Commentary: Money Market Reform

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On October 21, 2010, the President's Working Group (PWG) published a study that described ways to prevent future runs on money market funds. Money market funds are investment companies regulated by the Securities and Exchange Commission (SEC). Some of the PWG's prescriptions would cause money market funds to be regulated by federal banking authorities, rather than by the SEC, so the SEC naturally responded on November 3, 2010, with a request for public comment on the PWG's report.

Money market funds are a variation on the classic children's rhyme of the old lady who swallowed a fly, and "perhaps she'll die." To catch the fly, the lady swallowed a spider that wiggled and wriggled and jiggled inside her. In the rhyme, our hapless victim swallows larger and larger animals to catch the last one swallowed, until she swallows a horse. "She died of course."

Most children's rhymes are intended to impart some sort of moral instruction, and this one is no exception. The tale of the old lady and the fly teaches a variation of the law of unintended consequences. And so it is with the tale of money market funds.

Once upon a time, as recently as the 1970s, banks were forbidden to pay more than a set interest rate on savings account deposits. There were a host of reasons for this limitation, but suffice it to say that this limitation was consistent with the political and regulatory views of the time regarding safe banking practices. When inflation struck in the wake of the Vietnam War, interest rates skyrocketed. Ordinary bank depositors were disadvantaged, because banks were legally prohibited from paying higher interest rates. This also limited the ability of banks to make loans because they were unable to attract sufficient deposits to meet loan demand.

Rather than raise the cap on interest rates for deposits, a move that was politically unfeasible at that time, we swallowed the money market fund spider to catch the banking regulation fly. Under a new rule instituted by the SEC for the purpose, money market funds were permitted to offer a "stable net asset value." The rule permitted money market funds to treat what is really an equity investment as if it were a loan, paying back to the investor the amount initially invested, rather than the amount that actually reflects an investor's equity interest in the fund. This move was intended to be something of a stop-gap measure to allow retail investors to receive higher rates of interest until the interest rate cap was removed from savings accounts at banks.

The primary and intended result of the stable net asset rule is that, from the standpoint of an investor, a money market fund looks, acts and smells like a bank, and the amounts invested appear to be deposits. But, this is a mirage. Bank deposits are loans that depositors make to banks. Like all loans, when a bank pays back the deposit, it is paying back the principal of the loan. In the case of a money market fund, investors actually are buying equity in a mutual fund.

Money market funds eventually adopted a number of other practices to amplify their similarity to bank deposits. Most money market funds allow investors to write checks on amounts invested, and some even offer the equivalent of debit cards.

Money market funds also act like banks in the way they manage the money received from investors. Money market funds take money that is payable to investors immediately upon demand and they use it to make loans, which are payable over time. As a result, if investors demand immediate repayment in amounts that exceed the amount of cash on hand at any particular time, the fund will be unable to meet its obligations. This is particularly likely to happen if word gets around that some of the loans made by the fund have gone bad. Then investors rush to redeem before everyone else does, in a stampede that resembles a "run on the bank." This is a rational response on the part of investors, because bad loan investments by the fund mean that when the fund is liquidated, there will not be enough money to pay every investor the amount of their investment. The first to redeem are much more likely to be paid in full than those who wait until the end.

Before the banking regulatory reforms of the 1930s, a period fondly remembered as the age of "wildcat banking," major bank runs, where depositors rush in to demand repayment of their deposits, hoping to be paid before everyone else beats them to it, occurred about once every ten years. Bank runs are very disruptive events, and aside from a few cranky economists, most of us believe they are a very bad thing.

Legislation enacted in the depths of the Great Depression put an end to wildcat banking in the United States. To avoid runs, modern bank regulations impose three principal requirements: first, banks must hold a certain amount of capital, which is a buffer against a sudden increase in depositor demand; second, banks are required to purchase insurance from a federal agency, the Federal Deposit Insurance Corporation (FDIC), to insure that depositors will receive the full value of their deposits, up to a relatively large cap; and, finally, the Federal Reserve provides immediate loans to banks that experience a sudden need for instant cash, and when a bank fails anyway, the FDIC immediately seizes the bank and assumes control so that depositors can be assured of receiving their money.

Despite their similarity to banks and susceptibility to runs, money market funds were not required to install any of the same “run preventers” used to regulate banks. Congress and the SEC believed that it was not necessary to apply banking regulations to money market funds. Legislators and regulators initially perceived money markets funds as a temporary political expedient necessary until the cap on interest rates could be removed for banks, and didn’t expect that a permanent regulatory structure would be necessary. Moreover, it was believed, foolishly as it turned out, that money market funds would never grow to become a particularly important part of the economy, so that a run on them would never cause the sort of widespread calamity associated with bank runs. Money market funds were only permitted to make very short-term loans, which it was hoped would limit their ability to get into trouble in the first place. Most importantly, money market funds were required to disclose that investments in them were not protected like deposits in banks. Regulators expected that disclosure would restrict the appeal of money market funds to persons who were willing and able to undertake a higher level of risk than typical bank depositors. Each of these rationales turned out to be wrong, which led to the rebirth of wildcat banking in the guise of money market funds.

Even when caps were lifted on the amount of interest that banks could pay on deposits, money market funds survived. Money market funds always paid higher interest rates than commercial banks. Without the costs of regulation—the need to maintain capital, pay for FDIC insurance, or deal with banking regulators—their operating costs were lower, so they were able to provide higher returns. As a result, what started as a political expediency became a permanent fixture of the capital markets. Money market funds grew to become the primary purchasers of commercial paper. This made them systemically important, because their abrupt withdrawal from that market could cause the industrial giants who relied on that market to collapse.

These realities eventually led to a result that might have been perfectly predictable given money market funds’ essential resemblance to bank deposits: when some of the funds’ commercial paper investments became suspect, a run ensued, resulting in major collapse and the recent economic crisis. The ultimate in unintended consequences.

Lehman Brothers collapsed in September 2008. As it happens, the Reserve Primary Fund, a very large money market fund, had a large exposure to Lehman Brothers commercial paper. The Fund’s more savvy institutional investors quickly demanded redemption, which forced the Fund into liquidation. This event led to a general panic and a run on money market funds. Funds reacted by hoarding cash, which caused a collapse in the commercial paper market. Major issuers of commercial paper began to replace this funding by drawing down their bank revolving credit lines. This reaction severely reduced the capital of commercial banks, which were already on life support. In effect, the run on money market funds caused a major commercial banking crisis.

The panic stopped only when the US Treasury employed taxpayer money to guarantee investments in money market funds. To restore order in the commercial paper markets, the Federal Reserve was forced to take the place of money market funds as a lender, a major intrusion into a sphere of economic activity belonging to the private sector. The Fed's "support" for the commercial paper market lasted for many months.

Our federal securities laws, and most of the regulatory apparatus of the SEC, are based on the theory that disclosure is the best way to regulate the securities markets. The money market fund crisis, however, provides a forceful demonstration of the limits of disclosure as a regulatory tool. Investors were well aware that their investments in money market funds were not insured, in the same way that bank depositors understood that their deposits were not insured prior to the banking reforms of the 1930s. In both cases, this knowledge caused runs, resulting in financial crisis. Rushing to the bank, or a money market fund, to demand repayment when their loans have soured is the rational thing for investors to do, since the last person to be repaid will likely lose everything.

Of course, in the 1930's, when federal banking and securities regulation were devised to deal with the financial crisis that sparked the Great Depression, banking activities were subjected to a more robust and intrusive form of regulation than applied to the securities markets.

The notion that disclosure-based securities regulation could serve effectively as the primary regulatory tool to protect the public from problems with money market funds was based on the erroneous assumption that a run on money market funds would not involve systemic risk. It was believed that an investment fund experiencing a redemption crisis would be forced to revalue, and ultimately liquidate, perhaps causing losses to investors, but with little effect on the national economy. The potential for losses is a fact of life for any investment in securities. However, the 2008 crisis demonstrated that a run on money market funds could cause just as much economic calamity as a run on banks.

The SEC has adopted several rules that provide greater limitations on the investments that may be made by money market funds and provide orderly procedures for their liquidation in the event they cannot repay the amounts originally invested. However, as long as investors can demand immediate redemption, and a money market fund uses investor capital to make loans with longer maturities, money market funds will be susceptible to runs. None of the rules adopted by the SEC will prevent runs and their deleterious effects on the national economy.

The 2008 money market crisis also demonstrates that it is possible for the US Treasury to stop runs on money market funds by guaranteeing investments. And the Fed has proven that it can make a market for commercial paper. But no one seriously believes the US taxpayer should backstop investments in money market funds or that the Fed should assume the role of being a primary lender in any market.

The PWG's report presents a fair amount of analysis and considers a variety of options, but at the end of the day, we are left with the same result our forefathers arrived at in the 1930s. Run prevention at money market funds will require the holy trinity of banking regulation -- capital requirements, deposit insurance, federal support and, if necessary, seizure of failed institutions.

Since banking regulation is the cure, there would seem to be no good reason not to rely on the regulatory apparatus already in place to do this job with banks. The regulatory institutions that do this type of regulation for commercial banks are well-established and have a wealth of experience with this type of regulation. The PWG's report makes this point, while elaborately and delicately going through great pains not to provoke the SEC and the Investment Company Institute (ICI).

They were provoked nevertheless. The SEC has requested public comment on the report, and the ICI has written furious letters and reports condemning the notion that money market funds should be regulated as banks.

Notwithstanding the strenuous objections from defenders of the status quo, I think there is little doubt that money market funds eventually will be forced to become banks or at least to become regulated in the same manner as banks. The only question is how much agony we will have to go through to get there.

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