Sincerely,

Vincent Randazzo

Vincent Randazzo
Executive Director
Coalition for Investor Choice, Inc.

Attachment: Supporters of H.R. 4216/S. 1802

SUPPORTERS OF H.R. 4216/S. 1802

National Organizations

American Association of Metropolitan Water Agencies
Association of Financial Professionals
Association of School Business Officials International
National Association of Corporate Treasurers
Public Finance Network:

- Government Finance Officers Association
- National Association of Counties
- U.S. Conference of Mayors
- National League of Cities
- International City/County Management Association
- National Association of Health and Educational Facilities Finance Authorities
- International Municipal Lawyers Association
- National Council of State Housing Agencies
- American Public Power Association
- Large Public Power Council

State Financial Officers Foundation
US Black Chambers, Inc.

Alabama

Alabama Associated General Contractors
Alabama Road Builders Association
Alabama State University
American Council of Engineering Companies of Alabama
Jason Reeves, Mayor, City Troy, Alabama
Joint Engineers Council of Alabama
Alabama League of Municipalities
Todd Strange, Mayor, City of Montgomery, Alabama
Young Boozer, Alabama State Treasurer

Arizona

League of Arizona Cities and Towns

California

California Housing Finance Agency
Greater Los Angeles African American Chamber of Commerce

Colorado

Eagle County Board of Commissioners

Florida

Florida League of Cities

Pinellas County Housing Finance Authority

Idaho

Ron G. Crane, Idaho State Treasurer

Illinois

Bill Cunningham, Member, Illinois State Senate
Chicagoland Chamber of Commerce
City of Chicago
Daniel J. Cronin, County Board Chairman, DuPage County
Deborah Conroy, Member, Illinois House of Representatives
Jim Durkin, Minority Leader, Illinois House of Representatives
John M. Cabello, Member, Illinois House of Representatives
Kelly Burke, Member, Illinois House of Representatives
Kimberly A. Lightford, Assistant Majority Leader, Illinois State Senate
Metropolitan Mayors Caucus
Michael E. Hastings, Member, Illinois State Senate
Michael Frerichs, Illinois State Treasurer
Michael J. Zalewski, Member, Illinois House of Representatives
Natalie Manley, Member, Illinois House of Representatives
Pat McGuire, Member, Illinois State Senate
South Suburban Mayors & Managers Association
Southwest Conference of Mayors
State University Annuitants Association
Tom Cullerton, Member, Illinois State Senate
William D. Burns, Chicago City Council

Indiana

1st Source Corporation
Association of Indiana Counties
Hoosier Trust Company
Indiana Association of Cities and Towns
Indiana Chamber of Commerce
Indiana County Treasurers' Association

Massachusetts

Bill Carpenter, Mayor, City of Brockton
Boston City Council
City of Boston
City of Cambridge
Deborah B. Goldberg, Massachusetts State Treasurer
IBEW Local 103 of Greater Boston
James M. Cantwell, Member, Massachusetts House of Representatives
Jon Mitchell, Mayor, City of New Bedford
Joseph Connolly, Norfolk County Treasurer
Kevin Merz, Treasurer/Collector, Ipswich, Massachusetts
Kimberley Driscoll, Mayor, City of Salem
Marc Waldman, Treasurer, Town of Wellesley
Massachusetts Chamber of Commerce

Massachusetts Housing Finance Agency
Massachusetts Municipal Association
New England Regional Council of Carpenters, Local 275
Thomas J. O'Brien, Treasurer, County of Plymouth
Thomas P. Koch, Mayor, City of Quincy
Worchester Chamber of Commerce

Michigan

Michigan Association of Counties

Minnesota

Association of Minnesota Counties

Mississippi

Lynn Fitch, Mississippi State Treasurer

Missouri

Missouri Association of Counties
Missouri Health and Educational Facilities Authority
Sylvester "Sly" James, Jr., Mayor of Kansas City, Missouri

New Jersey

County of Hudson Administrator
J. Christian Bollwage, Mayor, City of Elizabeth
New Jersey Association of Counties

New York

Kenneth W. Jenkins, Legislator 16th District, Westchester County
Mark Schroeder, Comptroller, City of Buffalo
Medaille College
Queens Chamber of Commerce
Queens Economic Development Corporation
Richard C. David, Mayor, City of Binghamton
Rochester Building and Construction Trades Council
Seamen's Society for Children and Families
Sean M. Ryan, Member, New York State Assembly
Timothy M. Kennedy, Member, New York State Senate
Town of Cheektowaga
Village of Williamsville

North Carolina

Duke Energy Corp.

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Ohio Council of Port Authorities
Armond Budish. County Executive, Cuyahoga County
Bill Bias, Treasurer, Athens County
Board of Commissioners, Franklin County
Board of Commissioners, Lake County
Bud Zappitelli, Fiscal Officer, New Albany Plain Township
Cecil Thomas, Member, Ohio State Senate
Charlie Adkins, County Commission, Athens County
Chris Burnham, President, Development Finance Authority of Summit County
Chris Chmiel, County Commissioner, Athens County
County Commissioners Association of Ohio
County Treasurers Association of Ohio
Daniel Horrigan, Mayor, City of Akron
Denise Driehaus, Member, Ohio House of Representatives
Development Finance Authority of Summit County
Dominic Paretti, Board of Education, Columbus City Schools
Dorsey Hager, Executive Secretary-Treasurer, Columbus/Central Ohio Building and Construction Trades Council
Ed Leonard, Treasurer, Franklin Ohio
Eddie Parks, President, AFSCME Retirees Subchapter 108
Edna Brown, Member, Ohio State Senate
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Fred Strahorn, Minority Leader, Ohio House of Representatives
Heather Bishoff, State Representative, Ohio House of Representatives
IBEW Local No. 8
Inter-University Council of Ohio
International Brotherhood of Electrical Workers Local 972
Jack Cera, State Representative, Ohio House of Representatives
Janine Boyd, Member, Ohio House of Representatives
Joe Schiavoni, Minority Leader, Ohio State Senate
Kathy Hecht, Auditor, City of Athens
Kenny Yuko, Member, Ohio State Senate
Lennie Wyatt, President, United Food and Commercial Workers Union Local 75
Lenny Eliason, County Commissioner, Athens County
Linda Bolon, County Treasurer, Columbiana County
Lou Gentile, Member, Ohio State Senate
Martin J. Sweeney, Member, Ohio House of Representatives
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Matthew A. Szollosi, Executive Director, ACT Ohio – Affiliated Construction Trades
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Ohio Municipal League
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Pete Gerken, County Commissioner, Lucas County
Roetzel & Andress
Scott Hammond, Business Manager, Sheet Metal Workers Local 24

Scott Schertzer, Mayor, City of Marion
Sprinkler Fitters Local 669
Steve Patterson, Mayor, City of Athens
Ted Linscott, President, Southeastern Ohio Central Labor Council
The MetroHealth System
Ohio Council of Port Authorities
University of Cincinnati
University of Toledo
William J. Roth, Jr., Mayor, City of Fairlawn
Youngstown State University

Oregon

Association of Oregon Counties

Pennsylvania

Pittsburgh Chamber of Commerce
Bill Peduto, Mayor, City of Pittsburgh
Federated Investors, Inc.
Frank, Gale, Bails, Murcko & Pocrass, P.C.
John Weinstein, Treasurer, Allegheny County
Mon Valley Progress Council, Inc.
Mon Yough Area Chamber of Commerce
Penn State University
Pennsylvania Manufacturers Association
Regional Learning Alliance
Rich Fitzgerald, County Executive, Allegheny County
University of Pittsburgh
University of Pittsburgh Medical Center
Wilson College

Texas

City of Dallas
City of Houston
Douglas Athas, Mayor, City of Garland
Harris Health System
Institute for Policy Innovation
Lower Colorado River Authority
Mesquite Independent School District
Texas Association of Business
Texas Conservative Coalition:
- Sen. Don Huffines (SD 16 - Dallas),
- Rep. Rodney Anderson (HD 105 - Grand Prairie),
- Rep. Cindy Burkett (HD 113 - Sunnyvale),
- Rep. Giovanni Capriglione (HD 98 - Southlake).
- Rep. Jeff Leach (HD 67 - Plano).
- Rep. Ron Simmons (HD 65 - Carrollton)

Texas Municipal League
Texas State University System

Trinity River Authority of Texas
University of Texas System

Virginia

Bill Carrico, Senior Member, Virginia State Senate
Charlottesville Regional Chamber of Commerce
City of Virginia Beach
Danville Pittsylvania Chamber of Commerce
Dominion Resources, Inc.
George Mason University
George Mason University Foundation
Greater Richmond Chamber of Commerce
Hampton Roads Chamber of Commerce
Loudoun County Chamber of Commerce
Lynchburg Regional Business Alliance
Old Dominion Electric Cooperative
Prince William Chamber of Commerce
Roanoke Regional Chamber of Commerce
Ron Villanueva, Member, Virginia House of Delegates
Virginia Chamber of Commerce
Virginia Transportation Construction Alliance

West Virginia

Parkersburg-Marietta Building and Construction Trades Council, AFL-CIO

State Financial Officers
FOUNDATION
LOOK TO THE STATES

December 1, 2016

The Honorable Paul Ryan
Speaker of the House
United States Capitol
Washington, D.C. 20515

Dear Mr. Speaker:

As you work to complete the legislative activity of the 114th Congress, we ask that you include in that process the expeditious enactment of H.R 4216, the Consumer Financial Choice and Capital Markets Protection Act. This bipartisan legislation, and its counterpart in the Senate (S. 1802, sponsored by Senator Pat Toomey) would address the significant unintended consequences of a Securities and Exchange Commission (SEC) rule which is undermining business and public infrastructure investment, and crimping state and local government finances.

As members of the State Financial Officers Foundation (SFOF), we are dedicated to developing, implementing and promoting conservative, fiscally responsible ("pro-growth") public policies. Those policies include maintaining efficient, low cost financing provided by money market funds, and maintaining access to a convenient and safe tool for obtaining market returns on cash in the management of public money.

Unfortunately, both of those objectives have been severely undermined by an SEC rule adopted two years ago, which went into effect six weeks ago. It requires institutional prime and tax-exempt money market funds to be offered only with a floating net asset value (NAV). Under this rule, only funds investing solely in U.S. government securities or offered only to certain retail investors who are "natural persons" may continue to use a stable NAV. This rule has led to a run on prime and tax-exempt money market funds, causing more than $1.2 trillion to no longer be available for business and public infrastructure investment. As a result, short-term interest rates have risen to their highest levels since the financial crisis, issuers of commercial paper have seen their cost of borrowing more than double, and issuers of municipal debt and their borrowers have all seen their cost of short-term financing rise from, in some cases, below five basis points last November to nearly 80 basis points today.

At the same time that the rule has caused our cost of short-term borrowing to rise dramatically, it has also driven down our investment income. As a result of the floating NAV rule, yields on prime money market funds are double that of government funds, but state and local governments are unable to benefit from those market rates of return on their short-term cash investments. This is reducing our projected revenue, making it more difficult to fund public services.

Even though the implementation date of the SEC rule has passed, the negative impacts persist as institutions continue to pull their investments out of prime and tax-exempt money market funds, leading to more fund liquidations and less private capital for our communities and businesses. Enactment of H.R. 4216 and S. 1802 is urgently needed to address this artificially created financial crisis caused by over-regulation and a failure by the SEC to conduct realistic cost-benefit analyses.

We look forward to working with you, alongside the new Administration, to advance conservative, pro-growth economic policies. Enactment of H.R. 4216 and S. 1802 would be a welcome step in that direction.

Sincerely,

Derek Kreifels, President
State Financial Officers Foundation

Mississippi Treasurer Lynn Fitch, National Chair
State Financial Officers Foundation

Idaho Treasurer Ron Crane, Vice Chair
State Financial Officers Foundation

North Dakota Treasurer Kelly Schmidt, Past Chair
State Financial Officers Foundation

Arizona Treasurer Jeff DeWit

Arkansas Treasurer Dennis Milligan

Colorado Treasurer Walker Stapleton

Georgia Treasurer Steve McCoy

Indiana Treasurer Kelly Mitchell

Kansas Treasurer Ron Estes

Kentucky Treasurer Allison Ball

Maine Treasurer Terry Hayes

Nevada Controller Ronald Knecht

Nevada Treasurer Dan Schwartz

South Carolina Treasurer Curtis Loftis

South Dakota Treasurer Richard Sattgast

Wyoming Treasurer Mark Gordon

P.O. Box 9584 ▲ Mission, KS 66201 ▲ (866) 816-0873 ▲ www.statefinancialofficers.com

Treasury Strategies
A Division of Novantas, Inc.
The Power of Experience

February 2, 2017

QUESTONS FOR THE RECORD
Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing entitled "The Impact of Regulations on Short-Term Financing"
Thursday, December 8, 2016

Thank you for the opportunity to supplement testimony from the hearing. In this letter, I address the specific question from Representative Rothfus regarding the recently implemented Money Market Fund (MMF) regulations and also fill in some blanks from the original hearing.

Overview

- New regulations which went into effect on October 14 will NOT achieve their stated objective of preventing bailouts and maintaining market stability, since **most money market assets are not subject to the rule.** The entire treasury and government MMF market, Local Government Investment Pools, retail MMFs of all types, and bank short term investment funds are all exempt. Of all the investors in the marketplace and all the investment options available (tens of trillions of dollars), the rule singles out just one segment – "non-natural persons" investing in Prime Funds and Tax Exempt Funds for draconian regulation.

- Prime money funds (PMMFs) are a key source of funding for the private sector. Both banks and corporations have relied upon Prime MMF funding for decades. Tax Exempt funds (TEMMFs) are a key source of funding for municipalities, universities and hospitals.

- $1.17 trillion or 73% of the market has left PMMFs. $130 billion or 50% of the market has left TEMMFs. So **the rule essentially eradicated the part of the market it tried to "improve", while leaving far larger segments of the market unaddressed**.

- One especially onerous part of the regulation prohibits the use of standard accounting methods (amortized cost) for funds with non-natural persons as investors. It was this broadly accepted accounting principal which enabled funds to maintain a constant net asset value (CNAV) of $1.00 per share to investors. Because of this prohibition, the institutional Prime and Tax Exempt MMFs must now float their net asset values.

- **Reinstating amortized cost accounting for all MMF investors, both natural persons and non-natural persons, is such an obvious and benign remedy** for the deleterious $1.3 trillion market shift we have just experienced, that it should be done immediately. Amortized cost accounting is an accounting principal used by almost all banks, almost all corporations and most other investors including all Treasury MMFs and all Government MMFs for their own portfolios.

Treasury Strategies
A Division of Novantas, Inc.
309 W. Washington
11th Floor
Chicago, Illinois 60606
t +1 312-443-0840
f +1 312-443-0847
www.TreasuryStrategies.com

Institutional investors are sophisticated, NOT confused

- The underlying notion behind the regulation is that the $1.00 CNAV causes Prime and Tax Exempt MMF investors to be confused between MMFs and bank deposits. That is simply ludicrous. These institutional investors are sophisticated financial professionals, corporate treasurers, institutional money managers, and managers in bank trust departments. There is absolutely no evidence they are confused between MMFs and bank deposits.

- If they were confused, why would they not also be confused about government and Treasury MMFs, which continue to be priced the same way Prime Funds were? The fact that the SEC chose not to include government and treasury funds under the regulation, after their purported study, is evidence in and of itself that the SEC concluded there is no confusion at all among these investors.

- Similarly, if the floating NAV is needed for increased transparency, it makes no sense that this should be applied only to institutional funds and not retail funds as well. Again, **there is absolutely no evidence that institutional investors are less sophisticated than retail investors and require such protection**.

- Regarding the floating NAV making it less likely for an investor to redeem in a stress situation, and why this would also not be a relevant point for retail investors: not only are we unaware of any such evidence, we see evidence to the contrary. In a 2014 whitepaper, Treasury Strategies presented a comprehensive game theory analysis of investor behavior. It concluded that neither a floating NAV or fees and gates provide disincentive for mass withdrawals during financial stress.

Tax Exempt MMFs support long-term infrastructure projects

- Municipal debt is issued to finance long-term infrastructure projects. Many project financing bonds are issued as serial bonds with maturities across an entire term spectrum, so part of every issue may be short-term and thus MMF eligible.

- As long-term bonds approach their maturity dates, they become short-term, and are thus also eligible investments for MMFS.

- From a working capital perspective, municipalities regularly issue Tax Anticipation Notes (TANs) and other short-term obligations to meet their working capital needs.

- Thus, MMFs support both the short- and long-term financing needs of municipalities. The damage done by this new rule is of great concern to municipalities, cutting financing previously provided by MMFs in half and raising its cost.

Administrative requirements of the new regulations

- It is logical to ask if the administrative burdens of the new regulations can be addressed to reduce their negative impact. The answer is no. These burdens are a direct result of the floating NAV, which requires accounting and system changes, not only by intermediaries who operate the funds, but also by the investors.

- Our 2012 study examined the operational consequences of potential MMF regulation changes. We concluded then that although fund companies might undertake the accounting and system changes required, investors were more likely to exit the funds. Indeed, some investors might be prohibited from remaining in the funds at all.

- The floating NAV is categorically unsuitable for sweep account investments, and again there is no administrative fix. Relative to other constant NAV options such as Eurodollar funds, repurchase agreements or offshore deposits, the floating NAV fund is simply at an insurmountable disadvantage for sweeps.

- For fiduciary managers, the floating NAV's natural/non-natural person distinction is another administrative burden for which there appears to be no remedy. Our research showed that most fiduciaries (wealth managers, asset managers, and bank trust departments) invest through omnibus accounts. Such accounts aggregate funds from different kinds of investors (individuals, small business, family trusts, private partnerships, etc.). To comply with the regulation, the fiduciaries have to determine which of their hundreds or thousands of customers are natural vs. non-natural persons (an ambiguous distinction), and exclude non-natural persons from the omnibus accounts. They are simply not able to do this with a high degree of confidence. To avoid the risk and cost of misclassifying, they instead exit the investment category entirely as our study predicted.

Conclusion

While some are calling for further study before deciding how to proceed, others ask if there are some obvious fixes to implement immediately.

- As stated above, **immediately reinstating a constant NAV for all investors in all MMFs** is an obvious and benign remedy for these threshold issues.

- We continue to be concerned about the implementation of multiple <u>simultaneous</u> regulations affecting corporate finance and investment. We do believe **further study of the simultaneous impact is required**, but not at the expense of delaying the action recommended above.

With the regulatory-induced demise of Prime and Tax Exempt MMFs, the market has lost a $1.3 trillion shock absorber, and America's businesses and municipalities have lost a $1.3 trillion primary source of capital.

FSOC recently applauded itself for the orderly flow of funds out of Prime Funds as the October regulations took hold. But we observe with great concern that is hardly a market test of the implications of the rule. That test comes in some unknown future stress scenario, not during a transition which was signaled two years in advance.

Not until that next stress event occurs, will we be able to observe how markets react and adjust, absent the $1.3 trillion shock absorbing capacity of the MMFs that have disappeared.

Respectfully submitted,

Anthony J. Carfang
Managing Director
Treasury Strategies, a Division of Novantas, Inc.

QUESTONS FOR THE RECORD
Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing entitled "The Impact of Regulations on Short-Term Financing"
Thursday, December 8, 2016

Mr. Deas: We have been told by proponents of a floating NAV that it would provide less incentive for mass withdrawals under stressed conditions. Are you aware of any research that indicates sophisticated institutional investors will be less likely to redeem shares in money market funds during times of stress if there was a floating NAV? Also, why would this argument not be relevant for retail investors and investors in funds that invest solely in U.S. government debt?

> We are not aware of any specific research on the decreased likelihood of institutional investors' redeeming floating NAV shares in times of financial stress compared to those with a fixed NAV. What we do believe is that the increased disclosures on the holdings of money market funds from the 2010 changes to Rule 2a-7 provide adequate information on their creditworthiness and ability to withstand stresses. The additional information embodied in the floating NAV is not worth the cost as evidenced by $1 trillion leaving prime funds subject to the floating NAV rules. The cure advanced in the form of a floating NAV has severely weakened the patient.

Mr. Deas: We have been told that a floating NAV is needed to provide increased transparency to investors so they will have a clearer understanding of the risks they face in the MMF portfolios, and it would make clear that investors will bear losses. If this is indeed the case, why only apply that increased transparency to institutional investors who invest in prime and tax-exempt funds? Is there research to suggest that institutional investors are less sophisticated than retail investors?

> We believe corporate treasurers and other institutional investors are much better able than retail investors to assess the risks of investing in money market funds with fixed NAV pricing. The remedy that has been implemented with retail investors able to choose fixed NAV pricing seems to have targeted the wrong investor group. The data shows that most of the $1 trillion that has left prime funds has flowed into government money funds, reducing the government's borrowing costs while crowding out funds that would in large part go to private sector.

Mr. Deas: There was a lot of discussion about the need to direct financial regulators to conduct a study of major regulatory initiatives for cumulative impacts on all financial institutions. If the economic impact of the SEC's floating NAV rule is significant, real and immediate, what additional information would a study provide about that specific impact, and can businesses afford to wait for the results? Are their some remedies, such as reinstating the stable NAV that are so obvious that they should be implemented immediately?

> We do believe that with $1 trillion having left prime funds, immediate action is justified. The costs have clearly outweighed the benefits of the change to floating NAV pricing. This will undoubtedly be an important component of the cumulative impact analysis we advocate, but completing such a comprehensive analysis should not delay a remedy to allow prime funds the option to price using amortized cost and penny rounding. However, the liquidity fees and gates included in the reforms to Rule 2a-7 have been more of a deterrent to corporate treasurers' use of prime funds, and with

liquidity fees and gates remaining in place, there will likely still be an aversion to prime funds.

Mr. Deas and Mr. Carfang: Mr. Deas was asked by one of our colleagues on the subcommittee if there are things that can be done to keep the floating NAV for non-natural persons investing in money market funds and address the administrative burdens on institutions seeking to invest in those funds. Conversely, is there a way to address the systemic risk concerns that have been raised with the stable NAV if it is restored?

We believe that the increased disclosures of underlying investments and mandated shorter terms for those investments should be retained in a reversion to stable NAV pricing for prime funds. This would be a risk-reducing measure.

QUESTONS FOR THE RECORD
Subcommittee on Capital Markets and Government Sponsored Enterprises
Hearing entitled "The Impact of Regulations on Short-Term Financing"
Thursday, December 8, 2016

<u>Mr. Konczal</u>: *The Seamen's Society for Children and Families serves over 1500 children and 800 families in Staten Island and Brooklyn in need of foster care, child care services and domestic violence prevention. As a result of the SEC's money market fund rule, their cost of financing on $5 million in debt held by tax-exempt money market funds rose from three basis points in November 2015 to 69 basis points today. On the remaining principal balance, they are paying over $26,000 more a year because of the rule. Another organization that supports H.R. 4216, to preserve stable value money market funds, is the Association of School Business Officials International. In a letter to the Committee, they say the SEC rule is squeezing school district budgets and undermining their efforts to provide the highest quality education possible for our nation's students. As a proponent of the floating NAV, is this what you intended to happen, and is it worth the incremental benefit of the regulation?*

H.R. 4312 would go beyond removing the floating NAV requirement of institutional municipal money market funds that emerged out of the SEC's 2014 rule-writing. It would also remove institutional prime requirements as well, whose collapse in the financial crisis posed a dangerous systemic risk. Perhaps a targeted effort at institutional municipal markets would be of interest, but as it stands the proposal is too broad and would go far beyond providing relief to schools and other municipal organizations.

Though it is unfortunate that businesses can't keep low rates of borrowing associated with the systemic risks the financial system posed in 2008, their previous low cost of financing was not the result of lending fundamentals but instead of a regulatory arbitrage that proved to carry large systemic risks for the rest of the economy. The intention isn't to harm any specific business, but instead to ensure that the cost of financing reflects the risks those activities pose to the economy.

<u>Mr. Konczal</u>: *I fully support the need to preserve market stability, but I'm not sure how the SEC's money market fund rules would accomplish that. As you know, retail funds are exempt from the floating NAV requirement. U.S. government funds are exempt from both the floating NAV and the gates and fees provisions. Local Government Investment Pools (LGIPs), which make up about 25% of the institutional prime money market fund market, were delinked from Rule 2a-7 by the Government Accounting Standards Board in December 2015. Bank short-term investment funds are exempt from the rules. And after observing the impact of the floating NAV rule in the U.S., the Europeans appear to have abandoned their efforts to ban stable value funds for institutional investors. If the goal of the SEC's most recent money market fund rules is to prevent bailouts and maintain market instability, how would that be accomplished if so much of the market is exempt from the rule and only the most sophisticated investors in the market are subject to the rule?*

As the SEC found, retail investors are significantly less likely to make large withdrawals in response to market stress or panic. This was seen both during the financial panic itself and during 2011 worries over Eurozone debt. Retail investors are also a smaller portion of the market, a fraction of the size of the institutional market.

<u>Mr. Konczal</u>: *We have been told that a constant NAV is an accounting fiction and you asserted that investors are confused between bank deposits and investments in prime money market funds. Do you really believe that financial professionals such are corporate treasurers are confused*

and, if so, what specific evidence do you have? Further, if financial professionals are confused, why would individual investors not be similarly confused?

The argument for removing the regulatory arbitrage that characterizes fixed NAV money market funds isn't predicated on investors being confused. Indeed, the most disturbing part of a run in the money market is how *rational* it is. Investors have an incentive to be the first out the door, and knowing, in a rational manner, that others maintain this, they will be quicker than they would be otherwise to remove funds. This trigger a self-fulfilling prophesy.

A floating NAV requirement means there is less incentive for mass withdrawals under stressed conditions with a floating NAV. There is no "cliff effect" of breaking the buck that comes from the penny-rounding rule. It greatly reduces the first-mover incentive, as there is no moment where investments are redeemable at par and then it is not. Indeed, regular, small fluctuations would in turn make investors less likely to panic. This also effects fairness: losses are mutualized, rather than concentrated among late movers while first-movers receive their investments at par. It also helps with transparency, as there is a clearer understanding of the risk faced by investors.

Note that confusion over whether a money market fund has FDIC insurance does add to this effect and panic, but it is not necessary for the urgent regulatory actions that have been taken.

Mr. Konczal: *In your testimony, you asserted that a fluctuating NAV is necessary because investors are confused between bank deposits and investments in prime money market funds. Do investors not have this same confusion vis-a-vis government and treasury funds, which are priced precisely the same way? To what to you attribute this cognitive disconnect?*

As noted above, confusion isn't the primary motivation for a run. Government money market funds that are exempt from this requirement maintain 99.5 percent of their total assets in cash, government securities, and collateralized repurchase agreements. This was increased from the original proposed 80 percent. These securities are liquid during a stressful market scenario, indeed capital movement into these funds characterized the 2008 crisis.

Their credit default risk is an order of magnitude lower than other assets. Indeed, this is a space where investors, who do have a desire for a stable money market fund option, can put money with having significantly less exposure to run risk.

Government Finance Officers Association
National Association of Counties
U.S. Conference of Mayors
National League of Cities
International City/County Management Association
National Association of Health and Educational Facilities Finance Authorities
International Municipal Lawyers Association
National Council of State Housing Agencies
American Public Power Association
Large Public Power Council

July 28, 2016

The Honorable Gwen Moore
U.S. House of Representatives
2245 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Moore:

The organizations listed above, representing state and local governments, authorities and other public entities, wish to express their support for H.R. 4216, *The Consumer Financial Choice and Capital Markets Protection Act*.

Our organizations have long opposed the Securities and Exchange Commission (SEC) modifications to SEC Rule 2a-7 of the Investment Company Act of 1940 that change the net-asset-value (NAV) accounting methodology for money market mutual funds (MMMF) from stable to floating. Our members rely on the hallmark stable NAV feature in a variety of ways. First, many governments have specific state or local statues and policies that require them to invest in financial products with a stable NAV. The policy reason for this is to ensure that public funds are appropriately safeguarded to best serve the entity. Second, MMMFs with a stable NAV are the most commonly used investment by state and local governments. Forcing governments to find alternative investments to MMMFs creates additional risk for public funds by driving them to potentially invest in other, less suitable products. Finally, non- MMMF options may not meet liquidity standards required by their governments to meet cash management policies and statutes. H.R. 4216 would enable state and local governments to continue to use stable NAV funds for their essential and critical investment needs.

In addition to the vital use of MMMFs as state and local government investments, it is important to note that MMMFs are the largest purchasers of short term municipal securities. Due to the new SEC rules, these funds are likely to curb their appetite for these securities, thus decreasing demand and increasing costs to state and local governments that issue this type of debt. In fact, at least 19 tax-exempt money market funds holding at least $17 billion in assets have closed, or announced they will close in 2016, and the pace of liquidations is expected to accelerate as the compliance date approaches. The closing of these funds as a result of the new SEC rules hurts state and local governments both as investors of these funds and as issuers of securities purchased by these funds.

While governments will also be adversely affected by the liquidity fees and redemption gates provisions, which would be imposed during times of fiscal stress, H.R. 4216 is an important first step to help governments from having their investment operations disrupted. We continue to call on Congress and the SEC to provide exemptions for state and local governments from these other provisions, so that they can have unrestricted access to their public funds.

Thank you again for introducing this important legislation. We look forward to working with you and supporting your efforts to help state and local governments on this money market mutual funds issue and other regulatory and financial matters of mutual interest.

Sincerely,

Emily Swenson Brock, Government Finance Officers Association, 202-393-8467
Michael Belarmino, National Association of Counties, 202-942-4254
Carolyn Coleman, National League of Cities, 202-626-3023
Larry Jones, United States Conference of Mayors, 202-861-6709
Elizabeth Kellar, International City/County Management Association, 202-962-3611
Chuck Samuels, National Assn of Health & Educational Facilities Finance Authorities, 202-434-7311
Chuck Thompson, International Municipal Lawyers Association, 202-466-5424
Garth Rieman, National Council of State Housing Agencies, 202-624-7710
John Godfrey, American Public Power Association, 202-467-2929
Noreen Roche-Carter, Large Public Power Council, 916-732-6509

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