

# ViewPoint: Money Market Funds

## A Proposal for a Capitalized Special Purpose Entity

7 February 2010

During the recent financial crisis, money market funds experienced significant liquidity problems following a general reduction of liquidity in the market brought to a head by the collapse of Lehman Brothers and the resulting failure in a large money market fund. That failure resulted in the fund “breaking the buck,” which prompted massive industry-wide redemptions and left the government with another systemic risk to manage in already frozen financial markets. However, this is only part of the story. Money market funds also play a crucial role in our economy, bringing together issuers of and investors in short-term financial instruments. It is important to note that while the government was required to take extraordinary actions in support of the industry during the financial crisis, the government (taxpayers) did not absorb any losses, and in fact generated a surplus associated with this support.

This paper examines both the role of money market funds, and ways in which idiosyncratic risk (fund-specific risk) and systemic risk (industry-wide risk) can be significantly mitigated, resulting in a beneficial outcome for issuers, investors, and the financial system. We look at several of the proposals being considered and we support a combination of Proposal 1 and 9 (below) to achieve this outcome.

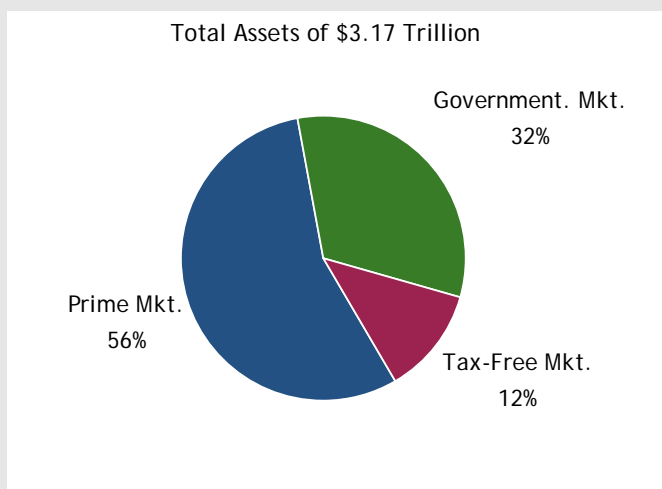
### The Role of Money Market Funds

Money market funds are extremely important to our economy in acting as credit intermediaries matching over \$3 trillion of issuers and investors. The issuers of short-term debt instruments include the U.S. Government and its agencies, corporations (including banks), and state and local municipalities. The investor side of the equation is equally diverse including corporations, municipalities, pension plans, trust funds, hospitals, universities, and individuals, all of whom use money funds for some portion of their operating funds or as a component of a broader portfolio. Money market funds are attractive to investors specifically because they provide a stable net asset value (NAV) and daily access to funds, while also providing a competitive yield versus bank deposits and direct investments. Prior to the recent crisis, money market funds had successfully provided this service to the financial markets since the early 1970s without ever requiring government intervention.

Professionally managed money market funds provide a mechanism for screening issuers, and are structured to meet the liquidity needs of the investors in the fund while maintaining a diversified portfolio of credits. Without money market funds, investors would likely be limited to insured bank deposits and U.S. Government instruments because the average money market fund investor does not have the resources to assess or monitor the credit quality of a diversified portfolio of individual issuers in an increasingly complex framework of global markets. Likewise, the absence of money market funds would force issuers, including corporations and municipalities, to turn to banks or other lenders for their short-term borrowing needs since money market funds currently hold over 40% of outstanding commercial paper. Clearly, the bulk purchases of commercial paper by money market funds add efficiency for both issuers and investors.

Money market funds are a subset of the asset management industry, and they are considered a separate asset class given the combination of credit and liquidity characteristics that need to be addressed in managing these funds. In addition, these funds have unique administrative, accounting, servicing and custody issues.

Figure 1: Total 2a-7 Market by Mandate



As of 1 February 2010

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As a result, investment managers, custodians, mutual fund administrators, and accountants have professionals dedicated to the special needs of money market funds. While it is difficult to get a precise number, it is reasonable to assume thousands of jobs (including call centers, administrators, credit analysts, programmers, accountants, and portfolio managers) are directly tied to the money market fund industry, with many more jobs indirectly tied to the industry through the funding it provides corporations and municipalities.

## What Happened in September 2008

Money market funds have long been considered a “safe haven” by investors. This perception was challenged in the Fall of 2008 when The Reserve Primary Fund “broke the buck.” It is important to understand what happened and why it happened in order to learn from the situation and craft a comprehensive solution.

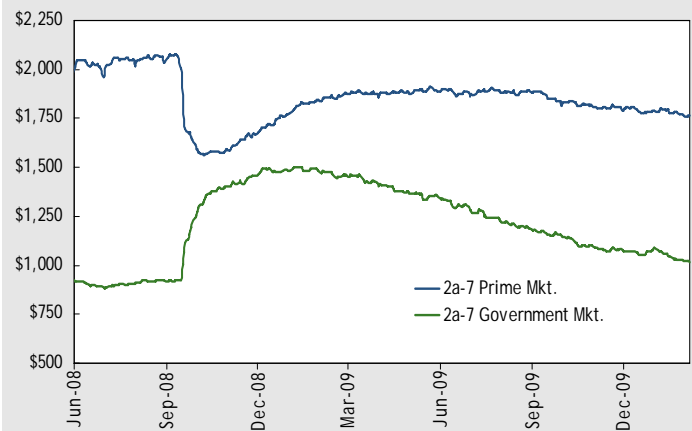
First, financial markets had become increasingly illiquid over the summer of 2008 as the financial crisis deepened and finally froze with the Lehman bankruptcy on September 15, 2008. While money market funds had been meeting their obligations over this time frame, operations were increasingly under pressure as there was no investor demand for most short-term obligations of issuers other than the U.S. Government. As a result, credit-worthy issuers could not issue commercial paper, outstanding short-term liabilities for high quality issuers were being priced at a deep discount, and secondary markets were generally frozen.

Second, Reserve had made a decision to own a significant amount (over 1% of the Primary Fund) of Lehman commercial paper. This company-specific decision was not shared by many others in the industry, and in fact, this decision highlights the idiosyncratic risk associated with credit or maturity structure decisions made by an individual manager. Unfortunately, given the stressed liquidity environment, this fund-specific decision had wider ramifications for the industry.

Third, when investors began to focus on The Reserve Primary Fund’s holdings of Lehman paper on September 15 and 16, 2008, investors began to withdraw their funds en masse. This classic run-on-the-bank quickly spread from The Reserve Primary Fund to all “prime” institutional money market funds as investor confidence, which was already shaken by the financial crisis and Lehman bankruptcy, reached panic proportions. In many cases, investors purchased U.S. Treasury Bills or U.S. Government money market mutual funds as the ultimate safe-haven to wait out the financial storm. As an industry, approximately \$400 billion was withdrawn from prime institutional funds between September 10th and September 30<sup>th</sup>, as depicted in Figure 2.

The redemptions effectively eliminated much of the prime funds’ liquidity cushion requiring sponsors to sell “money good” assets at a discount in order to maintain liquidity. If unchecked, such sales would have reduced fund values and, over time, could have resulted in additional funds breaking the buck. Realistically, money market funds are designed to balance the normal liquidity needs of various investors in the funds; they are not designed to deliver 100% of all investors’ funds simultaneously and instantaneously.

Figure 2: 2a-7 Prime and Government Daily Assets



Finally, as liquidity sources evaporated, money market funds could no longer roll maturing obligations for most issuers other than U.S. Government entities, eliminating a critical funding source for many important sectors of the economy.

Fortunately, the U.S. Government responded with a series of emergency programs to stabilize the situation. These programs included the Treasury’s Temporary Guarantee Program for Money Market Funds and the Federal Reserve’s Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. The former temporarily guaranteed money market fund balances as of September 19, 2008, and the latter allowed money market funds indirect access to the discount window in order to raise liquidity. The combination of government programs successfully turned investor sentiment more positive, and rapidly returned money market funds to normal functioning as evidenced by investors returning over \$400 billion to money market funds during the fourth quarter of 2008. Most importantly, short-term credit markets recovered rapidly as money market mutual funds resumed normal operations, and the government programs were wound down without taxpayers incurring any loss.

## Addressing Idiosyncratic and Systemic Risk in Money Market Funds

Several proposals have been put forward to address idiosyncratic and ultimately systemic risk associated with money market funds. Understanding the initial source of the problem and the subsequent behavior of investors is critical to designing an appropriate framework for the future. In this section, we examine several of the proposals that have been made for reducing risks related to money market funds. Based on our analysis, we believe a combination of Proposal 1 and Proposal 9 is the best way to reduce the likelihood that money market funds could represent a systemic risk to the U.S. financial markets in the future.

### Proposal 1 (recently adopted): More Conservative Portfolio Parameters, Increased Transparency, and Changes to Operations

As noted earlier, the money market fund liquidity problem exploded when The Reserve Primary Fund broke the buck causing investors to lose confidence in the safety of prime money market funds. The reason behind Reserve Primary Fund's failure was a holding in Lehman Brothers commercial paper. Despite the fact that most of the industry was not exposed to Lehman, investors redeemed anyway as they were concerned as to "who would be next."

Last summer, the SEC put out a proposal regarding portfolio management characteristics for money market funds that included more conservative investment parameters related to credit quality, maturity, and liquidity, as well as transparency to investors. The Investment Company Institute (ICI), along with several large money market fund sponsors, including BlackRock, responded favorably to these proposals.

On January 27, 2010, the SEC adopted changes to Rule 2a-7, implementing many of the portfolio changes that had been discussed. We continue to support these changes, particularly increasing portfolio credit quality, adding a weighted average life requirement, decreasing the average maturities, and adding liquidity requirements, as well as increasing information disclosure. We believe these changes will go a long way to reduce the likelihood of fund-specific problems. However, more conservative portfolios on their own will not address systemic risk in illiquid or frozen capital markets, therefore we recommend considering additional measures.

### Proposal 2: Floating the Net Asset Value

Many investors specifically use money market funds because of their \$1.00 NAV feature. For many investors, floating the NAV negates the value of the product. A floating NAV fund generates taxable gains and losses with each subscription and redemption, creating a tax and accounting burden for institutions that use these funds on a daily basis for their working capital.

For many retail investors, money market funds are used as an alternative to a traditional checking account, or as a sweep vehicle within a larger account, to facilitate day-to-day transactions. Burdening institutional or retail investors with the complexity of taxable recognition of small gains and/or losses will undermine the convenience achieved by the money market fund structure. When asked, the vast majority of money market fund investors have indicated an unwillingness to invest in floating NAV funds.

It is worth noting that over the past few years, several firms introduced "enhanced cash" and/or "low duration" funds as alternatives to money market funds. Collectively, these fluctuating NAV funds never achieved significant scale, performed poorly in the financial crisis, and were subject to redemption runs. Needless to say, investors do not consider these suitable alternatives to money market funds.

The clear risk in floating the NAV on money market funds is the substantial contraction of a product with \$3 trillion of financial intermediary activity. As discussed, both issuers and investors will be forced to look elsewhere. In this scenario, banks would need to assume substantial additional lending responsibility as a way to replace commercial paper, and this activity would need to be financed with deposits, which introduces a different set of risks. Likewise, investors will be forced to buy direct instruments or find other investment alternatives.

### Proposal 3: Real-time Publication of the Shadow NAV

An interesting nuance of money market mutual funds is the fact that the prices of the underlying assets may result in a market-based NAV per share that is slightly higher or slightly lower than \$1.00. Under current SEC rules, the "shadow NAV" may decline to \$0.9975 before disclosure is required. According to the amendments approved by the SEC on January 27, 2010, money market funds will be required to disclose the shadow NAV monthly with a 60-day lag. While we favor increasing transparency to investors by publishing the shadow NAV monthly with a 60-day lag, we are concerned about the unintended consequences of moving to "real-time" publication of the shadow NAV. With real-time information, investors are likely to trade in and out of funds on a much more frequent basis, resulting in increased volatility and increased fund liquidity risk.

### Proposal 4: A two-tiered system for institutional and retail money market funds

There has been substantial discussion around the behavior of "institutional" versus "retail" clients, and the possibility of creating funds with different characteristics for the two groups of investors. Realistically, many funds intermingle clients, and it would be unworkable to differentiate between the two types of funds. Fund complexes that use a multiple class structure in which there is a single portfolio with multiple share classes would find it difficult to define themselves as "retail" or "institutional."

Further, there is often overlap between retail and institutional clients. For example, retail shareholders often invest in money market funds through institutional share classes, through 401(k) plans or broker or bank sweep accounts where there is one institutional decision-maker acting on behalf of many retail customers. Unfortunately, a two-tier approach to money market funds, delineating between "retail" and "institutional" funds, would be difficult to implement and may lead to gaming behavior by investors. For example, investors using portals might choose to disguise themselves to the fund family. As a result, we support the use of a single set of portfolio characteristics and liquidity requirements rather than a tiered approach.

It is worth noting here that regardless of the decision regarding "institutional" and "retail" funds, under the new know-your-customer rules, managers will need additional disclosure about underlying clients from portals and other aggregators.

#### **Proposal 5: A two-tier system with "stable NAV" and "floating NAV" money market funds**

Investors can currently choose between stable NAV money market funds and floating NAV bond funds. As previously noted, investors have expressed a strong preference for investing cash in a stable NAV product. Introducing a two-tier system with both stable NAV and floating rate NAV money market funds is likely to cause confusion. In addition, the proposals adopted by the SEC in January increase the liquidity of funds and create more conservative portfolios which significantly addresses the idiosyncratic risk associated with an individual fund. We are concerned that additional portfolio management constraints will endanger the commercial viability of money market funds.

#### **Proposal 6: Mandatory redemptions-in-kind for large redemptions**

Most money market mutual funds are permitted (based on fund prospectus) to make in-kind redemptions to shareholders when it is in the interest of the fund (and its remaining shareholders). In practice, this is difficult to execute as most shareholders do not want in-kind redemptions and many do not have the ability to handle direct investments in securities. In addition, this approach does nothing to satisfy the demand for liquidity that begins this chain of events and could make the situation worse if recipients of the in-kind redemption decide to sell securities immediately. For smaller funds, it is often not possible to deliver a perfect pro-rata set of securities to redeeming shareholders. Under the rules issued this January, money market fund boards will now have the ability to suspend redemptions if a fund either breaks the dollar, or is about to break the dollar, and goes into liquidation. Rather than mandating in-kind redemptions, we support the new rule giving mutual fund boards the discretion to suspend redemptions with the option of making in-kind redemptions to address emergency situations.

#### **Proposal 7: Liquidity Exchange Bank**

The private sector has suggested the creation of a Liquidity Exchange Bank (LEB) which would create a bank to act as a liquidity provider of last resort. As currently conceived, the LEB would be industry-funded and would provide a fixed amount of buying capacity in the case that a money market fund cannot generate liquidity for money-good assets.

While we do not object to the idea of an LEB per se, we have a few concerns about this approach. First, we feel strongly that individual fund sponsors should take responsibility for idiosyncratic risk associated with the funds that they operate. Depending on the structure, we are concerned that the LEB could have the effect of "socializing" risk, and encouraging risk taking as each firm would believe a broader backstop would protect their investors. Second, any money market mutual fund solution must also address systemic risk. As we saw in September, 2008, the capital markets were frozen and due to the idiosyncratic risk at Reserve, investors lost confidence broadly in the safety of their money market funds. The result was a liquidity run even on money market funds that did not have credit issues. A privately funded LEB might be able to address the risk of a single fund or a few funds, however, a systemic failure would rapidly deplete the funds of the LEB. In order for the LEB to be effective in addressing systemic risk, the LEB must have a way to access the Federal Reserve's discount window, and in turn provide that liquidity to participating funds.

As discussed in Proposal 9, we are proposing a combination of (i) capital at risk to address idiosyncratic risk and (ii) access to liquidity to address systemic risk. We can envision a scenario in which a LEB that has access to the Fed window is a part of the overall solution.

#### **Proposal 8: Government Insurance Program**

During the crisis, the government put in place a Temporary Guarantee Program. Under this program, money market funds paid four basis points (six basis points if the NAV was below .9975) to the U.S. Treasury in exchange for a guarantee of investor balances as of September 19, 2008. This program remained in effect until September 2009, and played an important role in restoring investor confidence. As of the conclusion of the program, the government had collected \$1.2 billion in revenues without paying any claims. Clearly, the program accomplished its goal at no out-of-pocket cost to the taxpayer; however, there are several issues which effectively preclude the establishment of permanent government-backed insurance program. As with the LEB in Proposal 7, these issues include the potential for encouraging risk-taking by individual fund companies and thus increasing idiosyncratic risk. In addition, a permanent insurance program could have unintended consequences by creating flows of capital into money market funds from insured bank deposits or into prime money market funds from government money market funds.

## Proposal 9: Capitalized Special Purpose Entity

Money market funds are currently a pass-through vehicle in which interest earned covers fees and expenses with the net income being passed through to investors. Under current FASB rules, the sponsor of a money market fund cannot set aside any “capital/reserves” against future potential losses. We are suggesting a new structural approach in which money market funds would be managed by a special purpose entity with a charter limited to operating money market mutual funds. In effect, this entity would be a regulated subsidiary of the investment manager. This entity would be required to have capital, the level of which would be determined based on a combination of the total assets under management and the composition of those assets. Importantly, this entity would have access to the Federal Reserve discount window as a source of emergency liquidity.

This approach addresses both idiosyncratic risk and systemic risk. Individual investment management firms will have capital at risk to address credit and/or liquidity issues. By making this the first line of defense, firms will have an even stronger incentive to manage these funds prudently since they will have direct “financial skin in the game” in addition to the substantial reputational risk that they already bear. The risk of systemic failure would be addressed by providing access to the discount window. In return for this access, in addition to regulation under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 to which managers of money market funds are already subject, the special purpose entity would be subject to regulatory oversight by the FRB and might be assessed an annual fee from the FRB. In the event of a problem, the special purpose entity would be required to use its capital to support the share value of the money market funds.

The required capital should reflect the special nature of these entities and the specific funds being offered. Unlike a traditional bank, the special purpose entity would hold very high quality, very short maturity securities or other instruments per the SEC guidelines for 2a-7 funds. There would be no large maturity mis-match between “deposits and lending”, nor would the credit exposure be comparable to a traditional bank. Instead, regulators should consider both the size, concentration, and the composition of the assets. For example, the capital charge for Prime funds would exceed the charge for Treasury funds.

Likewise, a large complex would have a higher total dollar capital charge than a smaller provider, although similar in proportion to their respective assets under management. Each sponsor would be required to achieve a minimum capital level within a certain timeframe and maintain such capital to asset ratios as may be determined by the regulators.

We believe a capitalized special purpose entity is the most effective approach to mitigating potential systemic risk to the financial system by money market mutual funds. The approach outlined here creates an alignment of interests in addressing idiosyncratic risk, and provides a practical solution to mitigating systemic risk. The risk the government faced in support of the industry was in dealing with market illiquidity. Once the FRB provided the industry with indirect access to the discount window (by putting the AMLF liquidity facility in place), money market funds quickly returned to normal operations. Fortunately, the FRB did not incur any losses in making this liquidity available and money market funds were back providing an important source of credit to the economy within a short period of time.

We recognize that this proposal requires a number of legislative and regulatory changes. Depending on the definition of the special purpose entity as a “bank” or a “non-bank”, the specific changes will differ. Likewise, the inclusion of a LEB would require different changes. It is important to come to a conceptual agreement on how best to address both idiosyncratic and systemic risk, and then develop a plan to execute the desired solution.

## Conclusion

Money market mutual funds are important for issuers, investors, and employment. They are critical for municipalities and private issuers of commercial paper and other short-term debt instruments as they provide a source of funds. Money market funds are also important to a wide range of investors as they provide a competitive and convenient alternative investment for investing cash. In addition, thousands of jobs are directly tied to the money market fund industry, and many more are indirectly tied to the funding the industry provides to the economy. As outlined in this paper, a combination of measures can be introduced to address idiosyncratic and systemic risks, and still enable money market mutual funds to continue to play a vital role in our economy.

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