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The Importance of Context in the Discussion Around Money Market Funds

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In the debate around money market funds, we've seen too many instances of participants in the discussion taking positions or making assertions without properly putting things in context. This is troubling, because a poor sense of the big picture can increase the risk of bad policy outcomes for funds and investors.

That's why we stressed the importance of context in a recent comment letter on a report, Money Market Fund Systemic Risk Analysis and Reform Options, from the International Organization of Securities Commissions (IOSCO). Let's look at two key points from that letter.

Market Context: 1994 Versus 2008

At the beginning of the IOSCO report, you'll find this sentence:

The financial crisis of 2007–2008 highlighted the vulnerabilities of [money market funds], and most notably, their susceptibility to runs. We disagree that the financial crisis revealed any such flaws in money market funds. Rather, it shows us the importance of context—how investors react in the very rare event that a money market fund is unable to return a full $1.00 per share ("breaking a dollar") depends entirely on events that precede and surround that occurrence.

Prior to 2008, the only other time a money market fund had broken a dollar was in 1994. At that time, the banking system was not mired in crisis, so there was no reason for investors to lose confidence in the assets their funds were holding. Not only did the 1994 event not trigger a run, money market fund assets actually grew during the month after the fund broke a dollar.

The context of 1994 provides quite the contrast with the context of 2008, when, like many market participants, money market funds were hit by a global crisis that began to take hold long before the intense turmoil of September 2008.

The financial crisis was, first and foremost, a crisis in the real estate markets. As the real estate markets collapsed, the banking system experienced enormous stress as structured investment vehicles, originally designed to move liabilities off banks' balance sheets, suddenly were brought onto those balance sheets. The banking crisis that followed was catastrophic. At least 13 major institutions went bankrupt, were taken over, or were rescued in the 12 months before Lehman Brothers failed. Lehman's failure was an especially difficult shock for the market because it represented an abrupt reversal by the U.S. government from its previous decisions to intervene and rescue Bear Stearns, Fannie Mae, and Freddie Mac.

In contrast to massive failures in the bank sector, only a single U.S. money market fund, the Reserve Primary Fund, could not return $1.00 per share after Lehman failed. Many other money market participants were hit by a severe liquidity freeze when banks, seeking to preserve their liquidity, refused to lend to one another and investors lost confidence in government policy.

Yet, keep in mind another key piece of context from 2008. Even in these extreme conditions, investors remained invested in money market funds—they shifted their assets from prime money market funds, which held financial institutions' securities, to Treasury and government and agency money market funds, which did not. About $300 billion flowed out of prime money market funds; for every dollar that left these funds, however, 63 cents flowed into Treasury and government and agency funds.

Policy Context: 2008 Versus 2012

Strangely, recent policy developments also are ignored or overlooked in the discussion around money market funds. The SEC's 2010 amendments to U.S. money market fund regulation have made these funds even more liquid, transparent, and stable than ever before. We therefore urged IOSCO to avoid falling into the trap of looking at these funds and reform options as though it were still 2008.

As we told IOSCO, the success of the 2010 policy reforms was amply demonstrated by the market events of last summer. In 2011, money market funds weathered two financial market shocks attributable in large measure to government gridlock: the looming U.S. federal debt ceiling crisis in mid-2011 and deteriorating conditions in European debt markets throughout the year.

Reflecting these circumstances, investors withdrew $213 billion from prime money market funds over the six-month period from June 2011 to November 2011. While these outflows were smaller than the flows prime funds experienced during the worst months of the financial crisis, they were still quite large, totaling 13 percent of the assets of prime money market funds as of May 2011.

Thanks to the 2010 reforms, funds had plentiful liquidity to meet redemptions. As of May 30, 2011, prime money market funds held an estimated $643 billion in daily and weekly liquid assets, well in excess of the outflows they experienced over the next several months.

Our letter provides much more context on money market funds. You can find it and other information on our Money Market Fund Resource page.

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