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Financial Stability Board
c/o Secretariat, Bank for International Settlements
CH-4002 Basel
Switzerland

RE: Consultative Document: Strengthening Oversight and Regulation of Shadow Banking

Ladies and Gentlemen:

Please see the attached paper commenting on the Financial Stability Board's Consultative Document entitled "Strengthening Oversight and Regulation of Shadow Banking, An Integrated Overview of Policy Recommendations." Also attached for your consideration is my submission to the Financial Stability Oversight Council commenting on its proposals relating to money market funds.

Sincerely,

Melanie L. Fein

Melanie L. Fein

Attachments

The Financial Stability Board's Consultative Document on Shadow Banking

By

Melanie L. Fein*

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I. INTRODUCTION

The Financial Stability Board ("FSB") recently issued proposed recommendations for regulating the so-called "shadow banking system."[1] The FSB's recommendations are seriously flawed in at least three important respects:

> First, the FSB erroneously defines the "shadow banking system" as "credit intermediation involving entities and activities *outside* the regular banking system;"[2]
>
> Second, the FSB characterizes "shadow banking" activities as largely unregulated;[3] and
>
> Third, the FSB includes money market funds ("MMFs") within the definition of "shadow banking."

This paper shows that, contrary to the FSB's description, shadow banking in the United States exists squarely within, and not outside of, the regular banking system. Banking organizations are the dominant "shadow banks" in the United States.

Moreover, the FSB's characterization of shadow banking as unregulated is incorrect. The U.S. shadow banking system operates under the direct supervision and regulation of U.S. banking authorities who have long promoted, supported, encouraged, defended, and otherwise facilitated shadow banking activities within the regulated banking system.

Finally, MMFs, in contrast to commercial banks, lack the key features of shadow banks that raise systemic risk concerns—leverage, illiquidity, opacity, and moral hazard resulting from government subsidies. Moreover, MMFs are highly regulated, even more so than banks.

The FSB's view of shadow banking as a phenomenon outside the regulated banking system is disturbing because it suggests that the member agencies of the FSB have a flawed understanding of the forces that destabilized

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[1] Financial Stability Board, Consultative Document, Strengthening Oversight and Regulation of Shadow Banking: An Integrated Overview of Policy Recommendations, Nov. 18, 2012 ("Consultative Document").

[2] Financial Stability Board, Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, Oct. 27, 2011, at 1 (emphasis added). In the 2012 Consultative Document, the FSB has revised its definition slightly as "credit intermediation involving entities and activities *(fully or partially)* outside the regular banking system." (emphasis added). Consultative Document at 1.

[3] Financial Stability Board, Consultative Document at 1 ("But whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements.").

the financial system in 2007-2008 and may be pursuing misguided financial reform policies and agendas. The shadow banking illusion tends to obscure the real sources of systemic risk within the regulated banking system and evades the question of why banking regulators failed to appropriately supervise such activities prior to the financial crisis. More importantly, it evades the question of whether the extension of bank regulatory principles to financial institutions outside the banking system is appropriate.

The failure to recognize shadow banking as a product of banking regulation may explain why regulators have sought to impose bank-like regulation on nonbank entities, such as MMFs. Such regulation is inappropriate for entities that bear none of the risk characteristics of shadow banks, however, and is unlikely to strengthen the financial system. More likely, it will smother beneficial nonbank financial activities and potentially increase rather than decrease systemic risk.

II. THE FSB ERRONEOUSLY DEFINES "SHADOW BANKING"

A. Banks are the Prevailing "Shadow Banks" in the U.S.

Banks engage in every type of shadow banking activity identified by the FSB. The principal shadow banking activities and entities encompassed within the FSB's definition include the following:

- Securitization vehicles such as asset-backed commercial paper conduits and structured investment vehicles;
- Securities lending;
- Repurchase agreements;
- Money market funds;
- Securities broker-dealers;
- Investment funds, including exchange traded funds and hedge funds that provide credit or are leveraged;
- Finance companies, including auto finance companies and leasing companies;
- Providers of credit insurance and financial guarantees.[4]

Banks and their affiliates engage in each of these activities to a dominant extent. The securitization market would not exist without banks, as described in detail below. Banking organizations also are leaders in securities lending

[4] Financial Stability Board, Consultative Document: Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Nov. 18, 2012. See also European Commission, Green Paper: Shadow Banking, March 19, 2012.

activities and command the market for repurchase agreements as borrowers, dealers, and custodian banks. Banking organizations sponsor and advise numerous types of investment funds, including hedge funds and almost one-half of all money market funds.

All of the major securities broker-dealers in the United States are affiliated with banks or bank holding companies. Banking organizations control finance companies of all kinds, including auto finance and leasing companies. They provide credit insurance and financial guarantees to support their own activities as well as their customers' activities.

The involvement of banking organizations in these activities is obscured by the fact that they frequently occur through separate subsidiaries operating under different names. Large banking organizations conduct their operations through hundreds, even thousands, of subsidiaries. These subsidiaries generally are wholly owned and operated in tandem with other affiliates under the same corporate umbrella. The growing size, complexity, and diversity of these organizations has made them increasingly opaque, which may explain the FSB's inability to recognize them as part of the regulated banking system.[5]

B. Banks Dominate the Securitization Market

Securitization activities are at the heart of the shadow banking system. Securitization involves the origination of loans, packaging them into pooled trusts, and selling interests (i.e., securities) in the trust to investors, along with various intermediate steps. Banking organizations engage in each of these activities and dominate the securitization market. Indeed, without banks, securitization would not exist as a major financial activity.

Prior to the financial crisis, large banking organizations were instrumental in sponsoring and guaranteeing specialized forms of securitization—including structured investment vehicles ("SIVs") and asset-backed commercial paper conduits ("ABCP"). These structures proved destabilizing to the banks themselves and ultimately the financial system as a whole. Federal Reserve economists have concluded that these activities are what triggered the financial crisis.[6]

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[5] See generally Dafna Avraham, Patricia Selvaggi, and James Vickery, A Structural View of U.S. Bank Holding Companies, Federal Reserve Bank of New York, Economic Policy Review, July 2012.

[6] See Covitz, Liang, and Suarez, The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market, August 24, 2009, available at SSRN.com. See also Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez, Securitization Without Risk Transfer, Aug. 8, 2011.

Economists at the Federal Reserve Bank of New York have empirically examined the role of banking organizations in securitization activities and recently published the results of their study.[7] Based on an analysis of "virtually the entire universe of nonagency asset-backed activities from 1978 to 2008," they concluded that:

> [B]anks are by far the predominant force in the securitization market.[8]
>
> [T]he evidence suggests that very little securitization-based intermediation is actually in the shadow, with much of it remaining within the scope of regulated bank entities."[9]

The Reserve Bank economists presented empirical data showing that banks have been a significant force in securitization "all along" and that their dominance varies depending on their role with different products:

> We show that the degree of bank domination varies according to product type and securitization role. Banks are inherently better suited to compete for the data-intensive trustee business, capturing in most cases more than 90 percent of these services. Having a strong role in securities underwriting, banks are able to exploit their expertise to capture a significant fraction of asset-backed underwriting as well. Naturally, in issuing and servicing the different segments of the securitization market, banks face competition from nonbank mortgage lenders and consumer finance companies. Nevertheless, we show that banks were able to retain a significant and growing share of issuance and servicing rights as well. Despite the greater complexity of a system of intermediation based on asset securitization, which appears to have migrated and proliferated outside of the traditional boundaries of banking, our findings suggest that banks maintained a significant footprint in much of this activity through time.[10]

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[7] Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012.

[8] *Id.* at 58.

[9] Nicola Cetorelli, Benjamin H. Mandel, and Lindsay Mollineaux, The Evolution of Banks and Financial Intermediation Federal Reserve Bank of New York, Economic Policy Review, July 2012, at 10.

[10] Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012, at 48. See also Nicola Cetorelli and Stavros Peristiani, The Dominant Role of Banks in Asset Securitization, Liberty

The Federal Reserve economists concluded that regulated banking organizations "have in fact played a dominant role in the emergence and growth of asset-backed securitization and that, once their roles are explicitly acknowledged, a considerable segment of modern financial intermediation appears more under the regulatory lamppost than previously thought."[11]

These findings call into question not only the FSB's view of shadow banking as something outside the regulated banking system, but also its recommendations for regulating it.

III. SHADOW BANKS ARE HIGHLY REGULATED IN THE U.S.

The FSB's view of shadow banking as existing outside the regulated banking sphere tends to cast blame on nonbank financial institutions for the financial crisis and creates the misimpression that banking regulators were powerless to prevent the crisis.[12] This view encourages the misguided assumption that future crises can be prevented by applying bank regulatory concepts to nonbank financial institutions and bringing them within the scope of the regulated banking system.

These suppositions are belied by the fact that shadow banking activities were well within the supervisory grasp of banking regulators in the years preceding the financial crisis. Economists now are acknowledging this fact. As

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Street Economics Blog, Federal Reserve Bank of New York, July 19, 2012, http://libertystreeteconomics.newyorkfed.org/2012/07/the-dominant-role-of-banks-in-asset-securitization-.html ("we provide a comprehensive quantitative mapping of the primary roles in securitization. We document that banks were responsible for the majority of these activities. Their dominance indicates that the modern securitization-based system of financial intermediation is less "shadowy" than previously considered.").

[11] Nicola Cetorelli and Stavros Peristiani, The Role of Banks in Asset Securitization, Federal Reserve Bank of New York Economic Policy Review, July 2012, at 48. See also *id.* at 60 ("We demonstrate that large bank holding companies—and, to a lesser extent, investment banks—have been significant contributors to all phases of this [securitization] process. Although much of the securitization activity appears to have been done outside the regulatory boundaries of banking, we find strong evidence to the contrary.")

[12] See Statement of Treasury Secretary Timothy F. Geithner at a hearing before the House Committee on Financial Services, April 20, 2010, Serial No. 111–124, at 13 ("[O]ur system allowed large institutions to take on excessive risk without effective constraints. In particular, this system allowed the emergence of a parallel financial system—what some have called the shadow banking system. This system operated alongside and grew to be almost as big as the regulated banking system. But it lacked the basic protections and constraints necessary to protect the economy from classic financial failures."). See also Tim Geithner, "Financial Crisis Amnesia," New York Times, March 1, 2012 ("Regulators did not have the authority they needed to oversee and impose prudent limits on overall risk and leverage on large nonbank financial institutions. . . . A large shadow banking system had developed without meaningful regulation, using trillions of dollars in short-term debt to fund inherently risky financial activity.").

one economist recently put it: "When looked at closely, modern financial intermediation seems less "shadowy" than we thought."[13] Recognition that traditional banks are the real shadow banks is an important predicate to any reform proposals aimed at preventing a future financial crisis.

A. U.S. Banking Regulators Oversee Shadow Banking

The shadow banking system has long existed under the supervisory sponsorship of U.S. banking regulators. Indeed, in a sense, banking regulators gave birth to the shadow banking system.

Regulators have broad authority to determine the scope of activities that are permissible for banks and bank holding companies and to impose regulatory restrictions to minimize the risks of such activities.[14] Since the early 1980s, banking regulators have used their authority under the banking laws to permit banks and bank holding companies to engage in an ever-increasing range of activities now characterized by the FSB as "shadow banking."

Regulators have permitted banks to engage in securities lending since the 1980s.[15] In 1985, the interagency Federal Financial Institutions Examination Council issued a supervisory policy governing such activities.[16] In 2007, the Federal Reserve, in a joint regulation with the Securities and Exchange Commission, granted an exemption allowing banks to engage in securities lending activities without registering as securities brokers under the Securities Exchange Act of 1934.[17]

[13] Remarks by Nicola Cetorelli, Federal Reserve Bank of New York, at the Second Annual Conference of the Office of Financial Research and Financial Stability Oversight Council, Assessing Financial Intermediation: Measurement and Analysis, Dec. 6, 2012.

[14] See National Bank Act, 12 U.S.C. § 1 et seq.; Bank Holding Company Act of 1956, 12 U.S.C. § 1841 et seq. These laws give regulators extensive supervisory powers to examine and monitor activities of banks and bank holding companies to ensure they are conducted in accordance with safe and sound banking principles.

[15] See OCC Interpretive Letter No. 380 (Dec. 29, 1986); Chase Manhattan Corporation, 69 Fed. Res. Bull. 725 (1983).

[16] See Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985) (addressing appropriate regulatory guidelines for growing securities lending activities of banks). See also Comment Letter to the Securities and Exchange Commission from J. Virgil Mattingly, Board; William F. Kroener, FDIC; and Julie L. Williams, OCC (Dec. 10, 2002) (noting that banking regulators had adopted interagency guidelines to "ensure that banks conduct their securities lending activities in a safe and sound maker and consistent with sound business practices, investor protection considerations and applicable law"). See Office of the Comptroller of the Currency, Banking Circular 196, Securities Lending, May 7, 1985; Bank Holding Company Supervision Manual § 2140, Securities Lending.

[17] 12 C.F.R. § 218.772.

Banking regulators also have long permitted banking organizations to engage in repurchase agreement transactions. In 1992, the Federal Reserve issued extensive guidance on such activities, including guidelines on credit policy, dealings with unregulated securities dealers, control of collateral and securities, overcollateralization, confirmations, margin requirements, and operations.[18] The Federal Reserve encouraged such activities by exempting them from reserve requirements.[19]

Regulators permitted banks and bank holding companies to acquire securities broker-dealers beginning in the early 1980s.[20] Banking regulators successfully defended these activities against litigation brought by the securities industry challenging them as contrary to the Glass-Steagall Act, intended to divorce banks from the securities business.[21] Today, all of the major securities broker-dealers in the United States are part of banking organizations. Regulators also authorized banking organizations to acquire consumer and commercial finance companies, including auto finance and leasing companies, a large number of which now are part of the regulated banking system.

Regulators also permitted banking organizations to organize and advise a variety of investment funds, including hedge funds and mutual funds. The Office of the Comptroller of the Currency (OCC) permitted national banks to guarantee such funds[22] and expanded the authority of national banks to issue guarantees to their customers and affiliates generally.[23] Banks have long been permitted to provide credit enhancements and guarantees for asset-backed commercial paper conduits and structured investment vehicles.[24]

Banking regulators have permitted large banking organizations to issue and trade credit default swaps and other derivatives for many years. Banks currently have a credit exposure of approximately $400 billion on a total notional

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[18] See Federal Reserve Board, Bank Holding Company Supervision Manual § 2150, Repurchase Transactions.

[19] 12 C.F.R. § 204.2(a)(1)(vii)(B). The exemption applies to repurchase agreements using collateral guaranteed by the U.S. government and agencies thereof.

[20] See BankAmerica Corporation, 69 Fed. Res. Bull. 105 (1983) (Federal Reserve Board Order approving BankAmerica Corporation's acquisition of Charles Schwab & Company).

[21] See Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207 (1984).

[22] See OCC Interpretive Letter No. 1010 (Sept. 7, 2004).

[23] 12 C.F.R. § 7.1017(b) ("a national bank may guarantee obligations of a customer, subsidiary or affiliate that are financial in character, provided the amount of the bank's financial obligation is reasonably ascertainable and otherwise consistent with applicable law."). 73 Fed. Reg. 22215, 22226 (April 24, 2008). The OCC noted that a bank must adopt appropriate risk management processes in connection with its guarantee activities.

[24] See Federal Reserve Board, Bank Holding Company Supervision Manual § 2128.04, Credit-Supported and Asset-Backed Commercial Paper.

amount of approximately $14 trillion in such derivatives.[25] Such activities are subject to supervisory oversight.[26]

All of these activities, which the FSB labels "shadow banking," are within the supervisory governance of banking regulators in the United States. Banking regulators have broad powers to examine such activities, to limit the scope of such activities, and to prevent unsafe and unsound practices in the conduct of such activities.[27]

B. Securitization Is a Supervised Banking Activity

Securitization lies at the core of the shadow banking system and is largely a product of banking regulation. Banking regulators approved securitization as a permissible activity for banks in the 1980s, overcoming legal objections that such activities violated the Glass-Steagall Act.[28]

In the 1990's, the Federal Reserve Board added a section to its Bank Holding Company Supervision Manual describing the benefits of securitization and prescribing risk controls for banking organizations engaged in such activities.[29] The Manual describes the extensive involvement of banking organizations in securitization activities:

> Banking organizations have long been involved with asset-backed securities (ABS), both as investors in such securities and as major participants in the securitization process. In recent years, banking organizations have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans and by expanding their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

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[25] See Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2012. The pendency of the Volcker Rule has reduced such activity from previous levels.

[26] See *Id.* ("The OCC and other supervisors have examiners on-site at the largest banks to continuously evaluate the credit, market, operational, reputation, and compliance risks of bank derivatives activities. In addition to the OCC's on-site supervisory activities, the OCC continues to work with other financial supervisors and major market participants to address infrastructure, clearing, and margining issues in OTC derivatives.").

[27] See 12 U.S.C. § 1818.

[28] See Securities Industry Association v. Clarke, 885 F.2d 1034 (2d Cir. 1989), *cert. denied,* 110 S. Ct. 113 (1990).

[29] Federal Reserve Board, Bank Holding Company Supervision Manual § 2128.02.

The Manual identifies at least five benefits of securitization:

> While the objectives of securitization may vary from one depository institution to another, there are essentially five benefits that can be derived from securitization transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on deposits funding the asset. Second, securitization provides originators with an additional source of funding and liquidity. The process of securitization is basically taking an illiquid asset and converting it into a security with greater marketability. Securitized issues often carry a higher credit rating than that which the banking organization itself could normally obtain and, consequently, may provide a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the banking organization's asset-liability mix. This is especially true if the banking organization has a large investment in fixed-rate, low yield assets. Fourth, by removing assets, the banking organization enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the banking organization's funding base, thereby reducing dependence on local economies.[30]

The Federal Reserve's Division of Banking Supervision and Regulation in 1990 issued guidance to Fed examiners on the supervision of securitization activities by banking organizations:

> It is appropriate for banking organizations to engage in securitization activities and to invest in ABS, if they do so in a prudent manner. Nonetheless, these activities can significantly affect their overall risk exposure. It is, thus, of great importance, particularly given the growth and expansion of such activities, for examiners to be fully informed on the fundamentals of the securitization process, on the various risks that securitization and investing in ABS can create for banking organizations, and on procedures that should be followed in examining banks and inspecting bank holding companies in order to effectively

[30] *Id.*

assess their exposure to risk and management of that exposure.[31]

The OCC in 1996 also issued supervisory guidance to national banks regarding their securitization activities[32] and in 1997 issued a Handbook for Asset Securitization.[33] In 1999, the banking regulators issued further interagency guidance on asset securitization activities.[34] In 2004, the regulators granted an exemption from the capital rules for asset-backed commercial paper conduits.[35] This action resulted in a ballooning of the amount of ABCP outstanding and was a significant factor in the buildup of subprime mortgages and the housing bubble that ultimately caused the financial crisis.

These supervisory actions show that securitization activities have long been a part of the regulated banking system, not an element of a separate "shadow banking system" beyond the reach of banking supervisors. Given the role of these activities in the financial crisis, it perhaps is not surprising that banking regulators would want to depict these activities as outside of their supervisory purview. But the facts show otherwise. Securitization is a regulated banking activity. The FSB's characterization of securitization as a shadow banking activity "outside" the regulated banking system is misleading and wrong.

IV. MONEY MARKET FUNDS ARE NOT SHADOW BANKS

The FSB's inclusion of MMFs in its definition of shadow banks is misguided. Money market funds have none of the distinguishing characteristics of either banks or shadow banks. They are not operating companies but rather pools of securities. Their activities are limited to investing in short-term, high-quality securities with the objective of providing safety of principal, liquidity, and a return to their investors.

[31] Federal Reserve Board, Division of Banking Supervision and Regulation, SR-90-16 (FIS) (May 25, 1990); Supervision and Regulation Task Force on Securitization, Examination Guidelines for Asset Securitization.

[32] OCC Bulletin 96-52 (Sept. 25, 1996) ("The Office of the Comptroller of the Currency today issued its first guidelines to banks involved in asset securitization activities. The guidelines focus on the need for bankers to understand fully the risks involved in securitization and to take steps to manage those risks effectively. OCC issued the bulletin on securitization because a growing number of banks are increasing their reliance on securitization to diversify funding sources and efficiently manage liquidity and capital.").

[33] Comptroller's Handbook for Asset Securitization (Nov. 1997).

[34] See OCC Bulletin 99-46, Interagency Guidance on Asset Securitization Activities (Dec. 1999).

[35] 69 Fed. Reg. 44908 (July 24, 2004). The exemption allowed banking organizations to sponsor and guarantee ABCP conduits without requiring consolidated capital treatment.

MMFs do not originate or spread risk through leverage like banks do. MMFs invest in obligations of banks that meet their credit standards but are not a guaranteed source of funding for the banking system.

A. MMFs Lack the Features of Shadow Banks

MMFs lack the defining features of shadow banks. They are not unregulated or even lightly regulated but rather are highly regulated under the Investment Company Act of 1940. Indeed, their regulation surpasses that of banks in stringency.

MMFs lack the risk features of shadow banks. MMFs are permitted to incur only minimal credit risk and are subject to strict portfolio diversification and liquidity requirements. Each MMF portfolio must have a weighted average maturity of no more than 60 days and a weighted average life of no more than 120 days. A MMF must be able to liquidate 10 percent of its portfolio in one day and 30 percent in one week. No more than five percent of its portfolio generally may be invested in obligations of any one issuer.

MMFs seek to maintain a stable net asset value (NAV) of $1.00 but are required to calculate a market-based NAV as well. If a MMF's market-based NAV falls one-half a penny below $1.00, it must cease offering its shares at $1.00 or liquidate. This requirement minimizes losses to fund shareholders in the event a MMF "breaks the buck." Only two MMFs in the United States ever have broken the buck. Shareholders in these funds nevertheless got back nearly their entire investment.[36]

MMFs lack the mechanism by which banks and shadow banks generate and multiply risk—leverage. Unlike either banks or "shadow banks," MMFs are almost completely unleveraged. Whereas banks generate assets equal to approximately ten times their capital, MMFs generate just $1.00 of assets for each dollar of shareholder equity. Moreover, MMF assets are short-term and capable of being liquidated to meet shareholder redemptions. MMFs thus do not create or spread credit risk as banks do.

MMFs also lack another key characteristic of both banks and shadow banks—opacity. MMFs are the most transparent of all financial intermediaries. They are required to make extensive disclosures about their operations, activities, investments, risks, service providers, fees, and other matters in prospectuses

[36] The Reserve Primary Fund, which broke a dollar in 2008, returned 99 cents on the dollar to its shareholders. A smaller fund that broke the buck in 1994 returned 96 cents on the dollar.

made available to investors. They also are required to disclose detailed information about each investment in their portfolios.[37]

Banks enjoy access to permanent government subsidies in the form of deposit insurance and government liquidity facilities, which give rise to ongoing moral hazard. MMFs operate successfully without these subsidies.

B. MMFs Are Not Prone to Runs

The FSB's Consultative Document repeats the erroneous claim of U.S. banking regulators that MMFs are "susceptible to runs." This claim is founded on no empirical evidence other than events during so-called "Lehman Week" when the entire U.S. financial system verged on collapse.[38] At that time, MMF investors sought safety by rapidly transferring their assets from prime MMFs to government securities or MMFs that invest only in U.S. government securities. The flight to safety resulted not because MMFs are susceptible to runs but because the government's chaotic response to the mounting crisis caused investors en masse to anticipate a financial catastrophe. MMFs gained assets during the crisis and served as a safe haven and source of liquidity for investors.

Unlike banks, MMFs have no history of runs. There was no run on MMFs during the ABCP crisis in 2007 or the sovereign debt crisis in 2011. As noted, only two MMFs *ever* have failed to repay their investors 100 cents on the dollar, and only one MMF broke a dollar during the financial crisis. In contrast, banks failed by the hundreds during the crisis, as they have done during every episode of financial instability in the past 40 years notwithstanding deposit insurance, access to government liquidity, and prudential supervision.

Appended hereto is a paper I submitted to the U.S. Financial Stability Oversight Council responding in greater detail to claims that MMFs are susceptible to runs.

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[37] Such information includes the name of the issuer, category of investment, CUSIP number, principal amount, maturity date, final legal maturity date, coupon or yield, and amortized cost value. Banks are not required to publicly disclose any information concerning the composition of their loans or investment portfolios. MMFs regularly value their portfolios at market prices and publicly disclose their market priced net asset value to four decimal points. Banks value a substantial portion of their assets at book value, making it difficult for depositors, investors, and even regulators to know their true condition at any given time.

[38] Federal Reserve Chairman Bernanke has said the crisis was the "worst financial crisis in global history, including the Great Depression." Testimony of Ben Bernanke before the Financial Crisis Inquiry Commission, Transcript dated Nov. 17, 2009 at 24.

C. A Floating NAV May Increase Risk

The FSB has endorsed the policy recommendations of the International Organization of Securities Commissioners (IOSCO) for MMFs. Most of IOSCO's recommendations already have been implemented for MMFs in the United States. A key recommendation has not been implemented, however; namely, the requirement that MMFs operate without a fixed $1.00 NAV.

Policymakers in the U.S. have expressed concern that a floating NAV could have unintended consequences and increase, rather than decrease, risk. A floating NAV could create risks where none exist now, for example, by making MMF investors overly sensitive to miniscule fluctuations in the market NAV of MMFs. Moreover, a floating NAV would eliminate the utility of MMFs for many investors, requiring costly accounting adjustments and making MMFs ineligible investments for many investors.

The President's Working Group on Financial Markets in the U.S. has questioned the advisability of eliminating the $1.00 NAV:

> Such a change may have several unintended consequences, including: (i) reductions in MMFs' capacity to provide short-term credit due to lower investor demand; (ii) a shift of assets to less regulated or unregulated MMF substitutes such as offshore MMFs, enhanced cash funds, and other stable value vehicles; and (iii) unpredictable investor responses as MMF NAVs begin to fluctuate more frequently.[39]
>
> * * * *MMFs with floating NAVs, at least temporarily, might even be more prone to runs.[40]

Researchers in the United States have studied data comparing the run risk of fixed NAV funds in the United States with variable NAV funds in Europe during the week of September 15, 2008.[41] These researchers found no difference in run risk between the two. They concluded that requiring MMFs to adopt a

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[39] President's Working Group on Financial Markets, Report on Money Market Fund Reform Options, Oct. 2010 ("PWG Report"), at 4 and 19-23. The PWG is comprised of the Secretary of the Treasury and the chairmen of the Federal Reserve Board, Securities and Exchange Commission, and Commodity Futures Trading Commission.

[40] PWG Report at 22.

[41] Jeffrey N. Gordon and Christopher M. Gandia, Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem? Columbia Law and Economics Working Paper No. 426 (Sept. 23, 2012), available at SSRN.com.

variable NAV structure in lieu of the current $1.00 NAV would not make MMFs less susceptible to runs.

V. CONCLUSION

The FSB's Consultative Document erroneously defines the shadow banking system as existing outside the regulated banking system. This paper shows that, at least in the United States, banks and their affiliates are the dominant shadow banks, engaging in extensive shadow banking activities under the supervision of U.S. banking regulators.

The FSB has identified important weaknesses in the regulated banking system. The FSB need not create the illusion of a separate shadow banking system to pursue solutions to these problems, however. Banking regulators in the U.S. have broad supervisory powers they can use to correct vulnerabilities in shadow banking activities of large banking organizations. Regulators should focus their reform efforts on such institutions already under their jurisdiction. The guise of shadow banking as something outside the regulated banking system can only lead to misguided reform efforts aimed at entities that are not the source of the problem.

The FSB's attempt to paint money market funds with the shadow banking brush is particularly misguided. These entities have none of the defining features of shadow banks. They are unleveraged, transparent, and liquid. Unlike traditional banks, they do not have a history of runs. MMFs are not an appropriate target of shadow banking reform efforts.