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Muni Money Market Funds Decimated by Rules Intended to Save Them.

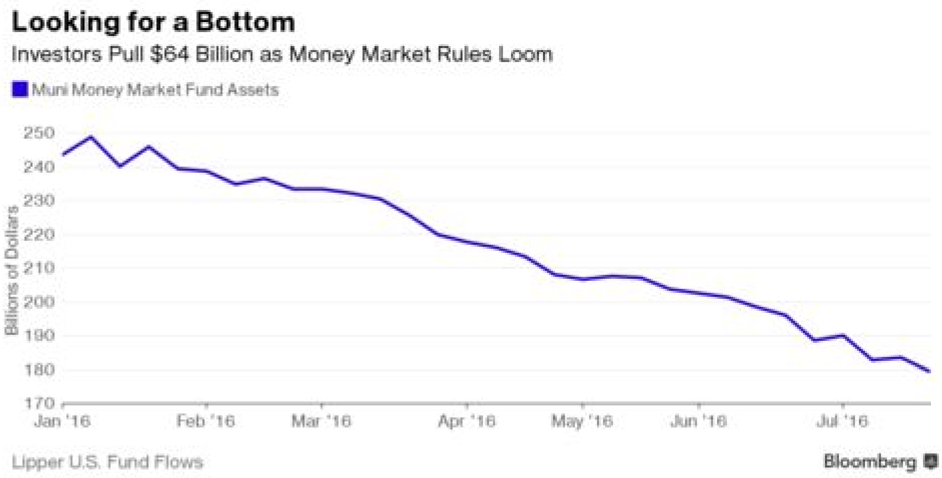
Municipal money market funds are hemorrhaging cash in advance of rules aimed at reducing the risk of runs on the pools.

Assets have plunged $64 billion since the beginning of the year to the lowest levels since 1999 as investors pulled money from tax-exempt funds in 25 of the last 30 weeks and shifted into ones that buy only government debt. These government-only funds are exempt from Securities and Exchange Commission rules effective in October that require floating net-asset values and impose liquidity fees and redemption suspensions under certain conditions.

The new regulations are adding more pain to funds that have been plagued by seven years of the Federal Reserve's zero interest-rate policy.

"They're in danger of going extinct, especially if you don't get a rate hike anytime in the next couple of years," said Peter Crane, president of Westborough, Massachusetts-based Crane Data LLC. "Municipal money market funds lobbied hard to get an exemption from the SEC's rules, but the SEC threw them under the bus."

Ryan White, a spokesman for the SEC, declined to comment.



In 2014, the SEC adopted new money-market rules after a four-year debate between the fund industry and regulators. The rules were aimed at preventing a repeat of the run on one money fund during the 2008 credit crisis. The $62.5 billion taxable Reserve Primary fund "broke the buck" because of losses on Lehman Brothers Holdings Inc. debt it held. The fund's move to reprice shares below $1 sowed panic among investors, who pulled $310 billion from money funds in a single week, helping freeze credit markets.

Under SEC rules taking effect Oct. 14, municipal-money funds whose investors are institutions, including municipalities such as Los Angeles, must abandon their $1 per-share value and allow their prices to float. Retail tax-exempt funds can keep a stable $1 per-share fixed price.

In addition, both institutional and retail funds may impose liquidity fees and suspend redemptions if weekly liquid assets fall below 30 percent of total assets. If weekly liquidity falls below 10 percent, money market funds must impose a 1 percent liquidity fee, unless the board decides it's not in the fund's best interest.

The changes don't apply to Treasury and government-only funds.

Liquidity Situation

The rules shocked muni money fund managers. The historical average for seven-day liquidity has been between 70 percent and 80 percent for decades, said Mary Jo Ochson, who oversees $14.7 billion in tax-exempt money funds at Pittsburgh-based Federated Investors Inc. The funds, which invest in highly rated short-term debt, remained liquid during the financial crisis, she said.

"You don't have a liquidity situation in these funds, they're extremely high quality," Ochson said. In the financial crisis "they did exactly what a cash vehicle should do, but are being hit very hard."

The SEC said tax-exempt money market funds have greater credit and liquidity risks than government funds.
Municipal money market funds managed $179.4 billion as of July 27, a 26 percent decline since the beginning of the year, according to Lipper U.S. Fund Flows data. In 2008 they had more than $500 billion.

Colleen Meehan, who manages about $6 billion of muni money market funds at Dreyfus Corp., said investors are balking at the prospect of liquidity fees and redemption gates. In June, UBS Asset Management said it would transfer money in its tax-exempt sweep funds to a government money fund.

Rate Environment

"It's a lot easier for people to just move out of these other products into government-only funds until they address what their concerns are" from both a compliance and systems standpoint, Meehan said. The Fed's zero-interest rate policy hasn't helped.

Between Oct. 21, 2015, and March 2, 2016, the yield on short-term municipal bonds was 0.01 percent. The average yield over the past seven years is 0.15 percent.

"Tax exemptions don't help you if there's no income to tax," said Crane.

In March, yields shot to 0.40 percentage points as investors sold shares to pay income tax bills, and new money didn't flow back. It currently stands at 0.44 percentage points, the highest in more than seven years and 90 percent of 1-month Libor, the taxable-rate.

As a result, it costs more for states, cities, hospitals and other non-profits to borrow in the short-term market.

While fund outflows in the first quarter could be attributed to the rate environment, the money investors pulled since March has been a result of coming money market changes, said Ochson.

"We're cheap as can be now," she said. "Rates are attractive, liquidity is high, the funds couldn't look any better if you tried, however you have money market regulations that have certain features that clients don't like."

Tax-exempt money funds won't go the way of the dodo, an extinct flightless bird native to the island of Mauritius, but the industry will be much smaller, both Ochson and Meehan said. It will take time for investors to get more comfortable with floating net asset values and realize the probability that the funds having weekly liquid assets fall below 30 percent is very small.

"We're going to be attractive to similar taxable products," said Meehan. "And maybe someday we'll be in a normal rate environment when it will really make sense."

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