Of Black Swans and Money Funds

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Good morning. I'm Paul Stevens, president and CEO of the Investment Company Institute, and it's my great pleasure to welcome you to our 10th annual conference devoted to the structure and operations of the equity, fixed income, and derivatives markets.

We have an outstanding program for you--and one that is quite timely, in light of the historic events that are still unfolding in global financial markets. You are in for a fascinating day-and-a-half.

These events call to mind a recent book--The Black Swan, written by Nassim Taleb. The title refers to the one-time scientific certainty that all swans were white. A certainty, that is, until early European voyagers to Australia discovered that some swans are, in fact, black.

Taleb's premise is that the human animal usually bases its behavior on what it knows, or thinks it knows, extrapolating from the comfortable realm of experience. Yet very often, events occur that diverge so sharply from that middle-of-the-bell-curve normality that no one anticipates them, although well they might. And these extraordinary occurrences--what Taleb calls "Black Swan events"--are often

the turning points that shape our history, and have far more impact than the unfolding of all that is familiar and predicted.

In the last year--and particularly in the last month--America’s financial system has been beset by unforeseen but predictable events. We could have predicted that the housing bubble would end badly, although no one could have foreseen how badly. From the freeze of the auction-rate markets to the government takeover of Fannie Mae and Freddie Mac to the disappearance of the independent investment banking giants--flocks of black swans have darkened the skies.

No part of the financial system has escaped. Today, I want to talk about the impact on money market mutual funds, which for so many years have been a steady, predictable mainstay of finance for both corporate and household America. Let me describe for you what has happened and share some insights about ICI’s efforts to protect shareholders and others who have such a large stake in the success of money market funds. And then I’ll conclude with some thoughts, some very preliminary thoughts, on how the aftermath may alter our industry.

But first, let me set the historical and economic backdrop for these recent events.

Money market funds themselves were born of a Black Swan moment--the explosive inflation of the 1970s. Rapidly rising interest rates laid waste to a banking world governed by Reg Q and its precise limits on what banks and thrifts could pay on deposit accounts. Higher rates were available in the money markets--but the price of entry was steep, because those securities traded in increments of $100,000. The mutual fund industry, ever innovative, seized the opportunity to create a product that would let individual and corporate savers tap into the those markets with minimum investments of $1,000 or less.

The SEC’s adoption of Rule 2a-7 in 1983 assured that these funds would follow strict guidelines on credit quality, maturity, diversification, and liquidity. Within these guidelines, money market funds could seek to maintain a steady $1.00-per-share net asset value. Current yields and this stable NAV became key selling points for money funds, positioning them as an excellent cash-management vehicle.

On that foundation, money market funds grew rapidly. Assets quadrupled from 1984 to 1997, when they first topped $1 trillion. And they tripled again, to $3 trillion, by 2007. As they grew, money funds became a premier cash-management product for both the corporate boardroom and that kitchen table that we hear so much about on the campaign trail. This year, America’s households entrusted money funds with almost one fifth of their short-term assets, and corporate treasurers logged almost a third of corporate assets in those funds.

But for the economy, money funds’ role on the other side of the balance sheet is even more important:

- For Corporate America--as of June, money market funds held more than 40 percent of outstanding U.S. commercial paper, the vital short-term borrowings through which companies finance payrolls, inventories, and trade.

- For state and local governments--money funds held almost one-fifth of outstanding municipal securities.
- For the U.S. Treasury--money funds held one-fifth of marketable Treasury bills.
- For brokers and bankers throughout the land--money funds held at least one-quarter of the repurchase agreements that these institutions use to maintain their liquidity.
- And for consumers, whose credit-card, home-equity, and auto loans are substantially financed by asset-backed commercial paper held by money market funds.

In sum--the $3.4 trillion in assets held by money market funds is vital fuel for the financial engines that drive the American economy.

Few people appreciate the central economic role that money market funds play. That obscurity is, in fact, a tribute to their historic success and stability. In the 25 years since Rule 2a-7 was adopted, $325 trillion have flowed in and out of money market funds. That's almost one-third of a QUADRILLION dollars. Even Washington recognizes that a quadrillion dollars is a lot of money. Yet with these enormous flows, until the events of last month, only once had money fund investors suffered any loss of principal.

Money funds' central role, however, came into focus for government authorities--particularly the Federal Reserve and the Treasury Department--when fears of rising mortgage defaults started to squeeze credit markets a year ago. We at ICI began a concerted campaign to keep these agencies, along with the SEC, informed of strains in the markets as our members experienced them.

These lines of communication proved vital in the last month. The sequence of events is well-known to everyone in this room: Fannie and Freddie went into conservatorship, Lehman Brothers went into bankruptcy, and AIG was teetering on the brink--and, on Tuesday, September 16, the Reserve Primary Fund announced that it could not pay $1.00 per share and would "break the buck." As Reserve faltered, a wave of redemptions started to sweep over money market mutual funds: Between September eleventh and September seventeenth, ICI figures show that the assets of institutional money market funds fell by $176 billion. Couple that drop with a flight to the safety of funds investing solely in government paper, and you find that assets of institutional prime money funds fell by $239 billion--almost one-quarter of a trillion dollars--in one week.

At this point, it's important to note that money funds typically are sold into two distinct markets--so distinct that funds could almost be viewed as two separate products. The larger portion--upwards of 60 percent of total assets--represents institutional accounts, cash management tools for corporations, hedge funds, and large investors. The balance represents money market funds sold to retail investors. This distinction is crucial, because the heavy flows that hammered money funds were driven largely by institutional clients. But the fact that retail money funds serve as Main Street's alternative to banks meant that Reserve's announcement brought the financial crisis home to millions of investors. That was evident in headlines such as "Beyond Wall Street, Losses Spill Over."

Even before Reserve's announcement, ICI entered into around-the-clock talks with the Fed, Treasury, and SEC. Let me express here, for myself and on behalf of our industry, our deep admiration and appreciation for the dedicated public servants at the Treasury, Fed, and SEC. Their extraordinary dedication and ingenuity was paramount as they sought ways to stem the panic that was sweeping through U.S. markets and, indeed, through markets internationally. They recognized, in this context, that the intense pressure on money funds could shut down access to short-term financing that the economy must have to function.

I am proud to say that the public officials' efforts were matched by those of the fund industry. The direct involvement of senior executives from our member firms, coupled with intense work on the part of ICI's staff, brought industry expertise and deep experience to bear as the government developed its response to these unprecedented circumstances.

The results were unveiled on Friday, September 19th. The Fed created two new conduits to pump liquidity into the money markets--one for high-quality asset-backed commercial paper held by money funds, the other for agency securities. And Treasury Secretary Hank Paulson announced a new guarantee plan for money market funds--federal insurance for investors, for the first time in the 36-year history of money market funds.

Needless to say, Treasury's guarantee program has excited a lot of interest--and stirred up quite a few misconceptions. Let me see if I can shed some light on these issues.

One important fact is this: Money market mutual funds did not ask for federal insurance for our product. We nonetheless welcomed the guarantee program, because Secretary Paulson regarded it as essential to get ahead of the unfolding crisis by bolstering confidence in money funds and preserving those funds' crucial role in the economy. As subsequent events have proved, his judgment was correct. But we also embrace his concept that the federal guarantee is a voluntary, temporary, emergency backstop. Indeed, there is a strong consensus that it should be nothing more. It is my hope, as I told several journalists on September 19th, that credit markets soon will return to normal and the guaranty program will never be called upon to pay a claim.

That's a very different picture than the one painted by bank lobbyists. They would have you believe that the money fund guarantee was devised as a means of sweeping deposits out of their vaults. They clamored for money market funds to pay FDIC-level assessments--amounts that they themselves don't pay. And they boasted, in the pages of major newspapers, of the victory they scored when Treasury announced that the guarantee would be limited to the amounts that investors held in participating funds as of September 19th.

The real story is this: It was ICI that proposed the September 19th cap. We did so to remove any opportunities for arbitrage and to prevent further disruption to the financial system. Protecting investors, not securing competitive advantage, was our sole focus.

When we proposed the September 19th cap to Treasury officials, they were surprised. When those officials shared our recommendation with bank lobbyists, they were stunned. But for us, it was simply the right thing to do.

We have continued to work closely with the Treasury to develop the specifics of the temporary guarantee program. We have kept up intense two-way communications with our members about the program, as well as the Fed's asset-backed commercial paper credit facility. We have kept government officials closely informed about industry developments and concerns. And we have worked non-stop with the media and our members to improve understanding of these fast-paced developments. We have fielded scores of press queries, providing everything from data to off-the-record guidance, and we've sent a steady stream of communications materials to our members.

So where are we now?

The record of September shows the remarkable resilience of money market funds and their sponsors. The assets of prime institutional funds fell by 30 percent, yet Reserve Management remains the only fund group to break the buck.

Retail investors continue to express confidence in money market funds: Assets rose in three of the four reporting weeks in September.

Enrollment in the Treasury guarantee program stays open until October 8th--this Wednesday--and interest is strong. On October 1, we hosted almost 1,400 fund executives, directors, operations and compliance professionals, investors, and government officials at a webinar on the program.

Money funds have found the Fed's asset-backed commercial paper credit facility very helpful in restoring liquidity to at least one segment of the commercial paper market. Through last Wednesday, the Fed's facility had extended roughly $150 billion to help remove illiquid ABCP from money funds' books.

And last week Congress passed, and President Bush signed, the Emergency Economic Stabilization Act, empowering Treasury to buy the troubled mortgage-based assets that underlie this crisis.

Yet the crucial element--free and liquid trading in the money markets--remains elusive. Our members, and other major players in these markets, still report strains, which are evident in the spreads on various securities as well.

So the immediate challenge remains: We must all work together--public sector and private; buy side and sell; funds, banks, and dealers--to find mechanisms to unfreeze these markets. To that end, we are continuing our urgent discussions with all responsible policy-makers. I am confident that once the thaw begins, it will advance rapidly.

What are the longer-term implications? Clearly, the regulatory regime established by Rule 2a-7 has proven to be flexible and resilient. But the landscape of the money market has been forever altered. We are prepared to engage in a thorough examination of how the money market can function better, and how all funds operating in that market should be regulated. That includes the money market funds now governed by Rule 2a-7.

There is no segment of our economy– and certainly no part of the financial industry--that is insulated from the consequences of the current crisis. Mutual funds are no exception. But we are no strangers to crisis, given our 70-year history. And I'm certain of this: just as in the past, we will emerge from the current crisis as the indispensable tool for millions of average investors to participate in the global securities markets.

Thank you for your time and attention.

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