

Agreeing to Disagree

Regulators, Fund Managers and Investors Embrace Different Approaches to Protecting Money Market Funds from Runs

As the third anniversary of the Lehman Brothers bankruptcy approaches, federal regulators and leaders of the money market fund industry are actively debating how best to prevent the kind of run on prime money market funds that followed Lehman's collapse and prompted a temporary federal guarantee program that funds could elect to join.

For many in the regulatory community, the answer to mitigating the systemic risks presented by money funds is simple: let the net asset value (NAV) of fund shares float with the value of funds' underlying securities. Advocates of the floating NAV argue that jettisoning the stable NAV – the defining feature of money market funds for 40 years – would reduce the risk of runs because investors would come to accept minor fluctuations in funds' NAVs. They believe this would curb the impulse to be first in line to redeem one's investments should a fund's NAV dip below a dollar.

Many fund managers view the elimination of the stable NAV as the death knell for the money market funds industry. They argue that the expectation of principal stability is the foundation of the \$2.7 trillion money market fund industry and that the end of the stable NAV would trigger a substantial outflow of money fund assets to federally insured accounts or to higher-yielding but more risky investments, such as unregulated private or offshore funds. Such a development would not only undermine a highly successful investment vehicle, the industry maintains, but also eliminate a reliable source of short-term financing for American businesses.

PREVENTING SHOCKS TO THE SYSTEM

The central question confronting the funds industry and regulators is how best to avoid the kind of market disruption that followed the failure of the Reserve Primary Fund in the wake of the Lehman Brothers bankruptcy in 2008. Heavily

invested in Lehman debt and without a parent sponsor to support it, the fund “broke the buck,” triggering a run by institutional investors. The wave of redemptions not only sunk the Reserve Primary Fund, it raised concerns about the stability of money market funds generally. Washington responded by instituting a temporary guarantee program for money market fund investments.

To help reach a consensus on the optimal means of making funds less susceptible to runs, regulators, fund managers, academics and institutional investors gathered recently at a forum sponsored by the Securities and Exchange Commission. The discussion quickly revealed that regulators and industry professionals were unable to agree even on the cause of runs, let alone on measures to prevent them. Nor could they agree on the unintended consequences of some of the reforms under discussion.

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Responding to the floating NAV proposal, funds industry representatives argued that the Reserve Primary Fund's demise was the result of a liquidity crisis, not a credit crisis, and that a floating NAV would not prevent similar events in the future. They posited that the implementation of tougher regulations governing 2a-7 funds – particularly more stringent liquidity requirements – would help stabilize funds during market crises. They argued as well that measures to enhance transparency with regard to funds' investments also would promote greater stability. Finally, they pointed out that these reforms, implemented over the past year, might be sufficient by themselves to address the systemic risks of concern to regulators.

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Funds industry representatives have long argued that, historically, money market funds deliver benefits that other financial services providers, including banks, cannot provide. They tout the efficiency and low cost of capital provided by money market funds; the transparency of their investment portfolios; and the access they provide retail investors to an asset class that otherwise would be unavailable to them.

The benefits of a stable NAV were reiterated by two institutional investors attending the roundtable. A corporate treasurer and a treasurer from the public sector stated explicitly that they would exit money funds if a floating NAV were instituted. The corporate executive further stated that as an issuer of commercial paper, it would be difficult – if not impossible – to replace money market funds as purchasers of the company’s debt, almost 40% of which, she noted, is held by 2a-7 funds. Both treasurers stated that money funds were central to their efforts to diversify their investments and that they would not be comfortable shifting their entire cash position to banks. They also noted that they value the \$1.00 NAV from a bookkeeping and tax perspective.

WEIGHING THE OPTIONS

During the SEC forum, several alternatives to the floating NAV were discussed. These include:

- The **imposition of regulations** similar to those governing banks on money market funds
- A **private liquidity facility** funded by fund complexes with access to the Federal Reserve’s discount window
- **Mandatory capital reserves** that would position funds to better withstand runs

Not surprisingly, banking regulators voiced support for a proposal to subject the money fund industry to regulations similar to those imposed on banks, which reflects the view of some observers that U.S. money market funds effectively serve as a shadow banking system. That proposal prompted only minimal discussion by the roundtable’s attendees.

A representative of the Investment Company Institute (ICI) discussed the ICI’s proposal to create a private liquidity facility, which would be able to access the Federal Reserve’s

discount window during crisis periods. The funds industry would collectively own and fund the liquidity facility, which would buy illiquid securities from a fund experiencing a liquidity crunch. The facility also would be able to borrow from the Fed. Regulators noted that the point of the day’s exercise was to identify ways of minimizing taxpayer involvement during a crisis, not institutionalizing it.

A senior executive at a large fund family proposed that each fund create a liquidity buffer by salting away a small portion of the fund’s income over time until a specified capital requirement had been met. This idea prompted debate about the appropriate dollar value of the buffer and whether it was reasonable for only the fund’s shareholders to bear the cost of creating the liquidity buffer. There were also concerns that it would take too long to build an adequately sized liquidity pool, especially in the current low-interest rate environment. One participant addressed that challenge with the suggestion that fund complexes issue debt to instantly create the buffer, a solution that many discounted due to its complexity.

NO CONSENSUS IN SIGHT

The SEC forum did not generate a list of future steps or even a time line for additional debate. What it did do was highlight the complexity of the challenge facing fund managers and regulators as they search for ways to protect investors, the funds industry and taxpayers. It did not focus on the impact of the various reforms on corporate and municipal issuers, the overall economy and the capital formation process. Clearly, investors value the stability, simplicity and convenience offered by money market funds, but the very popularity of money funds presents systemic risks that regulators are determined to address.

Treasury Secretary Timothy Geithner may have put it best when he described the challenge facing the stakeholders as “to figure out how to bring a little more resilience into [the money market fund industry] without depriving the economy of the broader benefits that those funds provide.” Afterward Geithner added, “It’s hard,” which may be the only observation on which all of the parties can agree.

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