Potential Impacts of the New Money Fund Rules

Last week's unveiling of the long-awaited new rules governing money market funds prompted a flood of commentary from the fund industry and reports from the financial press in a matter of just a few days. This month, we wish to focus specifically on how we believe the changes will have profound ramifications on all short-duration fixed income investors, and not just shareholders of money market funds. We plan to address the rules' impact on the money fund industry in a later article.

Highlights of the New Rules

In a live presentation delivered by Mary Schapiro, chairwoman of the Securities and Exchange Commission (SEC), she re-affirmed most of the key amendments announced on June 24, 2009 to the existing so-called 2a-7 rules with some modifications. The industry still awaits the full document of the new rules, and we highlight the relevant items germane to our discussions here.[1]

1. A fund must keep at least 10% of its portfolio liquidity overnight and 30% within seven days. U.S. Treasury securities and certain other government securities qualify as liquid assets.
2. The allowable bucket for illiquid securities is reduced to 5% of the portfolio from 10%.
3. Investments in securities rated second tier (A-2/P-2/F2) are reduced to 3% of the portfolio from 5%. Exposure to an individual issuer is reduced to 0.5% from 1%.
4. The maximum weighted average maturity (WAM) is reduced to 60 days from 90 days. The maximum weighted average life (WAL), a new limit measuring average final maturities, is set at 120 days.
5. Collateral of repurchase agreements (repos) qualified for "look through" treatment must be cash items or government securities.

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Expected Capital Markets Impact
As can be expected, the new rules intend to make money market funds safer by reducing maximum credit, liquidity, and allowable interest rate risks. Because the fund industry represents a very substantial part of the investor base for money market debt, we believe the new rules will have a tangible impact on the supply and demand dynamics of this market. We estimate that non-government money market funds make up 57% of the short-term debt market based on the $3.22 trillion in the size of the market and the $1.83 trillion in total assets of non-government funds.[2] Such impact may include higher demand and lower yield for shorter and higher quality securities and lower demand and higher yield for longer-term, lower-quality paper.

Reduced Yield Potential: All else being equal, yield potential on money funds is likely to drop, at least in the near term. As funds shorten up their WAM and WAL, they will be forced to purchase securities with shorter maturities, which typically offer lower yield. Increased exposure to Treasury securities also will have a similar effect of lowering portfolio yield. The increased demand by money funds for sought-after shorter bonds and government securities may drive the yield on these securities down further, leading to lower yield potential for all cash investors.

On the other hand, the newly out-of-favor securities may offer attractive yield opportunities for investors not subject to the money fund rules.

Bifurcation of Market Liquidity: With the implementation of the new rules, we expect that securities with short-term maturities will become more liquid, while longer-term securities will become less liquid. Before these new rules changes were handed down, commercial paper with good credit quality that matured within 90 days generally had very good market liquidity and dealer support. Issuers also like to tap this part of the short-term market because of strong investor demand. Under the new 7-day liquidity requirements, we think a portfolio manager will have considerable difficulty investing beyond 30 days while remaining compliant. The new rules redefined the liquid portion of the portfolio from 90-days to a significantly shorter period of time.

An implication on other investors could arise if securities maturing beyond 30 days fall out of favor with money funds and become less liquid. Yield, on the other hand, may rise to compensate for that risk. Note that because of the new 7-day liquidity requirements fund managers may not be able to take portfolio WAM up to 60 days.

Reduction in Non-government Repos: The new 'look through" limitation of repurchase agreement collateral to cash and government securities is an interesting development that could potentially eliminate money funds from buying non-government repos altogether. Under the current rule, a fund may have up to 25% of its portfolio in repos from a single repo dealer, as long as it can "look through" to underlying collateral to determine its true risk exposure. Now disqualified from the "look through," repos backed by non-government securities will be treated as the credit risk of the repo dealer. Demand for these types of repos will likely drop as a result. Having fallen out of favor after the Bear Stearns failure,

non-government repos were making a comeback in some money funds as they offered some yield advantage. The new rules will likely slow down, if not halt altogether, that trend.

Due to a lack of clarity in the SEC's press release, another interpretation of the repo rule is that repos not backed by cash or government securities may not be allowed in money market funds at all. If this is the case, we would expect the size of the non-government repo market to be further reduced. As a consequence, the liquidity and value of these now ineligible securities, many of which are private mortgage and asset-backed bonds, will likely further deteriorate.

Changed Issuer Funding Behavior: Over time, we expect corporate and GSE issuers to modify their funding strategies to cope with these new regulations. Specifically, we expect commercial paper and discount note issuers to seek shorter maturity debt to satisfy money funds' need to comply with the 30% 7-day liquidity requirement. We also expect a lower issuance of floating rate notes (FRNs) due to the new 120-day WAL rule that penalizes the use of FRNs in money market funds.

A Cottage Industry of Re-engineered Securities: This last item on our list is more of a cautionary note than a predicted outcome. When Wall Street has the opportunity to fully digest the revised money market fund rules, we expect to see the introduction of engineered securities that will be tailor-made to satisfy the terms of this new environment. We suggest that, should this be the case, investors remain wary of products that may fit the letter but not the spirit of the new regulations.

Is the World better off?

In parting words, we applaud the SEC for putting the new provisions in place to better safeguard a long-treasured investment product from credit risk and market gyrations. We very much view the new set of rules as a compromise between making a money fund safer and keeping it attractive to investors. We also think this is an intermediate step toward a broader resolution of some major issues in the industry, including flexible net asset values, shareholder behaviors, and backup liquidity solutions.

The impact to capital markets from the new regulations cannot be overlooked. As money funds modify their strategies to comply with the new rules, we expect shifting supply and demand dynamics in securities of various credit quality, maturities, and underlying collateral.

We believe that these changes may result in new uncertainties. For example, as issuers scramble to issue shorter-maturity debt to money market funds, are they going down the same path of financing long-term obligations with short-term debt? As the market for non-government repos retreats, will moderately-sized broker-dealers be exposed to higher liquidity risk? As the government makes money market funds safer, is it encouraging more investors to chase yield in funds not subject to the 2a-7 rules? Only time will tell and we will be sure to maintain a watchful eye.

[1] For detailed descriptions of Chairwoman Schapiro's address, please refer to the SEC press release 2010-14 on January 27, 2010. http://www.sec.gov/news/press/2010/2010-14.htm

[2] Investment Company Institute, "Historical weekly money market data," as of January 27, 2010. http://ici.org/research/stats/mmf/mm_01_28_10. Securities Industry and Financial Markets Association, "US Bond Market Outstanding" as of September 2009. http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USBondMarketOutstanding.pdf

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