# Wringing the Risks Out of Money Funds

## A Commentary on the SEC Proposed 2a-7 Rule Amendments

On June 24, 2009, the Securities and Exchange Commission (SEC) announced the long-anticipated proposed amendments to the 2a-7 rule that regulates money market mutual funds. The proposed changes were prompted by the extraordinary events in the money fund industry that took place after the Reserve Primary Fund's net asset value (NAV) dropped below a constant dollar ($1.00) per share last fall.

We do agree that the proposed changes will make money funds marginally safer. However, we feel this proposal did not address the fundamental issue of preventing a run on the funds. As institutional cash investors, we also fear that, by allowing funds to halt redemptions without advanced notice, the usefulness of the funds as cash management vehicles may be significantly diminished. As part of the ongoing dialogue of making the funds safer, we have several of our own proposals below that we think will be beneficial to institutional money fund investors.

**Comments on the SEC Rule Amendments:**

***Improved Liquidity:*** The proposed rule requires that institutional money funds keep at least 10% of assets in cash or securities readily convertible to cash (e.g U.S Treasuries) within a day, and at least 30% within a week. Retail funds, which tend to experience less fund flow fluctuations, must keep at least 5% in daily liquidity and 15% within a week. The current rule does not have such requirements.

**Our Take:** We view these new liquidity requirements as minimum maintenance levels, since most large "prime" funds (those that can invest in corporate securities) are already managed to these levels after the Reserve Fund event. **We see two potential drawbacks of this change:** 1) If a run on a fund begins to develop, the 10% and 30% liquidity buffers would still seem inadequate; 2) by requiring 30% of a portfolio to mature within a week, the rule may encourage funds to invest disproportionately more in securities with longer maturities in a so-called "barbell" structure. Over time, this barbell structure may present higher interest rate and liquidity risks.

***Shortened Maturity Limits:*** The proposal would restrict the maximum weighted average maturity (WAM) of a fund to 60 days from the current limit of 90 days. It

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Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.3488
lpan@capitaladvisors.com

also introduces a new concept of maximum *"weighted average life"* maturity (WALM) of 120 days. This WALM (sometimes called "Spread WAM") looks to the *legal final* maturities of individual securities with floating rates, extendible or reset features. Compared to the reset dates of one or three months as allowed by the current rule, the legal final dates may be as long as 13 months for corporate securities and two years for government securities. This rule change is intended to reduce long-term floating rate securities in a fund.

**Our Take:** Both the WAM and the WALM will be used, but the 60 day WAM rule may have minimal impact since most prime funds are already within this target WAM. **We applaud the SEC decision on the WALM rule, and view it as the single most significant improvement in the entire proposal.** It addresses *credit, liquidity, and structure* risks at the same time. On credit and liquidity, the WALM takes into account the higher sensitivity of long-term floating rate securities to negative credit or liquidity events than fixed term short-term commercial paper. On structure risk, it helps to reveal a fund's potential risk of maturity extensions in securities that allow issuers to postpone maturities under adverse conditions (e.g. extendible commercial notes).

***Higher Credit Quality:*** The proposal would limit money funds to securities with only the highest short-term credit rating category (Tier 1), removing the current 5% allowance in Tier 2 names.

**Our Take: We view this rule refinement as having little real impact for three reasons**: 1) The majority of the large prime funds had already shunned Tier 2 names before the credit crisis; 2) the troubled assets that impaired the Reserve fund and caused other fund sponsors to provide support either had A-1/P-1 short-term ratings (Lehman Brothers) or AAA long-term ratings (the various structured investment vehicles or SIVs); 3) the tarnished reputation of credit rating agencies calls into question whether ratings should be considered as a criteria in determining credit worthiness at all.

***Suspension of Redemptions:*** The proposal would allow a fund's board of directors to suspend redemptions if the fund were to "break the buck" and face liquidation. The SEC would be notified but an approval would not be necessary. The intent of this measure is to allow funds to go through an orderly liquidation of the portfolio and treat all shareholders fairly.

**Our Take:** While acknowledging the merit of shutting off a fund's redemptions when a "broken buck" event is imminent, we are concerned with the potential liquidity ramifications that cash management shareholders may face. We believe that, in the absence of contingent liquidity, **suspension of redemptions generally leads to the wind-down of the fund.** Investors losing access to liquidity (other than periodic distributions of maturity proceeds, as the Reserve Primary fund has done) **would become a serious drawback that may dramatically reduce the viability of institutional money funds for corporations and other institutions.** Leaving the decision of when and how to halt redemptions to the fund management also increases the conflicts of interest between the management company and the shareholders, in our opinion.

***Purchases by Affiliates:*** The proposed rule would expand the ability of affiliates of money funds to purchase distressed assets from the funds in order to protect them from losses. Currently, an affiliate cannot purchase securities without individual approval from the SEC before a ratings downgrade or a default of the securities.

**Our Take:** We view this rule change as beneficial to the funds, but it fails to recognize the regulated nature of many of the funds' affiliates, or financial sponsors. The sponsors' credit and liquidity support is possible only when doing so will not jeopardize their legal obligations to their creditors, shareholders, and depositors. Because the fund support agreement is not contractual, the practical benefits of this rule change are far from being certain in the future.

***Other Changes:*** The proposal also would require fund managers to conduct periodic stress tests, and to identify investors whose redemption requests may pose risks for funds. Also discussed are enhanced disclosure of securities holdings, monthly reporting, and the ability to process fund redemptions at NAVs other than $1.00.

**Our Take:** Because of the lack of details on these proposals, we do not know with confidence how effective the measures would be. We do hope that the **stress test results would be shared with shareholders and the monthly posting of holdings would be more up-to-date**. For example, when a widely held security is impaired, the immediate posting of portfolio holdings to show minimal or no exposure may serve to dramatically reduce redemption requests.

**Run Risk Remains Unaddressed**
The SEC is also seeking public comments on three key areas: floating share prices, the role of the credit rating agencies, and the suitability of asset-backed securities in money funds. Noticeably missing is the issue of liquidity in the event of a run, a risk we view as the most pressing of all the issues facing money funds. We argue that this risk is not remediable through improved portfolio asset quality or a shorter WAM.

***Asset-Liability Mismatch:*** As we've written on several occasions, money funds are investment companies that have an apparent and inherent asset-liability management (ALM) challenge. Despite the shortened WAM rule on fund assets to within 60 days, the WAM of liability of all money funds is one day, meaning shareholders can redeem shares with one day notice. Improved credit quality and a better overnight liquidity cushion may improve a fund's liquidity marginally, but the large ALM gap remains at all times.

***Difficulty in Cash Conversion:*** As long as a mutual fund's assets are fully liquid and its NAV is not fixed, the ALM gap is not a critical issue because it can always sell assets to satisfy redemptions at the prevailing market prices. This is not the case with money funds, however. In reality, a fund cannot rely on market liquidity to satisfy significant redemptions by selling assets priced at or above their amortized costs. Considering that panic selling is often associated with significant market events, the sale often results in large realized losses and delays in trade executions. Losses may cause a fund to break the buck, while delays may cause it to freeze redemptions.

***Contagion Risk:*** Recent credit events have proven that money funds backed by strong assets (e.g. The Reserve Government Fund) and funds without specific credit issues can develop runs because of a sudden shift in investor confidence. Thus, higher credit quality and stronger liquidity alone are insufficient to prevent a run. Meanwhile, funds that avoided serious runs tended to be affiliated with banks that were perceived to be strong or "systemically important." We believe this implicit and contingent external support from affiliates is a more effective liquidity stabilizer.

This phenomenon of looking to "shadow guarantors" suggests that ultimately a backup support facility is needed to solve the money funds' ALM and convertibility issues. The success of the FDIC's deposit insurance program is a clear example of addressing similar problems in the banking industry. The

Treasury Department's whitepaper on Financial Regulatory Reform published on June 17, 2009 also indicated the possible need for "reliable emergency liquidity facilities."[1] We agree with the Treasury Department's assessment and would like to have seen this subject addressed in the SEC's proposed rule changes.

**CAG's View**

In recent months, we've published several whitepapers and given presentations at several treasury management associations (including Boston, New York and San Diego) on the systemic risk of institutional fund investing. In light of the SEC's proposed changes and the Treasury Department's commitment to reducing funds' systemic risk, we think the steps below would help make institutional funds safer and more stable.

1. **A 40% Concentration Limit in Financial Issuers**

The current 2a-7 rule does not have an industry concentration limit, which resulted in high **correlation risk** among financial issuers. We propose that no more than 40% of a fund's portfolio may hold issuers from the financial industry. This change could help limit the impact of issuer correlation risk, increase government securities in the portfolios, encourage non-financial firms to borrow in the CP market directly, and reduce financial firms' incentive to grow off-balance-sheet assets.

2. **A 5% Issuer Limit by Economic Interest with Look-Through Compliance**

The current issuer concentration rule of 5% applies to legal entities but not economic entities. To illustrate, under the current rules, asset-backed commercial paper (ABCP) are special purpose vehicles (SPV) that receive beneficial support from a larger financial firms, but are considered separate entities. We propose that these conduits be viewed as affiliates within their parents and the 5% limit should encompass both the SPVs and the larger entities that provide this support. Additionally, since certain CP programs are in fact portfolios of underlying assets, these assets should be subject to a look-through provision and be combined with their economic issuers in the calculation of issuer limit.

3. **Public Disclosure of Shadow Pricing**

We propose that fund management calculates and publishes a fund's "shadow" NAV based on the underlying securities' actual market prices on a daily basis. Shareholders will have full visibility of how far the NAV deviates from $1.00 and approaches the point of "breaking the buck." If implemented, the actual NAV

does not have to float as long as the shadow price moves within a narrow band. **We think this disclosure provides a real life impairment check on the amortized cost based $1.00 per share**. We also think the shadow NAV can be used as triggers for forced redemption suspensions and wind-down events.

4. **Public Disclosures of 5% Shareholders**

Institutional shareholders tend to have higher fund flow fluctuations, so it helps to understand their likely behavior in a run scenario. Even under normal market conditions, unexpected redemption requests from large shareholders tend to have serious liquidity and yield impact on other shareholders. We propose that the number and relative size of shareholders who hold at least 5% positions should be publicly disclosed on a regular basis (at least monthly). Shareholder activities that result in the loss of 5% or more of fund assets should be reported immediately in an 8-K style SEC filing.

5. **Stress Testing Based Subordinated Capital Cushion**

We believe fund sponsors should stop providing *implicit* credit support to money funds, thereby avoiding the moral hazard of funds taking on undue risk and causing financial distress to their sponsors. As support entities, the sponsors should provide a subordinate capital cushion to the funds, properly sized based on the stress test results of potential interest rate, credit and liquidity risk impact. The capital cushion should be adjusted in response to periodic stress test results. The buffer could then be set in consultation with the sponsors' primary regulators and with accounting oversight.

6. **Contingent Liquidity SPV**

The most critical and also the most difficult element, is the issue of contingent liquidity. Some of our previous recommendations might be relaxed if a liquidity facility was in place to provide liquidity backed by ***good*** assets. We favor a public-private solution that resembles some of the recent government liquidity programs. This facility would allow a fund to borrow with non-defaulted assets as collateral from an SPV, jointly created by the industry and the government, and would require a mandatory 10% of hold back capital. For example, if a $10 billion fund needs $5 billion to satisfy emergency redemptions, it may sell $5.55 billion of its good assets into the SPV and receive $5 billion in cash and $550 million in a 2a-7 eligible CP issued by the SPV. The new CP would be used to cushion credit losses in these securities sold into the SPV. The facility would be a pure liquidity facility that would not involve credit risk to the government, provided that the subordinated capital cushion was sufficient to cover credit losses. The industry

would self fund by collecting premiums from participating funds to pay for the government's annual facility fees.

**Conclusion: If You Build it Again, Will They Come Back?**
The debacle in the money markets started in August 2007, when money funds were found to be exposed to subprime mortgages. The Lehman Brothers bankruptcy and the buck-breaking event of the Reserve Primary Fund brought the turmoil to a climax. Market liquidity and short-term financing were severely impacted as a result. It may take a long time and endless efforts to repair investors' damaged trust in the safety and liquidity of prime money funds.

On the heels of the recommendations from the Group of Thirty[2] and the Investment Company Institute[3], the SEC's proposed rule amendments were a step in the right direction in making money market funds safer. The overall impact of the changes, if implemented, however, would not prevent another run on the funds, in our opinion. We think that many, if not most, of the largest prime money funds were already abiding by these rules in September 2008, but almost all of them experienced some loss of assets in their prime funds. Thus, the substantive solution needs to be stronger portfolio credit quality backed by contingent external liquidity.

We believe these changes, along with our proposals, would improve the resilience of money market funds and reduce the run risk. Money market funds have been invaluable suppliers of short-term credit and indispensable tools for institutional cash management. The efforts by the regulators and the industry are certainly commendable steps to win back investors' trust in prime money funds. In the end, whether and when investors will wholeheartedly embrace the product again depends on how successfully the regulators and the fund industry move in the direction of better safety and liquidity for the funds without losing relative yield advantage to other cash instruments.

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[1] U.S. Department of the Treasury, A New Foundation: Rebuilding Financial Supervision and Regulation, June 17, 2009, Page 38: "…these measures should not, by themselves, be expected to prevent a run on MMFs of the scale experienced in September 2008. We propose that the President's Working Group on Financial Markets (WP) should prepare a report considering fundamental changes to address systemic risk more directly. Those changes could include, for example, moving away from a stable net asset value for MMFs or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources. Page 38

[2] Group of Third, Whitepaper Title - Financial Reform: A Framework for Financial Stability, January 15, 2009.
[3] Investment Company Institute, Report of the Money Market Working Group, March 17, 2009.

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