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Three Gaps in the FSOC's Account of Money Market Funds in the Financial Crisis

By Paul Schott Stevens

Given money market funds' critical role in the economy and markets, the policy discussion around these funds should be precise and should demonstrate a clear understanding of the facts. Unfortunately, policymakers have been guided on occasion by a narrative about money market funds that is inaccurate and unsubstantiated.

The most recent example comes in the *2012 Annual Report* of the Financial Stability Oversight Council (FSOC), released last week; this report is the subject of Treasury Secretary Timothy Geithner's testimony before Congress today. Referring to changes for money market funds under consideration at the Securities and Exchange Commission (SEC), the report says, "these reforms are intended to address the structural features of MMFs that *caused a run on prime MMFs and the freezing of the short-term credit markets* after the Reserve Primary Fund was unable to maintain a stable net asset value (NAV) in September 2008." (emphasis added)

This is a startling mischaracterization of that time of crisis and the role of money market funds in it. Let's examine a few key points that counter the narrative put forward by the FSOC.

Money Market Funds Were But One Player in the "Worst Financial Crisis in Global History"

The notion that money market funds caused short-term credit markets to freeze altogether ignores the context of what Federal Reserve Chairman Ben Bernanke has described as "the worst financial crisis in global history, including the Great Depression." This crisis had reached a critical stage well in advance of the problems of the Reserve Primary Fund in September 2008. At least 13 major institutions had gone bankrupt, been taken over, or been rescued during the 12 months before Lehman Brothers was allowed to fail.

In this maelstrom, as documented in my June 21 testimony before the Senate Banking Committee, investors everywhere reacted to the widespread uncertainty over the stability of financial institutions and the lack of predictable government policy responses to a crisis gripping the global banking system. Money market funds and their investors were neither the first nor the largest of these retreating investors. Instead, they were simply among the most easily observable market participants, because money market funds offer the most transparency and disclosure of money market participants.

Money Market Funds Were Not the Primary Source of Pressure in the Commercial Paper Market

The data here are clear. During the month of September 2008, outstanding commercial paper declined by $185 billion. ICI data show that money market funds reduced their holdings of commercial paper by $164 billion in that month. However, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) program also held $152 billion in commercial paper as of October 1, all of which arose from money market fund sales to commercial banks in September. Hence, money market funds' net reduction (after adjusting for sales to the AMLF program) amounted to $12 billion, or a relatively small 6 percent, of the $185 billion decline in outstanding commercial paper.

Investors Did Not Abandon Money Market Funds

Even in the extreme conditions prevailing in fall 2008, investors demonstrated continuing high confidence in money market funds. About $300 billion flowed out of prime money market funds, the holdings of which included securities issued by financial institutions. For every dollar that left these funds, however, 61 cents flowed into Treasury and government and agency money market funds. In a classic “flight to quality,” they moved to less risky assets—choosing money market funds as their vehicle.

Sound policy is best achieved through meticulous analysis of the problems that the policy purports to address, in light of subsequent events. Here, we have seen that the far-reaching changes to money market funds adopted by the SEC more than two years ago have profoundly changed money market funds and helped them to weather subsequent crises, such as the U.S. debt ceiling impasse and the deteriorating conditions in the European debt markets. In our view, a thorough analysis of these developments—and a well-informed understanding of recent history—easily expose the faulty premises upon which the case for the SEC’s “structural reforms” rests.

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