A World Without Money Market Funds?

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Money Market Fund Summit

Investment Company Institute

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Thank you, Ed, and good morning everyone. I want to start by thanking ICI for facilitating this forum, and really, for leading the conversation on money market fund reform for the past several years. When you think about the level of discussion and debate that has occurred among policymakers, regulators, investment companies, the media, and not least of all—the investors that we all serve—it really has been a great education for many people.

But the dialogue has been, by turns, both encouraging and frustrating. We were greatly encouraged last year, for example, when the SEC adopted improvements to Rule 2a-7, which strengthened money market fund standards for liquidity, credit quality, maturity, and transparency. But we've been frustrated more recently by some of the rhetoric calling for money market funds to essentially be turned into short-term bond funds—or banks.

We're going to have some very important discussions today. My aim this morning is to simply set the table for these discussions, and remind folks sitting on all sides of the table exactly what is at stake for money market fund investors, what is at stake for issuers of short-term debt, and what is at stake for

the U.S. economy.

At Vanguard, we have what we call a “Plain Talk” philosophy… What that means is, basically, no prospectus should be unreadable…. No investment concept should be unexplainable… and no investor should take action without fully understanding what they are getting into.

So with that communication philosophy in mind, I’m going to talk about why these funds have been so important, and then, what the world might look like without money market funds… because, make no mistake, *that* is the conversation we are having. Whether we are talking about floating NAVs or bank-like regulation or some of the other proposals we’ve heard, the issue in front of us is a choice… a choice between a world *with* money market funds… and a world *without* money market funds.

The world with money market funds

Let’s start by talking about the world *with* money market funds. That’s the world we’ve known for the past 40 years. During that span, more than *$325 trillion* have flowed into and out of these funds. [1]

And today, *1 out of every 4 Americans* (over the age of 18) owns a money market fund, as do an untold number of institutional investors.

People have come to depend on money market funds for a wide range of uses…

- Scraping together a down payment for a first home? Use a money market fund.
- Need a spending account in retirement? Use a money market fund.
- Need a sweep account for trading stocks, bonds, and mutual funds? Use a money market fund.
- Have a tuition payment due next fall? Use a money market fund.
- Need to establish a rainy day or emergency account? Use a money market fund.

This is not terribly complicated stuff. And money market funds are not terribly complicated products. In fact, they may be as close as you can come to a homogenized product in the mutual fund world. (If you look under the hood—and you can—they all look strikingly similar).

But at the same time, money market funds are *one of the most important financial innovations of the past century*. Think about what happens for the two parties on either side of the money market fund investment:

- For *investors*, these funds have provided better returns than they can receive from other types of cash management vehicles, like bank accounts.
- For *issuers*, whether you’re General Electric or the local sewer authority, these funds have provided simple, diversified sources of funding at costs lower than can be found from other sources.

I’m a bit of a science fiction devotee, and this sort of win/win situation could classify as *financial alchemy*. Generally, that’s not supposed to happen in markets like these.

So, how does it happen? How can investors and issuers (and the broader economy) all benefit? It comes down to the structure of the funds and the nature of their investments: They are short-term, transparent, very high-quality, and very low-cost. Money market funds are intermediation vehicles that serve investors and issuers at a cost measured in basis points rather than percentage points.

And it allows trillions of dollars to be recycled into the economy, providing short-term funding for school districts to meet payroll, for large corporations and small businesses to maintain inventories, and, in general, for businesses and governments to keep the lights on and keep operations running smoothly.

I have to reluctantly tip my cap to whoever co-opted the term "shadow banking system" in reference to the money markets. It's a stroke of branding genius. It sounds like something that is shady, corrupt, dangerous, and probably illegal in 34 states.

Instead, I think of the money market system as highly regulated, transparent, efficient, operating in plain daylight, and absolutely critical to the functioning of our economy.

Maybe we need to rebrand it with a new term, like the *"Bright and Sunny Economic Stability System."*

Importance to individuals

As you know, speaking broadly, there are two main types of investors in money market funds: Institutional investors and retail investors. The institutional business makes up a large and important part of the overall market. These funds have more than $1.8 trillion [2] in assets—roughly two-thirds of all assets in money market funds today.

But I'd like to spend a few moments focusing on the retail segment—the individual investors. I believe, as a representative of Vanguard and our more than 10 million clients, it's an important perspective to bring to the discussion. As you know, money market fund investors are also taxpayers… and voters… and employees… and business owners… and consumers… and people who take their personal finances very seriously.

And we've heard from them through several different channels… in conversations with clients at Vanguard… in the discussions conducted by the ICI's Money Market Fund Working Group… in comments submitted to the SEC. People value their money market funds. They recognize that these funds are different than bank accounts, and different than short-term bond funds… They value their money market funds, and the three reasons we've heard most often were *safety*, *convenience*, and *yield*. And in that order of importance: Safety, convenience, and then yield. Jack Brennan has called this the money market fund "hat trick" for investors.

1) When investors talk about *safety*, they're relying on a reputation that's been earned over the past 40 years. Investors clearly understand that money market funds are not guaranteed or insured. But they know that these funds provide the highest level of stability that can be found in any security. That reputation is based in a record of safety and stability that has withstood:

- Stock and bond market crashes
- Six recessions
- Many changes in political balances of power and Administrations
- Wild swings in short-term interest rates … (from the high teens in the early 1980s to essentially zero percent today).
- It's a reputation for safety that has withstood two setbacks over the past 40 years. The first was when a small institutional fund broke the buck in 1994. [3] The other, as we all know, occurred in the bright spotlight of one of the worst days in our financial history.
- It's a reputation for safety that has held firm as some U.S. 2,800 banks have failed over that same 40-year span. [4]
- And it's a reputation for safety that has *improved* over the decades, with the adoption of Rule 2a-7 in 1983 and improvements to that rule last year.

2) When investors say they value *convenience*, it's the ability to withdraw money, quickly and easily, through transfer or free check writing, accessible at any time. As an aggregation vehicle, money market funds also provide investors with access to types of liquid assets that are largely unavailable to most people. Money market funds are, perhaps, the very best example of the "mutual" aspect of the mutual fund industry. If you think about it: As an individual, you can open a brokerage account, buy 50 different stocks and bonds, and construct a well-diversified portfolio. It might not be very cost-effective, but you can do it. However, you cannot, as an individual, phone up General Electric and ask to purchase 7-day commercial paper. Or call your local municipality and buy variable-rate demand obligations. Without money market mutual funds, individuals would have no realistic access to these liquid markets.

3) When investors talk about *yield*, they talk about the historical income advantage that money market funds have provided over comparable banking products. Since 1985, investors in retail money market funds have been paid at least $225 billion more in returns than competing bank products [5]. It can be hard to maintain that long-term perspective at a time when money market funds are yielding zero percent, but over the past 40 years, money market funds have averaged an annual return of [6] 5.5%—compared to an average interest rate of 3.5% for bank savings accounts over that same span.

The world *without* money market funds

So I'd like to turn now from the world that we've known for the past four decades to imagine a world *without* money market funds. This is where I get to put my science fiction hat back on and talk about an alternate universe.

If the structure of these funds is significantly changed—say, by mandating excessive capital requirements or by floating the $1 share price—money market funds as we know them would disappear. And I don't believe the ramifications of "a world without money market funds" has been fully considered or understood.

- If money market funds are eliminated, investors will need to look for alternatives. It's been posited that some investors will end up in ultra-short-term bond funds (which are riskier than money market funds, and don't maintain a stable $1 share price). But the fact is, investors have shown great

preference for the stable share price offered by money market funds. The $2.7 trillion currently held in money market funds dwarfs the amount held in higher yielding short-term funds with fluctuating share prices, even as money markets are earning essentially 0% in today's low interest rate environment.

- Still, those that do elect to use ultra short-term bond funds will need to hire diligent tax accountants, because every transaction in these funds—every trade in a brokerage account, every withdrawal, every check written—could potentially be a taxable event. *The Wall Street Journal* recently dismissed this idea as "people wanting to enjoy less paperwork." With due respect to the editorial board, we don't believe they fully understand the potential havoc this will wreak for investors.
- If money market funds are eliminated, many individual investors will migrate to bank checking and saving accounts, where they will soon miss money market funds' historically higher income levels and safety record. [Again, that's 2,800 bank failures since 1971 vs. 2 money market funds that have broken the buck—at a cost of zero dollars to taxpayers [7] In fact, more banks have failed in the last two weeks (6) than have money market funds in their entire history.]
- While the choices for individuals will be limited in a world without money market funds, the cash management options for institutional investors could actually become more expansive and exotic: Unregulated offshore accounts, unregistered funds [such as 3(c)1 and 3(c)7 funds], cash pools, and other novel Wall Street products still yet to be dreamed-up.
- A world without money market funds will hurt not only lenders (money market fund investors) but also borrowers—the issuers of short-term debt. Today, money market funds finance more than half [8] of all short-term debt for state and local governments, hospitals, school districts, and sewer authorities. In the absence of municipal money market funds, borrowing will become less efficient and more expensive, and will further stretch government budgets that are already trying to do more with less.
- Borrowing will also become more difficult and potentially more expensive for corporations and small businesses that currently depend on money markets to efficiently pair borrowers and lenders each and every day. On the day after money market funds disappear, many CFOs and treasurers across the country will find themselves in line at banks to pay significantly more for loans and revolving lines of credit. Their sources of funding will become much less diversified, which will be harmful in the long run.
- A world without money market funds sounds like a bonanza for the banking system. But probably not. Yes, banks will have less competition and will be able to charge higher fees to customers and offer lower yields on interest-bearing accounts. But at the same time, banks have grown accustomed to and dependent on money market funds over the past four decades.
    - Do banks have the infrastructure and capacity to make alternative products available and add even more to their reserves at a time when they are struggling to meet new capital requirements?
    - Is the FDIC prepared to add $2.7 trillion in deposits under its umbrella?
    - And are taxpayers willing to foot the bill if these banks—now with larger FDIC-insured deposits—go bust?
- Perhaps the most troubling aspect of our world without money market funds will be the drag it will place on the overall economy. When you clog up the flow of affordable, short-term financing to companies and governments, you hamstring economic growth. Given the state of our economy, this is simply unacceptable.
- Americans will feel the squeeze from all sides: Slower job growth; higher rates on credit cards, mortgages, and car loans; higher state and local taxes; greater uncertainty and volatility in the stock and bond markets.

We take threats to the interests of our investors very seriously. I think it's better to have a *pre -mortem* analysis of the importance of money market funds rather than *post-mortem* regrets.

Close

I don't mean to sound dramatic. But this is a serious topic, and I'd ask participants on all sides of this debate to bear in mind:

- The great improvements that have been made to money market fund regulations over the years…
- … and the law of unintended consequences that could be realized with significant changes to the structural integrity of these funds.

Remember, at the end of the day, many of us in this room are stewards of other people's money. What's at stake is incredibly important to millions of investors, businesses, and the health of the overall economy.

Thank you for listening. I'm looking forward today's discussions.

endnotes

[1] Source: ICI.

[2] Source: ICI http://www.ici.org/research/stats/mmf/mm_05_12_11

[3] Community Bankers U.S. Government Money Market Fund broke a dollar in September 1994 and ultimately paid investors $0.96 per share. Reserve Primary Fund broke a dollar in September 2008. Source: Report of the

Money Market Working Group, ICI: /pdf/ppr_09_mmwg.pdf

[4] Source: FDIC: http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=1971&EndYear=2011&State=2

[5] Source: ICI.

[6] Source: ICI calculations, based on MMDA rates and MMF yields from Bank Rate Monitor and iMoneynet, respectively for the period January 1986 to April 2011. For the period, January 1971 to December 1985, ICI proxied the MMDA rate by using the passbook ceiling rate which was in effect under Reg Q and the MMF yield by using the yield on the 3-month T-bill rate.

[7] Source: http://www.fdic.gov/bank/individual/failed/banklist.html

[8] Note: 53%, as of latest ICI calculations. Source: Mike McNamee.

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