AFR Americans for Financial Reform

AFR Statement on 11/3 House Financial Services Capital Markets Subcommittee Hearing

On behalf of Americans for Financial Reform (AFR), thank you for the opportunity to submit this statement to the Subcommittee today. Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.[1]

We are disturbed that the Committee is once again choosing to consider deregulatory bills which will roll back needed protections for investors and for the broader economy, rather than turning its attention to the weaknesses in our regulatory system revealed by scandals at Equifax and Wells Fargo, or the financing needs of millions of Americans impacted by natural disasters across the country. Several of the bills under consideration today by the Subcommittee raise especially grave concerns.

H.R.2319: Consumer Financial Choice and Capital Markets Protection Act of 2017:
HR 2319 would reverse an important post-financial crisis reform and allow money market funds to present their share value to investors as stable, even though shares in money market funds are investment products that carry market risk to investors. By doing so, it will contribute to restoring the misperception that money market funds are similar to insured bank deposits and have an implicit government backstop. This misperception was reinforced during the 2008 financial crisis, when, in the face of a massive run on prime money market funds, the Treasury Department provided a public taxpayer guarantee of the entire sector, over $3 trillion in assets.

The run on money market funds in the 2008 crisis, and the resulting massive public bailout, definitively demonstrated the dangers of allowing investors to perceive an investment product like money market funds as free of risk. In order to reinforce clarity on the true valuation of money market fund shares, regulators reversed a 1982 regulation that permitted prime institutional money market funds to report valuations to their investors through an approximation method which generally permits them to report each share as worth one dollar, even if the actual market value of shares differs from a dollar. This change did not apply to government funds or retail funds. In response to this more accurate "floating net asset value (NAV)" method of valuation, which makes market risk clear, some institutional investors have withdrawn their funds from prime funds and re-allocated them to government funds, which have less market risk.

HR 2319 would reverse this change and once again permit prime money market funds to present themselves to investors as having a stable share value of $1. This change would again contribute to a misperception that money market funds have an implicit backstop from the government. While HR 2319 claims to prohibit further government bailouts of money market funds, it does not in fact do so. ***HR 2319 includes an explicit loophole that would permit the government to again provide public assistance to bail out money market funds in time of crisis.*** The definition

[1] A list of AFR coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

of “covered Federal assistance” that would be prohibited by HR 2319 is carefully phrased to exclude any Federal Reserve program that is “part of a program or facility with broad-based eligibility established in unusual or exigent circumstances.”[2] This language mirrors the language of Section 1101 of the Dodd-Frank Act, which permits the Federal Reserve to provide emergency lending assistance under Section 13(3) of the Bank Holding Company Act so long as such lending is provided as “in unusual or exigent circumstances…in any program or facility with broad based eligibility”.[3] Section 13(3) of the Bank Holding Company Act is the same provision that was used to extend trillions of dollars in credit to major Wall Street banks for a period of years during the 2007-09 financial crisis. HR 2319 would leave this provision open for use by money market funds.

Thus, HR 2319 would at the same time restore the ability of prime money market funds to falsely present themselves to institutional investors as a stable value product akin to a bank deposit, while also permitting such funds to receive government support through the Federal Reserve during periods of financial stress. We believe that this type of deregulation will only reinforce misperceptions about the risk involved in money market fund investments and will increase dangers to the stability of the financial system.

H.R ___, The Small Business Credit Availability Act: AFR previously opposed a broader version of this bill, which expanded permissible leverage and investments for business development companies (BDCs).[4]

The new version of this bill would still greatly expand the amount that BDCs are permitted to borrow. Specifically, the bill would double BDC leverage limits from the current 1-1 level (one dollar of borrowed money for each dollar of investor equity) to 2-1. In contrast, conventional closed-end mutual funds can only leverage 1-2, or borrow one dollar per two dollars of investor equity. Note that this fund-level leverage is in addition to the leverage that already exists in BDC portfolio holdings, due to investments in risky subordinated debt and structured products. For example, research from Wells Fargo shows that effective leverage at many large BDCs is already 5-1 or greater.[5] This means that a doubling of permitted regulatory leverage could lead to effective leverage of up to 10-1, or ten dollars in debt for each dollar in equity.

These high leverage ratios expose retail investors and retirees to a significantly greater risk of investment losses. As outlined by Professor Mercer Bullard in his testimony today, BDCs already charge much greater fees to investors than comparable investment products. It would add insult to injury to permit BDCs to also increase the risk of investment losses by significantly boosting their leverage.

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[2] See Section 66(a)(2)(C) of the Investment Company Act as added by Section 2 of HR 2319.
[3] See Section 13(3)(A) of the Bank Holding Company Act.
[4] Americans for Financial Reform, “Opposition Letter to HR 3868”, November 3, 2015. http://bit.ly/2iZfXK9
[5] Bock, Jonathan, Finian O’Shea and Joseph Mazzoli, “Equity Research: The Q4 2015 BDC Scorecard”, Wells Fargo Securities, September 10, 2015.

Nor is there any evidence that this increase in permitted leverage is needed to serve the public policy goals of the BDC structure, which is channeling funds to small and mid-market operating companies. It would be much more effective for BDCs to attract additional capital by offering a better deal and lower fees to investors, rather than increasing the risk to investors and to the companies they support by increasing their borrowing. Furthermore, as Professor Bullard documents in his testimony, BDCs are currently investing a large fraction of their funds in other financial companies and securitization structures, rather than directly supporting operating companies.

H.R. ___, Expanding Investment Opportunities Act: We have not yet completed our review of this legislation, which would allow Closed End Funds (CEFs) to take advantage of many registration exemptions created by the SEC for offerings issued by operating companies. However, we share the concerns that Professor Bullard expresses in his testimony that there are significant differences between CEFs and actual operating companies that could render these exemptions inappropriate for CEFs.