COVID-19's Impact on Money Markets, Crane's Fund Symposium

Keynote Address: COVID-19's Impact on Money Markets

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As prepared for delivery.

Thank you, Pete, for that kind introduction and for the opportunity to join you all here today. This conference is just another example of the invaluable service that Crane Data and you, Pete, personally, provide to the fund industry and to cash managers everywhere.

Crane's always brings great knowledge and deep insights to issues surrounding money market funds, and Pete has a great understanding of those funds and their investors. My colleagues and I at the Investment Company Institute have benefited enormously from our relationship with you and your firm—and so I thank you most sincerely for your contributions and your friendship.

As you all may know, this conference is one of my last public events as president and CEO of ICI. There is a symmetry to this, when you consider that my first professional experience in the fund world was related to money market funds. In January, I announced my retirement, effective at year-end. And earlier this month, the Institute's Board unanimously elected a new president and CEO, Eric Pan, who will take the reins on November 9. Eric is a veteran capital markets regulator who for nine years directed international regulatory policy at first the Securities and Exchange Commission and then the

US Commodity Futures Trading Commission. He also has a long track record as an academic focusing on financial regulation and corporate governance.

Those of you who know Eric are keenly aware of his intellect, deep knowledge, and global perspective. In Eric, the Board has identified a strong leader to maintain and advance the Institute's proud traditions of advocacy based in solid data and sound analysis. I am pleased to be leaving ICI in such capable hands.

I have spent nearly half of my working life at ICI. Before I leave, I have one last assignment: directing the completion of a comprehensive report on the market turmoil triggered by the COVID-19 pandemic and the economic restrictions that governments ordered in response. We are focusing especially on the experiences of regulated funds in that episode.

We are currently publishing that report as a series of research papers. And the next paper will look at money market funds—which landed back in the headlines in March because institutional prime funds had outflows, and because the Federal Reserve created a Money Market Mutual Fund Liquidity Facility to add liquidity to the markets and restore the flow of credit to the economy.

I'll describe our report to you in detail in a few minutes, but let me give you three quick findings:

- First, contrary to what you might read in the papers, money market funds were not the trigger for the market turmoil.
- Second, the Securities and Exchange Commission's reforms of 2010 and 2014 resulted in a much more resilient money market fund sector. Institutional prime money market funds, for example:
  - saw considerably smaller dollar outflows,
  - were substantially more liquid,
  - saw much smaller reductions in their holdings of commercial paper,
  - and made less use of Federal Reserve liquidity facilities during the COVID-19 crisis than during the global financial crisis.
- But despite that—and this is my third key finding—one of the principal 2014 reforms actually made money market funds more susceptible to market strains. We offer clear evidence that a fund board's option to impose liquidity fees and gates at the 30 percent weekly liquid asset threshold added to the stresses on prime institutional money market funds. Our members say that many institutional investors interpreted this board option as a requirement to restrict redemptions when liquidity reached that level. So the standard of 30 percent weekly liquid assets became a new hair-trigger—creating the potential for destabilizing feedback that the 2014 reforms were intended to avoid.

Those are the topline messages. Let me take a step back now for context.

Since the global financial crisis of 2007–2009, the regulated fund industry has been keenly interested in ways to make funds of all types more resilient. Funds are major participants in the capital markets. Even more important, they are the vehicles that hundreds of millions of investors trust to help them realize their most cherished financial goals. In both of those roles, funds recognize that they have an overwhelming interest in participating in a financial system that is robust, yet resilient to market stresses.

That means we support effective regulation. We support market structures and rules that allow investors to take reasonable risks in pursuit of commensurate returns—because risk-taking supports entrepreneurship, innovation, opportunity, and economic growth.

Given our stake in this debate, it should come as no surprise that ICI has written more than 30 comment letters, published more than 15 research reports and white papers, and given more than a dozen speeches on topics around financial stability over the past decade or so. And those don't even include much of the work we devoted to money market funds during debates over the 2010 and 2014 reforms.

What we have sought, with our advocacy, research, and legal analysis, is a reasoned debate based in data and a clear understanding of the facts. The kind of debate that's clearly desirable—but often hard to achieve, either in Washington or in multinational policy circles.

The COVID-19 market crisis of last spring has brought the issue of financial stability back into the spotlight. Given that the turmoil started in short-term credit markets, it should come as no surprise that money market funds are again a major topic. The New York Times foreshadowed the arguments to come on March 19, when it ran a story headlined: "Why We Are Once Again Rescuing a 'Safe' Investment."

And so the fund industry, led by ICI, is once again engaging in the financial stability debate. With our new papers, we are bringing to bear the detailed data, the depth of industry knowledge, and the sophisticated economic and legal analysis that you would expect from ICI.

What have we found?

To begin with, we've learned that the models and mindsets formed by the global financial crisis—mindsets that we hear reflected in the statements of many regulators, academics, and journalists—do not apply to the current situation.

The COVID-19 crisis was different from the global financial crisis. Then, we had a credit crisis that started in the financial system and spread to the real economy. This year, we had a global health crisis that hit the real economy through the actions taken to try to contain the virus—and that then spilled into the financial system.

Those differences tell us that any policy responses to the COVID-19 market turmoil must be tailored to the actual events of 2020. This crisis was not a replay of 2007 to 2009, and recycled remedies will not fit.

We also find that the market turmoil of March was triggered by a massive rush to gain liquidity—the “dash for cash”—by businesses and investors of all types. The demand for cash was so great that the Treasury market—usually deemed the safest of safe havens in a financial storm—was severely dislocated. From March 9 to March 18, Treasuries faced so much selling pressure that the yield on 10-year Treasury notes posted its second-largest increase in 30 years.

The turmoil then spread to other fixed-income markets— commercial paper, corporate bonds, and municipal debt. Investors and companies sought to defend themselves against the falling and dislocated markets and from the economic shutdown. So they moved to the quality and liquidity of government money market funds, which became a liquidity vehicle of choice for all types of investors. Investors seeking to preserve or bolster their liquidity poured 834 billion dollars into government money market funds in March. More than 40 percent of those dollars came from outside the mutual fund sector.

Prime money market funds, by contrast, had outflows. Those flows were much smaller—139 billion dollars in March—than the inflows to government funds. They were also far smaller than the outflows during the global financial crisis—reflecting in large part the shift in assets away from prime funds due to the SEC’s 2014 reforms. Simply put, money market fund investors were far less exposed to commercial credit risk in this crisis than they were in the financial crisis.

As this turmoil was unfolding, the Federal Reserve stepped in, taking bold actions to inject large amounts of liquidity into the locked markets. One of those actions was creation of the Money Market Mutual Fund Liquidity Facility, or MMLF. Our data show that the markets quickly became less volatile after the Fed’s actions, though many dislocations persisted for weeks.

That’s what happened. What does it mean?

Let me focus on two questions that I think will be key to the policy debates—and to the future of money market funds as a critical financing and cash-management vehicle.

- First, did money market funds trigger or accelerate the turmoil that struck and nearly shut down the fixed-income markets in March?
- And second, did the Federal Reserve have to “bail out” money market funds—or “bail them out again,” as many critics would emphasize?

Well, I’ve already given you our answer to the first question—and that is an emphatic “NO.”

In our papers, we reconstruct the events of March in detail. The timing and sequence of these events is critical to understanding the causal factors of the crisis. The data show that market dislocations were deep and widespread well before investors started to move away from prime money market funds.

Let me give you two pieces of evidence:

- From February 24 to March 11, the spread between interbank lending rates and overnight index rates set by central banks—known as the FRA-OIS spread—more than quadrupled, from 13 to 54 basis points. That is a widely recognized measure of stress in credit markets. Over that same period, prime money market funds had net outflows totaling just 11 billion dollars.
- Another indicator—we ran an analysis of thousands of news articles that appeared in March covering the COVID-19 market turmoil. We found heavy coverage linking the Treasury markets to COVID-19 throughout early March. Mentions of money market funds, however, were few—until a sharp spike on March 19, the day after the Fed announced the MMLF. In other words, there wasn't enough activity around money market funds to draw the financial press's attention until the Federal Reserve's action.

There is more evidence in our paper, and I would urge you to read it when it appears soon. But we are quite comfortable in saying that money market funds did not drive this financial crisis.

But did those funds need a rescue? That's certainly been the suggestion in the press and in some official statements.

Well, the answer to that is simple: the Federal Reserve stepped in to rescue the financial system and the broader economy. The MMLF is a tool designed to help restore liquidity and restart the flow of credit to the economy. As the New York Fed's Liberty Street Economics blog said, "By helping prime and muni MMFs meet demands for redemptions and by reducing outflows from the industry, the facility not only improves overall market functioning but also supports the provision of credit to the real economy."

It's important to note that the MMLF is just one of eight facilities that the Fed created, in addition to numerous other measures.

When usage of the MMLF was at its peak, on April 8, that facility accounted for only 2.7 percent of the expansion of the Fed's balance sheet. By June 3, when the expansion of the Fed's balance sheet peaked, the MMLF was less than 1 percent of the total. In other words, the MMLF was dwarfed by other Fed actions.

More broadly, I would argue that the Federal Reserve was doing its job when it stepped up to rescue the economy. The Federal Reserve was created to provide liquidity to the financial system in times of extraordinary shocks—and the COVID-19 pandemic was extraordinary indeed. As New York Fed President John Williams has said, "The events of the past year have demonstrated the critical role central banks can and must play in extraordinary times when market stress and dysfunction threaten to spill over into the economy."

The Fed's actions were timely, creative, flexible—but most of all, necessary. Critics viewing this episode in hindsight as a "bailout" need to adjust their perspective.

It's been a great pleasure to share with you today some of our findings and analysis on the experiences of money market funds in the COVID-19 crisis. ICI is dedicated to the preservation of money market funds as vital vehicles for short-term finance, for cash management, and for investment. And so I can pledge to you that we will continue to bring our data, our industry expertise, and our economic and legal analysis to bear to ensure that any debates over these funds are informed and productive.

Thank you for your time and attention.
