

Financial Regulation Altering the Cash Management Landscape

By BNY Mellon Cash Investment Strategies¹

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Executive Summary

Following the asset value decline of the Reserve Primary Fund, a large U.S. money market mutual fund, in September 2008, financial regulators and industry groups in the U.S. and Europe have been introducing new rules to shore up various types of money market funds to try to avoid a similar event in the future. On both sides of the Atlantic, funds are being required to hold more of their assets in highly liquid, overnight securities and to shorten the maturity of their holdings. At the same time, higher capital requirements under Basel III regulations will encourage banks to issue longer-term debt. In keeping with the laws of unintended consequences, these new regulations could create a disconnect between the supply and demand of shorter-maturity securities. We believe this could present new challenges for institutions looking to manage their liquidity needs across multiple time horizons and risk tolerances. The following discussion looks at some of the more significant regulatory changes for money market funds and banks over the last year and their potential effects on the global cash management landscape.

Supporting Money Market Funds

Given the severity of the global financial crisis, it is no surprise that regulators around the world are reviewing the market monitoring systems and safeguards in place. Since money market funds are the life blood of the financial system, providing key short-term financing for businesses, banks and governments, they have been one of the primary targets for reform. As large buyers of commercial paper (CP) issued by banks, money market funds help provide liquidity in the CP market. One of the more dramatic moments during the recent credit crisis was when the U.S. money market fund Reserve Primary “broke the buck” in September 2008, as its net asset value fell below \$1 a share because it held debt issued by Lehman Brothers Holdings Inc., which declared bankruptcy that month.

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Suddenly a vehicle previously considered nearly as safe as cash itself both lost value and stopped redemptions, which had ramifications throughout the entire money market universe. Commercial paper issuance virtually dried up overnight.

A little over a year later, in December 2009, the London-based Institutional Money Market Funds Association (IMMFA) revised its code of practice to improve the standards for maturity, credit quality, liquidity and disclosure for its members' funds. IMMFA is the trade association that represents the European triple-A rated money market funds industry. According to the group, it seeks to promote the interests of its members by ensuring that they offer a consistently high quality product to investors, in particular by maintaining a set of standards in its code of practice. All members are required to abide by the code and obtain a triple-A rating for their funds.

In addition the Committee of European Securities Regulators (CESR) has issued proposals for a two-tiered approach to money market funds in Europe, separating very liquid short-term funds from riskier longer-dated funds.

Europe Strengthens Money Market Funds Guidelines

In 2002, IMMFA introduced its own code of practice to establish European best practice standards in the absence of European legislation comparable to Rule 2a-7 adopted by the Securities and Exchange Commission (SEC) to regulate U.S. money market mutual funds.² Last year's revisions by IMMFA required that the funds hold at least 5% of their assets in overnight securities and 20% in securities maturing within five business days. Other requirements, according to the chairwoman of their Communications Committee, include:

- Monitoring and limiting any deviation between amortized and market value on at least a weekly basis, and implementing an escalation policy to act upon material discrepancies (starting at 10 basis points at the fund level).
- Maintaining a weighted average maturity (WAM) of no more than 60 days and a weighted average final maturity (WAFM) of no more than 120 days.
- Ensuring that each instrument held by the fund presents appropriate risk for the period during which it is held by the fund.
- Providing same-day liquidity with no penalty applied to redemption, and no fees charged to enter the fund or on redemption.³

In addition, the Committee of European Securities Regulators (CESR) has issued proposals for a two-tiered approach to money market funds in Europe, separating very liquid short-term funds from riskier longer-dated funds. Both the IMMFA and the European Fund and Asset Management Association (EFAMA) have endorsed a similar bifurcation of funds to reduce interest rate and credit risks.⁴ Meanwhile, the

² <http://www.immfa.org/About/Codefinal.pdf>

³ Kathleen Hughes, "Security for All Seasons," *The Finance Director*, May 5, 2009.

⁴ Nat Mankelov, "Euro MMFs Close in on Risk Definition," *FTMandate*, November 2009.

In the U.S., the SEC introduced tighter restrictions on the liquidity and maturity of holdings in registered money market mutual funds by amending Rule 2a-7. Specifically citing the Reserve Primary Fund and its effect on the money market universe, the SEC published new rules on liquidity and transparency for registered money market mutual funds during 2010.

UK's Financial Services Authority (FSA) has raised concerns about money market funds that are marketed as "cash" funds, saying that such labeling was "potentially misleading as it implies little or no risk to capital." In a recent update on money market funds it said some funds had poor monitoring practices and in some cases lacked criteria for deciding what kinds of underlying investments were allowed. The FSA said it would provide formal feedback to those firms and "follow up on remedial action where necessary."⁵

SEC Imposes Higher Liquidity Requirements on U.S. Money Market Funds

In the U.S., the SEC introduced tighter restrictions on the liquidity and maturity of holdings in registered money market mutual funds by amending Rule 2a-7. Specifically citing the Reserve Primary Fund and its effect on the money market universe, the SEC published new rules on liquidity and transparency for registered money market mutual funds during 2010.⁶

For all taxable money market funds, at least 10 percent of assets must be in cash, U.S. Treasuries, or securities that are readily convertible to cash within one day. In terms of weekly liquidity, at least 30 percent of assets in all money market funds must be in cash, U.S. Treasuries, certain other government securities with remaining maturities of 60 days or less, or securities that are readily convertible to cash within one week. This establishes specific minimum liquidity mandates.

The average maturity limits for such money market funds have also been shortened to limit the exposure of funds to interest rate movements. As with the IMMFA money market mutual funds, U.S. registered money market mutual funds now have a maximum WAM of 60 days and a maximum weighted average life (WAL) maturity of 120 days.

The SEC provisions also introduce new "know your investor" procedures, requiring funds to hold sufficiently liquid securities to meet foreseeable redemptions. U.S. funds have now implemented procedures to identify investors whose redemption requests may pose risks for funds and anticipate the likelihood of large redemptions. Another new requirement is for money market fund managers to conduct periodic stress tests to examine the fund's ability to maintain a stable net asset value per share in the event of shocks such as interest rate changes, higher redemptions, and changes in credit quality of the portfolio.

⁵ Life Insurance Newsletter," Financial Services Authority, Issue 3, November 2010.

⁶ <http://www.sec.gov/news/press/2010/2010-14.htm>

In an effort to increase transparency, the SEC now requires money market funds to post their portfolio holdings each month on their websites. In addition the funds will have to send detailed portfolio schedules to the SEC each month to help create an interactive database through which the SEC can better oversee money market fund activities.

The new rules continue to limit a U.S. money market fund's investment in rated securities to those in the top two rating categories (or unrated securities of comparable quality). At the same time, money market funds continue to be required to perform an independent credit analysis for every security purchased. As such, the credit rating serves as a screen on credit quality, but is not meant to be the sole factor in determining whether a security is appropriate for a money market fund.

Increasing Transparency

The new SEC rules also tighten requirements that allow a money market fund to "look through" the repurchase issuer to the underlying collateral securities for diversification purposes. Collateral must be cash items or government securities (as opposed to the previous requirement of highly rated securities) and the fund is required to evaluate the creditworthiness of the repurchase counterparty.

In an effort to increase transparency, the SEC now requires money market funds to post their portfolio holdings each month on their websites. In addition the funds will have to send detailed portfolio schedules to the SEC each month to help create an interactive database through which the SEC can better oversee money market fund activities. This information would be available to the public 60 days after the SEC receives it and would also include a money market fund's "shadow" net asset value (NAV), or the mark-to-market value of the fund's net assets, rather than just the stable \$1.00 NAV at which shareholder transactions occur. Previously, a money market fund's "shadow" NAV was reported twice a year with a 60-day lag.

Improving Money Market Fund Operations and Orderly Liquidations

Many of the SEC's new provisions are directed at improving the fund's ability to conduct business in the event of a shock. For example, money market funds and their administrators are now allowed to process purchases and redemptions electronically at a price other than \$1.00 per share in order to facilitate share redemptions in the event of a fund breaking the buck. Under the new rules, a money market fund's board of directors may suspend redemptions if the fund is about to break the buck and the board decides to liquidate the fund (previously the board had to request an order from the SEC to suspend redemptions). In the event of a threatened run on the fund, this allows for a more orderly liquidation. However, the fund must notify the SEC prior to acting on this rule.

While money market fund regulators are pushing funds toward shorter-dated securities, global bank regulators are moving banks in the opposite direction. Under the new Basel III Accords, banks will be encouraged to issue longer-term debt because commercial paper and repurchase agreements (repos) will not be treated as a stable funding source.

In addition to the new SEC rules, the President's Working Group on Financial Markets in the U.S. listed a number of possible further reforms in 2010 aimed at making the funds more stable and less susceptible to runs.⁷ The group is chaired by the U.S. Treasury Secretary and includes the chairman of the Federal Reserve, the SEC and the Commodities Futures Trading Commission.

The alternatives included introducing a floating net asset value for funds rather than the current fixed value of \$1 per share for most funds. This would allow the value of the assets to change based on market swings. The group acknowledged that introducing a floating rate could have unintended consequences such as diverting investors into unregulated alternatives offshore. Other alternatives considered a private emergency liquidity facility that funds could draw in times of market stress, insurance for money market funds, and — similar to European proposals — a two-tiered system with different regulations for stable-priced and floating-priced funds. The group now wants the Financial Stability Oversight Council, which was set up under the new Dodd-Frank financial reform law, to review their recommendations and decide next steps.

Basel III Accords Push Banks Toward Longer-Dated Debt

While money market fund regulators are pushing funds toward shorter-dated securities, global bank regulators are moving banks in the opposite direction. Under the new Basel III Accords, banks will be encouraged to issue longer-term debt because commercial paper and repurchase agreements (repos) will not be treated as a stable funding source.⁸ As a result, banks will be reducing their reliance on repos, just as the new liquidity requirements for money market funds are increasing the demand for repos for overnight maturities.

We believe the combined effect of these bank and money market regulations will have significant effects on the cash management landscape. In addition to a reduction in the supply of repo and commercial paper issuance from banks, we expect there will be a tighter supply overall of shorter (60 days or less) maturity money market securities. We also expect to see reduced interest in shorter maturity (two- or three-year) floating rate notes and greater interest

⁷ <http://www.treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf>

⁸ <http://www.bis.org/bcbs/basel3.htm>

In our view, such significant changes in the supply and demand of shorter-maturity money market securities could present new challenges for institutions looking to manage their liquidity needs across multiple time horizons, risk tolerances and geographies.

in short maturity bills and government bonds. Since bank deposit rates are currently higher than money market fund rates and bank deposit insurance has been increased to \$250,000 per account, we believe there will be a shift from money funds to retail bank deposits. As a result of these changes, we also expect bank funding costs and LIBOR to be higher as banks compete for funding.

In our view, such significant changes in the supply and demand of shorter-maturity money market securities could present new challenges for institutions looking to manage their liquidity needs across multiple time horizons, risk tolerances and geographies. One of the lessons of the liquidity squeeze during the recent financial crisis was the need for careful liquidity management for institutional investors with complex and often illiquid underlying investments. We believe tiered approaches to cash management across maturities could become more attractive to those investors as the supply and demand mismatch created by new regulations further complicates the challenge of liquidity management.

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