SEC action could harm municipal finances

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Over the years, state and local officials have learned the hard way that agencies of the federal government have a penchant for proposing new regulations and standards that have a major impact on state and municipal budgets. The usual worry is that the federal government will impose new unfunded mandates, which force communities to divert dollars away from key programs and services, while taxpayers see a larger share of their property tax dollars consumed by federal dictates.

It's easy to develop new mandates, standards or regulations when other people or governmental entities have to pay, especially when the regulations are intended to meet a popular public need or outcome. The problem is that unfunded mandates are almost always extraordinarily unfair and incomplete, because the authors pass the buck on the hardest question of all: where the money will come from.

Most of the federal regulations that impact states and localities are imposed by the U.S. Environmental Protection Agency, the Department of Transportation, the Department of Health and Human Services, the Department of Education, and other familiar entities.

There may, however, be a new entry into the too-crowded field of regulators who do not look at the fiscal impact of their actions: the Securities and Exchange Commission.

The SEC is moving forward with new regulations governing money market mutual funds (MMMFs). Clearly, it is important for the SEC to do its job and make sure that MMMFs are safe and strong. But the SEC should not implement any change that would undermine these funds or their ability to continue functioning in a way that benefits government and taxpayers.

For a refresher on MMMFs, the Investment Company Institute provides an overview: “A money market fund is a type of mutual fund that seeks to offer investors a variety of features, including return on principal, liquidity, and a market-based rate of return, all at a reasonable cost. Although the net asset value (NAV) per share of a traditional mutual fund changes daily in response to market factors, money market funds are structured to avoid these changes by seeking to maintain a stable share price, typically $1 per share.”

The Investment Company Institute also notes that “investors use money market funds as a ‘parking place’ for cash between investments because money market fund yields are typically competitive with those of most savings accounts. For institutions of all kinds – businesses, nonprofit organizations, government agencies, and financial institutions – money market funds are a preferred vehicle for cash management.”

MMMFs are an important part of our governmental finance system in two clear ways.

First, money market mutual funds invest in local and state governments, buying municipal bonds and providing essential capital for important projects that put people to work and build our economy: schools, roads, bridges, fire stations, police stations, public works facilities, water and sewage treatment facilities, city and town halls, parks, recreation facilities, public housing, and much more. According to testimony submitted to Congress last summer by the National League of Cities and many other local government organizations,

MMMFs are the largest investor in short-term municipal bonds, holding 56 percent of all outstanding short-term bonds, equaling nearly $352 billion.

Second, local and state governments across the country use MMMFs as an essential part of their cash management practices and policies. The use of money market funds for short-term investments and as a cash management tool is cited as a best practice by the Government Finance Officers Association, because MMMFs are highly liquid, stable, have a reasonable rate of return, and have minimal risk.

MMMFs are already strictly regulated by the SEC, with standards in place that govern the credit quality, liquidity, diversification and maturity of these investments. Because of this, MMMFs are able to maintain a fixed or stable net asset value, generally at $1 a share, making the funds attractive to investors because of the certainty and lack of volatility.

The problem is that the SEC is giving strong consideration to a major structural change in MMMFs that would have a serious negative impact on municipal finances. On its face the change sounds harmless: moving MMMFs from a fixed net asset value (NAV) to a "floating" NAV. The reasons behind such a change are unclear, as MMMFs are already highly regulated, stable and safe.

In the real, practical world, however, this change would fundamentally alter the attractiveness of MMMFs to investors.

As the National League of Cities, International City/County Management Association, GFOA and other have testified, "[c]reating a marketplace where the NAV changes from fixed to floating would make MMMFs far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt costs for many state and local governments across the country" as the number of investors in municipal bonds is reduced significantly.

With cities and towns using MMMFs as a core element of their cash management, the NLC points out that moving to a floating NAV would force many, if not all, municipalities to divest a significant part of their investments from MMMFs (because of the increased risk and because MMMFs with floating NAVs could violate investment policies), and this would destabilize what is now an important and stable part of municipal finance strategy. Communities would be pushed to products with greater risk, higher fees, and greater costs for taxpayers.

The bottom line is that the SEC should not fix something that is not broken. Moving from a stable to a floating NAV would decrease available capital for key projects that are essential to local economies, and it would increase borrowing and cash management costs for taxpayers. This may not be a traditional unfunded mandate, but the result would be the same – intrusive regulation by a federal agency without consideration of the negative impact on states, localities, citizens or taxpayers.

The SEC should do its job without imposing new rules that would harm municipal finances.

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