The Case For Prime Money Market Mutual Fund Liquidity Insurance

A Comment Submitted on Potential Money Market Fund Reform Measures in President's Working Group Report

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A year after the COVID-19 market meltdown, the first major debate on financial regulation under the Biden administration is shaping up to be about prime-money-market mutual funds.

While banks held up well during the pandemic (demonstrating the success of Dodd-Frank capital rules), prime-money-market mutual funds (which invest in short-term government bills and commercial paper) experienced massive redemptions in March 2020. The withdrawals mirrored those during the 2008 financial crisis, despite U.S. money-fund reforms that went into effect in 2016. As with the bank runs of the Great Depression, money-market funds tend to see major redemptions when their net asset values (NAV) "break the buck" (falling below $1) and investors race to pull their money to avoid taking a hit.

In fact, there is a growing consensus that not only did the previous money-market-fund reforms implemented in 2016 fail to prevent runs but they may have made the money-market runs worse by requiring fund companies to impose gates and fees on investors when a money fund's assets decline by 30 percent. The reforms also attempted to get investors more comfortable with small losses by creating a "floating NAV" (extending NAV quotes to four decimal places instead of two to allow investors to see small fluctuations in returns), but that seems to have had no effect on preventing runs.

Now, prime-money funds (which act very much like bank-deposit accounts for institutional cash) face the possibility of being banned altogether.

This isn't an issue that affects only high-net-worth individuals. Given that retail investors make up a sizable amount of money-market assets and that institutional cash holdings often belong to many pension plan holders, a fragile money-market system can create risks to the savings of middle-and lower-income Americans as well.

Furthermore, when interbank lending froze amid the run on money-market funds during the global financial crisis, it had massive implications for the extension of credit to poorer households and contributed to ensuing double-digit unemployment.

As in 2008 when the Fed used its "lender of last resort" powers to create a facility (the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility or "AMLF") to bail out money funds thought to be holding Lehman commercial paper that were experiencing mass redemptions and fire sales, the Fed in 2020 once again ended up intervening by establishing a similar facility (the Money Market Fund Liquidity Facility or "MMLF").

In effect, through these programs, the Fed is providing an ad hoc insurance mechanism for money funds in the event of runs.

To make a more permanent system of deposit insurance for prime money funds, Congress should create an FDIC-like agency for prime-money funds that would more permanently institutionalize the AMLF and MMLF facilities of 2008 and 2020.

There could be many preemptive benefits from having money-fund insurance in preventing runs in the first place.

The mere presence of deposit insurance prevents runs (born by information asymmetries around asset and liquidity uncertainty) in a manner that economists Doug Diamond and Phil Dybvig described in their famous 1983 Journal of Political Economy paper "Bank Runs, Deposit Insurance, and Liquidity."

Bank runs are triggered by a self-fulfilling prophecy in which depositors pull their money for fear that others will do the same. Because of the dynamics of runs, an otherwise-solvent bank can lose its funding during times of financial stress. If you credibly take away the fear that others can impose meaningful losses on you, you can make runs disappear.

This is effectively what the creation of deposit insurance worldwide has done: eliminate traditional bank runs on a large scale. As of now, in the United States, FDIC insurance applies only to bank deposits (insuring up to $250,000 of deposits per bank).

There are more similarities between bank deposits and money-market funds than people realize. Like banks, prime-money funds provide a special function in financial markets by supporting credit origination, maturity transformation, and payments facilitation.

Money-fund insurance would be bought by the fund sponsor (in the same way banks pay deposit insurance premiums to the FDIC) and be passed on to consumers in the form of slightly higher fees.

There are some regulatory hurdles that exist with creating FDIC-like deposit insurance for prime money funds. The FDIC federal deposit fund doesn't have enough funds to ultimately stop runs, so having the money-fund insurance be backed by the U.S. Treasury (the full faith and credit of the U.S. government) is essential in making it a credible tool.

As an alternative to money-fund insurance, Congress could give money funds access to the Fed's discount window. One challenge with this approach, however, is that the Fed would have to classify money funds as banks and impose 6 percent Dodd-Frank capital requirements, a potentially excessive cost.

Federal Reserve Vice Chair for Financial Supervision Randal Quarles and the rest of the Federal Reserve Board of Governors currently seem unwilling to make a capital-requirement exemption (or at the very least lighter capital requirements to reflect the much less risk involved) for prime-money funds.

There are several other prime-money-fund reform proposals being floated — which include creating money-fund swing pricing or subordinated share classes (both operationally difficult for money funds), banning prime money funds, or forcing them to be converted to more-liquid ETFs and move away from problematic daily NAV pricing. Almost all seem to agree on abolishing the gates and fees of the 2016 money-fund reforms, which seems to have made things worse.

Of the reforms under consideration, money-fund liquidity insurance is the simplest path, with operational and regulatory ease of allowing prime money funds to function largely the same way they do today but simply requiring them to pay small insurance premiums into an insurance fund. Some may argue that the insurance premiums would make prime money funds less viable. It would be essential to find the happy medium that's sufficiently small not to be disruptive while still paying for potential liquidity insurance needs during times of financial stress.

Others might also argue that FDIC-like insurance might create moral hazard, that is, To what degree are you incentivizing money-market funds to invest in riskier securities by insuring losses? I would argue that if there are any moral-hazard risks, they already exist in the sense that the Fed money-market fund-liquidity programs of 2008 and 2020 are already providing de facto insurance.

Despite the growth of administrative bloat in Washington over the past hundred years, the FDIC has been one of the most effective regulatory agencies, preventing bank runs that were all too common before the Banking Act of 1933. Likewise, a money-fund insurance program could foster more financial stability by preventing money-fund runs (which seem to have become a decadal event) while preserving an effective vehicle to provide short-term lending that supports economic growth.