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ICI VIEWPOINTS

AUGUST 13, 2012

Correcting the Record: Uncovering Regulators' False Narrative of 2008

By Mike McNamee

The regulators who are campaigning for structural changes in money market funds are building their case in part on distortions, exaggerations, and misunderstandings about money market funds, their investors, and their role in the financial markets. Given what's at stake—the grave damage that funds, their investors, and the economy would suffer if concepts promoted by some at the Securities and Exchange Commission (SEC) go forward—it's crucial that the record be clear and accurate.

Today, we're looking at a set of myths that have embedded themselves firmly in regulators' statements—the false narrative of the 2008 financial crisis. The farther we get from those events, the more determined regulators are to claim that money market funds were at the center of the crisis—a tale that, at best, is incomplete and misleading.

Misstatement: Money market funds' "retreat from [the short-term] markets [in September 2008] caused them [the markets] to freeze."

That's how SEC Chairman Mary Schapiro put it in her latest testimony before the Senate Banking Committee. Another version of the myth, from the *2012 Annual Report* of the Financial Stability Oversight Council (FSOC): "structural features of money market funds…*caused a run on prime money market funds and the freezing of the short-term credit markets* after the Reserve Primary Fund was unable to maintain a stable net asset value in September 2008." [emphasis added]

The notion that money market funds *caused* short-term credit markets to freeze conveniently ignores altogether the context of those events—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 long before 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, triggering Reserve Primary's problems. The credit markets started to seize up on September 15—before Reserve Primary Fund failed. On the same day that Reserve Primary broke the dollar, American International Group (AIG) collapsed and was rescued—signaling that even investment-grade firms could fail almost without warning. Following these events, concerns rapidly spread in financial markets that the debt of numerous other large investment and commercial banks posed much greater risk than previously thought.

In this maelstrom, 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—they were simply among the most easily observable market participants.

Data clearly demonstrate that money market funds were *not* the primary source of pressure in the commercial paper market in September 2008. During that month, outstanding commercial paper declined by $185 billion. ICI data show that money market funds reduced their holdings of commercial paper by $164 billion in September. However, between September 22 and October 1, 2008, the Federal Reserve's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) program acquired $152 billion in commercial paper—every dollar of which came from money market fund sales to commercial banks. Net of their sales to AMLF, which were designed by the government to pump cash into the market, money market funds accounted for just $12 billion, or about 6 percent, of the $185 billion decline in outstanding commercial paper. Other investors clearly were pulling back from commercial paper issuers in a stressed market.

Elsewhere in the short-term markets, it's clear that a variety of market participants were pulling back their exposures to financial institutions, particularly banks. Banks' borrowing from the Federal Reserve's discount window, excluding the commercial paper

programs and lending associated with AIG and Bear Stearns, rose from $170 billion as of September 10, 2008, to $587 billion as of December 17, 2008, and remained at that level through the end of 2008 as other participants withdrew funding from banks.

Banks also quit lending to each other. Interbank lending by commercial banks fell more than 30 percent, or nearly $145 billion, on a seasonally adjusted basis. The stresses were reflected in the spread between the three-month London Interbank Offered Rate (LIBOR) and the overnight index swap (OIS) rate, a traditional measure of the health of the banking sector. The LIBOR-OIS spread jumped from less than 100 basis points on September 12, 2008, to nearly 370 basis points one month later, as banks ceased to lend to each other. (We now know that, if anything, the LIBOR-OIS spread may have *understated* the pressures in the banking system, based on recent reports that certain banks participating in the LIBOR survey were underreporting their funding costs.)

What hit the short-term credit markets in September 2008 was a flight to safety—that is, a near-universal retreat by all investors from securities issued by financial institutions. Charges that money market funds caused those markets to freeze are a startling mischaracterization of that time of crisis.

Misstatement: The "Treasury Department temporarily guaranteed the $1.00 share price of more than $3 trillion in money market fund shares."

This statement from Chairman Schapiro's testimony implies that Treasury put $3 trillion at risk. That's an exaggeration.

The Treasury's Temporary Guarantee Program for Money Market Funds (TGP) was designed to cover losses in funds that signed up and paid fees to participate. The structure of the program ensured that losses, if there were any, would be a miniscule portion of the total assets of participating funds. The reason: if a participating fund's value dropped by just 0.5 percent, the TGP rules required the fund to liquidate and pay off its investors, with the TGP covering any losses up to a preset industrywide limit. The sharp trigger and preset limit would help hold losses to far less than the $3 trillion that Chairman Schapiro and others have suggested.

As it happened, the TGP expired on September 18, 2009, without receiving a single claim. Instead, Treasury—and, as a result, taxpayers—received an estimated $1.2 billion in fees paid by participating money market funds. Other than that one-year program, money market funds have never been insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency—as these funds' investor disclosures and advertisements clearly state. No such guarantee is in place today.

What's interesting is that the official rhetoric about money market funds' role in the financial crisis has become even more shrill with the passage of time. The *2011 Annual Report* for FSOC, for example, said that these funds "added considerably to market stress." Now, in FSOC's 2012 report, regulators have promoted money market funds to the *cause* of all that market stress—without providing any evidence to support that claim.

For more on regulators' false narrative of 2008, please see "Changes in Money Market Oversight Must Be Based on Fact, Not Fiction" in the August 13 issue of InvestmentNews.

This is the second ICI Viewpoints *posting on myths and misstatements about money market funds. The previous entry:*

- Correcting the Record: The "Susceptible to Runs" Myth

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