"Do Money Market Funds Create Systemic Risk?"

Presentation by Melanie L. Fein
At the American Enterprise Institute
June 28, 2012

Thank you Peter and AEI for inviting me to present my papers on the subject of whether money market funds create systemic risk. I have submitted three papers that address various aspects of this question, each of which is posted on the AEI website for this program.

Each of my papers gives the same answer to the question: "Do money market funds create systemic risk?" The answer is "no." To the contrary, MMFs contribute systemic safety and liquidity, not risk.

As is clear from my papers, I believe that MMFs play an essential role in the U.S. financial system. It is unfathomable to me why anyone would want to eliminate a financial product that affords investors more safety of principal, more liquidity, more transparency, greater diversification, efficiency, convenience, and a market rate of return, than any other product in the financial system.

One need only look at the regulation of MMFs to see that they are not the type of entity that creates systemic risk. They are regulated under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934. These laws impose the following requirements and restrictions. Please note that banks and bank holding companies are subject to none of the following:

1. ***Simple Structure***. MMFs are not operating companies like banks. They do not have complex structures, operating subsidiaries, or off-balance sheet activities. They consist of pools of securities held in trusts managed by registered investment advisers subject to fiduciary duties on behalf of millions of shareholders. These shareholders are widely disbursed and include families,

wage earners, mothers, grandmothers, veterans, retirees, farmers, students, shopkeepers, entrepreneurs, pension funds, charitable foundations, municipalities, small businesses, and large businesses.

2. ***Governance***. MMFs are governed by independent boards of directors—meaning a majority of the directors are independent—and who are subject to fiduciary duties.

3. ***Independent Custodians***. MMFs are required to keep their assets with qualified, independent custodians, typically banks and trust companies.

4. ***Credit Risk Standards***. MMFs may invest only in high quality securities that present no more than minimal credit risk—that means generally U.S. government securities, high quality municipal securities, dollar-denominated bank CDs, and highly rated commercial paper. No more than 3 percent of their portfolios can be held in "second tier" securities, which are unrated securities that nonetheless meet the minimal credit risk requirement.

5. ***Diversification***. MMFs are subject to strict diversification rules—they can hold no more than 5 percent of their portfolios in securities of any one issuer, and no more than one-half of one percent of their portfolios in any one issuer of second tier securities.

6. ***Maturity limits***. The "weighted average maturity" of MMF portfolios must be 60 days or less, with a "weighted average life" maturity of 120 days or less.

7. ***Liquidity***. MMFs are subject to strict liquidity requirements. No more than 5 percent of their portfolio securities can be held in investments that cannot be sold at carrying value within 7 days. MMFs must be able to liquidate 10 percent of their portfolios into cash equivalents in one day and 30 percent in five business days. In practice, MMFs have substantially exceeded

these liquidity amounts and currently hold 2-3 times the amount of liquidity they did during Lehman week in 2008.

8. ***Market valuation***. MMFs may offer their shares at $1.00 per share only if the actual market NAV of their portfolios remains within half a penny of $1.00. If the NAV falls below that amount, the fund generally must close and distribute its assets pro rata to its shareholders. Only two MMFs in history ever have "broken a dollar" one of which was in 2008 and the other in 1994. Shareholders of those funds were paid 99 cents on the dollar and 96 cents, respectively.

9. ***Leverage***. MMFs have virtually no leverage. They do not engage in leveraged lending or complex derivatives transactions. They carry one dollar of assets for every dollar of capital, unlike banks which carry assets equal to roughly ten times their capital.

10. ***Transparency***. MMFs are required to disclose details of every security in their portfolios, including the CUSIP number, principal amount, maturity date, yield, and amortized cost value.

All of these requirements help to make MMFs the safest, most liquid, most diversified, and most transparent financial entities in the financial system. These entities are not a source of systemic risk.

Different definitions of systemic risk exist, but I think Ben Bernanke got it more or less right when he said: systemic risk is the "risk that disruptions occurring in one firm or financial market may spread to other parts of the financial system, with possibly serious implications for the performance of the broader economy."

That is a very broad definition, but it generally describes what happened in the financial crisis of 2007-2008. Disruptions occurred at banks and other financial institutions engaged in undercapitalized risk-taking, excessive leveraging, and over-reliance on short-term funding for subprime mortgages—none which MMFs are permitted to engage in—all supported by government policies. As a consequence of these risky activities, banks and other institutions had difficulty meeting their obligations to their own uninsured depositors, counterparties, and investors, including MMFs. Disruption then spread to other parts of the financial system as the markets lost confidence in the banking system and in particular lost confidence in the government's ability to stabilize the banking system. Confidence was shattered when the Fed allowed Lehman Brothers to declare bankruptcy and 24 hours later announced an $85 billion bailout of AIG.

The result of course was widespread panic that gripped the entire financial system. It is not surprising that investors ran from the markets amid the contagion. It was an entirely predictable response that should have been foreseen by the Fed and Treasury and apparently was foreseen. Chairman Bernanke told the Financial Crisis Inquiry Commission "we were very sure that the collapse of Lehman would be catastrophic. We never had any doubt about that."

In the midst of the panic, many investors sought safety in MMFs that invest only in government securities. Many MMF shareholders transferred their shares from funds that invest in commercial paper—so-called prime funds—to funds that invest only in U.S. government securities. As this occurred, MMFs stopped buying commercial paper, much of which was issued or guaranteed by banks. Banks then had to take this commercial paper onto their own balance sheets, which threatened to deplete their capital. They didn't have enough capital because the banking regulators had exempted bank-sponsored asset-backed commercial paper conduits from consolidated capital treatment in 2004.

In order to prop up the bank commercial paper market, the Fed announced that it would buy commercial paper from banks, and the Treasury announced a temporary partial guarantee of MMFs in order to slow the pace of redemptions and corresponding commercial paper liquidations by MMFs.

These emergency measures were necessary to relieve the pressure on banks, which lacked the capital to meet their commercial paper obligations. These measures have been characterized by the Fed as a “rescue” of MMFs. But in reality what occurred was a large bank bailout—one of many bank bailouts during the crisis.

MMFs did not create the systemic risk that exploded into a full-blown financial crisis in 2007 and 2008. They may have been part of the collective response to the systemic shock that occurred when the systemic risk erupted, but they did not create the underlying risk that shook the system. To the contrary, they provided a safe haven for investors during the crisis. MMFs contributed strength, not weakness.

The crisis did not prove that MMFs are subject to “runs.” Rather, it showed that in periods of extreme financial distress when financial markets are collapsing, MMF shareholders will reallocate their assets from prime funds to government-only funds or other available lower risk assets. The crisis showed that MMFs will act to protect the assets of their shareholders amid market uncertainty and will comply with applicable regulations that limit their investments to those with minimal credit risk. Such actions by MMFs are those of responsible money managers that owe fiduciary duties to those whose money they manage.

No evidence has been presented showing that MMFs are inherently susceptible to runs in circumstances other than a full-scale panic such as occurred in September of 2008. No “run” on MMFs occurred during the bank commercial paper crisis in 2007, the disturbance surrounding the failure of Bear Stearns in 2008, or at any of the other destabilizing points that preceded the Fed’s decision to let Lehman fail.

SEC Chairman Schapiro recently testified to Congress that MMF sponsors have voluntarily provided support to their funds on approximately 300 occasions since the 1970s. Yet, she did not say that any of these instances was accompanied by a run. There is no support for the implication that, in the absence of sponsor support, runs would have occurred or that funds would have broken a dollar. In any event, I am one who concurs with the conclusions in a Fed staff research report that found sponsor support to be a source of moral hazard and systemic risk, and I have argued that it should be restricted in a recent letter to Fed Governor Tarullo which is posted on the SEC's web site.

One reason why MMFs have not experienced runs is likely that MMF investors have confidence that MMFs are professionally managed and subject to SEC liquidity, credit quality, diversification, stress testing, disclosure, and other requirements designed to promote their safety.

If MMFs ceased to exist, many investors that currently invest in them would invest in commercial paper directly. These investors predictably will retreat from the market in a contagion, just as they did in September 2008. Without MMFs as a risk buffer, both retail and institutional investors may believe their investments are more exposed and thus be more likely to flee at the onset of a crisis. Many investors also likely would be forced to invest in uninsured bank deposits if MMFs ceased to exist, thereby increasing the size of too-big-to fail banks and the potential for bank runs by uninsured depositors. The Fed has nothing in its toolkit to stop a run by individual investors, whereas the Fed can purchase assets from MMFs in a major crisis and thereby channel liquidity to stabilize the markets.

It is true that the collective withdrawal of MMFs from the short-term markets amid a crisis may reduce credit availability in those markets, particularly for banking organizations, which are the principal borrowers. But MMFs cannot be expected to prop up the funding market for banks at the expense of their own shareholders, who include tens of millions of investors that rely on MMFs to safeguard their short-term liquid assets. Government policies that seek to prevent MMFs from withdrawing from unstable markets will compromise their ability to provide liquidity to these investors and the broader economy during times of stress with far more negative systemic consequences.

The MMF ideas advocated by the Federal Reserve seem little more than a thinly veiled attempt to have MMFs and their shareholders subsidize the banking system in a crisis. But the Fed's proposals are unlikely to have even that effect. Neither a capital buffer nor floating NAV would prevent MMFs or their shareholders from withdrawing from turbulent markets. Nor would delayed redemption rights for MMF shareholders. MMFs still would act in the best interest of their shareholders and still would comply with SEC rules that limit their investments and impose fiduciary duties on their advisers.

Even if the Fed could force MMFs to prop up banks during times of uncertainty, such action would increase rather than decrease systemic risk. Banks and other borrowers, knowing that continued short-term funding is assured, would have a reduced incentive to act prudently and would be less likely curb their reliance on short-term funding. Excessive reliance on short-term credit to fund long-term assets is the reason why so many banks failed during the financial crisis and why we even had the crisis. That is the real problem that needs to be addressed, not MMFs.

Despite what the Fed implies, it is not the job of MMFs to support the credit markets or the highly leveraged activities of banks and their affiliates during a crisis. That responsibility resides with the Fed, the Treasury Department, and the FDIC, not MMFs. MMFs are not guarantors of the credit markets, or of banks.

Ironically, at the same time the Fed has criticized MMFs for withdrawing from the short-term credit markets recently, both in the U.S. and Europe, the Fed and other banking regulators have encouraged banks to do just the same. Incredibly, the Fed seems to want MMFs to take on credit risks that it views as too risky for banks.

Rather than distort the regulation of MMFs in pursuit of policies that can only result in the permanent withdrawal of MMFs from the credit markets, the Fed should find ways of enhancing the resiliency of those markets by bolstering the role of banks as lenders. Banks, after all, are designed for credit risk. They are given deposit insurance and access to the discount window. They are permitted to leverage their capital to take credit risks. MMFs are not.

What I find most interesting about the Fed's MMF proposals is that, in the name of reducing systemic risk, they all involve subjecting MMFs and their shareholders to increased risk. Not less, but more risk.

> The capital buffer idea assumes that MMFs in fact will incur and absorb losses and thereby creates the self-fulfilling moral hazard of actual losses as MMF managers go further out on the risk curve to buy bank commercial paper with incrementally greater risk, as bank-affiliated MMFs did in 2007 and 2008, knowing there was a backstop in their affiliated bank holding companies.
>
> The imposition of shareholder redemption restrictions increases the risk that MMF shareholders will not have full access to their liquid assets during a crisis, and thereby increases the potential for heightened panic and harmful economic fallout.
>
> The floating NAV idea creates risk by eliminating the penalty of "breaking the buck" that currently acts as a discipline on MMF portfolio managers. Currently, if a MMF's NAV falls half-a-penny below a dollar, the fund must close and distribute its assets pro rata to its shareholders. That is a major risk-barrier for MMF managers that would be lost under the floating NAV concept.

The Fed's proposals may reflect the difficulty the Fed is having in de-leveraging and de-risking the banking system. Transferring risk from the banking system to MMFs may seem like one way of making the banking system safer. But increasing risk for MMFs and their shareholders is not a sensible way of reducing systemic risk overall and can only backfire. It merely reshuffles risk from one location to another. Worse, it transfers risk from institutions that are designed to assume risk to institutions that are not. Unlike banks, MMFs have been carefully structured to minimize risk to investors—they are not structured to carry risk, as are banks. MMFs do not have access to deposit insurance or the discount window. Because they operate without the benefit of the federal safety net, they are subject to regulations and fiduciary duties that substantially limit their ability to take risk.

In conclusion, MMFs are not now a source of systemic risk. The SEC should not make them a source of systemic risk by accepting the Fed's misguided proposals that appear primarily designed to benefit large banks at the expense of MMFs and their shareholders.