

ICI VIEWPOINTS

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What's the “Exposure” of Money Market Funds to Europe?

At the American Economic Association (AEA) meetings in Chicago early this month, speakers and attendees at several sessions asked: do money market funds pose systemic risks? Recent developments—both in regulation and in the markets—make it even more difficult to argue that they do.

On the regulatory front, the Securities and Exchange Commission (SEC) in 2014 revised Rule 2a-7, which money market funds must follow, and required funds to fully implement the changes by October 2016. As we discussed in a [recent series of ICI Viewpoints](#), the rule changes induced investors to move an estimated \$1 trillion out of prime money market funds (those that invest significantly in commercial paper and bank CDs) into government money market funds (which invest almost entirely in Treasury and agency securities, as well as repurchase agreements backed by those securities) from January 1, 2015 to December 31, 2016.

FIGURE 1

The Share of Government Securities in Taxable Money Market Fund Portfolios Has Risen Sharply
Percentage of the assets of taxable money market funds

Source: Investment Company Institute compilation of SEC N-MFP data

As a result, the composition of the assets in taxable money market funds (i.e., the combined assets of government and prime funds) is quite different today than it was even a few months ago. The vast majority (87 percent) of the assets of taxable money market funds now consist of government securities or repurchase agreements backed by government securities (Figure 1). Compare that to two years ago, when the share was considerably smaller (56 percent).

Why does this matter? Treasury and agency securities are the most creditworthy and liquid securities in the market—precisely the kinds of securities that investors demand during periods of financial stress.

Repurchase agreements, often called “repos,” are short-term (often overnight) loans in which borrowers pledge collateral to lenders. In the case of money market funds, this collateral consists almost entirely of Treasury and agency securities. As such, repos provide

liquidity during periods of market stress. For example, when Lehman Brothers failed in September 2008, the Treasury securities collateralizing repos rose in value and the yield on those repos dropped sharply, consistent with their liquidity and creditworthiness.

FIGURE 2

Overnight Rate on Repurchase Agreements Backed by Treasury Collateral Percent; September-October 2008

Sources: Depository Trust & Clearing Corporation; Federal Reserve Bank of St Louis

In December 2016, 70 percent of the collateral backing repurchase agreements held by taxable money market funds was in Treasury securities.

Other market developments also have eased concerns about systemic risk in money market funds. One concern—expressed, for example, during the eurozone crisis of 2011—was that money market funds were exposed to large European banks that were under stress. Such concerns have resurfaced, with [a recent government report](#) suggesting that money market funds could still be vulnerable to shocks to European banks.

But any “exposure” that money market funds now have to European entities is quite different from that of 2011.

Figure 3 shows taxable money market funds’ holdings of securities issued by European entities (primarily large European banks). These holdings totaled \$934 billion in early 2011. That figure dropped sharply in 2011 because money market funds reduced their exposure to European banks during the eurozone crisis. In 2016, the exposure of taxable money market funds to European entities again dropped sharply, from \$607 billion in April to \$353 billion in December (note that, consistent with the values in Figure 3, the April and December levels are based on three-month moving averages). As the figure makes clear, however, the large majority (\$247 billion) of this remaining “exposure” to European entities reflected repos, which were collateralized by US Treasury and agency securities.

FIGURE 3

Taxable Money Market Funds’ Holdings of Securities Issued by European Entities Billions of dollars*

* Holdings are reported as a three-month moving average to reduce seasonality.

Source: Investment Company Institute compilation of SEC N-MFP data

In sum, although money market funds still have “exposure” to European banks, it is a very different kind of exposure. In fact, this kind of “exposure” is likely to make money market funds even *more* resilient during periods of market stress—as will the host of reforms implemented since the financial crisis.

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