Money Market Funds – Preserving Systemic Benefits, Minimizing Systemic Risks

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The Role of MMFs in the US Financial System

- A specialized type of mutual fund that is allowed to use amortized cost valuation in order to seek to maintain a stable $1 NAV per share
  - Offers daily redemption, check-writing privileges
  - In return, subject to strict maturity, credit quality, liquidity, diversification and disclosure rules under SEC rule 2a-7
- Significant purchasers of commercial paper, US and municipal government debt, repurchase agreements
  - Approximately $3 trillion invested in MMFs
- Investors have a strong expectation that the $1 NAV will remain stable and that the "buck" won't be "broken"
  - Before 2008, only one MMF had broken the buck

MMFs During the Financial Crisis

- In September 2008, right after Lehman filed for bankruptcy, a $62 billion MMF broke the buck because it had to write down its Lehman holdings
  - Investors were shocked, and there was soon a run-like cycle of redemptions by institutional investors from prime MMFs
- As part of the crisis, credit markets froze, including the markets for CP and repos
- At least 20 MMF sponsors provided support to their MMFs to prevent them from breaking the buck
- The government intervened:
  - UST temporarily guaranteed investors' pre-existing MMF fund balances
  - The Fed created a number of liquidity facilities to support the money markets and CP markets in particular

Systemic Risks and Criticisms of MMFs

- Susceptible to run-like cycles of redemptions because of difference between market value of portfolio and $1 NAV
  - Contagion can spread to other funds during crisis
- Are they “shadow banks”?
  - Similar liquidity to demand deposits
  - Check-writing
  - Maturity transformation
  - Investors may think they are insured or safe
  - They have an implicit government guarantee for which they do not pay

Systemic Benefits of MMFs

- Criticisms and systemic riskiness are overstated
  - MMFs have only broken the buck twice (compared with thousands of bank failures)
  - The recent crisis was fundamentally rooted in the regulated banking and investment banking systems and spread to MMFs
- MMFs are significantly safer than banks
  - Much shorter term and more liquid assets, more diversification, higher credit standards
  - MMFs relieve potential demands on the DIF

Systemic Benefits of MMFs

- The linchpin, with CP, of a market-based alternative system to the banking system for providing working capital to industrial and financial firms
- MMFs are significantly more transparent than banks, and thus their primary investors, institutions, can perform due diligence on their managers and portfolios
  - Market discipline works in this context, unlike in the market for banking deposits, which are "informationally insensitive" services
  - The resulting positive externalities have, until 2008 and since, kept MMFs from breaking the buck

Systemic Benefits of MMFs

- CP brings more discipline to the market for providing working capital for firms
  - Liquid and tradable
  - A more focused investment in a particular company
  - Generally lower interest rates and fees
  - Thus more efficient at allocating capital
  - Insulated from pressures in banking system because of disintermediation

Minimizing the Risks and Keeping the Benefits

- SEC tightened the maturity, disclosure and credit quality rules and introduced new liquidity standards
- President's Working Group has analyzed a number of proposals, including:
  - Floating MMFs' NAV
  - Government guarantee
  - Bank-like regulation
  - Private, industry-wide emergency liquidity facility