Weathering the Worst: Making Money Market Funds Even Stronger

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President’s Address

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Thank you, Jack [Lockridge, Executive Director, Federal Bar Association], for that introduction, and thanks to you and to Tom Lemke for your dedication and leadership in assembling another outstanding program. I’d also like to thank the program committee and the staffs of both organizations. ICI and the Federal Bar Association have enjoyed a fruitful partnership for more than a dozen years, and each year this conference is one of the high points for the fund industry. Let me add my welcome to the thoughtful comments that they’ve made to open this year’s program.

When I spoke to this conference last year, the wounds of the financial crisis were still quite fresh. Since then, as Tom Lemke noted, we have been engaged in the national effort to strengthen our financial and regulatory system to reduce the chances of future crises.

Today, I’d like to discuss that process of reform with regard to one specific product–money market funds. As you all know, a string of failures in major financial institutions drove investors and liquidity out of the money markets beginning in the summer of 2007. The list of institutions that failed, were taken over, or needed government assistance is long: American Home Mortgage, Northern Rock, Countrywide, Citigroup, Merrill Lynch, Washington Mutual, Wachovia–and of course Bear Stearns.

In September 2008, the failure of Lehman Brothers, coupled with the government's rescue of Fannie Mae, Freddie Mac, and AIG, prompted mounting concerns about the viability of financial and nonfinancial businesses alike. The result was a liquidity and credit crisis that threatened the global economy.

This sequence of events battered virtually every part of the financial system, including all issuers, investors, and intermediaries in the money markets. But the failure of Reserve Primary Fund to maintain its $1.00 net asset value focused much of the attention on money market funds.

Many forms of government intervention ultimately stemmed the crisis. The Treasury Guarantee Program for Money Market Funds helped calm the waters. Facilities established by the Federal Reserve helped restore liquidity to the markets for commercial paper and asset-backed securities. One measure of the success of these facilities is that the Treasury collected $1.2 billion in guarantee fees from money market funds, but paid out no claims. Money market funds and other market participants clearly benefited from these interventions.

As markets began to recover, our industry understood the need to address a concern that was by no means apparent during the long and successful run money market funds have enjoyed as a stable, secure tool for cash management and investment.

In short: how can we make money market funds more resilient under extreme market conditions – able to withstand another deep and widespread loss of liquidity in the money markets?

The Institute and our members have devoted countless hours to working on this problem. There are three points that I'd like to discuss with you today.

First, the fund industry and the Securities and Exchange Commission (SEC) already have made significant and important progress toward making money market funds more secure. The rules approved by the SEC last month require for the first time that money market funds maintain specified levels of liquidity–levels that are significant in themselves, but are intended as minimums. The Commission also granted money market fund boards significant powers to arrest a flood of redemptions and implement an orderly liquidation of a troubled fund. These and other measures provide a high degree of protection in the event of severe redemption pressure. The significance of the SEC's new rules for money market funds should not be underestimated.

Second, the search for ways to make money market funds even more secure under the most adverse market conditions has not stopped. The Institute and its members remain active on a number of fronts, as I will describe shortly.

My third point is that the fund industry remains open to a wide range of ideas on reform of money market funds–with one exception. We strongly oppose the notion of forcing money market funds to abandon their objective of maintaining a stable per-share value. The steady net asset value (NAV)–typically $1.00 per share–is a fundamental feature of money market funds.

Make no mistake: forcing these funds to “float” their NAV *will* destroy money market funds as we know them. It will penalize individual investors and exact a high price in the American economy. But it will not–repeat, *not*–reduce risks to the financial system. By any measure, it is a *bad* idea.

Those are the headlines. Now let’s step back and look at the context.

Before the start of the financial crisis, few of us would have expected money market funds to become the focus of so much attention. During their history of 30-plus years, these funds have been a steady, predictable mainstay of finance. For retail investors, money market funds have long provided the only means to obtain access to higher-yielding money market instruments. For institutions of many kinds, these funds are a preferred vehicle for cash management.

Their popularity with investors also has given money market funds an important role in financing the American economy. Over time, money market funds have become an important and irreplaceable pipeline in the flow of short-term capital.

Consider what the $3.1 trillion invested in money market funds means to our economy.

Money market funds are about jobs. They hold almost half of the commercial paper that businesses issue to finance payrolls and inventories.

Money market funds are about communities. They hold nearly two-thirds of the short-term debt that finances state and local governments.

Money market funds are about ordinary Americans. Credit-card, home-equity and auto loans are substantially financed by asset-backed commercial paper held by money market funds.

Money market funds even play a vital role in financing the U.S. government. One dollar out of every six in short-term paper issued by the Treasury ends up in a money market fund.

In all of these contexts, the ready availability of capital through money market funds lowers the cost of financing. It helps create and maintain jobs, promotes capital investment, helps state and local governments fund their operations, and keeps the wheels of commerce turning.

Those wheels nearly locked up at various times throughout the financial crisis. The chain of events illustrated the systemic importance of the money markets and the key role that money market funds play in them. The heavy redemption pressure on money market funds clearly revealed vulnerabilities that needed to be addressed–not just to sustain money market funds, but to protect the financial markets and the economy. We have taken those problems very seriously, and continue to do so.

Some observers believe there is a simple solution to these challenges: force money market funds to float their per-share value. By their account, the amortized cost accounting that allows a money market fund to seek to maintain a stable net asset value makes these funds more vulnerable to runs. They argue that investors are prone to sell stable-value shares when there are small drops in the value of the funds’ underlying securities below the fixed $1.00–but wouldn’t sell if the shares’ value floated routinely.

Proponents of this idea, and other measures that would have the same effect, are motivated by sincere concerns about reducing systemic risk. But their prescription in many cases reveals a bank-centered view of the world and a nostalgia for the 1970s that investors simply don’t share.

Repeatedly, these critics say that money market funds are part of a “shadow banking system” that operates with “no supervision.”

Of course, as you all know, money market funds hardly operate in the shadows. The public disclosure regime to which they are subject exceeds anything known to the banking sector. And they operate under a strict regulatory regime–one that embraces all the regulations applicable to mutual funds generally, as well as highly detailed standards for management of their portfolios.

Even so, we have looked at this proposition in detail, in the light of market data and investor behavior. And we have concluded that the notion of forcing money market funds to float their value would wreak havoc on our markets–without any offsetting benefits.

First, hard experience shows that mutual funds that float their NAV are not immune to redemption pressure. That’s clear from the record of floating-value ultra-short bond funds–they lost half of their assets in the course of 2008. Similarly, French floating-value money market funds, known as tre ? sorerie dynamique funds, lost about 40 percent of their assets in a three-month time span from July 2007 to September 2007. Clearly, the experience of these other funds demonstrates that a fluctuating per-share value would not eliminate the possibility of wholesale redemptions from money market funds during a future crisis.

Second, the proponents of floating value ignore the severe dislocations that it might cause for investors and issuers–and, by extension, American businesses and workers.

Investors, both retail and institutional, clearly see the advantages of stable-value funds. They’ve demonstrated that by voting with their dollars. At the end of 2009, there was $2.9 trillion invested in taxable money market funds. By contrast, short-term bond funds held just $184 billion–despite their higher yields. Money market funds’ 15-to-1 advantage in total assets–at a time when yields on money market funds are razor-thin–speaks volumes about the needs and preferences of investors.

A retail investor expects that $1.00 put into a money market fund will count for $1.00 when writing a check or making a withdrawal. If money market funds lose their stable value, retail investors who want a stable-value cash investment will have no alternative but to use bank accounts–by no means an ideal substitute.

Institutional investors already have many alternatives. But they stick with money market funds in large part because a floating-value fund would mean constant accounting and tax headaches. In such funds, investors must track realized or unrealized capital gains and losses in their position and conduct detailed recordkeeping when there are changes in the value of their money market fund investments.

So if regulators forced money market funds to abandon their stable $1.00 value, institutional investors would leave. As one institutional investor has told us, "If a money market fund is not dollar-in, dollar-out, you won't have my dollar." Indeed, many institutions are required by law or by investment policy to keep cash in stable-value accounts.

And where would they go? Banks might seem to be the obvious winners. But banks don't want large institutional deposits. In fact, banks now "sweep" institutional deposits off of their books and into money market funds and other short-term instruments, so that the banks can avoid carrying large demand balances. Wiping out stable-value money market funds won't make banks any more eager to assume those liabilities.

Instead, institutions that want or require stable value would probably turn to the true "shadow banking system"—private pools, here and overseas, that promise to maintain a fixed price. These alternatives would neither be registered with the SEC nor subject to regulation under the Investment Company Act 1940, including Rule 2a-7. They would not assure investors the same protections that money market funds do with respect to credit quality, maturity, liquidity, and other aspects of portfolio management. Investors will be more likely–not less–to withdraw their assets from such funds in a future crisis.

In short, forcing money market funds to float their values would kill these funds as we know them–without reducing systemic risk. In fact, it seems highly likely that the world would be a riskier place for investors, for issuers, and for the markets.

At the same time, the flow of hundreds of billions of dollars that money market funds supply to various sectors of the economy, with great efficiency and at low cost the borrower, would be severely disrupted. Short-term financing that is vitally important to businesses would be at risk, and with it jobs for American workers. A gaping hole would emerge in municipal finance, exacerbating the budget woes of communities around the nation. Consumer lending would become less available and more expensive. None of this would be good news for an economy struggling to recover from recession. Importantly, with money market funds out of the picture, it is not apparent how these financing needs would be met. There is no readily apparent substitute to today's money market funds.

Given this analysis, it came as no surprise to us that investors, the businesses and municipalities that depend on these funds, and consumer advocates all have spoken out against floating the value of money market funds. Out of more than 120 comment letters filed with the SEC, the ones that favored floating values could be counted on the fingers of one hand. By contrast, scores of letters opposed this idea, from writers as disparate as the American Public Power Association, the city of Brookfield, Wisconsin, the National Association of State Treasurers, AARP, and the Consumer Federation of America–not to mention individual investors strongly opposed to changing the fundamental nature of this product.

Clearly, this is a bad idea–and we should reject it.

What do we suggest instead? First, let's recognize that the SEC and the fund industry have already made major strides toward the goal of making money market funds more resilient even under extreme conditions.

This Wednesday will mark the first anniversary of the release of the report of ICI's Money Market Working Group and the wide-ranging proposals that this group made to address weaknesses in money market fund regulation. When that report was issued, ICI's members pledged to adopt those recommendations voluntarily.

Now, the SEC has approved final amendments to Rule 2a-7 that will raise credit standards and shorten the maturity of money market funds' portfolios–reducing credit and interest rate risk. They require more frequent disclosure of money market funds' holdings, so both regulators and investors will better understand funds' portfolios.

The SEC amendments also directly address the liquidity challenge. They impose for the first time explicit liquidity requirements that would require money funds to maintain daily liquidity of 10 percent of their assets, and weekly liquidity of 30 percent of their assets. As substantial as they are, those requirements are minimums. Funds also must adopt "know your investor" procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly.

On top of these changes, the SEC took an important step to help address any future run on a money market fund–like the one that struck the Reserve Primary Fund. The Commission gave money market fund boards the ability to suspend redemptions if a fund is about to break the dollar–a powerful tool to assure all of the fund's shareholders of equitable treatment, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund.

With money markets and money market funds operating smoothly once again, the importance of this and other steps taken by the SEC has not been fully appreciated.

Frankly, the Commission deserves credit for addressing these issues quickly and decisively. Has there been similar progress made in banking…in housing finance…in the regulation of derivatives…or in any of the other areas where the crisis laid bare substantial flaws in regulation? I think it's safe to say that the strides taken on money market fund regulation are unsurpassed.

But even with this great progress, our search for ways to weather-proof money market funds has not stopped. ICI and our industry are not resting.

For example, we are actively engaged in a task force sponsored by the Federal Reserve Bank of New York to strengthen the underpinnings of a vital portion of the money market–tri-party repurchase agreements. The task force includes regulators, clearing banks, cash borrowers, and lenders, including money market funds. It is developing a set of recommendations intended to reduce the risks related to this $1.7 trillion market. The goal is to improve the clearance and settlement arrangements and credit and liquidity risk management practices of market participants, while also providing greater transparency into this market for regulators. These reforms will be vital for all participants, including money market funds, which provide around one-quarter of the lending in this market.

ICI has also pursued the challenge of providing a stronger backstop for money market funds in a time of crisis. After it issued its report last March, ICI's Money Market Working Group began to explore additional ideas for providing liquidity for money market funds to meet redemptions when liquidity has dried up in the markets. In part, we have responded to an idea advanced in the Treasury Department's June 2009 white paper on financial regulatory reform, which called for exploring measures to require money market funds "to obtain access to reliable emergency liquidity facilities from private sources."

Today, I'm pleased to tell you that we are moving forward rapidly to complete a blueprint for such a liquidity facility. This would be a state-chartered bank or trust company, organized and capitalized by the prime money market fund industry and managed and governed in accordance with applicable banking laws. It would be dedicated to providing additional liquidity to prime money market funds in the event of severe market conditions.

Assets in these funds currently stand at $1.8 trillion. Remember, the SEC's new liquidity requirements soon will require prime money market funds to hold, at a minimum, $540 billion in assets that are liquid within seven days, of which $180 billion must be redeemable on any given day. This facility would provide a second buffer to assist prime money market funds in meeting redemptions.

We have discussed this facility with regulators and other policymakers, and recognize that there are significant hurdles we must clear to create such an institution.

I can't give you an exact timetable on when–or even if–this liquidity facility might be launched. I can tell you that ICI's Executive Committee supports establishing such a facility if industry participants and regulators can agree on a workable model.

While we have committed to pursuing this liquidity facility proposal, we are not shutting the door to other ideas that would meet the goal of making money market funds even more resilient in the face of another deep and pervasive freeze in markets.

What I've described for you is a multi-layered approach to enhancing the resilience of money market funds.

The foundation is the sound risk-limiting regulations that have been in place under Rule 2a-7 since 1982, reinforced by new credit, maturity, and disclosure standards.

These have been enhanced by the SEC's new liquidity requirements, including the "know your investor" rules to increase awareness among both fund advisers and fund boards of the potential for sudden redemptions.

Add to that the authority provided a money market fund board to halt a run in the fund and implement a fair and orderly liquidation.

New reforms of the tri-party repurchase agreement market will ensure that money market funds will have greater confidence in their collateral and enhanced security in those agreements.

And finally, we are working on a facility that can provide a mutual pool of liquidity available in times of severe market stress.

Taken together, these measures would provide a wholly new level of protection for money market funds, their investors, and the markets.

What will the next financial crisis look like? No one can say where it will arise or how it will spread.

But when that storm strikes the short-term credit markets, money market funds would be prepared–with stronger portfolios, with deeper liquidity within each fund, with a pool of liquidity supported by the entire industry, and with extraordinary tools to stem any panic.

For money market fund investors, all this means greater protections. For the economy, it means the critical flow of financing that these funds provide is more likely to continue unimpeded.

I'm proud of the progress that we've made to make money market funds even stronger, and I'm proud of the leadership our industry has shown in making those changes. I hope you share in that pride.

Thank you for your time and attention, and I hope you have a very productive three days here at the conference.
