

MEMO# 17767

July 13, 2004

FDIC ISSUES FYI BULLETIN REGARDING EFFECTS OF INTEREST RATES ON MONEY MARKET FUNDS

[17767] July 13, 2004 TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 11-04 RE: FDIC ISSUES FYI BULLETIN REGARDING EFFECTS OF INTEREST RATES ON MONEY MARKET FUNDS The Federal Deposit Insurance Corporation issued an FYI bulletin in which it discussed the effects of interest rates on money market mutual funds.¹ Specifically, the FDIC's report examines the effects of interest rate scenarios on money market fund yield and net asset value. The report points out that while money market funds have been affected by prolonged periods of low short-term interest rates, they may be more affected should short-term interest rates spike upward, the effect of which could cause the market value of some money market fund investment holdings to decline, potentially driving the fund's net asset value below \$1.00 (so-called "breaking the buck"). The report recounts how a similar scenario occurred in 1994 when the Federal Reserve aggressively raised the Federal funds rate by 125 basis points over a 60-day period in an effort to ward off inflation. The FDIC report also discusses the challenges facing money market fund managers with respect to asset selection. The report expresses concern that some managers, facing an inability to cut expenses, may take on additional risk by buying higher-risk, higher-yielding and less liquid assets. The report adds that even investing in traditional assets has become more challenging for money market funds, as there is limited supply of good quality short-term investments. Finally, the FDIC report addresses potential risks to FDIC-insured banks and their affiliates that sponsor money market funds. In this regard, the report discusses the various liquidity, reputation, and legal risks facing a banking organization should its money market fund break the buck. In addition, for banking organizations that hold money market funds as an investment, the FDIC report points to the credit risk inherent in this type of investment and stresses the importance for fund management to perform proper due diligence and monitor the fund's performance on an ongoing basis. Barry E. Simmons Associate Counsel 1 See FDIC FYI: An Update on Emerging Issues in Banking - Effects of Interest Rates on Money Market Mutual Funds, dated May 19, 2004. The report is available from the FDIC's website at <http://www.fdic.gov/bank/analytical/fyi/2004/051904fyi.html>.

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