

“These Great Masses of Money”: Making Money Market Funds Even More Resilient

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At the outset, let me congratulate IMMFA’s Chairman Travis Barker, your newly-appointed CEO Gail Le Coz, and all your Board for the strong leadership that your organization is demonstrating in these challenging times. I am deeply honored by your invitation to speak this evening to such a distinguished audience, including so many friends and colleagues.

Before crossing the pond, I was curious to learn more about the Merchant Taylors Company and about our venue this evening. I gather that the organization of “tailors and linen armourers of London” dates from the early Fourteenth Century, when the “good men of the trade” first sought to regulate their craft. The Royal Charter of 1503 refers to it as “The Guild of Merchant Taylors of the Fraternity of St. John the Baptist in the City of London,” but not, I think, because that saint was especially noted for his wardrobe – Matthew’s gospel reports only that John favored a garment of camel’s hair. No, it appears to be because King Richard II in 1390 authorized the members of the Company to “hold and keep in an

honest manner the feast of meat and drink on St. John Baptist's Day.”

What better place to hold and keep a feast than in this great Hall? And of course the Hall has quite a history of its own. James I dined here, as did Czar Alexander I and Frederick II of Prussia. “God save the King” was first performed here. The famed South Sea Company, the focus of a legendary financial bubble in the 18th Century, was a tenant once upon a time. And the Hall was destroyed twice—once by the Great Fire of 1666 and again by the Luftwaffe during World War II.

Royal and spiritual patronage no doubt helps—but, whatever the reason, there is comfort in the fact that a trade association and such a glorious structure can prove resilient to so much for so long a time.

Resilience—the quality of being able to thrive and succeed in the face of severe challenges—has been on all our minds of late, and the Investment Company Institute is no exception. In the wake of the worst financial crisis that we've seen in generations, it is a quality we all have come to value anew.

That's one reason why I am so confident of the future of our industry in the United States. Our mutual funds have qualities of enduring value to investors—limits on leverage, mark-to-market valuation, diversification, transparency, low costs, and strong governance. They also operate within a framework of strict regulation that is a valuable legacy of our last great financial crisis in the 1930s.

Certainly, the more than 90 million investors we serve continue to demonstrate their own strong confidence in fund investing. Our weekly tracking shows that investors started returning to stock funds in mid-March, and equity funds posted a \$6.6 billion inflow in the second week of May. And U.S. retirement savers, who make voluntary contributions to various employer-sponsored plans, have not been deterred by the market crisis: fewer than one in 25 have changed their contribution rates, and fewer than one in six have adjusted their asset allocations.

Historically, this same high confidence has been evident among money market fund investors as well. That confidence was sorely tested last fall, of course, and I would like to share with you tonight our thinking about how to make money market funds and the markets in which they invest even more resilient.

Permit me to start by invoking the memory of an illustrious Victorian who knew something about financial calamity. I refer to Walter Bagehot, the banker, essayist, and journalist. Bagehot laid down what has been called the “bedrock of policy thinking during financial emergencies.”

Recent events have led many financial experts back to Bagehot's wisdom. In a speech last year, for example, Federal Reserve Chairman Ben Bernanke quoted from Bagehot's 1873 classic, *Lombard Street*. “Credit,” Bagehot writes, “means that a certain confidence is given, and a certain trust reposed.”

Confidence and trust, of course, are key ingredients of all mutual fund investing. That's true in the U.S., the UK, and across Europe, even though our products have different features, including our money market funds. In the U.S., these funds were invented in the 1970s, at a time when high inflation was

outstripping the regulated interest rates that banks could pay. Even with their advantage in rates, money market funds had to earn the confidence of investors to persuade them to take their savings out of the familiar bank around the corner and entrust them to a faraway mutual fund sponsor.

Fortunately, money market funds met and exceeded investors' expectations. In 1983, the Securities and Exchange Commission wrote the basic structure of U.S. money market funds into a milestone regulation, known as Rule 2a-7. Over the next 25 years, nearly \$325 trillion dollars flowed in and out of U.S. money market funds without loss of principal. That's almost one third of a quadrillion dollars—five times the estimated output of all the world's economies last year.

In fact, in that quarter of a century, until September of 2008, only one fund had ever failed in its objective of maintaining a stable \$1.00 net asset value per share.

Then came the events of 2008. The credit crisis brought about an unprecedented string of failures by financial firms and government interventions, in the U.S. and Europe. The roll call of the names that have fallen into bankruptcy, takeover, or government rescue is still shocking.

No part of the global financial system was spared, including money market funds. Throughout 2008, a number of fund sponsors stepped up to support their funds. And then, last September, hard upon the failure of Lehman Brothers, the Reserve Primary Fund saw its net asset value fall below \$1.00, becoming the second U.S. money market fund in history to “break a dollar.”

The Federal Reserve and the U.S. Treasury quickly stepped in, taking several actions to shore up the money market in general and to calm money market fund investors in particular. This sequence of events has raised legitimate questions about how the money market operates and how money market funds should be regulated within that market.

Here again, I'll quote Bagehot: “I believe that our system, though curious and peculiar, may be worked safely; but if we wish so to work it, we must study it.”

So study it we did. ICI's Executive Committee formally chartered a Money Market Working Group, composed of senior industry executives, last November, to fulfill our responsibility to examine recent events and to propose ways to make money market funds even stronger.

Vanguard's Chairman, Jack Brennan, led an intensive examination of these issues. The Working Group's challenge was daunting: on the one hand, it desired to preserve the fundamental characteristics of our money market funds that have made them so valuable to investors, to issuers, and to the U.S. economy; on the other, it clearly recognized the need for changes in regulation and industry practice to make money market funds resilient against even the most adverse market conditions.

The Working Group devoted months of intense effort to its study. They sought out the opinions of a wide range of issuers, investors, money market participants and experts in the United States and

abroad. We are very grateful for the valuable insights gained from our discussions with IMMFA and from the experiences of money funds in numerous other jurisdictions around the world.

Walter Bagehot was right when he observed, “Money will not manage itself.” In that spirit, the Working Group’s report, which was completed in March, provides a blueprint for the future of this vitally important product. The Report offers new and heightened standards for the operation of money market funds in every key area, including liquidity, credit quality, maturity, client concentration, and transparency.

For example, the Working Group proposes requiring, for the first time in the history of Rule 2a-7, daily and weekly minimum liquidity requirements on money market funds.

The Working Group’s proposals would tighten limits on portfolio maturity and would increase standards for credit quality.

Significantly, the Report addresses a risk that current regulations overlook: “client risk.” The Working Group found that a money market fund’s ability to maintain liquidity is closely related to the composition and diversification of its shareholder base.

As these and numerous other recommendations are adopted, tomorrow’s money market fund investors should face even less risk. But, as Walter Bagehot wrote: “In wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them.”

So the Working Group went further, to examine ways to halt contagion and treat all investors in a fund fairly if that fund should break a dollar in a future financial crisis. They proposed that the SEC authorize money market fund boards to suspend redemptions of fund shares if a fund is facing a cascade of redemptions that it is unable to meet, and therefore must liquidate. This may not sound radical in Europe, where funds have that power already, but it is a major change from U.S. practice. The goal here, again, is to prevent a rush for the exits and treat all shareholders fairly should a fund face extraordinary pressure.

Now, ICI is not the only group that has been pondering the future of money market funds after the events of last September. No doubt you have heard some of the competing proposals, which would fundamentally alter the current regulatory or business model of American money market funds. Our Working Group found that the proposals are simply impracticable and could hurt the shareholders who depend on these funds, as well as issuers and other participants in the money market. Predictably, some of the ideas that surfaced—such as regulating these funds as if they were banks—are fading from the policy dialogue.

One idea is hanging on, however -- the notion of eliminating the stable net asset value per share that has been characteristic of U.S. money market funds since their inception. This is a matter of serious

concern, because our members tell us—and our Working Group confirmed—that the stable NAV is a crucial feature of money market funds, and a fluctuating NAV could destroy the value of the product. Because this is so important, let me take a moment to enumerate the problems with this idea.

First, investors clearly desire a fixed NAV. A recent survey of major institutional investors in money market funds found that the majority overwhelmingly rejected the idea of floating the NAV. A money fund that strives to maintain a fixed value offers innumerable investor benefits—ease of accounting and operational advantages. In the U.S., the fixed NAV simplifies a complicated tax treatment that would be required if the fund's capital gains and dividends were reported separately. And for many institutions, bylaws or investment policies require them to hold their ready cash in an instrument with a fixed value.

What is the case for ignoring those benefits and forcing a floating NAV? Critics of the fixed NAV say that institutional investors respond to the small differences that can arise between a fund's "shadow price" and the \$1.00. This response, they argue, could destabilize a fund and set off a run. There are two problems with this theory. First, our long experience shows that very few institutions behave in that way, because most investors use money market funds to seek liquidity, not to arbitrage the difference between the shadow price and the NAV. Second, we looked specifically at the experience last fall of short-term bond funds and some European funds with floating NAVs. These funds saw sizeable outflows last fall—exactly the outcome that the critics say they can prevent with floating NAVs.

Lastly, there is the factor that regulators sometimes overlook—investor choice. If investors want a fixed NAV, and they cannot get it from the U.S. funds operated under Rule 2a-7, they will look elsewhere for alternatives. And there are many alternatives that do or could offer a fixed NAV. So if regulators mandate a floating NAV for U.S. money market funds, they may well simply drive trillions of dollars into funds to be managed elsewhere, in some cases with less regulation and oversight -- hardly a desirable outcome.

While this debate continues, our Working Group's Report generally has been well received. The SEC has indicated that it will come forward with a package of proposals in June, and we look forward to working with the Commission on it.

But we are not simply waiting for regulators to act. Members of the Working Group committed their firms to move ahead voluntarily on as many proposals as they could. And ICI's Board of Governors called upon all money market funds to do the same. Reports from our members indicate that they are moving rapidly to implement these proposals.

I am happy to note that we see some return to normalcy in the money markets. For example, spreads of many money market instruments have narrowed appreciably. The spread between Libor and the overnight index swap rate has also come in substantially. And use of the Federal Reserve lending facilities targeted toward money market funds and the commercial paper market is also declining.

None of this means that we can ignore the need to make the money market and money market funds even more resilient against the next financial crisis. To the contrary, we must and will work hard with our regulators to ensure that money market funds continue to serve as the low-cost, efficient cash management tool highly valued by our investors and so beneficial to our economy. I know you have a similar objective here. In that vein, I am pleased to note that IMMFA's leadership is working with colleagues at the European Fund and Asset Management Association to develop a pan-European definition of money market funds. This is an important initiative, and we look forward to what emerges.

As we pursue these and other reforms, let me give the last word to—who else?—Walter Bagehot. In Lombard Street, he described the rapid collapse of one of the City's most prominent trading houses of the time. The lesson, he said, was clear. “[W]e must not confide too surely in long-established credit, or in firmly-rooted traditions of business,” Bagehot wrote. “We must examine the system on which these great masses of money are manipulated, and assure ourselves that it is safe and right.”

It is that large task that we are joined in together, and we at ICI look forward to working with our counterparts at IMMFA, across the EU and around the globe as we accomplish it. Thank you very much for your hospitality and your attention.

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