

ICI VIEWPOINTS

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It's Highly Unlikely that Money Market Funds Will 'Break the Dollar' in U.S. Debt Crisis

The continuing impasse over the U.S. government's borrowing limit—the “debt ceiling”—and efforts to rein in the growth of federal debt has raised many questions for investors in all types of financial assets. ICI believes that money market funds are no more vulnerable to these events than other assets: As ICI Chief Economist Brian Reid [wrote yesterday](#), “I don't know of any scenario in which money market funds would be disproportionately affected compared to other market participants by a failure to raise the debt ceiling.”

However, to increase public understanding and address investor concerns, ICI Viewpoints has addressed [recent trends in flows](#) to and from money market funds and [whether money market funds would be forced to sell](#) their U.S. government securities in the event of a credit-rating downgrade or default.

Now, some people are asking whether a U.S. government downgrade or default would drive down the value of money market fund assets to the point where funds would “break the dollar”—be unable to maintain their stable \$1.00 per-share net asset value.

Our analysis suggests that's highly unlikely. Money market funds have always operated under strict regulations, and [those rules were tightened in 2010](#). In practice, managers are exceeding the rules' standards for safety. For example, government money market funds are carrying almost twice as many liquid assets as the current standards require, and they've shortened their portfolios considerably. For these reasons, the chances that a downgrade or default would force money market funds to break the dollar seem remote.

Bear with us as we explain.

In January, ICI published a [comprehensive study](#) of how market forces affect the mark-to-market net asset values (NAVs) of money market funds.

That paper identified four factors that are primarily responsible for changes in a money market fund's per-share market value:

- changes in interest rates;
- the maturity of the fund's portfolio;
- net flows of new money into or out of the fund; and

- credit events affecting securities in the fund's portfolio.

Our paper showed that large changes in these factors are necessary to force a money market fund to break the dollar, i.e., see its mark-to-market value fall below \$0.9950. Even in the event of a downgrade, such extreme changes are highly unlikely.

Let's look at each of these factors.

Changes in interest rates: Either a downgrade or a default would be likely to increase the market's perception of risk in U.S. government debt and lead to higher interest rates. Higher rates, in turn, drive down the market value of securities already held in a fund's portfolio.

Rating agencies and market analysts have suggested that rates on U.S. Treasury securities might rise anywhere from 25 to 70 basis points in the event of a credit rating downgrade. That's not enough to force money market funds to break the buck. Our January study found that a 100 basis point increase in interest rates would reduce money market funds' per-share market value by only 17 basis points, to \$0.9983. Indeed, it takes a rapid 300 basis point rate increase on every security in a fund's portfolio to drive the fund's per-share market value to \$0.9950.

The maturity of the fund's portfolio: The longer a portfolio's dollar-weighted average maturity (WAM), the greater the impact of changing interest rates on the fund's per-share market value. The calculations in the previous paragraph, for example, are based on a fund with a 60-day WAM—the maximum maturity allowed under the 2010 amendments to the SEC's Rule 2a-7.

In fact, government money market funds have been reducing their maturities. According to data from [iMoneyNet](#), the WAM for government money market funds was less than 45 days in late July. Our January study showed that a fund with a 45-day WAM can withstand a 400 basis point rate increase before its per-share market value falls to \$0.9950.

Net flows of money out of the fund: Heavy redemptions from a fund can magnify any existing deviation between a fund's per-share market price and its \$1.00 NAV. In our January paper, we showed that even when interest rates and flows are both working in the same direction, a fund's per-share market value may not move very much.

Let's say there's a 100 basis point increase in interest rates. A fund would have to experience redemptions of almost 70 percent of its assets to see its per-share market value fall below \$0.9950. That's not very likely: redemptions have exceeded 60 percent of taxable money market fund assets in only 0.06 percent of the weeks between April 1996 and December 2010.

A fund can counter the impact of heavy redemptions by keeping its portfolio very liquid. If the fund has securities with very short maturities, it can meet redemptions without forced sales of securities that might have dropped in value. The SEC recognized this in its Rule 2a-7 amendments, when it required taxable funds (including government funds) to hold 10 percent of their assets in cash or securities that are liquid within one day, and 30 percent of assets in securities liquid within five business days.

In fact, government funds are far exceeding those standards: On June 30, the average government fund had 58 percent of its assets in securities that would mature within five business days, according to iMoneyNet.

Credit events affecting securities in the fund's portfolio. A downgrade in the U.S. government debt would, of course, be a "credit event"—an unprecedented credit event. The impact of that event would depend on the market's reaction as expressed through changes in interest rates on U.S. government securities. As discussed above, the interest rate impact that most market analysts anticipate would not be large enough to force money market funds to break the dollar.

As discussed in our [FAQs on money market funds and the debt ceiling](#), if the U.S. government failed to pay interest or principal when due on a security in a money market fund's portfolio, the fund must dispose of the security in an orderly manner, unless the fund's board determines that disposing of the security would not be in the best interests of the fund and its shareholders. The board may consider market conditions, among other factors, in making that decision. In unsettled markets following a default on U.S. government securities, a board may determine that disposal of its U.S. Treasury securities would not be in the best interests of the fund or its shareholders, particularly if the default promised to be of short duration.

The bottom line. Along with other market participants, money market fund managers are facing challenging and dynamic market conditions. Fortunately, these managers have been looking far ahead and appear to have been preparing their funds for these conditions. Their decisions seem prudent and reflective of the markets in which they operate. For those reasons, the chances that a downgrade or default would force money market funds to break the dollar seem remote.