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BANKTHINK

Leave Money Market Funds Alone!

By John D. Hawke Jr.

In the wake of the financial meltdown of 2008, an increasingly persistent attack on money market mutual funds is underway. Present and former high government officials, academics, and some editorial writers have joined the fray, each offering their own approach for reengineering the money fund industry.

Common to all is an apparent failure to examine in depth – or, at least, a lack of appreciation for – the enormous disruption that would be caused by any of the various "remedies," or to make a conscientious cost-benefit analysis of the proposed changes – changes that would inevitably threaten the continued viability, availability and utility of this extremely safe, efficient and popular investment vehicle.

The "sky is falling" posture of the critics is based on the singular experience of 2008 when the Reserve Primary Fund "broke the buck" – that is, suffered a drop in its net asset value (NAV) to something less than $1.00 – because of its improvident investments in Lehman Brothers debt – an investment undoubtedly made on the optimistic and erroneous assumption that the government would never let Lehman fail. When Lehman did fail in September 2008 – twenty months into the financial crisis, in the midst of financial chaos of a sort that had not been experienced for many decades, and after the collapse of the subprime, securitization and auction rate markets, and the failure or forced sale of Countrywide, Bear Stearns, IndyMac, FreddieMac, FannieMae, Merrill Lynch and many banks – the Reserve Fund's net asset value dropped to just under $1.00 per share.

Under normal circumstances – and there had only been one prior incident of a fund breaking the buck – this would not be of great consequence. Indeed, the ultimate loss to the fund's shareholders was virtually imperceptible – less than one cent per share. Had money fund shareholders experienced a credit loss of such insignificance under other circumstances, caused by a credit failure involving a less prominent issuer, in a less turbulent environment, the market would almost certainly have ignored it. But in the midst of the financial crisis, when some of our largest institutions had already failed and others were on the brink, with a loss caused by the failure of a major and highly visible investment bank that did not get anticipated government support, many investors in other funds – principally institutional investors – concerned about the potential for their investments being frozen or their funds breaking the buck, redeemed out of money market funds, many moving to purely government funds. As a consequence even very healthy MMFs were faced with significant liquidity pressures.

These pressures were not the result of deterioration of MMF portfolios - they have had an excellent record of creditworthiness. The liquidity crunch was caused by an unusually large volume of redemptions, occasioned by severe uncertainties in a chaotic market, that threatened MMFs with losses as the result of having to liquidate perfectly good assets prior to their maturity in a "fire sale" environment.

Critics now point to this experience as evidencing a need to effect fundamental changes to the structure of MMFs, including such things as abandoning the stable $1.00 per share NAV or requiring a subordinated capital buffer. Some critics who have never been fond of MMFs would do away with them completely or force them into the banking system or bank-like regulation. But these critics seem to have given little or no thought to the consequences. For example, it would be virtually impossible for banks, which themselves are under severe capital pressures and face diminished loan demand support, to raise the new capital needed to support an inflow of trillions of dollars in new deposits. Moreover, since banks, with their higher cost structures, have not been significant providers of short-term credit, businesses and governments that have relied on MMFs for their short-term credit needs would be significantly disadvantaged. Even if they were able to support such an inflow, the pressure on banks that would result to seek higher returns in a time of low loan demand would likely raise their risk profiles.

More important, these critics have paid little or no attention to the fact that MMFs serve a tremendously important role in the daily cash management of millions of brokerage, trust and other accounts. Institutional money managers and trustees rely heavily on MMFs for the temporary housing of cash balances, and their systems have been structured and calibrated on the assumption that these balances will receive dollar-in-dollar-out treatment. Moving MMFs to a floating NAV – even if a floating NAV fund would continue to serve their needs – would cause havoc for these users and, at the very least, would require enormous investments in the retooling of systems.

The simple fact is that having a stable and predictable NAV is essential for a variety of automated internal and external transaction and accounting systems, and is critical for same- and next-day processing, for shortening settlement times, and for reducing float and counterparty risk among firms

Individual investors would be similarly affected. Many MMF investors access their funds with checks or debit cards or use them for bill-paying, uses that would be significantly impaired in a floating NAV environment. Of course, those who grumble about MMFs having cannibalized deposits from banks would point these users to the banking system. But over 30 million investors, with investments in excess of $2.6 trillion, perfectly aware of the option to use banks, have chosen MMFs over bank deposits for convenience, efficiency, predictability, and yield, and because MMF balances have less risk than bank deposits in excess of FDIC insurance limits. Over the 40 years that MMFs have existed, more than 2800 banks have failed at a cost of over $188 billion to the federal government, while only two MMFs were unable to meet shareholder redemption requests at 100 cents on the dollar (one paid 96 cents and the other over 99 cents on the dollar to its shareholders) at no cost whatsoever to taxpayers.

The premise behind the critics' floating NAV and subordinated capital proposals is that they will prevent "runs" - the rapid withdrawals of large amounts of MMF balances. But logic and evidence compel a contrary conclusion.

Requiring a floating NAV would almost certainly cause investors that are prohibited from investing in floating NAV funds, and others who want the predictability and convenience of a fixed NAV, to head for the doors as soon as such a change were put in place, and any future downward movement in the NAV would be likely to trigger even more redemptions by those who stayed. During the financial crisis, floating NAV funds in Europe experienced rapid shareholder withdrawals similar to those seen at stable NAV funds.

The proposed "buffer" of subordinated capital is similarly off the mark. First proposed by a group of academics – who have recently conceded that their original proposal was too complex and probably could not be made to work – have cobbled together another comparably complex proposal that pays little or no attention to the impact it would have on the millions of institutional and individual users who have come to depend on the safety, efficiency and utility of MMFs.

But more to the point, neither subordinated capital nor a floating NAV will stop runs. Only ready liquidity can deter and allow MMFs to cope with runs, and the proposals that have been suggested do not address liquidity. It was the constriction on liquidity that threatened the constant NAV at funds other than the reserve Primary fund and impacted the ability of MMFs to provide short-term credit to businesses and state and local governments – one of the most important functions of MMFs. The industry itself has proposed the creation of a "liquidity bank" that would be capitalized by the funds themselves and regulated as a bank, with traditional bank access to the Fed's discount window, but this idea has not gained support from bank regulators, who have yet to come forward with workable ideas for assuring liquidity in times of stress.

The SEC, however, has addressed liquidity, when it amended its Rule 2a-7 in 2010 to increase fund liquidity, credit quality and diversification. MMFs now must hold at least 10% of their assets in overnight cash ($260 billion in total across all MMFs) and 30% in assets that mature within one week ($800 billion). MMFs are also now required to hold even more cash if needed to meet anticipated redemption needs, and most hold cash and near-cash items well above these minimums.

The evidence is compelling that these changes are working. This past summer MMFs experienced large redemptions as investors reacted to the Greek debt crisis and the U.S. federal budget impasse. In June and July, investors redeemed over 10% of their prime MMF shares, a total in excess of $167 billion. Some MMFs experienced redemptions of between 20% and 45% of their assets. Yet no MMF broke a buck, and none was unable to meet redemptions. In short, the reforms adopted by the SEC in 2010 worked. In fact, the SEC itself has estimated that had these new requirements been in place during the financial crisis in September of 2008, the overwhelming number of institutional and retail funds would have been able to satisfy the level of redemption demands during individual days as well as during the week of greatest redemption pressure. Thus, there is good reason to believe that the liquidity crunch that followed the Reserve Primary Fund – an event of unprecedented magnitude – could have been averted or significantly mitigated.

The SEC has also changed how it supervises MMFs. Analysts within the SEC now pore through portfolio data submitted electronically by all MMFs, looking for signs of potential trouble. They can now access industry-wide data to look for investment concentrations by MMFs in particular issuers that may experience financial difficulties, and they follow up with MMF managers for explanations of trends, red flags and risky investments. In addition, investors have access to MMFs "shadow NAVs," funds' mark-to-market valuations that are reported on a monthly basis.

The SEC continues to refine its methods from experience and careful analysis of financial data. Its record with MMFs is far better than the record of bank regulators in maintaining the solvency of banks. Reengineering MMF regulation with untested structures will not enhance financial stability. It would make MMFs and our economy less efficient and more volatile, and would deprive tens of millions of investors and money managers of a liquidity and cash management vehicle on which they place great value and importance.

It is important to recall that despite the events of 2008, not a penny of taxpayer money has been lost in the support of MMFs, and the likelihood of losses to taxpayers in the future is extremely remote. The emergency liquidity facilities that were put into place by Treasury and the Fed after the Reserve Fund breakdown did not cost the government anything – indeed, they made a profit. This simply underscores the reality that MMF portfolios are basically required to be made up of high quality, short term instruments that will almost always liquidate at par at maturity.

At a time when markets are extremely skittish, it would be foolhardy in the absence of compelling need and a fully informed assessment of the consequences and the costs vs. benefits for policymakers to undermine MMFs. The SEC has been an effective overseer of MMFs, and its new regulation and surveillance operations appear to be working well. The critics should leave money funds alone and continue to evaluate the impact of the regulatory changes the SEC has put in place.

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