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Viewpoint: Brace for Higher Capital Charges for Money Market Funds*

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Banking organizations will be required to operate with substantially higher capital as a result of Dodd-Frank and the new Basel III capital framework. Some business activities will require more capital than others, particularly those that result in off-balance-sheet exposures for banking organizations. One such area where significantly more capital could be required is the operation of money market funds by large banking organizations.

Many investors consider these funds safer than deposits. During the recent financial crisis, only one money market fund failed, costing investors less than 2 cents on the dollar. But some funds required support from their sponsors to maintain a stable $1 net asset value. Many bank-affiliated money market funds needed such support, largely because of their portfolio investments in structured vehicles that failed.

Although the Securities and Exchange Commission has adopted reforms making it unlikely that any fund will fail in the future, the credit rating agencies are putting pressure on fund sponsors to guarantee their funds in order to receive the highest credit rating. Any such guarantee, whether implicit or explicit, will have significant capital consequences for banking organizations.

Under current capital rules (both Basel I and Basel II), an explicit bank guarantee against the credit risks of an affiliated money market fund would be considered a"direct credit substitute." As a result, the bank would need to hold additional capital against all the assets in the money market fund enhanced by the guarantee. Thus, if the guarantee is not capped or otherwise limited, the bank would need to hold additional capital against all the assets in the fund. The additional amount of capital would vary depending on whether the bank is subject to the Basel I or Basel II framework, but the additional requirement likely would be significant in either case.

The new Basel III framework was recently agreed to by United States and international financial regulators, and will not be fully implemented

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for several years. Under the Basel III framework, a guarantee of money market mutual fund would result in capital charges under both the risk-based capital requirements and the leverage ratio. The leverage ratio is not adjusted for risk, and therefore the capital charge under this standard would be prohibitive even if the money market fund held only U.S. government debt.

The capital implications do not change significantly if the bank does not issue an explicit guarantee, but instead implicitly guarantees the fund through words or deeds. This is made clear in both the Basel II and Basel III frameworks, and would also appear to be the case according to the preamble to the Basel I regulation.

Finally, Dodd-Frank would also mandate considerable capital charges if a systemically significant financial institution guarantees a money market mutual fund. It requires that these companies hold capital against guarantees of this nature, unless the Federal Reserve Board grants an exemption. In light of the recent financial crisis, the Fed would appear unlikely to be willing to grant such an exemption anytime soon.

In short, any commitment by a banking organization to provide an explicit or implicit credit guarantee of a money market mutual fund will result in markedly increased capital requirements for that organization, both under existing capital rules, under the new Basel III framework and pursuant to the Dodd-Frank Act. In light of the amount of assets typically held in a money market mutual fund, these capital charges will be very significant, if not prohibitive.