It's Greek to Me

Understanding Money Funds' Exposure to European Banks

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What do the recent events in Greece have to do with you? If you have money invested in a money market fund (MMF), the answer may surprise you. According to a recent report by Fitch[1], MMF exposure to European banks on represents 50% of the total assets of the 10 largest prime MMFs as of May 31, 2011. The WSJ[2] reports the biggest U.S. money-market funds hold roughly $1 trillion of debt issued by big European banks, causing concern for U.S. regulators and lawmakers. Why the concern? It turns out, European banks, in particular French banks, have large exposures to Greek debt.

It's been almost three years since money market funds faced their most significant challenge to date when the Reserve Fund "broke the buck" in September 2008 and prompted investors – primary institutional investors – to withdraw about $210 billion from prime money market funds over the next two days. Only when the US government announced the third day that they would temporarily guarantee money fund balances did the broad market panic subside.[3] Still, prime MMF aggregate assets dropped $450 billion (21 percent) in the four weeks beginning on September 10.[4] While several steps have been taken to minimize the credit and liquidity risk of MMFs since September 2008, MMFs still appear to be susceptible to a loss of investor confidence and another possible "run on the bank."

So what is an investor to do? The most important step is to be aware not all MMFs are the same. While commoditization of the MMF industry has occurred over the years, there still are important differences in terms of what MMFs choose to invest in. While it may take a trained eye to see these differences, differences do exist if one looks carefully enough. However, there are some simple ways to glean important information about portfolio risk without digging into all the details. One proxy for portfolio risk appears to be yield. According to a Federal Reserve staff working paper[5], "empirical evidence suggests that gross yield, especially leading up to the run in 2008, was predominantly an indicator of portfolio risk." So it turns out that by avoiding MMFs with the highest yields may be a simple way to help investors steer clear of MMFs that have higher portfolio risk. Basically, as a MMF fund investor, you should perform the same due diligence you would on any other investment.

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[1] Fitch Ratings, U.S. Money Fund Exposure to European Banks Remains Significant, June 21, 2011
[2] Wall Street Journal, "Unease Rises Over Funds", June 22, 2011
[3] Investment Company Institute, Report of the Money Market Working Group: Submitted to the Board of Governors of the Investment Company Institute, March 17, 2009
[4] Patrick E. McCab, "The Cross Section of Money Market Fund Risks and Financial Crises", Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C.
[5] Op. cit., McCab.