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U.S. Money Funds' European Peril: Banks

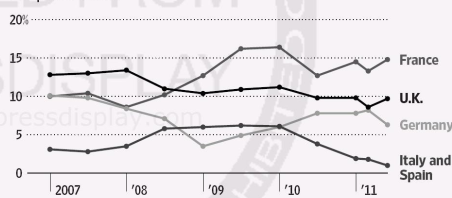
BY MARY PILON AND JON HILSENRATH

As Greece scrambles to avoid default, some U.S. regulators and lawmakers are concerned about money-market mutual funds' exposure to European banks.

While the biggest U.S. money funds have minimal direct holdings of Greek government debt, they hold roughly $1 trillion of debt issued by big European banks such as **BNP Paribas** SA, **Barclays** PLC and **Deutsche Bank** AG, according to industry analysts. And those banks hold piles of Greek and other European government bonds, exposing them to large potential losses if the European sovereign-debt crisis takes a turn for the worse.

The worry is that a default in Greece or other trouble spots like Portugal or Spain could cascade into a broader crisis, weakening the banks and subjecting money funds that hold those banks' debt to potential losses. Such a scenario would represent the market's biggest challenge since 2008, when the collapse of **Lehman Brothers Holdings** Inc. sparked a run on the world's largest money fund, **Reserve Primary Fund**.

Money funds are critical cogs in the global financial system, residing everywhere from individual U.S. investors' retirement savings accounts to the balance sheets of some of the largest financial institutions in the world. Investors view money funds as higher-yielding alternatives to bank deposits that can be accessed quickly. Money funds are considered less risky than traditional stock or bond mutual funds.



As of the end of May, half of all U.S. prime money-fund assets were invested in European banks, according to a report Tuesday by Fitch Ratings. About a third of the 10 largest prime money-market funds are in French, German and U.K. banks, according to Fitch.

A prime fund typically invests in high-grade corporate debt, as opposed to government securities.

Some Securities and Exchange Commission officials are worried about the situation, while the Federal Reserve is monitoring it closely, said people familiar with the matter. The House Committee on Financial Services will hold a hearing Friday with industry leaders to discuss the financial stability of mutual funds.

"For the U.S. markets, Europe is much more psychological," said Rep. David Schweikert (R., Ariz.), who serves on the committee. "We're starting to see people pay attention to sovereign debt."

Money managers said the chances of another major crisis are slim. Moody's Investors Service last week warned it might downgrade the long-term debt of French banks BNP Paribas, **Crédit Agricole** SA and **Société Générale** SA. All three are vulnerable to Greece and other European governments. But money funds hold short-term notes that weren't included in the downgrade warning.

In addition, some funds have been pulling away from weak European countries such as Greece and Portugal for months. Among those with low or no exposure to those countries are some managed by **J.P. Morgan Chase** & Co. and **State Street** Corp.

"Today's money funds are in a far better position to weather the kind of problems we saw in fall 2008," said Paul Stevens, chief executive of the Investment Company Institute, a trade group for the mutual-fund industry. "The data we see suggests that there's been a natural pulling away from the most concerning areas such as Portugal, Ireland, Spain and the like."

J.P. Morgan controls one of the largest prime money funds in the U.S., with about $130 billion in assets, according to Morningstar Inc. **Vanguard Group** Inc. and **Fidelity Investments** Inc. run funds with $110.6 billion and $77.6 billion in assets, respectively. All told, money funds hold about $2.7 trillion in assets, with 60% of the total in prime money-market funds, according to Peter Crane, president of Crane Data, which tracks money-market funds.

To generate higher yields, money funds sometimes stray from ultra-safe investments such as Treasury securities. Prime funds are among the biggest buyers of short-term debt known as commercial paper, which companies typically issue to cover short-term financing needs such as payroll expenses.

When Lehman collapsed in 2008, the Reserve Primary Fund suffered losses on Lehman paper, and investors fled. The fund "broke the buck" as its net asset value fell below the $1 a share that money funds seek to maintain. For several days, the commercial-paper market, the lifeblood of global corporate finance, virtually halted.

In the wake of that blowup, the Fed created special lending programs to backstop money funds, and made dollars available to foreign central banks, which lent the money to banks in their regions.

The SEC has since required funds to release monthly snapshots of their "shadow prices," which reflect the actual market value of their holdings, as opposed to the nominal $1 price at which shares are bought and sold. The SEC also issued rules that require funds to hold more-liquid, higher-quality assets.

Critics said the SEC moves haven't gone far enough, and worry that the European situation could result in a new round of losses for investors.

Already, low interest rates effectively have encouraged fund managers to move into higher-yielding but riskier debt such as that of European banks.

"There's been nowhere else to go [but Europe]," said Mr. Crane.

Money funds' exposure mostly is limited to European banks with U.S. subsidiaries.

Those banks do business in the U.S. but don't have a deposit base here, so they turn to money funds for access to dollars.

That was a fault line during the financial crisis. European banks had trouble tapping dollars, which pushed up their cost of borrowing in short-term money markets.

At the peak in December 2008, the Fed pumped more than $600 billion through programs designed to keep European banks making loans.

Fed officials have credited the lending program with helping to ease the crisis. The borrowing facilities barely have been used lately, but they could be tapped by the Fed and the European Central Bank if new money-market stresses emerge.

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