Decoding the New Regulatory Blueprint

Ten Ways Corporate Cash Investors May Feel the Impact

Introduction:

As far as financial weather conditions go, the past few months represented very unusual patterns for financial regulators, who broke the usual summer doldrums with a number of regulatory gales. While the new regulations will likely have a profound and lasting impact on our financial lives, most of us are simply overwhelmed by the sheer volume of new information to digest. Instead of getting bogged down by the details of the new rules, we thought it might be helpful to highlight the likely impact of the new regulatory environment on the average corporate treasurer in the short-duration investment space.

To get a sense of what a busy year 2010 has been for financial regulators, we should start with January 27, when the Securities and Exchange Commission (SEC) adopted the long anticipated amendments to Rule 2a-7 governing money market funds. On July 15, Congress passed the sweeping and controversial Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), a 2,300-page mammoth of legislation aimed at improving financial stability in the U.S. On September 12, the Basel Committee on Banking Supervision announced the new global capital standards for the Group of 20 Nations (Basel III). Most recently, on September 27, the Federal Deposit Insurance Corp. (FDIC) followed through on the so-called "skin-in-the-game" provision in the Dodd-Frank Act by requiring banks to hold at least 5% of the asset-backed securities (ABS) they underwrite. For the sake of space and sanity, we must omit other important and influential regulatory changes not directly impacting corporate treasurers.

To keep things simple, we came up with a Top Ten list of how the new regulatory environment may impact corporate treasurers in their cash investment decisions. Given the magnitude and the early-stage nature of Dodd-Frank and Basel III, this is not meant to be an exhaustive list. Some items may need to be revisited as more details emerge.

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1. Lower risks may lead to lower expected returns

At the risk of stating the obvious, we think the regulatory overhaul will achieve the intended effect of lowering the overall risk of destabilization in the financial system, but at the cost of lower expected future returns. The SEC's requirement for money market funds to hold more liquid assets is one example. The restriction on principal activities caused by Dodd-Frank and Basel III's call for more bank capital may lead to lower financial leverage, lower trading revenue and profit margins, and higher compliance and operational costs, all of which may lead to lower future returns for investors in regulated financial assets. The longer-run impact to the economy, such as reduced availability of credit to small businesses, may result in permanently lower business efficiency from the taxing effects of new regulations.

2. Money market funds may be safer and more liquid, but big unknowns remain

As one of the most popular liquidity management tools, money market funds deserve a special mention in the new regulatory regime. The new rule 2a-7 requirements on maturity structures, weighted average life, and holdings disclosure have resulted in better liquidity and credit protection for fund investors. Conversely, shorter maturities generally mean lower yield potential, which may contribute to lower income opportunity. Recent declines in money market fund assets may have partially reflected this trend.

We should be aware that the regulatory work on money market funds is not yet completed. Discussions continue on the feasibility of pricing the funds' net asset value away from the constant dollar, the creation of a liquidity backup facility, potential supervisions under the Federal Reserve as non-bank financial companies (NBFC), thus subjecting the funds to capital requirements and FDIC fee assessment. The Financial Stability Oversight Council (FSOC), a creation of the Dodd-Frank Act, likely will take over these issues where the SEC and the President's Working Group on Financial Stability leave off.

3. Bank credit quality may improve as the result of capital bolstering, but the compliance schedule and rating responses may introduce uncertainties

We view the long-term impact of Basel III capital requirements to be positive for bank credits. We think the new regulatory capital and liquidity requirements ultimately will foster better stability and credit quality in the sector, although compliance for small banks may result in capital-raising pressures. Several major U.S. banks were quick to indicate their abilities in complying with the new rules without raising additional capital. We suspect some of these assessments may be overly optimistic. Smaller regional banks also may have difficulty competing with larger firms for equity capital, thus their credit outlook may be less rosy.

Credit rating agencies' responses to diminished sovereign support for large global banks also should not be ignored. Both Moody's and S&P have suggested negative ratings implications as a result, but final ratings actions will reflect the net effect of lower government support and better capital positions after implementation.

Since Dodd-Frank and Basel III overlap in many areas of banking regulations, we think reconciliation issues between the two may introduce further uncertainties.

4. Supply of commercial paper may shrink further, possibly drastically

Investors worrying about the shrinking supply of eligible short-term investments may find the U.S. commercial paper (CP) market shrinking rather dramatically as a result of the Basel III's liquidity coverage ratio (LCR) requirement. The rule requires banks to hold a liquidity position of 100% of contingent net outflows within 30 days, which means that CP issued within 30 days that carries bank liquidity support needs to be fully backed by bank capital. Since most CP matures within 30 days and most top tier (A-1/P-1) CP programs receive bank liquidity support, the new Basel rule essentially makes short-term CP issuance prohibitively expensive for issuers. CP borrowers likely will turn to long-term borrowing instead of paying the higher banking fees, leaving even less supply in the short-term market. Although the LCR is not scheduled to come into effect until 2015, it is possible that banks will react sooner.

5. We may see the end of the asset-backed commercial paper (ABCP) market under the weight of the regulations

Since essentially all active ABCP programs today carry at least 100% bank liquidity support, the higher costs of Basel LCR will impact ABCP issuers particularly hard. What's more, sponsoring banks are required to hold additional capital against credit enhancement in partially supported programs. Therefore, the amount of required capital can exceed the CP outstanding, further reducing the incentive for banks to issue ABCP.

Other regulations had already crept into the ABCP space before Basel III. ABCP programs have been consolidated on bank sponsors' balance sheet according to FAS 166/167. Enhanced SEC regulations AB and 17 g-5, as well as the Dodd-Frank's skin-in-the-game and disclosure rules may weigh down the market further. Short of major regulatory revisions or exemptions, it is difficult to imagine the market will exist in the same size and form as it does today.

6. **A challenging environment lies ahead for term asset-backed securities (ABS), although greater transparency ultimately benefits investors.**

In addressing the "originate-to-distribute" model of loan origination that led to the subprime crisis, Dodd-Frank requires securitizers to retain 5% of the credit risk of the securitized assets. The Act also requires more information disclosure available to ABS investors, including making public the findings and conclusions of any third-party due diligence reports.

As can be expected, ABS issuers will bear significantly higher costs in complying with the new disclosure rules. The 5% risk retention also means higher capital requirement and lower volumes for transaction sponsors. Both factors may lead to a smaller securitization market and lower expected returns on ABS products. On the other hand, we think the benefits of greater transparency will lead to greater market confidence. Since better disclosures allow investors to better assess risk, Dodd-Frank should ultimately contribute to the return and stabilization of a smaller yet stronger securitization market.

7. **The municipal market faces the challenge of dried-up bank liquidity contracts, although the decoupling from bank credit may be a positive development**

Traditionally, municipalities have relied on bank liquidity facilities to fund their long-term debt obligations in the short-term market through variable rate demand obligations (VRDOs). Similar to CP issuers with bank liquidity, municipal issuers will soon face the reality of significantly higher bank fees as standby liquidity agreements come up for renewal. While a small percentage of municipalities may continue to have access to the VRDO market without bank liquidity, more issuers will have to either issue long-term fixed rate debt at higher interest costs, or turn to other alternative funding channels in the short-term market. In either case, the size of the VRDO market will likely be smaller.

A potential positive outcome of the debt market transformation could be the decoupling of the municipal market's credit conditions from the financial health of banks. Indeed, a trend has recently developed among issuers who rely more on improved market and investor sources of liquidity rather than bank liquidity for certain debt structures.

8. Systemic risk in the financial system may be reduced, although not eliminated

The introduction of a systemic risk regulator, the establishment of prudential standards, better quality capital, limitations on risky activities, and resolution authority should enhance the safety and soundness of U.S. financial markets, in our opinion. However, Dodd-Frank left much to be desired in addressing the systemic risk of too-big-to-fail institutions. Despite enhanced and broadened regulatory powers, large financial firms will always be highly complex with multiple entities subject to differing laws. An attempt to unwind one of these institutions using the new resolution powers may risk triggering a financial contagion the legislation tries to avoid.

Furthermore, more coordination is needed among regulators in different jurisdictions. Conflicts and ambiguity in Basel III, Dodd-Frank and a number of European Union rules need to be resolved to ensure the winding down of a systemic institution does not result in the shutdown of credit in other parts of the financial system or the triggering of a broader credit crisis, especially in an environment of low market confidence.

9. Shadow banking sector could pose risks

It is plausible to think that higher capital and liquidity requirements for various activities may reduce lending and drive more credit creation outside the banking system. Ironically, one should recall that the growth of the "shadow" banking sector, such as lightly-regulated mortgage brokers and structured investment vehicles, was the source of the recent subprime crisis. The increased role in the capital markets of private equity firms and hedge funds, which received fewer restrictions than banks from the new regulations, will likely continue. Other lightly regulated market participants and lenders may include business development companies, collateralized loan obligations, and private placement 144A funds. Treasurers should be aware of their presence and the possibility of some of these credits creeping into their investment portfolios.

10. The Fate of Fannie and Freddie Remains Uncertain

A major part of the financial market subject to financial regulation is one that did not receive clear answers from the recent legislation. The future of the housing government sponsored enterprises (GSE) Fannie Mae and Freddie Mac remains uncertain. The U.S. government seized these entities in September 2008, and instituted a number of support measures to stabilize the housing market. We think the housing giants are likely to remain critical to the government's mandate of promoting housing affordability and foreclosure prevention. However, all of the government's original support measures have expired, except for the capital purchase agreements which are set to expire at the end of 2012. The absence of a new regulatory framework for GSEs leaves an uncertain fate not only for Fannie Mae and Freddie Mac, but also for investors of GSE debt with maturities beyond 2012.

Conclusion:

In summary, the myriad new financial rules and regulations will take years to be clearly defined. A much longer period will be needed to implement them. While many of the requirements will have far reaching ramifications on our financial lives, we pay particular attention to the 10 ways we think corporate cash investors will most likely be impacted. Taken as a whole, the new regulations put the health of the world financial systems on a recovery course. There is no doubt that shortcomings remain, that uncertainties are many, and that implementation risk exists. Ultimately though, we believe investors will be better protected from a repeat of the financial crisis that we experienced over the past three years.
