Fear of Gate Closing

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The late US ambassador to Western Europe, Martin J. Hillenbrand, once used a German word, one of the longest in the German language, which was something like "Angstvordemtorschließen," to describe a rush to the exit. That is what was experienced in institutional money market funds last week when Lehman Brothers failed. Large holders of money market shares tried to get out before the losses were booked and in the process not only dumped the Lehman losses on everyone else, but also forced the distress liquidation of other money market assets, compounding the losses for those left holding the bag. The institutional money market fund concept has again been exposed as unsound.

Institutional money market funds have been exposed as banks without capital and without loss reserves. They operate under the assumption that there will never be a loss, or, if one is impending, the fund will be able to calmly run off the paper-at-risk before default occurs. That may have been true in the old days when failing companies bled slowly for weeks or months before they failed (Time), when managers of money market funds had better credit data than the investors in the money market funds (Information advantage), and when the funds could re-characterize a principal loss as a decrease in future income through arrangements with the dealer network (Illusions). But, those times are long gone. Bloomberg machines and the internet have destroyed Time, Information advantage, and the ability to maintain Illusions.

When something like the Lehman Brothers default occurs, to protect all of the shareholders, a money market fund should be allowed (required?) to immediately restrict a percentage of everyone's shares equivalent to the amount of defaulted paper. Those restricted shares would be redeemable only against actual recoveries. The alternatives would be either to immediately "break the buck" for everyone and restrict withdrawals, recognizing that a loss has occurred, or to require all money market funds to have capital and loss reserves, like a money market bank.

Another problem was recognized after the Lehman default. We experienced another "Herstatt problem." At the close of business in London on September 12, Lehman swept all of the London operation's cash to New York, as was customary. The customary return of cash to the London markets on September 15 did not occur because Lehman filed for bankruptcy before it could. That left creditors in London with nothing against their claims. That is not just an unfortunate event for those creditors. It exposes the same kind of structural problem in the global capital markets that existed in the global banking markets prior to the Herstatt Bank failure. If it is not solved, there will be considerably less scope for trust and efficiency in the global capital markets. National capital market regulators will restrict the movement of funds. International investment banks need something like the CLS Bank that was developed to solve the Herstatt problem.