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Talking Business

It's Time to Admit That Money Funds Involve Risk

By [JOE NOCERA](#)

In all the inevitable hoopla surrounding the coming anniversary of "[Lehman](#) weekend" — those fateful days in mid-September 2008, when the financial world seemed on the brink of collapse — here's an important event that will almost surely be overlooked:

On Sept. 18, just a few days after the anniversary, the [Treasury Department](#) will end a program that essentially gave the same kind of protection to money market investors that the [Federal Deposit Insurance Corporation](#) gives to bank depositors. The government guaranteed that investors wouldn't lose a penny.

When the program was instituted a year ago, you'll recall, the [Reserve Primary Fund](#), a \$62.5 billion money market fund, had "broken the buck." With \$785 million in defaulted Lehman bonds in its portfolio, it had been unable to maintain the \$1 share price that has long been a priority for money market funds, falling to 97 cents. Investors, who had long viewed money market funds as the equivalent of a bank savings account, raced for the exits.

[Henry M. Paulson Jr.](#), the Treasury secretary at the time, rammed through the guarantee in part because he wanted to quell investor panic, which he feared would spread like a contagion to other money market funds. And since money funds are big buyers of [commercial paper](#), he also wanted to prevent the commercial paper market from freezing up, with devastating consequences. With \$3.5 trillion in assets, money market funds had become a critical component of the shadow banking system.

Here we are a year later, and the money market fund business seems back to normal. No other money funds have broken the buck. The amount of money in money funds today is not at all different from what it was before Lehman weekend. Investors have, once again, come to think of them as a supersafe, yet turbocharged,

bank account.

Even the Reserve Fund, which is liquidating, reported a few days ago that, if all goes well, it expected to be able to return to investors 99 cents on the dollar. (Even if all doesn't go well, the fund expects to return 98.75 to its investors.) Not bad for a fund that supposedly "collapsed." And yet, in other ways, things aren't at all like they used to be. For starters, there is the issue of moral hazard. We now know that the money market fund industry, just like certain big banks, cannot be allowed to fail. The government will put taxpayers' money at risk, if need be, to prevent a run on money market funds. They are just too important to the system.

The Securities and Exchange Commission, meanwhile, is proposing new rules for money market funds: stricter limits on the kinds of securities they can hold, for instance, and new liquidity requirements. There is even talk of a "liquidity facility" to help the industry through another crisis.

[Paul Volcker](#), the former chairman of the Federal Reserve, told me recently that he believed that money market funds should be regulated like bank deposits since, as he pointed out, "when push came to shove, they got government support." He added, "If they are going to maintain banklike characteristics, they ought to be insured" — and regulated.

What very few people are talking about, however, is a more radical solution to the moral hazard question raised by money market funds. Maybe the right approach now is to acknowledge the truth. Money market funds are not, in fact, turbocharged bank accounts. They are investment vehicles. However "safe" the securities they invest in, they contain an element of risk. Indeed, the very reason they yield more than savings accounts is that they are riskier. That's how investing works.

So maybe, in this post-Reserve Fund world, it's time for the industry — and investors — to stop pretending that money funds are risk-free. As it turns out, there is a pretty simple way to do this. As it also turns out, the money market fund industry is dead-set against it.

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The key to the long-held perception that money market funds are akin to savings accounts is that stable \$1 "net asset value," or N.A.V. But it wasn't always that way. When money market funds were first created in the early

1970s, they had a “floating” N.A.V., just like any other kind of [mutual fund](#).

On the day a fund opened, it would be set at \$10 a share. Investors would get the numbers of shares that equaled their investment. The fund manager tried to maintain that price, but it would often fluctuate between, say, \$9.97 and \$10.03. “Most days, though, it stayed at \$10,” recalled Matthew P. Fink, the former president of the [Investment Company Institute](#), and the author of “The Rise of Mutual Funds.” But even when it didn’t, the world didn’t come to an end.

By the time money funds became truly popular, however, they did have that fixed \$1 share price. This was during the early 1980s, when interest rates had skyrocketed and money funds — unlike regulated savings accounts — offered market rates of interest. In the late 1970s, the industry had persuaded the S.E.C. to allow it to move to a stable N.A.V., which it pushed for precisely because it wanted money funds to resemble a bank account, with which they were competing. (Money funds even came with checks attached.) To accomplish this, a series of new regulations were required, one of which exempted money funds from mark-to-market accounting, while others imposed limits on the kinds of short-term securities they could hold.

I’ve always believed that the invention of money market funds was the secret key to the rise of the mutual fund industry. People flocked to them in the early 1980s because they were the only tool available to prevent middle-class savings from being eroded by inflation. Then, when the bull market began in 1982, Americans gradually moved that money into mutual funds.

But money market funds didn’t fade away, even after bank savings accounts were deregulated. Throughout their history, they offered higher yields than people could get at the bank, and even though they lacked government insurance, people used them the same way they used a bank account: as a place to park cash. The industry became so committed to the idea that money funds should serve as alternatives to bank accounts that on the rare occasions when a money fund threatened to break the buck — that is, lose a penny or two — the company that owned the fund invariably put up the cash to prevent any losses.

When the Reserve Fund broke the buck last year, it was only the second time that had ever happened. (The first time involved a much smaller fund, and had much less impact.) The industry, having built the business on the foundation of the \$1 share price, reacted in horror.

But when you think about it, the Reserve Fund didn't really "collapse." Rather, one of its securities defaulted and it lost a few pennies for its investors. It happens. The problem is that the fund industry has spent so many years training people to believe this could never happen, that they inevitably panicked when it did. And that panic, in turn, is what caused the government to rush to the rescue with its guarantees.

So yes, one way to try to solve the problem now is to make money funds "safer" than ever, largely through regulation. That is the route the S.E.C. is taking, and that the industry is encouraging. That route will continue to allow investors to believe that money funds are, essentially, higher-yielding bank accounts. It will also ensure that the moral hazard issue will never go away.

Here's the other way we could go: we could return to the floating N.A.V. There would still be rules about what kinds of securities a money market fund could hold, but it would also be a market-driven acknowledgment that money market funds were riskier than bank accounts. The proof would be the fact that the N.A.V. would occasionally fluctuate.

People who wanted absolute safety would move their money to the bank. But as the rest of us became psychologically accustomed to those fluctuations, panic would not ensue on the rare occasions when a money fund lost a penny or two. Moral hazard would be diminished.

Perhaps the most vocal proponent of this approach is Joel H. Goldberg, a former director of the S.E.C.'s division of investment management. He pointed out that one of the consequences of the new rules the S.E.C. was proposing — rules intended to protect the \$1 fixed price — was that they would inevitably diminish money fund yields, making them a less attractive alternative to bank accounts. By moving to a floating N.A.V., money funds would still be largely safe. But with somewhat fewer restrictions, they could still reap higher yields. The floating N.A.V. would be a way of saying, "With these rewards come some risks," however small.

As it happens, another person who has broached this idea is Andrew J. Donohue, known as Buddy, who has Mr. Goldberg's old job at the S.E.C. In several speeches last year, he suggested the possibility of moving to a floating N.A.V. In its recent proposals, the agency also asked for comments on the idea.

Those comments have been uniformly negative. "Over its history, a third of a quadrillion dollars — \$330

trillion — has moved through money market funds with no losses,” said Paul S. Stevens, the president of the Investment Company Institute. Consumers, he said, want the stable price, and depend on it. “They don’t just value the extra yield,” he said. “They value the convenience. And they value the safety.”

What the industry really fears, of course, is that if the illusion of complete safety is shattered — an illusion it has spent so much effort in creating — the money fund industry will evaporate, as people race back to the bank. But Mr. Goldberg says he believes that most people will adjust quickly to the idea that their money fund fluctuates in price a wee bit.

I think they would too. More important, a year after Lehman weekend, it’s time to begin limiting the need for the government to always ride to the rescue. It’s time to reduce moral hazard wherever possible.

Money market funds are a pretty good place to start.

Meet Joe Nocera at nytimes.com/nocera.

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