

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



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.

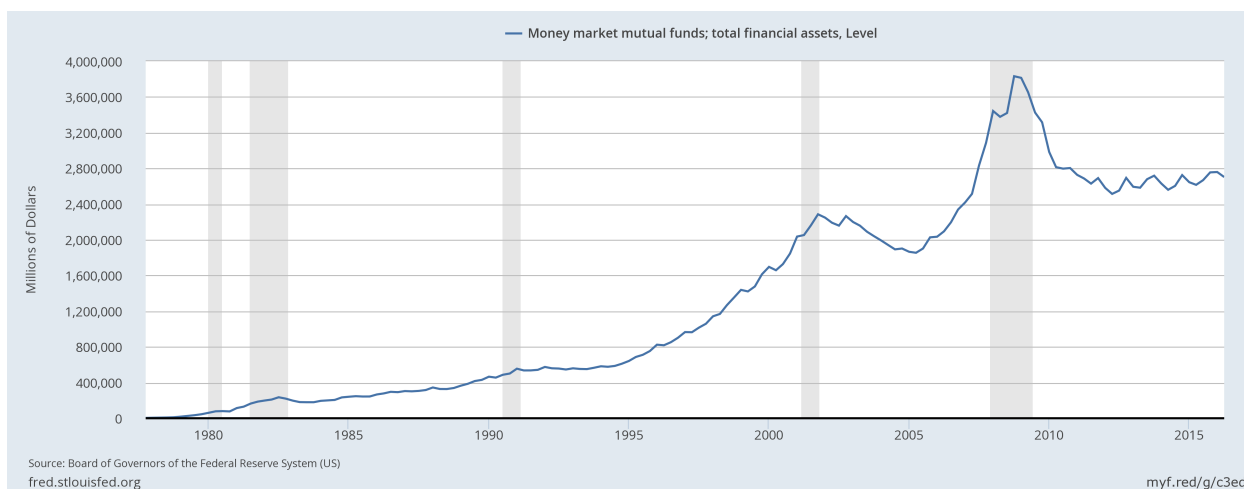
One of the primary elements of the shadow banking market is money market mutual funds, or money market funds (MMFs), whose collapse in the aftermath of the failure of Lehman Brothers was a defining moment for the panic. The reform of MMFs is thus an essential part of Dodd-Frank. Substantial progress 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.

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

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.

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

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