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Correcting the Record on Money Market Funds

Bad information can't give rise to good policy. Unfortunately, the regulators who are campaigning for structural changes in money market funds are building their case on information that is deeply flawed at best.

In testimony, speeches, and other statements, officials from the Securities and Exchange Commission (SEC), the Federal Reserve, and other agencies have made assertions about money market funds that distort the record, exaggerate the impact of these funds on the financial crisis, and reveal profound misunderstandings about money market funds, their investors, and their role in the financial markets. These misstatements aren't just incidental mistakes—they're the foundation of the regulators' case for fundamental changes to a vital financial product. As scores of [comments filed with the SEC](#) have documented, those changes would severely damage the value of money market funds for investors and the economy.

Because we believe the truth can trump misinformation, we're going to use this space to correct the record, focusing primarily on SEC Chairman Mary Schapiro's [latest testimony](#) before the Senate Banking Committee. Sadly, there are a lot of misstatements. Let's start with the myth that money market funds are "susceptible" to runs.

Misstatement: Money market funds are "susceptible today to investor runs."

Chairman Schapiro spelled out this myth in more detail in [a speech last February](#), when she said: "Funds remain vulnerable to the reality that a single money market fund breaking of the buck could trigger a broad and destabilizing run."

In the 40-year history of money market funds, two funds have "broken the dollar," or failed to maintain their stable \$1.00 net asset value. In one case—in September 2008—investors did pull back from other prime money market funds. In the other—in 1994—the world yawned because there was no impact on other funds or the markets.

That 50/50 record hardly suggests that money market fund investors are prone to running. Something else must have happened in 2008.

Well—you might say so. September 2008 was the peak of a financial firestorm that Federal Reserve Chairman Ben Bernanke has called "the worst financial crisis in global history, including the Great Depression." At least 13 major financial institutions went bankrupt,

were taken over, or were rescued in the 12 months before Lehman Brothers was allowed to fail on September 15, triggering Reserve Primary Fund to break the dollar on September 16. That same day, American International Group (AIG) collapsed and was rescued—demonstrating that even investment-grade firms were at risk and sowing further doubt about the government’s stop-and-go stance on rescuing financial giants.

In this maelstrom, investors everywhere reacted to the widespread uncertainty over the stability of financial institutions and the lack of predictable government responses by fleeing from securities issued by financial institutions. Investors pulled about \$300 billion from prime money market funds, which held such securities. But those investors didn’t run from money market funds. For every dollar that left prime funds, 61 cents went into Treasury and government and agency funds. It was a classic flight to quality—and money market funds were the vehicle of choice for fleeing investors.

And in 1994—the only other time a money market fund broke a dollar? There were no ripples when Community Bankers U.S. Government Money Market Fund broke the dollar. Investors did not run from other money market funds—in fact, fund assets grew during the next month. The crucial difference: there was no banking crisis and there was no chaotic government response. Absent a broader crisis, the failure of a money market fund had no impact on investors in other funds or the financial system as a whole.

The dictionary defines susceptible as “easily influenced...likely to be affected.” The fact that only two funds have failed in 40 years would suggest that money market funds are not “easily” broken. And the fact that investors only pulled back from one class of funds in the midst of a raging financial crisis would suggest that they are neither “easily influenced” nor “likely to be affected.” The notion that money market funds are “susceptible to runs” is a myth.

Misstatement: “Finally, money market funds offer shares that are redeemable upon demand, but invest in short-term securities that are less liquid. If all or many investors redeem at the same time, the fund will be forced to sell securities at fire sale prices, causing the fund to break a dollar, but also depressing prevailing market prices and thereby placing pressure on the ability of other funds to maintain a stable net asset value.”

Once again, Chairman Schapiro’s testimony promotes the notion that money market funds are a crisis waiting to happen. If there had ever been any evidence for that idea—and the funds’ 40-year record of stability argues otherwise—it certainly isn’t true now.

One of the most puzzling aspects of regulators’ campaign for changes to money market funds is their steadfast and willful refusal to acknowledge the dramatic improvements in these funds resulting from the SEC’s 2010 amendments to Rule 2a-7, the regulation governing these funds. Let’s look at how these reforms affect money market funds’ ability to meet shareholder redemptions and avoid fire sales.

Since 2010, taxable money market funds are required to hold at least 10 percent of their portfolios in assets that can be turned into cash that day, and 30 percent in assets that are liquid within a week. The 2010 reforms also reduced funds’ maximum weighted average maturity to 60 days, with a weighted average life of 120 days or less.

These changes have sharply increased money market funds’ ability to manage large fluctuations in investor flows. In practice, money market fund managers have kept their portfolios even more liquid than the requirements. For example, in April 2012, prime money

market funds held 29 percent of their portfolios in daily liquid assets and 44 percent in weekly liquid assets. In dollar terms, that means these funds have liquid assets that are twice the size of the outflows prime funds experienced during the week that Lehman Brothers failed.

Regulators' case for structural changes to money market funds is rooted in the notion that money market fund investors are prone to running from these funds at the first sign of trouble. Short of a repeat of "the worst financial crisis in global history," there's scant evidence to support that idea.

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