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Money Market Funds: Preserving Systemic Benefits without Systemic Risks

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During September 2008, soon after Lehman Brothers filed for Chapter 11 protection, the Reserve Primary Fund, a large and prominent money market mutual fund, “broke the buck”: it declared a net asset value that was less that the $1 per share that is standard for such funds because it marked down the value of Lehman debt in its portfolio. This event triggered a run on money market funds, particularly those with a large institutional investor shareholder base, as investors rushed to redeem their shares out of concern that they too might fall in value below $1 per share. A number of large money market funds avoided “breaking the buck” and stemmed redemptions only because their managers, often affiliated with large financial institutions, injected capital into the funds by purchasing troubled assets at par. Nonetheless, the run did not stop until the U.S. Treasury stepped in and guaranteed (albeit on a limited and temporary basis) money market fund shares against loss.

These events re-ignited a policy debate that has existed since the invention of the money market fund in the early 1970s. On one side of the debate are those who argue that money market funds are “shadow banks” that perform functions that are similar to those performed by banks and present similar risks: in particular, because the funds offer daily redemption rights but invest in assets with longer terms, there is a maturity mismatch that makes funds susceptible to runs. On the other side of the debate are those who argue that money market funds are different from banks because they are more transparent and invest in less risky and shorter-term assets and thus are fundamentally safer and because of the effectiveness of existing SEC regulation of money market funds. The Dodd-Frank Act has pushed federal financial regulators into this debate, requiring the President’s Working Group on Financial Markets to study the problem and make recommendations to the Financial Stability Oversight Council, which is tasked with determining whether money market funds present a systemic risk and thus should be subjected to bank-like prudential regulation by the Federal Reserve. The PWG’s study analyzed a number of potential regulatory responses, including changing SEC rules that allow money market funds to maintain a stable $1 NAV/share, requiring funds to participate in a liquidity facility or to maintain insurance, and regulating them as special purpose banks.

In this article, the author assesses both the potential for systemic risk presented by money market funds as well as their systemic benefits. While the literature describes both the funds’ susceptibility to runs and the benefits of keeping funds’ assets and activities out of the banking system and FDIC guarantees, it is underappreciated the extent to which money funds constitute an alternative from the banking system for financing the working capital needs of businesses that is insulated from other risks in the banking system. The author also examines the regulatory regime for money market funds as recently tightened by the SEC and some of the various proposals to address these funds’ susceptibility to runs.