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The New York Fed's Flawed Approach to Fixing the Money Market

By Brian Reid

William C. Dudley, president and CEO of the Federal Reserve Bank of New York, recently delivered a speech, [Fixing Wholesale Funding to Build a More Stable Financial System](#).¹ I was interested to read his remarks, as the New York Fed has been instrumental in pursuing reforms to strengthen the financial markets, particularly in the market for [tri-party repurchase agreements](#).

I was disappointed, however, that Dudley suggested money market funds are the key source of instability in the money markets. The facts don't support this view, as I've detailed in [a recent letter to Dudley](#). Worse, his focus on a single product risks diverting regulators from the far more useful approach that the New York Fed pursued in the repo markets—market-wide reforms.

Here are the key points from my letter.

- **Dudley Conveys a Faulty Narrative of the Financial Crisis**

At the beginning of his remarks, Dudley mentions the “extensive use of short-term funding” prior to the financial crisis and the contribution of supply-side factors to the mispricing of risk. He does not explicitly mention the supply-side effects of money market funds, but his focus on money market fund reforms implies that these funds were the primary source of supply-side factors.

As we discuss in [our comment letter](#) to the Financial Stability Oversight Council on its [Proposed Recommendations Regarding Money Market Mutual Fund Reform](#), money market funds cannot credibly be held to account for the credit bubble. The data simply won't support that argument.

From the beginning of 2000 to mid-2007, the money markets expanded by \$4.5 trillion, while taxable money market funds' holdings of these short-term securities increased by only \$299 billion. The repo and commercial paper markets grew substantially during this period, yet money market funds accounted for only 11 percent of the increased supply of funding to the repo market and less than 1 percent of the increase in the commercial paper market. In addition, money market funds financed, at most, 6 percent of home mortgage borrowing over this period.

Dudley's remarks also implied that money market funds were the primary source of pressure in the repo and commercial paper markets during the financial crisis. Again, the data say otherwise. For example, during September 2008, while the repo market declined by \$400 billion, money market funds increased their holdings of repurchase agreements by more than \$90 billion. Even during the week between September 16 and 23—when prime money market funds were enduring their largest outflows in history—money market funds expanded their lending in the repo market by \$67 billion. Clearly, the problems financial institutions had in obtaining repo funding originated with investors other than money market funds.

Events in the commercial paper market show a similar pattern: during late summer 2007, investors other than money market funds accounted for most of the decline in commercial paper. Even in September 2008, the sell-off of commercial paper by other investors equaled that of money market funds. In addition, these investors continued to pull back from the commercial paper market in October, while money market funds became net buyers. Again, the problems faced by commercial paper issuers were market-wide across a spectrum of buyers, not specific to money market funds.

- **The SEC's 2010 Reforms for Money Market Funds Are Much More Than a “First Step”**

Dudley downplays the [2010 reforms of money market funds](#) by the Securities and Exchange Commission (SEC) as “a first step” that

make money funds “somewhat less risky.” He also says these reforms do little to reduce investors’ incentives to run at the first sign of trouble.

The facts: today’s money market funds are stronger and substantially more resilient than the funds that were available in 2008, thanks to the tools and regulatory requirements provided by the SEC’s 2010 reforms.

The 2010 amendments addressed the liquidity challenges that prime funds faced during the financial crisis by imposing, for the first time, explicit minimum daily and weekly liquidity [requirements](#). In practice, money market funds are operating with liquidity well in excess of the required minimum levels.

These reforms will prevent “fire sales” of assets when money market funds are faced with large redemption requests. The vast majority of securities that funds hold to meet their mandated liquidity standards, namely U.S. government securities and repo collateralized with government securities, are exactly the securities that are highly sought after in a crisis. Even if investors pull away from a troubled prime fund, the impact on broader credit markets will be minimal, because the fund will be selling securities that other investors are eager to buy. Another reform, often overlooked, is that money market fund sponsors are now allowed to suspend redemptions and close a fund to prevent a fire sale of assets from spilling over into the markets and affecting other funds and investors.

- **Additional Reforms Endorsed by Dudley Are Bad Ideas**

Dudley endorses the idea of a minimum balance requirement as “the best one for financial stability purposes.”

ICI has extensively examined this concept, also known as the minimum balance at risk (MBR) or redemption holdback, and found it suffers [from many defects](#). By denying investors complete access to their fund shares, the MBR would make money market funds less liquid than other investment pools, including other mutual funds. The MBR also creates serious operational issues for funds, intermediaries, and investors that would reduce or eliminate the usefulness of many services that money market funds provide.

Given investors’ stated negative reactions to such holdback proposals, funds, intermediaries, and service providers will be unable to justify, from a business standpoint, the significant costs of complying with an MBR in the face of a rapid shrinkage of money market fund assets.

The danger here is that a policy response that focuses solely on one product—and in this case, on the most-regulated and most-transparent product in the market—will drive investors into less-regulated, less-transparent alternatives. This exit would increase, not reduce, risks to the financial system and would reduce information available to regulators.

You can learn more about money market funds at our [Money Market Funds Resource Center](#).

Brian Reid was Chief Economist of the Investment Company Institute.