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MONEY MARKET FUNDS IN 2012

Money Market Funds: What Really Happened in the 2008 Financial Crisis

The difficulties that the money market and money market funds faced during September 2008 are but one chapter in the worst financial crisis the United States has experienced since the Great Depression. Money market funds were not the cause of the financial crisis, but were directly affected by it.

Key Takeaways:

- Like many market participants, money market funds were hit by a global crisis that began to take hold long before September 2008.
- The financial crisis of 2008 was, first and foremost, a crisis in the banking system. 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 a change in direction by the U.S. government from its previous decisions to intervene and rescue Bear Stearns, Fannie Mae, and Freddie Mac.
- By contrast, a single money market fund (Reserve Primary Fund) could not return the $1.00 per share ("broke a dollar") after Lehman failed.
- As a result of Lehman's failure and uncertainty about the government's stance towards troubled institutions, money market funds and all 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 securities of financial institutions.
- Even in these extreme conditions, investors remained invested in money market funds—but they shifted their assets from prime money market funds, which held financial institutions' securities, to Treasury money market funds, which did not. About $300 billion flowed out of prime money market funds.
- Despite these massive redemption pressures, all money market funds other than the Reserve Primary Fund were able to maintain a stable $1.00 net asset value (NAV).
- The Treasury Guarantee Program for money market funds helped stabilize markets, but ICI worked to ensure it would be limited and temporary.
- No claims were made on the Guarantee program. Instead, Treasury and, as a result, taxpayers, received an estimated $1.2 billion in fee payments from participating money market funds.
- The SEC's money market regulatory reforms of 2010 addressed the problems exposed in 2008, particularly liquidity.

Detailed Timeline:

Key Market Events Leading Up to September 2008

- Difficulties in the subprime mortgage market began to spill over into the money and credit markets by mid-2007. Increasingly over the past several years, lenders had financed subprime and other mortgages by packaging them into derivative products, which were then sold in the financial markets.
- *June 2007:* Two Bear Stearns' hedge funds suspended redemptions in the face of deteriorating investments in securities backed by subprime mortgages.
- *Summer and fall of 2007:* A range of additional short-term investment pools (both unregistered and offshore) began to fail after investing in securities backed by subprime mortgages.
- *February 2008:* The auction rate securities market froze as securities for sale exceeded demand, auction agents refused to take the excess supply on their balance sheets, and the auctions failed en masse.
- *August 2007 to March 2008:* A number of major financial institutions such as American Home Mortgage Corp.; HomeBanc Corp.; Sachsen Landesbank; Northern Rock, plc; Financial Guaranty Insurance Company; and Countrywide failed. Others, such as Citigroup, Inc. and the monoline insurers Ambac Financial Group, Inc. and MBIA, Inc. needed significant help (both government and private) to survive.
- *Weekend of March 15–16, 2008:* The federal government orchestrated a rescue of Bear Stearns, allowing JPMorgan Chase & Co. to purchase Bear Stearns, with the federal government guaranteeing up to $30 billion in potential losses. Under this transaction, Bear Stearns's shareholders suffered very significant losses but its debt holders were unharmed. As of May 31, 2007, Bear Stearns's assets were 31 times its shareholder equity.

Key Market Events—September 2008

The financial crisis reached a critical stage during September 2008, which was characterized by severely contracted liquidity in the global credit markets and insolvency threats to investment banks and other institutions. In response, the U.S. government announced a series of comprehensive steps to address the problems, replacing the policy of making "one-off" or "case-by-case" decisions to intervene or not that was followed in the rescue of Bear Stearns, the federal takeover of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, and the $85 billion liquidity facility for American International Group (AIG).

- *September 7:* The government placed the nation's two largest mortgage finance companies, Fannie Mae and Freddie Mac, in receivership. The plan guaranteed the debt of the institutions, but essentially wiped out the equity held by shareholders.
- Long-circulated rumors about the stability of Merrill Lynch & Co., Inc., AIG, and Lehman gained traction.
- *Weekend of September 13 and 14:* Bank of America Corporation agreed to buy Merrill Lynch for $50 billion.
- *September 15:* Lehman, lacking a buyer and failing to obtain government assistance, declared bankruptcy, triggering an unexpectedly severe credit freeze.

- The future of AIG, one of the largest underwriters of credit default swaps, remained highly uncertain, as credit rating agencies threatened to downgrade the company's debt, a move that would have allowed counterparties to make margin calls on their contracts.
- *September 15:* With investors running for cover and credit markets freezing, yields on Treasury securities fell, while those on commercial paper jumped. The U.S. stock market declined nearly 5 percent, reflecting broad losses to financial companies.
- *September 16:* The $62 billion Reserve Primary Fund failed to maintain $1.00 NAV because it held 1.2 percent of its assets in Lehman commercial paper the day Lehman was allowed to fail. Reserve became only the second money market fund ever to "break the dollar."
- Following the events of September 15–16, concerns rapidly surfaced that the debt of remaining large investment banks (The Goldman Sachs Group, Inc. and Morgan Stanley) and certain banks (Wachovia Corporation and Citigroup) was a much greater risk than previously thought. Reflecting these concerns, the cost of insuring against defaults on these institutions rose dramatically. Corporate investors, conscious that developments were unfolding rapidly and seeking to protect their cash balances, often directed their treasurers to withdraw from prime money market funds, irrespective of those funds' portfolio holdings.
- These developments put considerable pressure on money market funds and other pooled investment vehicles, both domestic and offshore.
- *Week of September 15:* Investors redeemed from prime money market funds about $300 billion, much of which flowed to Treasury money market funds. Despite these difficulties, all money market funds other than the Reserve Primary Fund were able to maintain a stable $1.00 NAV.

Government Actions in 2008

- *September 16:* The Federal Reserve agreed to lend AIG up to $85 billion and to take a nearly 80 percent stake in the company, reversing an earlier indication that it would not participate in a rescue of the insurance giant.
- *September 19:* The Federal Reserve announced a series of broad initiatives designed to stabilize the market, which had ceased to function even for very short-term, high-credit securities.
    - The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance purchases of high-quality asset-backed commercial paper (ABCP) from money market funds.
    - The Commercial Paper Funding Facility (CPFF) provided a backstop to U.S. issuers of commercial paper through a special purpose vehicle that would purchase three-month unsecured commercial paper and ABCP directly from eligible issuers.
- *September 19:* Treasury announced its Temporary Guarantee Program for Money Market Funds, which temporarily guaranteed certain account balances in money market funds that qualified for and elected to participate in the program. The program expired on September 18, 2009. No claims were made on the Guarantee program. Instead, Treasury and, as a result, taxpayers, received an estimated $1.2 billion in fee payments from participating money market funds.
- *September 19 and 20:* ICI worked with Treasury and other regulators to limit the reach of the Treasury Guarantee Program, urging that the guarantee not be open-ended.

- *September 21:* The Federal Reserve Board approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies.
- *September 25:* After a credit downgrade on September 15 triggered a run on Washington Mutual, Inc., the bank was officially placed in receivership by the Federal Deposit Insurance Corporation and subsequently sold to JPMorgan.
- *October 3:* Congress passed and President George W. Bush signed the Emergency Economic Stabilization Act of 2008, which included the Troubled Asset Relief Program (TARP) that allowed Treasury to purchase assets and equity from banks.
- *October 13:* Treasury invested $125 billion from TARP in preferred shares in nine banks.
- *Fall 2008:* There was similar financial market turmoil in other parts of the world, and especially in Europe, which forced authorities in various countries to take dramatic action.
    - Governments of the Netherlands, Belgium, and Luxembourg rescued Fortis Bank.
    - Governments of Belgium, France, and Luxembourg rescued Dexia SA, a major European banking group.
    - British government rescued Bradford & Bingley plc, a mortgage lender.
    - Banks in Iceland collapsed.
    - Ireland supported its financial system, issuing a state guarantee that exceeded 200 percent of Irish gross domestic product, to cover certain bank liabilities.
    - Other European governments and authorities also acted to stabilize the markets, including actions by the European Central Bank to enhance liquidity as well as declarations from certain countries to support money funds and banks.
    - Beyond Europe, other countries, too, were confronted with acute challenges from the market turmoil that surfaced after Lehman declared bankruptcy.

Aftermath

- By mid-October, the assets of prime money market funds began to grow and continued to do so into 2009, indicating a return of confidence by institutional investors in these funds.

For more information on money market funds, their role in the economy, ICI's efforts to make these funds more resilient in the face of adverse market conditions, and the significant risk of undermining money market funds' value to investors and the economy, please see www.ici.org/mmfs or www.PreserveMoneyMarketFunds.org.