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ICI VIEWPOINTS

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An Outcome for Money Market Funds That We Must Avoid

By Paul Schott Stevens

Today, I provided ICI's views on the state of the money market fund industry at a hearing of the Senate Banking Committee, "Perspectives on Money Market Mutual Fund Reforms." My message to legislators was clear: Persistently viewing money market funds through the narrow prism of 2008, regulators are advancing plans for structural changes that would destroy money market funds, at great cost to investors, state and local governments, business, and the economy. We must avoid this outcome.

For almost five years, ICI has been deeply engaged in analysis and discussion of events in the money market and the role of money market funds. We take pride in the fact that our engagement helped produce the first comprehensive regulatory reforms for any financial product in the wake of the crisis—five months before the Dodd-Frank Act was passed.

The reforms for money market funds in 2010 benefit investors and the economy by raising credit standards and shortening maturities for funds' portfolios. They remove incentives for investors to redeem rapidly, by increasing transparency of fund holdings and authorizing an orderly liquidation if a fund risks breaking the dollar.

And those reforms sharply reduce the spillover effects of money market fund redemptions on the broader markets. As of December 2011, prime money market funds held $660 billion in assets that would be liquid within a week—more than twice the amount that investors redeemed from prime funds in the week of September 15, 2008. Today, prime funds keep more than 30 percent of their assets in liquidity buffers composed primarily of Treasury and government securities and repurchase agreements—precisely the instruments investors were seeking in 2008.

Money Market Funds Pass the Tests of 2011

We didn't have to wait long to put these reforms to the test. In the summer of 2011, markets were rattled by three significant events: the eurozone crisis; the showdown over the U.S. debt ceiling; and Standard & Poor's historic downgrade of U.S. government long-term debt.

Money market funds did indeed see large redemptions. From early June to early August, investors withdrew 10 percent of their assets from prime money market funds—$172 billion in all. During the debt-ceiling crisis, prime and government funds together saw an outflow of $114 billion in just four trading days.

But this withdrawal from money market funds had no discernable effects at all—either on the funds or on the markets. From April through December, prime money market funds kept their daily liquidity at more than twice the required level, and weekly liquidity stayed one-third to one-half higher than required.

Among the prime funds with the greatest exposure to European financial institutions, the average mark-to-market price of their shares fell by nine-tenths of a basis point. On a $1.00 fund share, that's nine one-thousandths of a penny.

It's clear from this experience that the reforms of 2010 have worked—and that money market funds today are a fundamentally different product than in 2008.

Regulators Cling to Myths Around Money Market Funds

Unfortunately, the regulatory community doesn't seem to have learned the lessons of 2011. They tell us that money market funds are "susceptible" to runs. They're worried that the government can't "bail out" these funds in a future crisis. Both of these statements are based in myths.

Let's look at September 2008. Regulators talk about the "contagion" from the failure of the Reserve Primary Fund on September 16, 2008. But Reserve Primary broke the dollar in the middle of a raging epidemic of bank failures. In the turmoil, banks were refusing to lend to each other, even overnight.

Two things stand out. First, Reserve Primary's breaking the dollar did not trigger the tightening of the commercial paper market—investors of all types began abandoning that market days before Reserve Primary failed. Second, investors did not flee from the money market fund structure. Rather, they fled from securities of financial institutions and sought the refuge of U.S. Treasury securities—by buying shares in money market funds invested in government securities. Assets of taxable funds—prime and government—declined by only 4 percent in the week of September 15.

The Treasury and the Federal Reserve stepped in to restore the financial markets. Let me be clear: money market funds received no financial support from the federal government. The Treasury guarantee program never paid a dime in claims—instead, it collected $1.2 billion for the taxpayers. It's quite a stretch to call that a "bailout." The Federal Reserve's facilities were designed to use money market funds to access the markets and pump in needed liquidity. That's Central Banking 101.

Our shareholders realize that money market funds are investments—and they bear the risk of loss. No one in the investment community believes that these funds carry a government guarantee—and no one in our industry wants one. Period—full stop.

A Troubling Misreading of Sponsor Support for Money Market Funds

My testimony permitted me to address the issue of sponsor support for funds. Since the 1970s, advisers to money market funds have on occasion chosen to address credit or valuation issues in their portfolios and support their funds. They did so with private resources—not taxpayer dollars. And they did so for business interests—to protect their brand or preserve their fund's rating.

The SEC hasn't released any data to back its claims about sponsor support. We can say, however, that we know of only one instance of sponsor support since the 2010 reforms, and that in that case the security in question was in no danger of defaulting.

Yet the SEC suggests that every case of sponsor support should be seen as a repeat of September 2008. They suggest that without sponsor support, money market funds would have triggered runs.

Decades of experience with these funds suggest just the opposite. Before the latest financial crisis, there was only one occasion when a money market fund broke a dollar, in 1994. As my colleague Karrie McMillan has discussed, the world yawned.

I invite you to read my full testimony, which goes into depth on importance of money market funds, the regulatory progress that has been made for these funds since 2008, and the necessity of preserving their benefits for issuers and investors.

Paul Schott Stevens was President and CEO of ICI.
