For release on delivery
Expected 10:00 A.M. E.S.T.

Statement by

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before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

January 24, 1980

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I appreciate the opportunity to appear before this Committee today to discuss questions relating to money market mutual funds. The spectacular growth of these relatively new intermediaries certainly must be regarded as one of the major financial events of the past year. The assets of money market funds are rapidly approaching the $50 billion mark, an almost five-fold increase since the end of 1978. The number of shareholder accounts over the same span has risen from about 500,000 to close to 2 million.

The substantial growth in both total assets and the number of shareholders indicates that many households, businesses, and institutional investors have elected to allocate at least a portion of their investable funds and transactions balances to money market fund accounts. For investors with limited resources, the funds are a convenient substitute for investing directly in the money market. For a management fee, the funds pass through the earnings of a diversified portfolio of large-denomination short-term investments. Diversification in such market instruments would otherwise be beyond the means or expertise of most households and many institutional investors.

The escalation of interest rates on money market obligations to levels well above the rate ceilings applicable to time and savings deposits accounts at banks and other thrift institutions has greatly enhanced the competitive position of money market mutual funds. To be sure, there would have been a substantial increase in direct market investment in any event, given the rate differentials that have prevailed. But the money market mutual funds, by offering an alternative investment tailored to customer needs, have provided the market's most successful response to deposit rate control.

Thrift institutions and many commercial banks are constrained in their capacity to pay market rates of return on all deposit liabilities because a

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substantial share of their assets, being long-term in character, carry the lower interest rate returns of the past. Indeed, the increased attractiveness to depositors of market instruments, including the shares of money market mutual funds, has led banks and thrifts to promote aggressively the money market certificate--their one short-term deposit instrument whose ceiling rate rises in tandem with 6-month Treasury bill rates. This has increased markedly the average cost of deposits, so that many depositary institutions--especially those with large mortgage portfolios--have been experiencing substantial downward pressure on their earnings margins.

Both commercial banks and thrift institutions have undoubtedly lost deposits to money market mutual funds. To be sure, large money center banks, as well as a few of the thrifts, have been able to recover some of these losses through reinvestments by the mutual funds in their large-denomination CD's and other liabilities. On net, money market fund acquisitions more than accounted for the increase in large CD balances at banks in 1979. Money market funds, however, also invest in the deposits of overseas banks and branches (Euro-dollars) and in commercial paper and other domestic money market instruments. It is impossible to assess with any precision the ultimate consequences for the distribution of credit of this re-channeling of funds flows, but one result clearly has been some net shifting of financial resources away from local credit users and away from the mortgage market.

The introduction this month of the 2-1/2 year "small saver" certificate, permitting both banks and thrifts to pay rates of return indexed to changes in market rates, should enhance the competitive position of depositary institutions, especially if short-term market rates begin to decline and if expectations of

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further declines become widespread. The effective ceiling rate is about equal to yields on comparable market instruments, and both the thrifts and banks have the advantage of a local presence. Other things equal, I am convinced that most people prefer dealing with local institutions.

In recent years, the financial regulatory agencies have taken a number of steps such as this to provide the opportunity for savers to obtain something more nearly approaching a market-determined rate of return at depositary institutions. This is admittedly a slow process, because of the earnings constraints imposed by the heritage of low rate long-term assets at many of the institutions. But I believe that our actions are quite consistent with our commitment to the gradual deregulation of maximum rates payable on deposit instruments. The extension of Regulation Q-type ceilings to money market mutual funds that some have proposed would run counter to this thrust.

To limit the yields on money market funds not only would be anti-consumer--and inconsistent with the nation's need to encourage saving--but it would also fail to recognize the inherent distinctions between deposits and money market fund shares. Deposits at federally insured institutions offer the saver assets that are absolutely free of risk of loss of principal, up to the $40,000 insurance limit per account, and that bear a fixed yield to maturity. Money market fund shares, on the other hand, are uninsured investments that offer no certainty with respect to the yield that will be earned over time. I do not want to leave the impression that there is a substantial degree of risk in money market funds--that does not appear to be the case. But they do entail some uncertainties not shared by deposits, and these should be understood by savers.

The statements of policy that money market funds must file with the SEC generally restrict their investments to high quality short-term money market instruments. There is the possibility, however, that a fund's investment in

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a particular asset could represent a large enough share of the market so as to render the securities virtually illiquid in certain circumstances. Moreover, there is some exposure to a change in capital values in the event of dramatic changes in interest rates, although this risk is not appreciable so long as average asset maturities are kept short. Portfolio maturities currently average only about 40 days, but there is no assurance that they may not lengthen in the future. Also, there is always the possibility of loss on funds assets, through defaults by commercial paper issuers or other borrowers, though this is minimized by the high quality commitment on paper held.

Money market mutual funds operate under the rules of the Securities and Exchange Commission, as stipulated by the Investment Company Act of 1940. Oversight by the SEC generally encompasses such considerations as the truthfulness of advertising, the fairness of valuation methods, and the use of legitimate investment and management practices. I presume that these and similar factors are being effectively monitored by the SEC, thus providing protection against risk of loss as a result of management impropriety.

Money market mutual funds generally allow shares to be transferred to third parties by wire and, often, by the use of check-like drafts. Shareholders thus are able to use these accounts for transactions purposes above specified minimum amounts. As substitutes in part for demand deposit checking accounts and for savings accounts, the rapid growth of the money market funds clearly has had an impact on the performance of the monetary aggregates.

Data regarding the transactions uses of money market mutual fund balances are very limited, but reported average turnover rates are relatively low--much lower than for demanddeposits and about in line with those for savings deposits. This may indicate that high minimum check sizes or check charges limit considerably the use of money market funds for transactions

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purposes. It may also be that the major portion of the amounts held in such accounts is intended for investment purposes, with only a small portion being regarded by holders as balances available to support ordinary transactions needs. In recognition of the substitutability of money market mutual fund shares for transactions and savings balances at depositary institutions, however, the Board plans to include such shares in its redefinition of the monetary aggregates to be published next month.

This brings me logically to the question of whether reserve requirements need to be applied to money market funds in order to enhance monetary control. The Board's answer at this point is that it does not appear to be a critical problem. There are, after all, a wide variety of financial instruments, having varying degrees of liquidity, that may act as substitutes for deposits. But if money market fund shares over time begin to exhibit more clearly the characteristics of transactions accounts, we may have to reconsider our position. So long as balances may be accessed by check writing or other immediate transferability features, the possibility remains that they may develop into a substitute payments system. If so, and in the context of our pressing need for a system of universal reserves on transactions balances as a means to insure effective monetary control, extension of the concept to money market mutual fund shares would then come to be in the public interest.

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