# Changes Are Coming to Money Funds

**What Corporate Investors Should Expect**

As a treasurer or a CFO, what would your reaction be if you were presented with the following description of a cash investment option? It's a structured fixed income product sold as equity without a stated maturity date. It makes no commitment to daily liquidity, nor does it guarantee principal protection and it pays a dividend instead of interest income.

The product described is, of course, a money market fund. While the institutional money fund has been beneficial to the treasury community as a cash management instrument, investors' preconceptions of its perceived safety and liquidity may have hindered their ability to seriously assess all the potential risks. The Reserve Primary Fund's exposure to Lehman Brothers and subsequent fund industry developments brought to bear many old (and some new) issues among fund managers, regulators and investors. As cash management professionals, we undoubtedly need to address these issues in the context of treasury management and be prepared for potential changes coming our way.

**Taking a Lesson from the Past**

It's often said that the best remedy for a problem is prevention and the next best thing is to learn from the past. Discerning what went wrong may help us understand what remedies may be on their way to address money fund issues.

Judging from the magnitude of the initial investor flight from prime funds, the widespread credit support from fund sponsors, and the unprecedented Treasury fund guarantee program, it is difficult to label the fund industry as being "healthy" and dismiss the runs on the Reserve Primary as "one off" events. In our opinion, the sudden and severe investor migration away from the prime funds was inevitable because of the endogenous credit and liquidity issues within the money fund industry. In other words, "breaking the buck" could have happened to a number of fund families besides the Reserve.

Aside from certain facts such as an extended period of low interest rates and the exuberant borrowing and lending in the housing market, lax credit standards and the competitive frenzy to grow fund assets among major fund families may have directly contributed to riskier securities in money fund portfolios. For example, some credit analysts approved structured investment vehicles (SIVs) and

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subprime mortgage securities against their own private convictions. Motivated by yield, some portfolio managers even invested in questionable securities that circumvented the SEC's ratings-driven formulaic 2a-7 rules such as Structured Investment Vehicles (SIVs) and mortgage conduits. For a time between 2006 and 2007, the industry was in the midst of a "how low can you go" fee-waiver contest to lure investors away from competitors, which encouraged frequent fund switching.

While the fund families are doing their fair share of soul searching, institutional investors also need to look inward and return to their roles as responsible consumers which includes steering away from "fund hopping", keeping fund managers informed of upcoming cash flows, and voicing concerns if the manager's credit policy or market campaigns become overly aggressive. In the end, investors can and should exercise their ultimate fund governance right and vote with their feet by moving out of a fund if they don't agree with the overall prudence of a money fund's investment practices.

**Expect Lower Yields**

It's of little surprise that significant changes will likely happen in the coming months. Public officials, including Treasury Secretary Timothy Geithner and SEC Chairwoman Mary Shapiro, expressed their preference in the overhaul of the existing 2a-7 rule. The influential non-profit policy think tank, Group of Thirty, proposed what many consider to be radical changes to the rule, which includes doing away with the stable $1.00 a share or regulating the money funds as banks in exchange for FDIC-style insurance. The fund industry, as represented by the Investment Company Institute (ICI), came up with its own recommendations for enhancements to the existing tenets of the SEC 2a-7 rule.

At the moment, the consensus among industry participants is to allow the temporary Treasury money market fund guarantee program to expire without congressional reauthorization in September 2009. The industry hopes to convey the message that it is well again by standing on its own without the government guarantee. In fact, most government money funds decided not to renew their subscription to the guarantee program in April 2009 which marks the first step in weaning the industry from government support. It is reasonable to think that the SEC should finalize its new money fund regulation before the guarantee expiration date to prevent a potential relapse of fund runs.

Without knowing what the SEC will do, we think one very likely outcome is the potential for lower yields. The proposals from the ICI working group to reduce average portfolio maturities, increase near-term liquidity, and satisfy additional reporting requirements may result in higher operating fund expenses and higher percentages of lower yielding securities. New product reviews and more stringent credit criteria also may result in higher average portfolio credit quality, and thus lower yield potential. If the SEC mandates more dramatic measures, such as a permanent government guarantee, a private insurance fund, or holding a subordinate class of capital, fund costs may be materially higher.

We think that, as cash management tools, the funds' reduced yield potential alone should not diminish its usefulness, as long as the safety factors also improve and the relative yield advantage over other cash products remains compelling.

**Liquidity Concerns Remain a Top Issue**

Although money funds are always presumed to provide same-day liquidity, shareholders are nevertheless exposed to the risk of fund runs. Now that recent events have heightened investors' concerns over the risk of runs, the fund industry must adequately address contingent liquidity and potential fund freezes before we can determine how the funds will best serve the institutional treasury community in the future.

Contingent liquidity refers to the sudden unexpected need for liquidity to satisfy large redemptions not met by a fund's own liquidity positions. History shows that such liquidity often comes from the financial institutions that manage the funds, but the subject is a sensitive one. Public admissions by these financial institutions of this implicit liquidity guarantee undoubtedly invite regulatory scrutiny and competitive criticism. Since it is difficult to predict the target or time of a run, the issue cannot be solved by a fund's internal liquidity, other than perhaps by those holding only overnight securities and direct Treasury obligations.

Proposals to address contingent liquidity range from making the Treasury guarantee permanent, to establishing a FDIC-style industry funded insurance fund, to changing certain funds to "narrow banks" that would be eligible for FDIC insurance. At the moment, both the fund and the banking industries are opposed to any form of insurance due to concerns of reckless risk taking, more regulatory oversight, and potential asset losses from bank deposits to money funds, among others. From the investors' perspective, explicit external liquidity is

undoubtedly a positive step but, as stated earlier, it may also mean higher fund expenses and lower yields.

Without contingent liquidity, the risk of potential fund freezes becomes more pronounced. In the past, funds were allowed to temporarily halt redemptions after obtaining permission from the SEC to prevent runs. There is currently a proposal from the ICI working group that calls for funds to have authority to halt redemptions without SEC permission. The practical reality is that once a fund halts redemptions, it is difficult to reopen the fund without also causing another run. This proposal may have the effect of allowing funds in distress to halt redemptions indefinitely until the assets mature, are sold, or the fund dissolves. Despite its remote probability, this change may make it problematic for investors to continue to treat money market funds as cash instruments if a fund can shut itself down without prior notice and enter an unwind mode as the Reserve funds have done. We think that this extended freeze issue would not become be a problem if a fund has contingent liquidity.

**Fund Industry Consolidation: A Friend and/or Foe?**

As a result of the precarious credit market and the low interest rate environment, several fund families have exited the money market fund business or have stopped issuing institutional share classes of late. Other funds have decided to let larger fund families run their funds for them. Industry veterans agree that, in the aftermath of the crisis, there will be more concentrated industry assets in a handful of mega fund families. While consolidation after a crisis is normal, investors need to be aware that this trend may bring benefits as well as risks.

Money funds can profit from industry consolidation through increased operating efficiency, more portfolio management and credit expertise, better trade execution, and potentially lower fund expenses. However, they may also be more prone to headline risk and market illiquidity. As funds become larger, the impact of a bad credit decision may be magnified due to the size of a problematic credit. With a limited number of buyers and sellers left, it is also more difficult to sell securities to raise cash as fewer investors are capable of buying large blocks. Since the funds' investment decisions are often highly correlated, player concentration also can intensify the systemic risk in the money markets.

Although not a solution favored by the fund industry, limiting a fund's size relative to the respective market may help to promote liquidity and stability. For

example, the FDIC rule capping each bank's deposits at 10% of the national deposit balances may serve as a model to address this issue. From the investors' point of view, while larger funds tended to offer better credit liquidity support in the past, this assumption may run into challenges if new regulations come into effect to address the size dynamics.

**Look Through To Evaluate Exposure**

The last point we want to stress is that the look-through provision of investment policy compliance, while often considered to be preferable, may become required by regulators and the accounting profession in the future. A look-through provision is a requirement in some investment policies to allow that individual corporate investors look into the holdings of money fund portfolios to assure compliance with corporate investment guidelines. In the past, the requirement of money market funds to comply with cash investors' individual policy guidelines often resulted in the funds participating only in government funds. To participate in the "prime" funds, investors subsequently made the concession not to subject the money funds to their investment policy restrictions. The crisis last fall brought the issue back to the forefront, especially after audit committees of corporate investors were surprised by the incompatibility of the money fund assets with their own investments policies.

As investors work through their issues with money funds, we can sense that some, along with their accounting firms, may want to revisit the look-through provision. Whether the provision becomes a compliance requirement or simply a recommendation of prudence, we think investors need to examine the underlying securities of the funds they own in order to evaluate their overall credit exposure. This process may introduce operational difficulty, but it is necessary because many funds employ very similar strategies and have similar credit exposures that may exacerbate large credit holdings in an investor's portfolio. If the look-through provision becomes a rule, we also expect government funds to gain more popularity at the expense of prime funds because of the hassle factor.

**Conclusions**

We believe that money market funds in general are excellent cash management tools for institutional accounts. The daily liquidity for operating needs, the convenience of $1 NAV, and the general high quality of underlying investments are difficult to replicate in other liquidity vehicles.

We pointed out earlier that institutional investors consider money market funds as cash; however, this may not fit the classical definition of "cash and cash equivalent." While such classification is appropriate, we also need to address when and if the conditions for the definition are not met, such as maturities within 3 months and being readily convertible into cash. If the funds undergo significant changes as a result of SEC 2a-7 rule revisions or other factors, we will need to reevaluate the appropriateness, and the concentration, of the funds in our liquidity portfolios.

We think that the Treasury guarantee grogram will be left to expire in September 2009 unless the stability of the money fund industry continues to remain fragile at that time. We must attempt to anticipate how the changes in the industry will impact our own decisions so that we will be prepared for these changes when they occur.

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