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FRBSF Weekly Letter

The Funds and their Critics

Widows and orphans, to their great delight, have suddenly found a way of tripling what they could earn on their passbook savings, simply by shifting their funds into money-market mutual funds (MMF's). Bankers and thrift-industry executives, to their great chagrin, find it difficult to match this competition because of the legacy of legislation passed almost a half-century ago. And Senate Finance Committee Chairman Jake Garn, calling the funds "legal but unfair," has announced that he'll call hearings soon to do something about the situation.

Money funds pool the money of many investors and place it in various liquid investments, such as Treasury bills, commercial paper, and bank certificates of deposit. Without pooling, those investments would be out of the reach of most small investors. But through a money fund, a small saver can earn interest at rates much higher than the maximum 5¼ percent that commercial banks can pay on traditional savings deposits—indeed, more than three times higher at recent MMF rates. And many funds also permit investors to write checks on their funds, although generally in minimum amounts of $250 to $500.

Stratospheric growth

With such advantages, money-market funds have grown stratospherically in the last two years, and especially in the last several months. A few mutual-fund firms began to offer money-market funds about a decade ago, when they saw that money-market instruments offered much higher yields than equities in a growing environment of inflation and high interest rates. Still, MMF assets barely exceeded $10 billion as late as December 1978, at which point they began to soar as the investing public responded to the growing differential between their yields and passbook-savings rates. Last week the assets of the 100-odd money funds reached $101 billion, for a 35-percent gain just since the beginning of this year.

Depository institutions are dismayed by this trend, especially in view of their difficulty competing directly with the funds. But their consumer deposits still dwarf money-fund assets in size (see chart). In January, banks and thrift institutions held about $377 billion in savings deposits, not to mention $778 billion in time deposits under $100,000.

Restrictive legislation

The present situation can be traced to the restrictive legislation of the 1930's, which developed the concepts of deposit interest-rate ceilings and the separation of investment banking from commercial banking. Congress passed the Banking Acts of 1933 and 1935, the Glass-Steagall Act of 1933, and the Securities and Exchange Act of 1934 to "establish a sound financial system." But in practice they tended to limit competition, especially bank competition, and involved increased Federal regulation of financial and banking markets. Later, as financial institutions innovated to avoid these restrictions, Congress acted to plug the loopholes—for example, by extending interest-rate ceilings to thrift institutions in 1966.

Many of these restrictions became untenable in the 1970's, however, because of high and variable interest rates, credit crunches due to deposit interest-rate ceilings, and technological changes such as computerized cash-management techniques. Banks made more intensive use of funds not subject to interest-rate ceilings, such as repurchase agreements and Eurodollar deposits. Regulators allowed institutions to offer new instruments at rates more closely tied to market rates, such as money-market certificates. Thrift institutions created new interest-paying check-like accounts, such as share drafts and NOW accounts. And money-market funds came into being as liquid, higher-yielding alternatives to bank checking and savings accounts. Congress legitimized many of these innovations by passing a landmark piece of legislation last year, which (among other things) called for the removal of all deposit interest-rate ceilings over a six-year period.

The legislative changes of the past generation did not create a "level playing field," however. The SEC, the watchdog of the investment-banking industry, applies one set of rules to mutual funds and other investment firms; various depository-institution regulators apply separate sets of rules to commercial banking and thrift-institution activities. Money-fund assets are not classified as deposits, despite their similarity to bank deposits, according to a recent Justice Department ruling. Thus the funds don't have to put aside a portion of their assets in sterile reserves, as banks and thrifts have to do with their deposits. However, during last spring's brief credit-control program, the funds became subject to a 15-percent reserve requirement on increases in their assets.

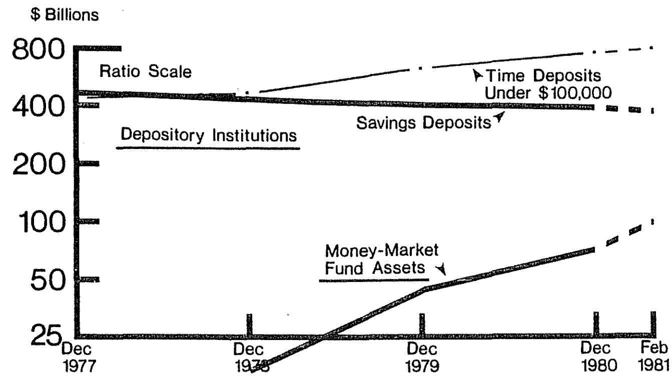
Again, because of the difference in legislative history, the funds have always been able to offer market interest rates, whereas banks and thrifts are still limited in their deposit activities—with restrictions either on their interest rates, maturities, or deposit size. And while several mutual-fund companies now own banks, banks are not permitted to own mutual-fund companies, sell securities, and underwrite municipal revenue bonds.

Legislative pressures
Against that background, the critics of the money-market funds have generated a flurry of activity in the halls of Congress and many state capitals. Iowa Congressman James Leach recently submitted a bill that would authorize the Federal Reserve to impose reserve requirements on MMF transaction (check-like) accounts. State legislatures in Alaska, Washington, Utah, Massachusetts, Georgia and Oklahoma meanwhile are discussing legislation that would restrict MMF activities in various ways—for example, by credit-allocation requirements that funds invest a specific portion of their assets in states where they have account holders. The Massachusetts bill, for example, would have required a Community Reinvestment Act-type of disclosure of MMF local investments.

The Illinois legislature is considering a bill that would authorize banks to offer money-market funds, although this could conflict with Glass-Steagall provisions separating commercial from investment banking. In this connection, the Supreme Court ruled in 1971 against a commercial bank which had set up a commingled mutual fund of the type now being considered, although that approach would have involved investment in equities rather than money-market instruments. In addition, the Washington legislature is considering a bill that would permit state-chartered financial institutions to set up special money-market time accounts supported by equal amounts of segregated assets. Under this plan, each account holder would be paid interest at a rate based on the yields of the particular investments supporting the account.

In another approach, the Utah legislature considered (and narrowly defeated) a bill calling for state regulation of funds offering check-like services. This would have required the licensing of funds "to help assure that checks will be paid upon presentation," and would have required that checks drawn upon fund accounts be "two party," that is, payable only to the investor himself. In other words, this legislation would have prohibited the third-party payments which are characteristic of transaction accounts in depository institutions. Separately, an Oklahoma legislator introduced legislation that would require money funds to advertise that their assets are not insured, as deposits are.

Funds' defense
The mutual-fund industry is now fighting back, in the press and in the halls of Congress and the various state legislatures. (In fact, some funds are encouraging their customers to write their Congressmen, recog-



nizing that more than five million satisfied customers could represent a potent lobbying force.) The funds argue, in effect, that they are not competing unfairly, and that depository institutions could obtain ample funds if they offered the large time certificates that the funds buy.

Regarding checking-account privileges—a sore point with the competition—the funds argue that the privilege is rarely used. Most funds stipulate a minimum of $500 per check, and the average holder draws no more than two or three checks a year. Regarding their lack of insured status, the funds claim that they are indeed quite safe, and that no one has ever lost a penny in them. The average maturity of the investments is now around 30 days, and some average a week or less, so that the funds are largely protected against capital losses when interest rates rise.

Fund executives also deny that they are harming depository institutions by their growth. They note that most of the money in the funds is in relatively large accounts, with nearly half of all MMF shares held by institutions. The average fund-holding is about $15,000, and the vast bulk of fund shares is in accounts of $10,000 or more. Thus, money of this type can easily move into Treasury bills or other instruments requiring miminum investments of $10,000 or more—and would not tend to stay anyway with banks or thrifts.

While agreeing that some fund shares may be bought with funds withdrawn from depository institutions, money-fund spokesmen also note that almost one-half of their assets are invested in depository-institution debt obligations, such as large time certificates and bankers acceptances. Smaller banks and thrifts claim that the funds siphon off their deposits into large money-center banks, but the MMF's claim in rebuttal that they are simply operating in conformance with SEC regulations. Some observers claim that with a liberalization of those regulations, the funds would channel more funds back into smaller communities.

Regulatory response?

In light of such conflicting claims about the MMF phenomenon, what can hard-pressed legislators and regulators do? One approach would be to reverse the deregulation trend, primarily by imposing reserve requirements on the funds similar to those imposed on their competitors. This raises the question of whether MMF shares are held as savings or as transaction balances. In the former case—individual shares—the relevant reserve requirement would be small or even zero. But in the latter case—institutional accounts—the requirement would be somewhat larger.

A second approach would be to speed up the deregulation trend and widen the opportunities for banks and thrifts to compete with money-market funds. The Depository Institutions Deregulation Committee, set up to implement last year's financial legislation, has some flexibility in this regard—but the committee has already been attacked by some thrift-industry spokesmen for moving too fast in deregulating deposit interest rates. Another possibility would be to permit depository institutions to set up their own money-market funds, through a revision of Glass-Steagall restrictions on such activities. (A bill of that type got through the Senate as far back as 1969.) Banker groups are now proposing a bill that would amend Glass-Steagall to permit banks, bank holding companies, and S & L's to create or operate investment companies, such as money-market or equity funds.

With such changes, banks and thrifts could carve out a niche for themselves in a fast-growing field. Otherwise, the money funds would have a clear field for further growth in today's environment of inflation and high interest rates—especially as the current debate continues and more widows and orphans learn of their advantages.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/4/81	Change from 2/25/81	Change from year ago Dollar	 Percent
Loans (gross, adjusted) and investments*	146,888	443	8,503	6.1
Loans (gross, adjusted) — total#	124,512	437	8,241	7.1
Commercial and industrial	36,794	170	2,580	7.5
Real estate	51,236	92	6,389	14.2
Loans to individuals	23,528	– 40	– 963	– 3.9
Securities loans	1,389	152	259	22.9
U.S. Treasury securities*	6,690	1	– 15	– 0.2
Other securities*	15,686	5	277	1.8
Demand deposits — total#	42,616	3,454	– 2,041	– 4.6
Demand deposits — adjusted	29,324	1,651	– 2,188	– 6.9
Savings deposits — total	29,892	665	2,015	7.2
Time deposits — total#	76,571	– 767	16,725	27.9
Individuals, part. & corp.	67,415	– 475	16,218	31.7
(Large negotiable CD's)	29,449	– 387	8,120	38.1

Weekly Averages of Daily Figures	Week ended 3/4/81	Week ended 2/25/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	66
Borrowings	35	87	250
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 184

* Excludes trading account securities.
\# Includes items not shown separately.

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