On Floating Net Asset Values of Money Market Funds: Will The Curtain Rise?

Abstract

Our recent participation at the Securities and Exchange Commission ("SEC")[1] roundtable discussion on money market funds and systemic risk gave us the impression that the government is moving closer to a policy draft on money market fund reform. Despite overwhelming complaints, the floating net asset value ("NAV") approach remains a top choice for the regulators. The industry's leading solution of a liquidity facility faces internal skepticism and possible failure in receiving government backstop liquidity. Although elegant and simple from a theoretical angle, the floating NAV approach requires the government to address asset flight risk, loss of short-term funding concerns, and the shift of systemic risk to the banking system. We propose that, should the government adopt such an approach, temporary liquidity and lending facilities are necessary to minimize market disruptions. We further propose a two-tier system with "risk-less" government funds receiving stable NAV treatment. Regardless of the policy outcome, corporate and institutional investors should choose funds less prone to run risk, remain calm during the transitional period, and formulate long-term plans based on likely paths before government decisions are handed down.

Introduction

On May 10, 2011, we were honored to participate in the Money Market Funds and Systemic Risk Roundtable discussion hosted by the SEC. Led by Chairman Mary Schapiro, the Roundtable consisted of all four SEC Commissioners, representatives of the Financial Stability Oversight Council (FSOC), and selected members of the money market fund industry, sponsors, investors and the academic community. Industry observers widely viewed the session as the last open debate before the SEC staff proposes rule changes on money market funds to the FSOC.

We left the Roundtable with the impression that the floating NAV approach remains a preferred option of the regulators. This approach, vehemently rejected by the fund industry and shareholders alike, was thought to have been tabled before. We felt compelled to reassess the issue, including the likelihood, timing, and potential ramifications of such regulatory actions. We also attempt to offer some general principles for corporate cash investors to deal with such dramatic challenges.

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Prelude

As background information, money market funds' vulnerability to run risks was exposed in September 2008 when a number of prime funds experienced serious asset flight in the darkest days of the financial crisis[2]. Unprecedented support from the Treasury Department and the Federal Reserve succeeded in stopping the runs, and in January 2010, the SEC adopted revisions to its Rule 2a-7 to make money market funds more resilient[3].

The Federal government recognized that its actions in 2008 may have created unwarranted expectations that it would come to the rescue of money market funds in future crises, which would distort incentives and heighten the industry's systemic risk. The President's Working Group on Financial Markets ("PWG") released several reform options to the SEC in October 2010 for further policy considerations[4]. The SEC promptly issued an invitation for the public to comment on the PWG report. By January 10, 2011, the deadline date, 51 comment letters were posted on the agency's website. More letters poured into that site and four days before the roundtable, 40 more comment letters were posted[5].

The Verdict Was In – Or So It Seemed

The overwhelming majority of fund sponsor and investor letters opposed floating the funds' NAVs, or pricing the funds according to the market values of the underlying assets, as opposed to their income adjusted (amortized) costs. The proposed two-tier system of money market funds received similar rejection. The small contingent of proponents included former Fed Chairman Paul Volker, Richmond Fed President Jeffrey Lacker and the Sqaum Lake Group, a circle of 14 economic and finance professors.

By contrast, the private liquidity facility option seemed to gather support from fund sponsors and investors. Details of the concept were officially unveiled by the Investment Company Institute (ICI), the industry trade association for mutual funds, on January 11, 2011[6]. Other options, which included mandatory in-kind redemptions, private insurance and special purpose bank treatment, received cool receptions for their operational impracticality or exorbitant costs.

The Roundtable Thickened the Plot

In late January, the industry went into another wait-and-see period, although behind the scenes discussions to garner sponsor support for the ICI liquidity facility continued. After reports of public disagreement, all of the major players seemed to be in agreement to present the ICI liquidity facility option as the only solution worthy of further

exploring. For a time, the floating NAV concept seemed to be off the table for good. Then…

In a well-timed editorial the day before the SEC Roundtable, the Wall Street Journal pointed to money market funds as one of "a few giant redwoods of moral hazard". It proposed a "simple solution of allowing fund share prices to float like the securities that they are", and not "bank deposits they are not". In feisty words, it suggested the SEC end "the too-big-to-fail club" and show "fund managers to the door"[7].

ICI President and CEO Paul Schott Stevens immediately shot back, pointing out progress made since the 2008 crisis and the "enormous" costs involved to float fund NAVs[8]. He elaborated on the lack of appetite for such an option from issuers, sponsors and investors of money market funds. He further cited the $1.2 billion of revenue to the U.S. Treasury from the temporary money market funds guarantees to dismiss the Journal's solution as "all cost with no benefit".

Discussions at the SEC Roundtable, held on May 10th, quickly turned to whether the fixed $1.00 NAV was the central cause for runs as it favors shareholders who redeem shares early at the full price. FDIC Chairman Sheila Bair thus addressed the stable NAV as "fiction" at one point. Three specific options were on the docket: a floating NAV, a private liquidity facility, and reserve/capital buffer requirements. While private sector participants, ourselves included, frequently pointed to potential for asset flight and market disruptions, Chairman Bair, former Chairman Volker, Fed Governor Daniel Tarullo, and Bank of England Deputy Governor Paul Tucker seemed unwavering in their preference to float the NAVs. The liquidity bank concept came under heavy regulatory fire as a thinly veiled conduit to access the Fed discount window without the functions of a real bank. Disagreements also remained on versions of the reserve/capital buffer concept.

Floating NAV Emerges As the Protagonist

Although nothing was settled by the SEC Roundtable, the body language from the regulators strongly hinted that none of the alternatives compelled them to abandon the floating NAV approach. In fact, it could be their leading, and possibly only, choice over the loud objections of the private sector. A flurry of industry activities, including a joint op-ed piece by the chairmen of two prominent fund companies in the Wall Street Journal[9], was confirmation to us that the industry also sensed this probable outcome.

To disinterested bystanders, floating the NAV does appear to be an elegant and far simpler solution than all others. If the goal is to rid financial markets of the threats from runs on money market funds, then letting the price of a fund equal its market value per

share sends the clearest signal that no external support is expected. In most fixed income investments, investors either wait before receiving the full value of their investments or pay a penalty for receiving cash sooner. Unlike other mutual funds, money market funds promise (albeit not guarantee) investors the full value of a $1.00 investment at any time regardless of the credit and liquidity conditions in the marketplace. This promise is thus, structurally fragile and untenable under extraordinary circumstances. By contrast, the price of a floating NAV fund fully reflects the market's view of the credit and liquidity characteristics of its underlying investments, thus reducing incentive to redeem early.

This solution, however, fails to recognize at least three potentially disastrous risks. First, most shareholders view money market funds as the functional equivalent of bank deposits notwithstanding their legal distinctions. The mere possibility of principal losses may drive away a very large segment of the shareholder base. Temporary government liquidity or guarantee facilities may be necessary to help funds satisfy redemptions without depressing asset prices from fire sales. In addition, issuers' loss of access to a significant source of short-term funding, at least temporarily, deserves serious consideration. Temporary lending facilities may be needed for corporate and municipal issuers to adjust their funding strategies. On both accounts, the regulators must weigh the policy consequences of providing these facilities against the moral hazard they seek to remove.

Lastly, floating the NAVs leaves corporate and institutional investors with no good alternatives for storing large liquid asset pools with adequate diversification benefits. We are especially concerned with investors being forced to maintain large uninsured balances with the few large banks at which they already have concentrated counterparty exposures. Such an approach runs the risk of shifting the systemic risk from one pocket of the economy to another, in our opinion.

Liquidity Facility Fails the Leading Role

Meanwhile, the fund industry's ambitious attempt to present a liquidity exchange bank as the leading solution came up short, in our opinion. The facility would provide liquidity by buying securities from money market funds in need at amortized cost and for an access fee. Participation is mandatory with each fund contributing a commitment fee. The ICI estimates that it will have $7 billion in starting capacity and grow to $23 billion by year three and $60 billion by year ten[10].

The concept, itself a mini-drama series, got started 18 months ago with a few non-bank fund sponsors[11]. Other sponsors initially took a cool stance on the proposal, but gradually came to support it, especially after the ICI took the lead in March 2010 and

submitted a formal proposal in January 2011[12]. From its rocky start, the liquidity facility has received a lukewarm response from its reluctant alliance of fund sponsors[13]. One sponsor thinks the cost, infrastructure and complications are "not worth the minimal liquidity" it provides[14]. The cost-sharing arrangements alienate some sponsors as large firms end up subsidizing smaller ones. Buying securities at amortized cost also seems unrealistic, especially given the criticism of the government facilities buying securities at costs significantly above market values during the credit crisis.

For all of its good intentions, the biggest shortcoming is the liquidity facility's reliance on the Federal Reserve's discount window as its backstop liquidity. Based on exchanges at the Roundtable, we think its application as a state-chartered bank will face a steep uphill battle. A number of the regulators warned of the risk of other non-bank industries gaining access to the Federal Reserve's liquidity with similar techniques.

And The Climax to Come

With matters moving onto the next phase, anxiety is high among industry observers that a policy draft may be forthcoming, perhaps even before the end of 2011. We think that, since the fund industry and shareholders failed to provide convincing alternatives, policy makers may come closer to the floating NAV approach, or at least will include it as a part of the solution. Although matters are far from certain, we think it is time for corporate and institutional investors to contemplate the likely course of such a decision, its impact on their cash investment strategies, and the ways to be prepared.

A Safety Net: We believe that, if the regulators abolish the amortized cost method, they will have a safety net in place to avoid or minimize runs at announcement. The effective date will likely be some time in the future so that investors, issuers, and fund sponsors will have time to chart new courses, if needed. If planned and executed well, we think disruptions to the overall financial system can be orderly, albeit painful and nerve-wracking for many.

A Two-Tier System: We further think that the SEC may consider a money market fund two-tier structure which allows some funds to maintain a stable NAV. We propose that government money market funds will receive this distinction. Note that fund runs, often misunderstood as runs on liquidity, are almost always caused by credit concerns with underlying investments. When the default risk is removed, market value fluctuations tend to trend back towards amortized cost for held-to-maturity securities. This two-tier structure offers investors a fixed NAV, low-risk and low-yield alternative to the floating NAV structure in prime and tax-exempt funds. We estimate this option puts assets on flight risk at less than $911 billion, far less than the $2.7 trillion if all funds were set to float[15]. Of the $911 billion, $334 billion are municipal debt and

estimated $212 billion are non-financial. Of course, one does not expect a full liquidation of the non-government funds, thus assets vulnerable to flight risk should be a fraction of the estimated figures. Of course, the SEC may adopt a two-tier system along retail and institutional lines, but the logistical challenges of identifying shareholders cannot be overlooked.

What This Means to Cash Investors

Assuming our analysis is correct that floating NAV remains a top choice for the regulators and that measures will be put in place to minimize asset flight during transition, what may be the implications for corporate cash investors? Given the uncertain nature of the subject, we can only offer some general guidance.

Do The Homework Now: Investors should stay with funds that are less prone to run risk as a general principle regardless of policy outcome. This requires shareholders to be aware of the potential causes for fund runs and invest in funds with conservative investments, large liquidity buffers, strong sponsor support and a low concentration of volatile investors. This may include keeping portions in bank deposits, government funds, repurchase agreements, and individual holdings.

Remain Calm: Instead of selling on impulse, investors should take time to evaluate prospective policy outcomes and observe the key facts before making a decision. Investors who sell large positions on impulse collectively may jeopardize their liquidity, as new fund rules allow sponsors to withhold redemption requests when a run risk develops.

Chart A Course: Review investment guidelines and decide whether to adapt to the new environment. Depending on whether a stable NAV option is offered, decisions may vary. Investors may consider keeping some non-sweep portions of their liquidity in floating NAV funds after a transitional period. Other options, including separately managed account solutions, may be considered.

The silver lining in the floating NAV option is that investors will not only recognize but also internalize the risk and reward dynamics of money market funds. Given limited alternatives for corporate investors, we believe more active investor involvement is required to successfully manage corporate cash portfolios, from investment guidelines formulation to asset allocation decisions. Such involvement will require more organizational resources, senior management attention, and deeper investment knowledge.

Epilogue

The great success of money market funds is undeniable as a result of their contribution to personal savings, corporate efficiency, and lower funding costs since their creation. On the industry's 40th birthday, one also should recognize that its objectives, investments, and shareholders have changed significantly over time. In a global financial system interconnected with asset securitizations and financial derivations, the noble notion of pricing funds with the securities' amortization costs has become a daunting task. To the regulator, doing nothing is not an option. To the fund industry, giving up the stable NAV is unthinkable. To the corporate investor, being prepared requires an understanding of all possible outcomes and a contingency plan.

The points and counter-points in the public arena on money market fund reform give us the impression that the floating NAV option remains a top contender as the regulators' pick. Recognizing the challenges to regulators, shareholders and issuers, we think a two-tier system with funds holding "risk-less" government securities receiving a stable NAV may be the least disruptive solution. It offers a choice to investors who truly value principal stability and liquidity. In any event, investors should do their homework, remain calm, and formulate a long-term plan before the curtain rises and a policy outcome is revealed.

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[1] See the SEC press release on May 6, 2011 titled "SEC announces agenda and panelists for Roundtable on money market funds and systemic risk." Replays of the webcast are available here: http://www.sec.gov/news/otherwebcasts/2011/money market funds-risk051011.shtml

[2] Among other literature, the Squam Lake Group's proposal to the SEC titled "Reforming Money market Funds" dated January 14, 2011 cites data from Moody's Investor Services data that holdings by institutional investors in prime money market funds dropped from $1,330 billion to $948 billion, and holdings by retail investors declined from $755 billion to $725 billion. A paper by Jonathan Macey of the Yale Law School titled "Reducing systemic risk: the role of money market mutual funds as substitutes for federally insured bank deposits" dated March 1, 2011 also gave accounts of the events in money market funds after the Lehman Brothers bankruptcy. See the links here: http://www.sec.gov/comments/4-619/4619-57.pdf; http://digitalcommons.law.yale.edu/fss_papers/2020/

[3] See the SEC PDF document "Final Rule: Money Market Fund Reform" (17 CFR Parts 270 and 274) http://www.sec.gov/rules/final/2010/ic-29132.pdf

[4] See the press release from the U.S. Department of the Treasury titled "President's Working Group on Financial Markets releases money market funds report" dated October 21, 2010. The complete text of the report is available here: http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf

[5] The link to the SEC's comment letter website for the PWG report is here: http://www.sec.gov/comments/4-619/4-619.shtml

[6] See ICI's January 11, 2011 press release "ICI details plans for a private liquidity facility to further strengthen prime money market funds." http://ici.org/pressroom/news/11_news_pwg_ici

[7] The Wall Street Journal Editorial, "Taxpayers and money market funds," Review & Outlook, May 9, 2011. http://online.wsj.com/article/SB10001424052748704517404576223081850781452.html

[8] Paul Schott Stevens, "Wall Street Journal editorial ignores 'economic disruption' of floating the value of money market funds", May 9, 2011. http://www.ici.org/money market funds/snav/11_resp_wsj_money market funds

[9] Edward C Johnson 3rd and F. William NcNabb III, "Your money market funds are safe," May 16, 2011, The Wall Street Journal, opinion section.

[10] See ICI presentation material by following the web link in note No. 11.

[11] Christopher Condon, "Fidelity, Vanguard said to plan emergency bank for money market," September 19, 2009, Bloomberg.

[12] ICI President and CEO Paul Schott Stevens first mentioned the concept in a March 15, 2010 address to a mutual fund managers' conference in Phoenix, Arizona. Also see ICI press release on January 11, 2011 titled "ICI details plans for a private liquidity facility to further strengthen prime money market funds." See link: http://www.ici.org/policy/current_issues/10_mfim_conf_pss_spch; http://ici.org/pressroom/news/11_news_pwg_ici

[13] As one example, in a Bloomberg article by Christopher Condon on April 1, 2010, BlackRock CEO Larry Fink was reported as saying "the last thing we need to do is socialize money-market risk" by creating an industry fund. http://www.bloomberg.com/news/2010-04-01/blackrock-s-fink-snubs-socialized-money-fund-proposal-backed-by-goldman.html. The firm subsequently announced its support for the facility.

[14] See the PWG comment letter from Fidelity Investments dated January 10, 2011. http://www.sec.gov/comments/4-619/4619-36.pdf

[15] According to the Federal Reserve's Flow of Funds report as of March 2011, of the $2,755 billion MONEY MARKET FUNDS assets, $1,218 billion (44%) are in Treasury, Agency and repurchase agreements. Of the remaining $1,534 trillion, $588 billion are in bank deposits. If one assumes 30% (from the Fed's CP outstanding data) of the $394 billion CP debt held by the funds, or $117 billion, are U.S. bank obligations, then $705 billion of the potential outflows from funds can be offset by inflows into the banking system. The remaining $911 billion represent borrowings by foreign banks, asset-backed conduits, municipal and non-financial borrowers, of which $334 billion are municipal. Borrowing by non-financial issuers likely does not surpass $212 billion if one assumes all of the $154 billion in corporate bonds and 10% of the CP holdings (again using the Fed data) are to this sector.

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