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Narrowing the Focus to Prime Money Market Funds

By Brian Reid

One of ICI's key points in our responses to recent policy proposals for money market funds is that no case can be made for applying fundamental changes to Treasury, government, and tax-exempt money market funds. Given the nature of their investments—and their recent experience in times of financial turmoil—Treasury, government, and tax-exempt money market funds simply don't require further substantial reforms.

ICI is far from alone in this view. Fidelity Investments recently looked atthe comment letters filed with the Financial Stability Oversight Council (FSOC) on its proposed reforms for money market funds. Of the FSOC comment letters that discuss differences in types of money market funds, 95 percent agreed that Treasury funds should be excluded from additional regulatory changes. For government funds and tax-exempt funds, those numbers are 86 percent and 83 percent, respectively. Even the presidents of the 12 Federal Reserve banks recognize that different types of money market funds have distinct risk profiles and different investor redemption patterns.

Let's take a closer look at the reasoning behind this strong consensus.

Background: Different Types of Money Market Funds

There are two main types of money market funds: tax-exempt and taxable.

Tax-exempt money market funds seek to maintain a stable net asset value (NAV) by investing in municipal money market securities. The dividends of these funds are not taxed by the federal government, nor, in some cases, are they taxed by states and municipalities.

Taxable money market funds also seek to maintain a stable NAV, but, by contrast, pay dividends that are taxed by federal, state, and local governments. Taxable money market funds break down into two categories.

- *Government money market funds*. These funds invest principally in U.S. Treasury obligations and other financial instruments issued or guaranteed by the U.S. government, its agencies, or its instrumentalities. One type of government fund is a Treasury money market fund, which primarily invests in direct government obligations, such as U.S. Treasury bills and other short-term securities backed by the full faith and credit of the U.S. government, either through direct purchases or repurchase agreements collateralized by such securities.
- *Prime money market funds*. These funds invest in a wider variety of high-quality, short-term money market instruments, including Treasury and government obligations, certificates of deposit, repurchase agreements, commercial paper, and other money market securities.

Tax-Exempt, Treasury, and Government Funds Don't Need Regulatory Reform

So, when it comes to changing the rules around money market funds, why should Treasury, government, and tax-exempt funds be excluded from regulatory efforts? ICI's comment letter to the FSOC addresses this topic at length (for a summary, read our related fact sheet).

For Treasury and government funds, there are three important points to consider: these funds hold securities that trade in deeply liquid markets, have reliably higher credit quality than any other short-term securities, and are exactly the type of securities that are

highly sought after in a crisis.

Not surprisingly, funds that only hold U.S. government securities or repo collateralized with U.S. government securities have weathered even the most turbulent financial conditions ably. In fact, Treasury and government funds saw substantial *inflows* during the 2008 financial crisis, as investors fled from investments in financial institutions toward instruments they viewed as safer and more liquid. In addition, empirical analysis shows that the tendency for government funds to receive net inflows during periods of market stress has remained strong since the financial crisis, indicating that investors will run to government money market funds when market uncertainty rises again.

More recently, consider the summer of 2011, when financial markets were roiled by the sovereign debt crisis in Europe and uncertainty generated by the U.S. debt ceiling debate. ICI analysis of industry data from July 2011 shows that half of government money market funds had inflows, while an additional 25 percent experienced only a small contraction in total net assets (2.7 percent or less) that month.

For tax-exempt funds, two key points are worth bearing in mind. First, tax-exempt funds have weekly liquidity far in excess of the required 30 percent. As of December 2012, tax-exempt funds had $288 billion in weekly liquidity, amounting to 77 percent of total assets. Second, tax-exempt funds did not suffer heavy redemptions during the financial crisis.

Temporary Gates and Fees Could Have Promise for Prime Funds

Even for prime money market funds, the measures regulators have advocated are clearly inappropriate. The reforms for money market funds adopted in 2010 by the Securities and Exchange Commission comprehensively addressed concerns raised by the experience of prime money market funds during the 2008 crisis. As ICI has detailed, subsequent market events have demonstrated the effectiveness of those reforms. In 2011, prime money market funds made it through market stresses without experiencing any problems meeting redemptions or disrupting short-term funding markets because they had higher liquidity and increased transparency.

If regulators can demonstrate the need for changes beyond the 2010 reforms, ICI believes that temporary gates and liquidity fees would fulfill regulators' stated goal of stopping excessive or unexpected redemptions from prime funds. As proposed by ICI, such measures would enhance the resiliency of prime funds without undermining their value to investors and the economy.

But no changes, not even gates and fees, are necessary for tax-exempt, Treasury, and government funds. Their fundamental nature —and recent performance in times of market difficulty—make that plain.

You can learn more about money market funds at our Money Market Fund Resource Center.

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