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Statement of the Shadow Financial Regulatory Committee

Systemic Risk and Money Market Mutual Funds

February 14, 2011

The financial crisis has highlighted the institutional features of our financial system and regulatory policies that unexpectedly resulted in financial instability. One of these is the failure of money market mutual funds to use traditional net asset value (NAV) accounting, which contributed significantly to the problems experienced by these funds.

Many investors and money market mutual fund managers were not prepared for the effect that the bankruptcy of Lehman Brothers had on the value of money market mutual funds fixed-income holdings. For example, the Reserve Fund needed to “break the buck” under the Securities and Exchange Commission rules for money market mutual funds because its underlying valuation moved more than ½ percent below the fixed \$1 NAV used by its funds. This led to a dramatic “run” on money market mutual funds in the aftermath of the collapse of Lehman Brothers by fund investors

The SEC has recently moved to require monthly disclosure of shadow asset values for large money market mutual funds. While the resulting transparent price signal may lead to greater market discipline on funds, it also could amplify the danger of a run by investors anxious to exit ahead of any actual revaluation of the fund. In contrast, if fund valuations were marked to market immediately using the full

NAV approach—as required for other types of mutual funds—this type of run would not have occurred, and there would not have been a strong economic incentive for money market mutual funds to liquidate positions.

Money market mutual funds that cater to institutional investors are especially vulnerable to runs. The “run” experienced during September 2008 at the Reserve Fund, the oldest institutional money market mutual fund, reflects this vulnerability, which then precipitated a broader run on money market mutual fund shares.

The policy response to the instability that occurred during fall 2008 was to provide federal insurance of pre-existing balances in money market mutual funds on a “temporary” basis. In order to stem the run on money market fund balances and preserve the potential for funding commercial paper through these funds. This insurance represented a new major federal commitment, and left little doubt that in the event of another fund crisis the federal government would step in to protect money market mutual fund investors.

The Shadow Committee believes that this extension of the federal safety net would be unnecessary if the SEC shifted to the floating NAV model for institutional money market mutual fund products. The relative sophistication of wholesale investors (compared to their retail counterparts) and their heightened tendency to run, as reflected in the 2008 crisis,¹ would be greatly moderated. In fact, adhering to the semi-guaranteed par asset value arguably suggests that money market mutual funds should be regulated as banks. It may also be time to rethink our regulatory approach to retail money market mutual funds. Indeed, the overall spirit of our suggestions is broadly consistent with proposals made by the President’s Working Group last fall. One of the major lessons of the financial crisis has been the importance of internalizing the costs of risk bearing and controlling moral hazard, which is also the basis of our proposal.

¹ In its earlier Statement No. 275 (September 14, 2009), “Strengthening the Resiliency of Money Market Mutual Funds,” the Shadow Committee suggested that regulators should encourage institutional money market mutual funds to sell and redeem shares at actual market values rather than a fixed \$1 price.