MONEY MARKET FUNDS: A CASE STUDY OF THE CONSEQUENCES OF COMPETITION

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I appreciate being asked to speak to you today about money market funds. Perhaps I am unique among those in attendance at this conference in that, despite my deep interest in the affairs of financial institutions and because I have been on the public payroll (in one form or another) for nine years, I have not accumulated any savings. Other than indirectly through retirement plans which have been administered for me, I have never invested in the shares of a money market fund, purchased a certificate of deposit, or made a premium payment for a deferred annuity. Whatever that may say about the inadequacies of my personal experience as a consumer of the goods and services offered by financial institutions, and in keeping with the classic definition of an expert as "someone who knows more and more about less and less," my assignment for today's session is to describe the regulatory framework applicable to money market funds.

A Brief Diversion in Economic History

To place the development of money market funds in context, it may be useful to retrace briefly the economic history of banking legislation. Between 1929 and 1933, bank failures, to some extent the expansion of branch banking by national banks, and surely the ability of investors to get a better rate of return elsewhere (principally in the soaring securities markets), left those banks which survived in a precarious posture facing a serious liquidity crisis. Accordingly, President Franklin D. Roosevelt, nine days after his Inauguration, imposed the famous Bank Holidays and Congress hurriedly passed legislation intended to ameliorate the crisis. The Banking Act of 1933 contained new powers for the Federal Reserve Board respecting extension of credit and membership, and established the Federal Deposit Insurance Corporation to insure qualified banks. The Reconstruction Finance Corporation, previously created in 1932, was empowered to make loans directly to banks and insurance companies; ultimately, it advanced over $2.9 billion.

Having placed a safety net beneath bank depositors, authorized regulatory controls over the extension of credit, and provided for the direct infusion of cash, Congress rounded out the so-called Glass-Steagall Act by prohibiting the payment of interest on demand deposits, by raising the minimum capital requirement for national banks, and by prohibiting commercial banks from operating security affiliates. In 1935, Congress empowered the Federal Reserve Board to impose reserve requirements for time and savings deposits held by member banks. In failing during this critical period to require all banks to become members of the Federal Reserve System, Congress perpetuated the so-called dual banking system, but with a new federal superstructure intended to control the critical aspects of banking without displacing existing state regulatory authority and supervisory responsibility over state-chartered banks.

Banks and thrift institutions compete for savings by offering to the consumer virtually identical or homogenous products: various demand, time, and savings deposit accounts. One way of looking at aspects of the New Deal-era banking legislation is to view Congress, to prevent bank failures and to thwart the excesses which it believed caused the Great Depression, as imposing on depository institutions an involuntary type of cartel arrangement, including dividing markets geographically and setting maximum fixed prices on the products to be sold. Similarly, the forced separation of commercial and investment banking, using the function of taking deposits as the litmus test, can be viewed as correlative Congressional action designed to limit competition by requiring product differentiation, again in the name of preventing undue speculation and other abuses with other people's money.

Concomitant with the political implications of the decline and fall of the Holy Roman Empire, classic economic theory teaches us that all cartels involving undifferentiated products are doomed inevitably to failure. First, all the participants must be permanently satisfied with the sales potential of the territory each was allocated. Second, all persons who are potentially capable of offering similar goods and services must be forced to join the cartel. Third, each of the participants must bear reasonably similar costs in constructing the product, so that the relative profitability each derives from the cartel-wide fixed sales price is comparable. Economists believe ambitious members of a cartel, in any event, will attempt to maximize profits, by finding ways to reduce the cost of constructing the product or by selling more products, until the marginal costs of production equal the marginal revenues to be derived therefrom. In this instance, individual depository institutions vied with each other by erecting a retail outlet on each corner within their balkanized territory, and by offering discounts from the fixed interest rate ceilings in the form of premiums (such as toaster ovens),finder's fees, and free services. In other words, they simply behaved like respectable, profit-maximizing companies in other industries and attempted to saturate their territory (if not to reach out to new territories beyond it) and to undercut the fixed sales price at every available opportunity. Nonetheless, there will always be some cartel members who are satisfied with their geographic boundaries and relative profitability, and simply choose to accept the benefits of fixed sales prices and eschew the risks and turmoil that accompany competition. In capsule form, that is a broad overview of how the banking and thrift industries attracted deposits during the first forty years after the New Deal legislation was passed.

A cartel will disintegrate most rapidly when challenged by a person who can exist (with a competitive product) outside the cartel's various restraints. The money market fund, a bastard offspring of seemingly limitless computer processing capability and of the marketing savvy of people who were used to the process of selling to the public shares in investment companies, was the competitive, differentiated product which exploited to the fullest the two most important legal limitations Congress had imposed on depository institutions. First, because the purchase of shares in investment companies has always been considered an entrepreneurial activity carrying some real risks, the price-fixing mechanism in Federal Reserve Board Regulation Q (which is keyed to the concept of a "deposit") was not applicable. Indeed, as little as eighteen months ago, when the phenomenon of money market funds was plainly evident, Congress again in the Depository Institutions Deregulation and Monetary Control Act followed conventional wisdom in basing the phase-out of federally administered interest rate ceilings on the definition of "deposit". Second, because the sponsors of money market funds were investment bankers selling shares in investment companies, the geographic restrictions enshrined in the McFadden Act and the so-called Douglas Amendment to the Bank Holding Company Act were not applicable. Thus, a money market fund could engage in sales efforts on an interstate basis and offer a fluctuating return on its shares which reflected the rhythm of the underlying money markets. In terms of product differentiation, and despite all the nice legal distinctions, owning shares in a money market fund apparently is perceived by the public as bearing relatively little risk of loss as compared to holding federally-insured certificates of deposit issued by depository institutions, at least where there is a difference of several hundred basis points in the yield.

Regulation of Money Market Funds

Money market funds are registered investment companies which make continuous offerings of redeemable shares to the public, and stand ready to sell and redeem those shares daily. In issuing their shares to the public, money market funds must comply with the full disclosure and prospectus delivery requirements of the Securities Act of 1933. Shares of a money market fund represent equity ownership interests and the return from the money market fund's portfolio investments (net after expenses) is distributed to its shareholders in the form of dividends. A money market fund differs from the classic mutual fund only in that money market funds invest solely in short-term debt obligations (including U.S. Treasury bills and notes, certificates of deposit, bankers' acceptances, and commercial paper), and they declare dividends daily. The most innovative development of money market funds as a type of investment company has been to seek to maintain a stable net asset value, permitting investors to purchase and redeem shares with reference to the same base point of $1.00, and to calculate the return on their investment in a simple, direct manner.

The money market fund itself is registered and regulated under the Investment Company Act of 1940, which is administered by the SEC. That statute provides a detailed, pervasive regulatory scheme governing all investment company operations. Specifically, in their registration statement investment companies must recite, and strictly observe, their investment objectives and fundamental policies. The investment adviser to an investment company must serve pursuant to a written contract which has been approved by a majority of the shareholders of the investment company, which precisely describes all compensation to be paid, and which continues in effect for not more than two years unless reapproved in a specific manner. Interestingly, the investment advisory contract must permit an investment company's board of directors to terminate the contract without penalty on not more than 60 days' written notice. Directors of an investment company play a very important role in resolving conflicts of interest and, by statute, at least 40 percent of the board must be independent; that is, they must be persons who have no adverse financial interest in the affairs of the investment company. Conflicts of interest are broadly prohibited in that persons affiliated with the investment company, directly or indirectly, cannot deal with the investment company except in situations identified in SEC rules where the opportunity for overreaching is remote or where the disinterested directors have reviewed and approved in advance the specific transaction that is being proposed. To reduce the risks inherent in all leveraging arrangements, open-end investment companies are prohibited from issuing any senior securities, and are permitted to borrow from banks only to a very limited degree. Also, pyramiding is effectively prohibited by making it unlawful (except in a de minimis amount) for investment companies to own the shares of another investment company. Investment companies are required to price all of their assets at least once daily in order to calculate the current net asset value attributable to each outstanding share. Because an investment company's assets consist primarily of highly liquid securities, all securities and other assets must be deposited with a qualified custodian and, to protect against larceny or embezzlement, all persons with access to an investment company's assets must be covered by a fidelity bond. Many investment companies also maintain errors and omissions policies to protect against other risks. Investment companies are required to adopt a code of ethics respecting the securities trading activities of all persons with access to or knowledge of the investment company's own portfolio trades and trading plans. Investment companies must maintain specified books and records relating to their investments, shareholder accounts, and other operational data, all of which is subject to periodic inspection by the SEC staff. Finally, the investment company's investment adviser, officers, and directors are charged with high fiduciary duties in the execution of their respective functions, especially with respect to the investment advisory fee, and courts have implied private rights of action so that shareholders may bring derivative or class action litigation to vindicate any alleged abuses.

That, in summary, is the regulatory framework within which money market funds must operate. With all respect to those who decry the intrusive nature of state and Federal bank regulation, it is well-recognized that there is no financial institution whose normal business affairs are subject to more detailed regulation, and public and private oversight, than the registered investment company. During the question-and-answer portion of this afternoon's program, I would be pleased to discuss these points further, or to describe the particular SEC regulatory efforts which have been aimed at the somewhat unique operational interests of money market funds, including: valuation and pricing of portfolio securities to maintain a stable net asset value; time of pricing; use of financial futures; restrictions on advertising and sales literature; yield quotations; and custodial requirements.

Inspections of Money Market Funds

Needless to say, the SEC was not unaware of the dramatic growth of the money market fund industry. The SEC staff has scheduled and completed several industry-wide inspection programs for money market funds. Those inspections revealed a few isolated problems: some transfer agents were having difficulty processing huge influxes of orders, and several money market funds were using improper asset valuation policies. Three SEC enforcement actions have been brought against money market funds, two involving serious "back office" problems and one involving grossly improper asset valuation policies. Finally, two money market funds have had difficulties in which SEC investigations may not yet have been concluded. In one case, an institutionally oriented money market fund seriously overvalued its securities portfolio, causing its investment adviser and distributor to take various actions costing them over $5 million to restore the principal. In the other case, a retail money market fund had $1.5 million embezzled from it through fraudulent redemptions; that loss possibly has been fully insured through fidelity bonding and has been fully guaranteed by the fund's investment adviser. To summarize, during a short period of enormously rapid growth, money market fund investors have experienced relatively minor difficulties, and there have been no serious frauds or abuses extending beyond the isolated incidents which provoked enforcement proceedings.

I believe money market funds presently are subject to a proven, complex regulatory framework which has been thoroughly and repeatedly tested with respect to registered investment companies for the past forty years, and with reference to money market funds during the past decade. When at the SEC, I frequently asserted that the very rigor of the Investment Company Act and the SEC's evenhanded enforcement of its provisions had materially aided the sales efforts of the money market fund industry. I see scant evidence of scandal or serious abuse, or for the need for further, new investor protections.

Pending Public Policy Questions

Several proposals currently are being advanced which may be of particular interest to you. First, many of your states have been asked to treat money market funds, and particularly those utilizing a check-writing arrangement to effect redemptions, as a depository institution subject to reserve requirements. One way of viewing this proposal is as an attempt by disgruntled cartel members to reestablish at least the sales price-fixing aspects of their cartel on non-members, using fallow reserves to force down the yield on money market funds to a point where the public could be expected to transfer their savings back to conventional depository arrangements. Under the rubric of helping "housing," those advocating this proposal want depository institutions to be able to return to the days when savers, large and small, are paid less than the market rate. It is textbook economics that any such shelter from competition surely will come at the expense of savers or taxpayers or both. Nor is there persuasive evidence that government-administered interest rate ceilings on deposits causally result in cheaper home mortgages. For example, banks are permitted unfettered judgment in the credit allocation function and they have long been a minor presence in the housing debt market because shorter term commercial loans are more lucrative. As their powers have been expanded (they now include purchasing consumer loans, commercial paper, and corporate debt securities), thrift institutions also can be expected to prefer shorter term assets.

On the substance, moreover, there really is little to the argument that money market funds need reserve requirements. As you know, depository institutions use deposits as leverage in making loans. Reserve requirements are a powerful, blunt tool used by the Federal Reserve Board in its Regulation D to control the creation of credit. But money market funds do not create credit: there is no multiplier effect when savings dollars used to buy money market fund shares are pooled for administrative convenience to buy money market instruments. And much of the "average" money market fund's assets consist of government securities, government-guaranteed securities, and securities issued by banks, against which it is at least redundant to impose reserve requirements. It is true, however, that the explosive growth of money market funds has transferred from commercial banks (making decisions in private) to money market fund managers (making decisions in public) much of the short-term credit allocation function. Interestingly, there has been no outcry from those selling (or wishing to sell) short-term securities into this marketplace that this shift in the credit allocation function has caused credit allocation to be inefficient, skewed, or otherwise distorted. To me, the case for reserves on money market funds falls very short of being persuasive.

The second proposal is the All Savers certificate now in pending Senate and House tax bills. The interest rate on the All Savers certificate would be pegged at 70% of the rate on a one-year Treasury bill, or about 10 ½% today. The Savings and Loan Foundation advertisements laud this new certificate of deposit, the first $1000 of interest on which would be tax-free, as a FAIR tax cut, "one of the most significant economic moves of the last 50 years." By the way, FAIR stands for "free", "affordable", "insured", and "rewarding". Critics of the All Savers certificate have said:

(1) "[N]othing [in the tax legislation] is quite so outrageous…" Hobart Rowan, Washington Post, July 5, 1981; and

(2) "[A] foolish piece of legislation: hideously expensive, badly designed even for the special purposes for which it is intended…. [T]hese certificates [are] distortionary, inefficient and extravagant." Editorial, Wall Street Journal, June 29, 1981.

John Chapoton, Assistant Secretary of the Treasury for Tax Policy, has stated the All Savers certificate is deeply flawed, “a bad idea, a dumb idea”. The All Savers certificate even merited front page, above-the-fold treatment in a recent edition of the Sunday Washington Post, with the entire story covering over two full interior pages. The Savings and Loan Foundation’s FAIR ads are now being countered with advertisements signed by trade associations for state and local governments, and the mutual fund and securities industries. The projected revenue loss to the Federal government attributable to All Savers certificates has been estimated at $4 billion; no one has been able accurately to predict how large the adverse effect might be on the borrowing costs of state and local governments. And no one any longer suggests the All Savers certificate will contribute to any new capital formation, although it may well reallocate into depository institutions $120 billion someone else spent a lot of time and effort raising.

Most economists, I suppose, would agree that the All Savers certificate is the “significant move” that the Savings and Loan Foundation believes it is, but I suspect they might be inclined to characterize it as retrograde. One might also observe that, while the very real troubles of the thrift institutions deserve serious attention, this is not a terribly straightforward approach to longer range solutions. Indeed, the Depository Institutions Deregulation Committee, which was charged by the 1980 Depository Institutions Deregulation and Monetary Control Act with the responsibility for dismantling the Regulation Q interest rate ceiling regime, appears to have gone forward with much of their deregulatory agenda, despite law suits by the savings and loan trade associations seeking to delay the phase-out or restore the traditional 25 basis point differential favoring the thrift industry. The flap over the All Savers certificate also has deflected serious attention from the so-called “regulators’ bill”, a piece of draft legislation initiated by the Federal regulators of depository institutions calling for the removal of geographic barriers to mergers between thrift institutions (and banks), and for the possible infusion of new cash into failing depository institutions through so-called “warehousing” techniques involving depreciated home mortgages and through the FDIC and FSLIC insurance funds. To the extent the thrift industry’s woes are attributable to the ravages of inflation, the success of the Reagan

Administration's economic recovery programs are deeply important to their discrete economic viability. Ultimately, of course, depository institutions will have to engage in a broader range of short and long-term lending to corporations as well as individuals, and to undertake liabilities with longer maturities, to escape from the inflation-riddled consequences of "selling long and buying short".

CONCLUSION

Money market funds are the simplest form of financial institution, pools of capital with no purpose in life other than to invest for their shareholders. The present regulatory environment in which they operate protects investors from the classic abuses. Neither principal nor income is guaranteed against risk of loss, but both a small saver and an institutional investor are reasonably safe. Adequate legal remedies are available if and when problems occur. There are far more pernicious scams afloat in this country than the money market fund, which efficiently delivers a high yield to any investor who chooses to buy a share. A famous banker from Atlanta, a man who was proud of his country origins and his reputation for dealing with practical problems in a practical way, may have given you the best advice about money market funds you'll receive this afternoon when he said, in another context: "If it ain't broke, don't fix it."