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MONEY MARKET FUNDS IN 2012

Money Market Funds Are Not Banks

Regulators are now considering imposing capital requirements on money market funds. This idea is a radical departure from the U.S. system of regulating mutual funds (including money market funds) and appears to stem from incorrectly assuming that money market funds are like banks.

Money market funds are neither banks nor unregulated. They manage risks very differently from banks—money market funds are required to hold diverse portfolios designed to limit risk.

- Money market funds are required by the Securities and Exchange Commission (SEC) Rule 2a-7 to hold a diverse portfolio of short-term, liquid, high-quality securities that pose minimum credit risk. A money market fund's portfolio is designed to limit risk. The restrictions include:
  - Weighted asset maturity of 60 days or less
  - Weighted asset life of 120 days or less
  - Minimum 10 percent in daily liquidity—assets can be liquidated in one day
  - Minimum 30 percent in weekly liquidity—assets can be liquidated in one week
  - Assets must pose minimal credit risk
- As of October 2011, 99 percent of money market funds' portfolios received the highest short-term credit ratings.
- To maintain a $1.00 net asset value (NAV), money market funds use amortized cost accounting to value their investments. However, they also must value their investments using market prices to ensure that the amortized cost NAV is not materially different than the market value.
- Money market funds are investment products that are financed 100 percent through equity. Money market fund investors are equity shareholders, not deposit creditors.
- Money market funds use little to no leverage.
- Money market funds' portfolios are transparent: funds report their holdings on a monthly basis, and some funds report more frequently. Most securities in money market fund portfolios are followed and evaluated by credit rating agencies.
- Money market funds are not insured or guaranteed by the U.S. Federal Deposit Insurance Corporation (FDIC) or any other government agency.
- Money market fund shareholders rely upon the credit quality, liquidity, diversification, transparency, and sound management of the portfolio—not on capital—to minimize risks to their investment.

- A fund's prospectus provides a clear description of all risks and rewards associated with the fund, explicitly states that the fund is not government guaranteed, and creates no expectation of an explicit or implicit guarantee by the fund sponsor.
- Since the inception of money market funds in the early 1970s, only two funds have failed to maintain a stable NAV. Investors in these funds ultimately received between 96 and 99 cents on the dollar (i.e., their losses were between 1 percent and 4 percent of their principal).

Banks hold capital to protect taxpayers and their creditors from the risks inherent in their business.

- Banks are highly leveraged, relying on debt in the form of deposits, CDs, long-term bonds, and other borrowings to finance their business. These borrowings often comprise 80 to 90 percent of the bank's total assets, implying a leverage ratio of 4-to-1 ($4 of borrowing for every dollar of equity).
    - In contrast, a money market fund, like all mutual funds, may borrow no more than one-third of its total assets, implying a maximum leverage ratio of ½ and in practice money market funds generally rely on little if any borrowing.
- Banks serve society by providing financing, including mortgages and other long-term loans, for households, small businesses, and other borrowers who lack access to public credit markets. As a result, banks' portfolios consist primarily of loans to businesses and households. These loans can have maturities ranging up to 10 to 30 years and are often highly illiquid—they can't be called or sold quickly.
- Bank loans can be opaque because many bank borrowers have unique characteristics that make their credit quality hard to assess.
- To prevent depositors from running, banks are required to hold deposit insurance from the FDIC.
- As a result of their structure, banks are required to hold capital to protect depositors, other creditors, the FDIC, and ultimately taxpayers from losses that may arise from holding a portfolio of illiquid, opaque assets.
- Banks use amortized cost accounting to value their loan portfolios in their financial statements. However, the fair (mark-to-market) value of banks' assets may differ substantially from the amortized cost value due to the loans' long maturities, changes in interest rates, or changes in the credit quality of borrowers. (The longer the maturity of a loan or bond, the greater the impact of an interest rate change on the debt instrument's value.)
- Despite the existence of FDIC insurance, capital requirements and other prudential regulatory requirements, since 2000, 450 banks have failed according to the FDIC.

For more information on money market funds, their role in the economy, ICI's efforts to make these funds more resilient in the face of adverse market conditions, and the significant risk of undermining money market funds' value to investors and the economy, please see *www.ici.org/mmfs* or *www.PreserveMoneyMarketFunds.org*.