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40 Years Later, Money Market Funds Still Aren't Banks

Paul A. Volcker is a distinguished leader who for decades has devoted his prodigious talents to the service of our country. However, as he makes clear in his recent comment letter to the Securities and Exchange Commission, his long opposition to money market funds—dating back almost 40 years—hasn't ended.

Volcker's animus is based in a fundamental misunderstanding: he believes that money market funds are unregulated banks, which he says will pose massive risks unless they get bank charters and insurance. The former Federal Reserve chairman—who has spent his career in banking—appears to believe that bank regulation is the gold standard of security and safety.

Of course, the latest global financial meltdown was first and foremost a banking crisis. The extreme market conditions in the depths of that meltdown exposed some potential vulnerabilities of money market funds. The fund industry has taken the lead in addressing those problems, and the SEC has adopted significant reforms to make money market funds better able to withstand severe market conditions.

We've explained on many occasions—most recently in our own SEC comment letter on the President's Working Group Report—why prudential banking regulation and insurance are neither necessary nor appropriate for money market funds. Banking regulation would not have addressed the problem that hit those funds in September 2008—a sudden and widespread liquidity freeze in the money market. So we're forging ahead to develop a liquidity facility for prime money market funds, and are open to other ideas that make money market funds stronger without undermining their core characteristics.

Volcker's prescription, by contrast, would turn back the clock 40 years. His plan would layer onto stable-price money market funds all of the costs of banking regulation, on top of the risk-limiting regulations that money market funds already follow. Volcker recognizes that imposing two sets of rules on these funds would seriously undermine their ability to serve investors—but he welcomes that. He believes household savers and institutional cash managers would be forced back into the banking system, which would gain an implicit subsidy as investors accept low-yielding deposits.

What Volcker ignores is the enormous damage his proposal would do to investors—and to the economy. Households, businesses, nonprofit institutions, and state and local governments look to money market funds as stable, convenient, and liquid tools for cash management. Just the direct cost of forcing savers out of money market funds would be substantial: retail investors alone have reaped an additional $225 billion in returns by investing with money market funds since 1985.

The economic damage could be even worse, because money market funds provide vital short-term financing for businesses, consumers, governments—and even banks. Money market funds hold more than one-third of the commercial paper that businesses issue to finance payrolls and inventories, including a significant share of the asset-backed commercial paper that funds credit card, home equity, and auto loans. These funds hold more than half of the short-term debt that helps state and local governments fund operations and public projects, and $1 out of every $8 in short-term Treasury debt. There are few immediate substitutes to fill the financing gap that would be created by a rapid shrinkage of money market funds. Banks, in particular, can't afford to pick up the slack, because carrying the assets would require billions in new capital.

There's also substantial risk that money market fund investors would not put their cash into banks. Instead, billions of dollars could flow to less-regulated or unregulated cash pools, here and abroad, that aren't bound by the risk-limited regulations applied to money market funds. Those alternatives would be more subject to unexpected losses and runs than today's money market funds. Volcker merely waves off that hazard—but clearly his proposal could increase, rather than reduce, risks to the financial system.

Over almost 40 years, money market funds have emerged as a steady, predictable mainstay of the financial marketplace and a key component of the American economy. Their track record proves that the Paul Volcker who fought money market funds in the 1970s was wrong. We're sorry that today's Paul Volcker still won't see that.

- Visit ICI's money market funds resource center.
- Read ICI's letter on President's Working Group on Financial Markets (PWG) Report on Money Market Fund Reform Options.
- Read more comments on "Money Market Fund Reform Options" at the SEC's website.

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