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Correcting the Record: The Power of the SEC's 2010 Money Market Fund Reforms

By Mike McNamee

We've spent several days pointing out the myths and misstatements that regulators have put forward in their campaign to impose structural changes on money market funds. One recurring theme is the Securities and Exchange Commission's puzzling unwillingness to acknowledge the effects of its own reforms to these funds in 2010. The SEC was the first agency to adopt permanent new rules to address problems uncovered in the financial crisis. Its sweeping changes have made money market funds more resilient—as the standoff over the U.S. debt ceiling, the historic downgrade of the U.S. credit rating, and the ongoing European debt crisis have demonstrated.

Yet in her latest testimony before the Senate Banking Committee, SEC Chairman Mary Schapiro went out of her way to minimize the impact of the new rules on systemic risk. Her misstatements deserve a full response.

Misstatement: "The [2010] amendments did not (1) change the incentives of shareholders to redeem if they fear losses; (2) fundamentally change the dynamics of a run, which, once started, will quickly burn through fund liquidity; (3) prevent early redeeming, often institutional investors from shifting losses to remaining, often retail investors; or (4) enable money market funds to withstand a 'credit event' or the loss in value of a security held by a money market fund."

Let's take those one at a time.

1. Investors *always* have some incentive to redeem out of or sell *any* financial product—be it a bank deposit, a stock, a bond, or any other instrument—if they fear losses. That's human nature, and regulators might as well try to turn back the tides as hope to change that. Money market funds, like *all* financial assets, have risks. But the risk of investing in a money market fund is highly limited, by virtue of the regulations that the SEC has enacted over the last 30 years in Rule 2a-7—and significantly strengthened in the 2010 amendments.

2. The 2010 amendments *did* fundamentally change the dynamics of a period of heavy redemptions in at least two respects.

First, the 2010 amendments, for the first time ever, required money market funds to maintain specific levels of liquidity. Since 2010, taxable money market funds are required to hold at least 10 percent of their portfolios in assets that can be turned into cash that day, and 30 percent in assets that are liquid within a week. In practice, prime money market funds have exceeded those minimums by a significant margin, and now hold twice as much in liquid assets as the heaviest redemptions they faced in the worst week of the financial crisis in September 2008. Those liquidity requirements were tested by significant redemptions during the U.S. debt-ceiling and European debt crises in 2011—and funds met redemptions without problems. That makes it hard to believe Chairman Schapiro's assertion that redemptions "will quickly burn through fund liquidity."

What are these liquid assets? They're overnight loans and Treasury and other government securities—exactly the paper that anxious investors want to buy in a crisis. Remember, for every dollar that flowed out of prime money market funds in September 2008, 61 cents went back into Treasury and government money market funds. In a future crisis, government funds could simply buy many of the liquid assets of their prime counterparts to match investors' shifting demands.

Second, if a money market fund can't meet redemptions without breaking the dollar, the 2010 amendments allow the fund's board to liquidate the fund in an orderly manner—without a fire sale of portfolio securities or a first-mover advantage for early redeemers. Check out our earlier *ICI Viewpoints* entry for more on this important investor protection.

3. At the risk of repeating ourselves, Chairman Schapiro is again ignoring the powerful tool that the SEC gave money market fund boards in 2010 to protect slow-moving investors from suffering losses at the hands of first-movers. Equally important, the additional changes under discussion—forcing money market funds to float their value, or coupling capital requirements with holdbacks on investors' redemptions—won't stop sophisticated institutions from bolting from a troubled fund, particularly in the midst of a global financial crisis like 2007–2008.

The best way to prevent a recurrence of September 2008 is to prevent a recurrence of the crisis that was raging out of control for the 12 months prior. Regulators need to monitor any buildup of unsustainable risks in the banking sector and head off a collapse of confidence that will cause investors in *all* financial products to run.

4. Washington cannot outlaw credit losses on investments, whether commercial paper owned by money market funds or mortgages owned by banks. Risks have to be managed—and the 2010 reforms made money market funds far more capable of avoiding surprise credit events by raising the bar for credit quality of the securities they invest in and shortening the average maturity and life of the fund's portfolio.

The 2010 amendments also made money market fund portfolios far more transparent. New disclosure standards require a fund to report details every month on *every* security it holds, every piece of collateral backing repurchase agreements, and a wide range of other matters on the new Form N-MFP. Institutional investors have found this data invaluable in monitoring holdings of their funds and encouraging those funds to reduce credit risks. In fact, we hear that the SEC itself is monitoring Form N-MFP reports and contacting funds that could be taking credit risks that the regulators find worrisome.

For almost eight decades, the SEC has maintained that disclosure is a powerful tool in managing risks. It would be odd if regulators' self-imposed imperative to force structural changes on money market funds overwhelmed that principle.

Misstatement: The 2010 amendments to Rule 2a-7 "were not designed to address the structural features of money market funds that make them susceptible to runs."

Funny—Chairman Schapiro's statement in her testimony contradicts what her staff said in 2009, when the Commission proposed those amendments.

In the July 8, 2009, proposing release for the 2010 amendments, the SEC declared:

"Our proposals…are designed *to increase the resilience of money market funds to market disruptions* such as those that occurred last fall [i.e., September 2008]. The proposed rules would *reduce the vulnerability of money market funds to breaking the buck* by, among other things, improving money market funds' ability to satisfy significant demands for redemptions. If a particular fund does break the buck and determines to liquidate, the proposed rules would facilitate the orderly liquidation of the fund in order to protect the interests of all fund shareholders. *These changes together should make money market funds (collectively) less susceptible to a run by diminishing the chance that a money market fund will break a dollar* and, if one does, provide a means for the fund to orderly liquidate its assets. Finally, our proposals would improve our ability to oversee money market funds by requiring funds to submit to us current portfolio information." (emphasis added)
And that was *before* the triple crises of 2011 demonstrated that the 2010 amendments had met the SEC's goals by making money market funds stronger.

Misstatement: Money market funds continue to have "considerable exposure to European banks, with, as of May 31, 2012, approximately 30 percent of prime fund assets invested in debt issued by banks based in Europe generally and approximately 14 percent of prime fund assets invested in debt issued by banks located in the Eurozone."

Thanks to the new disclosures mandated by the 2010 amendments, regulators, investors, and analysts have had a ringside seat, with almost real-time monitoring, as money market fund managers have addressed the changing risk profile of European banks throughout the eurozone sovereign debt crisis. What those spectators have seen is that prime money market fund managers have had no direct exposure to banks in Greece, Ireland, and Portugal for many months. They've also seen fund managers reduce their exposure to eurozone-domiciled issuers by more than half in the past year, from 28.8 percent in June 2011 to 12.2 percent in June 2012.

Look a little deeper, and you'll see that roughly one-half of these funds' remaining exposure to eurozone banks is invested with banks that serve as "primary dealers"—counterparties to the Federal Reserve Bank of New York in its Treasury market dealings. And about half of that paper consists of repurchase agreements—overnight or short-term loans that are typically over-collateralized by more than 100 percent by U.S. Treasury or agency securities. In short, while regulators and critics point to all "European" investments as evidence that money market fund managers are taking undue risks, the institutions and securities that these funds invest in are actually deeply embedded in the U.S. financial system.

Close observers (or readers of *ICI Viewpoints*) also would have seen that money market funds have shortened the maturity of their remaining eurozone holdings substantially. In June 2011, only 37 percent of money market funds' exposure to French issuers was due to mature in 30 days or less. A year later, 80 percent of that paper was 30-day or shorter.

Just two years after the SEC's risk-limiting amendments to Rule 2a-7 (higher credit quality, lower maturities, and required liquidity levels) took full effect, money market funds have faced major challenges to the stability of the short-term credit markets. Those challenges brought exactly the type of heavy redemption pressures that those amendments were designed to address.

It's a rare event for regulators to see their handiwork tested so quickly. It's a shame that they feel they need to sell those new rules—and money market funds—short in their drive for further, damaging, structural changes.

This is the fifth and last in a series of ICI Viewpoints *postings on myths and misstatements about money market funds. The previous entries:*

- Correcting the Record: The "Susceptible to Runs" Myth
- Correcting the Record: Regulators' False Narrative of 2008
- Correcting the Record: What Money Market Fund Investors Know
- Correcting the Record: Investor Protections in the SEC's 2010 Money Market Fund Reforms

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