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TSI Says MBR Holdback Won' t Prevent Run, Could Destroy Money Funds

Consulting firm Treasury Strategies recently posted a letter to New York Fed President **William Dudley** entitled, "Response to Federal Reserve Bank of New York Paper, " Proposal to Mitigate the Systemic Risks Posed by Money Market Funds"." The comment says, "**We believe the paper makes a number of questionable and simplistic assumptions in an effort to address the problem of a run on money market funds**. The proposed solution creates myriad additional problems that would effectively dismantle the nearly $ 3 trillion money fund industry -- which has demonstrated remarkable stability throughout its history."

The letter says, "**We are writing in response to a Federal Reserve staff research paper recently released by the Federal Reserve Bank of New York (FRBNY) entitled The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds (the Staff Research Paper or Paper)**. Treasury Strategies, Inc. (TSI) would like to contribute the following information and views on the Paper for your consideration.... **The Paper attempts to address a problem, a run, which is arguably not a problem. It attempts to do it in a way that creates myriad additional problems**. Although it has demonstrated remarkable stability, the nearly $ 3 trillion MMF industry is in danger of being dismantled by such draconian " solutions" as proposed in the Paper."

It continues, "**We believe the Paper reflects a number of questionable and overly simplistic assumptions**. The Paper proposes that each MMF shareholder maintain a minimum balance at risk (MBR) of, for example, 5%. This amount is essentially a holdback of an individual shareholder' s investment balance that would be retained in the fund if the shareholder sought to redeem more than 95% of his/ her account. Every MBR would be in a subordinated position; aggregate MBRs would be first to absorb losses if the fund broke the buck within the 30- day period following redemption. The Paper claims an MBR approach would minimize the possibility of a run on MMFs, in the rare event that an MMF experiences distress that could lead it to break the buck. The Paper also claims this approach would increase fairness to shareholders, particularly retail investors, who may be slow to redeem shares in such a rare event –- fairness which the authors apparently believe is lacking now. **TSI disagrees with both claims, as we discuss below**."

Treasury Strategies tells us, "**Significantly, the Paper minimizes the very real possibility that institutional investors would abandon MMFs en masse as a cash management tool if the proposed MBR concept were adopted**. The Paper does not adequately consider potential damage to short- term liquidity markets, investors, or the financial system as a whole that would result if MMF assets shrank drastically."

They add, "**In this submission, we urge you to consider the following: A subordinated holdback or MBR is unlikely to " brake" a run by MMF investors amidst a crisis. The MBR would create a first mover advantage that may precipitate a run**. " First mover advantage" is an inherent characteristic of any financial market. Attempting to penalize the first mover flies in the face of market logic. The proposed MBR arrangement punishes the diligent investor.... The Paper overlooks the incentive of institutional investors to move into omnibus accounts and other critical problems, such as reduced liquidity. The MBR provision introduces complex and undefined accounting treatment for cash as well as the call option inherent in the subordination feature. **The MBR proposal is not substantially different from other holdback concepts that have been criticized as flawed and unworkable**. MMFs have performed flawlessly through severe market turmoil, including the recent Eurozone uncertainty."

Finally, TSI writes, "**We conclude that the subordinated holdback MBR concept discussed in the Staff Research Paper will not only fail to achieve the regulatory objective of preventing a run on MMFs (a rare occurrence to begin with), but will significantly hamper or destroy the $ 2. 6 trillion market for MMFs in the process, creating a huge vacuum in the short- term credit markets**. Furthermore, Treasury Strategies believes the MBR proposal will have severe negative consequences for investors, short- term borrowers, banks, businesses of all sizes, and the broader global economy.

We do not believe the MBR concept in the Paper should be considered a serious proposal for addressing what in any case is not a serious problem."

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