SEC beware, money-market funds can bring system down

Failure to reform money-market funds would be a mistake: Economist panel

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News reports suggest that the Securities and Exchange Commission may be backing away from a reform of money-market funds. This would be a mistake.

The debate over how to overhaul prime money-market funds has focused on preserving the commercial viability of these instruments while significantly lowering the threat they pose to financial stability. The latter objective should have priority.

The threat is a run by investors who believe they face impending losses on fund shares. In the two weeks after the failure of Lehman Brothers Holdings Inc., institutional investors reduced their investments in prime money-market funds by about 40 percent, amounting to almost $400 billion. Only a prompt guarantee by the U.S. Treasury -- a measure that is no longer a legal option -- stopped the withdrawals.

A handful of large bank-owned broker-dealers still borrow hundreds of billions of dollars each day from money-market funds. Clearly, a run would affect systemically important banks. Last week, Federal Reserve Chairman Ben S. Bernanke stated his concerns about the vulnerability of our financial system to a panic on money-market funds.

The Investment Company Institute, or ICI, the trade organization that represents fund sponsors, says the reforms that have been proposed are so expensive or so unattractive to investors that money-market funds wouldn't survive if they were adopted.

Asset Value

Three types of changes are now under consideration. The first of these would eliminate the “stable net-asset value” rule, which allows fund shares to trade at the book-accounting value (not market value) of assets, rounded to the nearest penny per share. That means the shares typically trade at $1 each, until they lose more than a half penny per share. Under the proposal, fund shares would trade instead at a variable net-asset value, that is, at the actual market value of the assets held by the fund, as is the rule for other forms of mutual funds.

The second proposal is to require that investors in money-market funds be protected by a “capital buffer.” In January 2011, the Squam Lake Group -- our bipartisan panel of economists, which has offered proposals on reforming the financial system -- submitted a comment letter to the SEC in response to the President's Working Group Report on Money Market Reform. We proposed that at least one of these two measures be adopted.

A third proposal has emerged. It would require that when an investor redeems money-market fund shares, a specified portion of the proceeds would remain in the fund and absorb its first losses over the next 30 days.

The ICI suggests that most investors won't use money-market funds if they have a variable net-asset value or a hold-back rule. The trade group also suggests that a capital buffer would be prohibitively expensive for a fund sponsor and its investors to share. The ICI provides no cost analysis.

One industry representative suggests starting with a buffer of 3 cents per $100 of fund assets, and then building this buffer up to 30 cents per $100 over a number of years. Money- market funds often have loss exposures to individual U.S. and European banks of more than 3 percent, more than 100 times this proposed initial buffer. If one of these banks were to encounter solvency concerns, only a far higher buffer would protect fund investors, and thus reduce the incentive for a run.

If the maximum loss to fund assets can indeed be absorbed by a tiny buffer, then the cost of providing a substantially larger one would be small because the investor would expect to lose at most a tiny fraction of the buffer investment. In any case, the expected return demanded by a buffer provider is commensurate with the riskiness of the assets held by the fund. This provides a strong incentive to the fund sponsor to manage risk conservatively.

Commercial Viability

Suppose, however, that the ICI is correct that the proposed reforms would eliminate the attractiveness of money-market funds for investors. What then should be done? Should the commercial viability of money-market funds take priority over the stability of the financial system?

A “yes” answer implies that taxpayers should backstop this business in any future crisis, either through another bailout or by absorbing the costs to the broader economy of a run on some of our largest financial institutions. Taxpayers shouldn't be forced to take this risk again.

Some have also raised concerns that if money-market funds become sufficiently unattractive, institutional investors will shift their funds to banks. Because most of a large institutional investor's bank deposits aren't insured by the Federal Deposit Insurance Corporation, this migration could increase the vulnerability of banks to runs.

Although we share this concern, regulators already monitor this risk through the extensive supervisory and capital-adequacy regime for banks. The Dodd-Frank Act charged the Financial Stability Oversight Council with controlling risks to the financial system. The FSOC's first annual report identified money-market funds as a risk to the system.

The council should reaffirm this conclusion and publicly endorse meaningful reform by the SEC to address this risk. If the SEC fails to act, the FSOC should designate some or all money funds, or their sponsors, as systemically significant non-bank financial firms and regulate them as such.

(The 12 members of the Squam Lake Group who signed this article are: Martin N. Baily, the Brookings Institution; John Y. Campbell, Harvard University; John H. Cochrane, University of Chicago; Douglas W. Diamond, University of Chicago; Darrell Duffie, Stanford University; Anil K Kashyap, University of Chicago; Frederic S. Mishkin, Columbia University; David S. Scharfstein, Harvard University; Robert J. Shiller, Yale University; Matthew J. Slaughter, Dartmouth College; Hyun Song Shin, Princeton University and Rene M. Stulz, Ohio State University. The opinions are expressed are their own.)

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