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The Fed, Not the Reserve Primary Fund, 'Broke the Buck'

By Peter Wallison

Since their inception in the 1970s, money market funds (MMFs) have been a highly successful financial innovation. Before the financial crisis, MMFs held approximately $3.6 trillion in assets; today, they are somewhat smaller, with about $2.9 trillion under management. The unique feature of MMFs, which probably accounts for their extraordinary popularity, is that they are permitted by the SEC to use amortized cost accounting for stating the net asset value (NAV) of their portfolios on a daily basis. This enables them to offer and redeem their shares at a fixed $1 per share. Without this feature, MMFs would be required to disclose small fluctuations in their asset values at the end of each trading day, requiring their shareholders-many of which are businesses-to record these tiny daily changes in their own balance sheets.

Not incidentally, because they can fix the NAV of their shares at $1, MMFs compete directly with bank deposits, even though they are not insured. For this reason, bank regulators and banks themselves have made numerous efforts over time to close down MMFs or at least make them less attractive competitors.

In the panic that followed the Lehman Brothers' bankruptcy and the AIG bailout in September 2008, investors rushed to quality, moving funds from corporate investments to the safety of government securities. Safety at this point was far more important than yield. These funds transfers were either made directly, through selling corporates and buying governments, or indirectly through the sale of shares in MMFs that were invested in corporates and the purchase of the shares of MMFs that were primarily or exclusively invested in government securities. In a report to the SEC commissioners, the staff of the SEC described these events:

Investors began selling prime money market funds [those MMFs that invested in prime quality private securities] on Friday, September 12th, ahead of Lehman Brothers' bankruptcy on Monday, September 15th. They continued to sell prime money market funds on Monday, September 15th. ...At the same time, investors began buying government money market funds, which include Treasury and government funds. During the Crisis Month (9/2/2008 to 10/7/2008), government money market fund assets increased by $409 billion (44 percent), whereas prime fund assets fell by $498 billion (24 percent).

In the midst of this rush to quality, on September 16, one MMF, the Reserve Primary Fund announced that it anticipated sufficient losses on its holdings of Lehman commercial paper, and that it would not be able to redeem all its shares at $1 per share. In MMF parlance, it "broke the buck." However, this does not mean that its investors suffered substantial losses. All told, the Reserve Primary Fund's shareholders did not lose more than one or two percent of the value of their shares, far less than the seven percent that stock market investors lost on a single day during the financial crisis, September 29, 2008.

Nevertheless, the idea has become widespread that there was some kind of connection between the losses at the Reserve Primary Fund (RPF) and the instability in the financial system that occurred after the Lehman bankruptcy and the AIG bailout. The withdrawal of funds from the RPF was somewhat dramatically called a "run," although in substantial part it was the result of a general investor move to the perceived safety of government MMFs. The fact that the RPF "broke the buck" added to the drama, but was not of material significance in light of the fund's eventual investor losses of less than one or two percent.

Making full use of this narrative, the Financial Stability Oversight Council (FSOC), a body of federal financial regulators created under the Dodd-Frank Act and chaired by the Treasury secretary, has been pressuring the SEC to change the accounting rules that have made MMFs competitive with banks. It has sought to eliminate the amortized cost accounting treatment or to introduce "loss absorption" proposals akin to capital requirements that would reduce MMFs' return on assets and thus their attractiveness as an alternative to bank deposits. These and other ideas are currently under consideration by the SEC.

In November 2012, the FSOC published a lengthy paper on why MMFs should be reformed, summarizing its concerns this way:

> [T]he 2007-2008 financial crisis demonstrated that MMFs are susceptible to runs that can have destabilizing implications for financial markets and the economy. In the days after Lehman Brothers Holdings, Inc. failed and the Reserve Primary Fund, a $62 billion prime MMF, "broke the buck," investors redeemed more than $300 billion from prime MMFs and commercial paper markets shut down for even the highest-quality issuers.

The inference we are to draw from this description is that "runs" on MMFs caused a breakdown in the commercial paper market. Given that the commercial paper market is one of the most important sources of short-term finance for business, this would be a significant indictment of MMFs if it were true.

But there is little reason to believe that the "run" on the RPF or withdrawals from other primary MMFs had anything to do with the shutdown of the commercial paper market. This is because the commercial paper market was already under stress and declining a year before the Lehman bankruptcy and the RPF "run." As one academic paper has observed:

> Commercial paper played a central role during the financial crisis of 2007-2009. Before the crisis, market participants regarded commercial paper as a safe asset due to its short maturity and high credit rating. Two events changed this perception. The first event began to unfold on July 31, 2007, when two Bear Stearns' hedge funds that had invested in subprime mortgages filed for bankruptcy. In the following week, other investors also announced losses on subprime mortgages. On August 7, 2007, BNP Paribas suspended withdrawals from its three investment funds because of its inability to assess the value of the mortgages and other investment held by the funds. Given that similar assets served as collateral for a specific category of commercial paper-asset-backed commercial paper-many investors became reluctant to purchase asset-backed commercial paper. The total value of asset-backed commercial paper outstanding fell by 37 percent, from $1.18 trillion in August 2007 to $745 billion in August 2008.

Thus, the decline in the size of the commercial paper market between August 2007 and the date of the Lehman bankruptcy in September 2008 was about $435 billion. During this period, the market was seriously stressed, and interest rates on the asset-backed commercial paper market (ABCP)-the largest category by far-moved sharply higher. Between the beginning of July and the end of August 2007, the interest rates on ABCP increased from 10 basis points to 150 basis points over the Fed funds rate.

However, *after* the Lehman bankruptcy, the AIG bailout, and the so-called "run" on RPF, the decline in the commercial paper market was much smaller. The market declined from about $670 billion to $420 billion-about half of the decline that took place *before* the Lehman, AIG and RPF events. In other words, the asset-backed commercial paper market was already in a serious decline before anyone had ever heard of the RPF, and the decline that occurred before the Lehman bankruptcy and the so-called "run" on RPF was far larger than the decline that occurred after those events.

So it is a bit of a stretch-to say the least-for the FSOC to attribute the "shutdown" of the commercial paper market to a supposed "run" on MMFs after the Lehman bankruptcy.

The real story here is not MMFs, but the Fed's irresponsible actions as the regulator of the largest banks in the period leading up to the financial crisis. During that time, the Fed allowed banking organizations to set up off-balance sheet vehicles, generally called "conduits," that held traditional bank assets such as mortgages and auto loans. These structures were financed with ABCP, which in turn was backed by a guarantee from the bank. This paper was primarily sold to MMFs.

Thus, with the approval of their regulator, U.S. bank holding companies were permitted to move assets off their balance sheets, while in effect to retaining the risk of the assets through the backup guarantee. Shockingly, these transactions were nothing more than a regulatory capital arbitrage, entered with the approval of the Fed. By the summer of 2007 the assets in these conduits had reached $1.3 trillion. By then, ABCP was the largest money market instrument in the U.S. financial markets; the second largest instruments were Treasury bills with about $940 billion outstanding.

When the problems at Bear Stearns and BNP Paribas came to light in July and August 2007, MMFs and others began to shed their holdings of ABCP by refusing to roll over this short-term paper. This forced the banks to acquire these risky obligations, weakening them financially and reducing their capital. In addition, they continued to have significant obligations to the MMFs and other holders of the billions of dollars in ABCP that were still outstanding. As a result, in the panic after the Lehman bankruptcy, the largest banks were required to hoard cash to cover these guarantees, refusing to lend to one another, even overnight-the signature event in the financial crisis.

A widely read academic paper summarizes this process: "Our main conclusion in this paper is that, somewhat surprisingly...the crisis had a profoundly negative effect on commercial banks because banks had (in large part) insured outside investors in ABCP by providing explicit guarantees to conduits, which required banks to pay off maturing ABCP at par....We argue that banks instead used conduits for regulatory arbitrage." Then, continuing, "[T]he key observation is that a capital charge for guarantees, similar to capital charges for on-balance sheet assets, would have most probably discouraged banks from setting up conduits in the first place."

The conclusion thus seems unavoidable that the proximate cause of the financial crisis was not the so-called "run" on the Reserve Primary Fund after the Lehman bankruptcy. Nor was it that fund's "breaking the buck." Both occurred, as outlined above, near the end of a much larger rush to the safety of government securities that had begun well before the Lehman bankruptcy.

Instead, the immediate cause of the financial crisis was the $1.3 trillion in ABCP conduits that were guaranteed by the largest banks, with the full approval of the Fed. As the underlying assets in these facilities declined in value, many buyers-including MMFs-refused to roll over their ABCP financing. This required the banks that had guaranteed these obligations to take them back onto their balance sheets in increasing amounts, weakening the banks as the financial crisis approached.

After the Lehman bankruptcy and the ensuing panic, the pressure on the banks was even greater; in their weakened condition, they were required to hoard cash to meet their obligations on maturing ABCP as well as other cash obligations, and thus refused to lend to one another, even overnight. This was the signature element of the financial crisis.

For this reason, the ensuing effort by the Fed to place the blame for the financial crisis on MMFs, and the corresponding efforts of the FSOC to pressure the SEC into changing the accounting rules for MMFs, are wholly misplaced and should be abandoned.

1 Financial Stability Oversight Council, "Proposed Recommendations Regarding Money Market Mutual Fund Reform," November 2012, p.4

2 Marcin Kacperczyk and Philipp Schnabl, "When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2001-2009," Journal of Economic Perspectives, Volume 24, Number 1, Winter 2010, p29.

3 Id., p 38

4 Viral V. Acharya, Philipp Schnabl, and Gustavo Suarez, "Securitization without risk transfer," Journal of Financial Economics 107 (2013), p516

5 Ibid.

6 Id., p 534

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