ICD COMMENTARY:
MONEY MARKET FUND REFORM OPTION #9

SEPTEMBER 2011

Institutional Cash Distributors, LLC
580 California St., Suite 1335
San Francisco, CA 94104
Member FINRA/SIPC
www.icdfunds.com
ICD COMMENTARY:
MONEY MARKET FUND REFORM OPTION #9

INTRODUCTION

There is an ongoing and spirited debate about how to best reduce Money Market Funds’ (MMF) susceptibility to systemic risk. The October 2010 President’s Working Group (PWG) Money Market Fund Reform Options¹ report provided an analysis of the financial crisis and its impact on MMFs. In the report the roundtable acknowledges the important changes to Rule 2a-7 in the form of new disclosure requirements, increased liquidity and other actions to strengthen the regulatory framework governing money market funds. The PWG report goes on to outline eight (8) new reform options and summarize the potential pros and cons of their implementation. These new reform options are currently under consideration.

This ICD commentary contends that the significant corrective reforms made to Rule 2a-7 by the SEC in 2010² are already in place and working, and that these reforms have been proactively adopted by industry leaders. Moreover, the synthesis of the new fund data made available from these 2010 reforms – in combination with new industry exposure analytics applications – have resulted in a compelling, new, end-to-end MMF investing process. We refer to this as Money Market Fund Reform Option #9.

Download PDF

ACTION: Final rule. Portfolio Liquidity 49 – 67, Disclosure of Portfolio Information 72-77
Money Market Fund Reform Option #9 makes best use of the 2010 SEC Rule 2a-7 fund holdings disclosures and minimum liquidity requirements amendments in innovating new MMF investment guidelines and exposure analytics applications. Further, this industry-adopted solution – referred to collectively as Option #9 – has reduced the critical risk management gaps that caused the run on MMFs in 2008.

Hidden Risks and Misplaced Blame: It is ironic that money market funds are associated with the start of the credit crisis of 2008. It was government, banks and mortgage brokers who precipitated and grew the asset bubble and it was the credit ratings agencies that seriously erred in assessing risk. The notion that money market funds were the cause - the ground zero of the financial crisis – is to misunderstand the real causes and to misrepresent the role of corporate treasurers.

Corporate Treasurers – Exemplars of Caution: Corporate treasurers are the institutional investors that move the MMF marketplace. They are, arguably, the most conservative professionals by practice and by behavior in finance. Their investment objectives are first and foremost preservation of capital, followed by liquidity, and then yield. Prior to 2008, investors, believing that all triple-A rated funds were equally safe in regards to preservation of capital and liquidity, focused more on yield. As the subprime mortgage-backed securities were bundled into even bigger mortgage derivatives and the toxicity spread worldwide the credit ratings agencies continued to provide triple-A ratings to prime funds even as several fund managers took exceptional risks to increase their fund yields. Investors were blind to these foreboding exposures.

Breaking the Buck: On September 16, 2008, the day after Lehman Brothers Holdings Inc. filed for bankruptcy, the Reserve Primary Fund, “broke the buck” as the Net Asset Value for the fund dropped below the stable price of $1.00 per share. Investors, without the benefit of fund analytics to assess underlying exposures of their portfolio positions, were unable to quickly or reliably differentiate between funds and were forced to sell en masse out of all Prime MMFs.
Too Much Regulation – Unintended Consequences: Since then, corporate treasuries have accepted the 2010 SEC Rule 2a-7 reforms and have adopted the resultant new MMF investment guidelines tools and exposure analytics applications. To add additional reform measures now, specifically any of the eight reform options under consideration by the PWG, would risk destabilizing the progress that has been made internally by the industry and would create the possibility of unintended consequences that may produce new systemic risks, or worse, diminish MMFs as a viable cash management financial product.

MMFs Are Essential to Global Financial Supply Chain: The damage from a diminished Money Market industry would not be isolated solely to money market funds and their investors. Money market funds are also key providers of liquidity and credit in the short term funding market. As detailed in the President’s Working Group report, “With nearly $3 trillion in assets under management, MMFs are important providers of credit to businesses, financial institutions, and governments. MMFs own almost 40 percent of outstanding commercial paper, roughly two-thirds of short term state and local government debt, and significant portions of outstanding short term Treasury and federal agency securities”\(^3\). Should these investment vehicles no longer perform their important function in the marketplace, corporations, municipalities and the federal government would have to seek access to credit through alternate means, potentially raising the cost of borrowing throughout the global economy.

**OPTION #9**

1. Reduces the motivation for MMF managers to take on undue risk

2. Creates better portfolio diversification

3. Dissuades investors from panic selling if one or more funds become problematic

4. Takes advantage of increased liquidity requirements
OPTION #9 REDUCES THE MOTIVATION FOR MMF MANAGERS TO TAKE ON UNDUE RISK:

The Reserve Primary Fund, “broke the buck” in September of 2008 and jeopardized the entire MMF industry. In 2007, the Reserve Primary Fund changed its purchasing strategy, buying short-term debt from headline risk brokerage houses like Lehman Brothers and Merrill Lynch. This helped move the Reserve Primary Fund from the 25th highest yielding prime fund at the beginning of 2007 to the 2nd highest yielding prime fund by the beginning of August 2008. During that time, the Reserve Primary Fund saw its asset size grow by over 350%.

While the Reserve Primary Fund’s asset size was increasing, so were the Credit Default Swap (CDS) prices on the headline-risk financial institutions. In fact, by July 31, 2008 Lehman Brothers, AIG, WAMU and Wachovia’s CDS prices more than doubled from their already expensive January 31, 2008 prices. Other financial institutions such as Wells Fargo, BNP Paribas and Lloyds had much smaller increases on much lower CDS prices.

5 YEAR CREDIT DEFAULT SWAP (CDS) PRICING

<table>
<thead>
<tr>
<th></th>
<th>WAMU</th>
<th>LEHMAN</th>
<th>WACHOVIA</th>
<th>AIG</th>
<th>WELLS FARGO</th>
<th>LLOYDS</th>
<th>BNP PARIBAS</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/31/08</td>
<td>311.94</td>
<td>151.01</td>
<td>119.41</td>
<td>120.48</td>
<td>65.09</td>
<td>62.00</td>
<td>62.00</td>
</tr>
<tr>
<td>02/29/08</td>
<td>408.98</td>
<td>202.48</td>
<td>175.38</td>
<td>180.59</td>
<td>93.35</td>
<td>84.89</td>
<td>73.43</td>
</tr>
<tr>
<td>03/31/08</td>
<td>484.58</td>
<td>293.77</td>
<td>176.75</td>
<td>180.46</td>
<td>95.63</td>
<td>85.59</td>
<td>80.33</td>
</tr>
<tr>
<td>04/30/08</td>
<td>287.75</td>
<td>157.35</td>
<td>112.62</td>
<td>97.93</td>
<td>65.62</td>
<td>48.66</td>
<td>40.84</td>
</tr>
<tr>
<td>05/30/08</td>
<td>320.18</td>
<td>177.90</td>
<td>121.22</td>
<td>115.32</td>
<td>62.26</td>
<td>49.67</td>
<td>43.73</td>
</tr>
<tr>
<td>06/30/08</td>
<td>580.82</td>
<td>279.92</td>
<td>209.91</td>
<td>214.15</td>
<td>113.82</td>
<td>84.07</td>
<td>70.47</td>
</tr>
<tr>
<td>07/31/08</td>
<td>931.70</td>
<td>328.91</td>
<td>249.59</td>
<td>243.33</td>
<td>104.69</td>
<td>71.90</td>
<td>47.93</td>
</tr>
<tr>
<td></td>
<td>199%</td>
<td>118%</td>
<td>109%</td>
<td>102%</td>
<td>61%</td>
<td>16%</td>
<td>-23%</td>
</tr>
</tbody>
</table>

(Bloomberg Market Data)


Between the two, Reserve Primary Fund was particularly well known in the industry because of its owner, Bruce Bent, the founder of the first money market fund in the 1970s. Until July 2007, both funds had about $25 billion of assets under management and charged similar management fees. In what follows we present the evolution of each fund’s returns, fund assets, and holdings over the period from July 2006 to August 2008.

In Figure 2, we present the returns on both funds relative to the industry average. Prior to August 2007, the returns roughly matched the industry average. However, starting in August 2007, the relative returns on the two funds diverged sharply: Relative to the industry average, the return on Reserve Primary Fund increased by about 50 basis points, while at the same time the return on Columbia Cash Reserves decreased by about 30 basis points. The return differential triggered significant money flows: Reserve Primary Fund tripled its assets under management, from $20 billion in August 2007 to $60 billion in August 2008, while Columbia Cash Reserves’ asset value declined, from $30 billion to $20 billion.

4 Crane Data Reports - 12/31/06; 5 Crane Data Reports - 07/31/2008; www.cranedata.com
6 Implicit Guarantees and Risk Taking: Evidence from Money Market funds Kacperczyk and Schnabl (2011)
The observed differences in both returns and fund flows were largely a consequence of the differences in the underlying fund portfolios, especially after August 2007. Figure 3 shows that the Reserve Primary Fund increased its holdings of risky assets from 0% to 60% while it reduced its exposure to safe Treasury Bills and repurchase agreements from 40% to 10%. In contrast, Columbia Cash Reserves actually decreased its holdings of risky assets slightly and kept the same level of safe Treasury Bills and repurchase agreements8.

---

7, 8 Implicit Guarantees and Risk Taking: Evidence from Money Market funds Kacperczyk and Schnabl (2011)
The preceding charts show that the Reserve Primary Fund was rewarded for taking on risk that was avoided by Columbia Cash Reserves. At that time many investors erroneously regarded triple-A MMF’s as having equal or similar risk. If corporate investors were using Option #9 methodologies in 2007 and 2008, this ICD Commentary argues that the Reserve Primary Fund may have lost investor asset support unless the fund managers modified their investment strategy. As growing assets is a primary fund company goal, the application of Option #9 may have changed the behavior of the Reserve Primary Fund managers and prevented the Reserve Primary Fund from “breaking the buck.”

10 As a collateral effect, we expect that the public disclosure of monthly market-based net asset values may have the effect of discouraging a fund’s portfolio manager from taking risks that might reduce the fund’s market-based net asset value. (July 2009) 86-7. See Fund Democracy/CFA Comment Letter (“Greater transparency should provide a strong incentive for funds to avoid the excessively risky practices that lead to instability and encourage redemption.”)
ICD COMMENTARY:
MONEY MARKET FUND REFORM OPTION #9

OPTION #9 CREATES BETTER PORTFOLIO DIVERSIFICATION:

MMFs are inherently diversified. Option #9 synthesizes dynamic fund data sets with purpose-built tools designed to further diversify MMF portfolios. The new analytics applications enable corporate treasurers to establish and monitor new investment guidelines that create portfolio maximums for fund holding issuers and countries. In Treasury Strategies’ white paper⁷, they recommended the following parameters and investment ranges. Investment guidelines should incorporate specific parameters and limits that match an institution’s investment objectives and risk tolerance. Black markers are position examples only.

ICD recently published the results of its Best Practices for MMF Investing survey that concluded on August 5, 2011. Of the 63 corporate treasury respondents, only one indicated that analytics were unnecessary.⁸

---

⁷ TreasuryStrategies.com/sites/default/files/TSI_NewApproachMMFInv.pdf
OPTION #9 DISSUADES INVESTORS FROM PANIC SELLING IF ONE OR MORE FUNDS BECOME PROBLEMATIC:

Many argue that fear is the oldest and strongest emotion. And it was fear of the unknown that caused institutions to over-react in September of 2008. The reality was that the great majority of other Prime Funds did not invest in headline risk companies at that time. Only four of the 40 Prime Funds on ICD’s Portal invested in Lehman Brothers. Only three of the 40 Prime Funds on ICD’s Portal invested in AIG, of which, two had minimal positions. None of the 40 Prime Funds on ICD’s Portal invested in Washington Mutual.9 All of the funds, including those with no positions in headline-risk companies faced major redemptions as investors were forced into panic mode when the global financial system seized. With limited holdings information available, institutions sold first and asked questions later.

If investors had access to cogent investment guidelines and dynamic exposure analytics tools they would have been able to discern which funds were exceedingly exposed to risk and would have made an orderly retreat from these high risk investments and the marketplace would have re-adjusted without chaos.

---

9 www.icdfunds.com
10 Transparency Plus 2.1 Comprehensive Report, icdfunds.com (August 2011)
OPTION # 9 TAKES ADVANTAGE OF INCREASED LIQUIDITY REQUIREMENTS:

New Rule 2a-7 liquidity requirements that were put into place in 2010 now require MMFs to hold 10% daily liquidity and 30% weekly liquidity, while allowing only 5% in illiquid securities.11 These added liquidity requirements put funds in much better positions to deal with large scale redemptions. Credit agency Moody’s most recent sector comment commends MMF’s strengthened liquidity position while confirming the resiliency of the fixed NAV.

With enhanced disclosure and in-depth analytics programs corporate treasurers are also better equipped to track the duration of their portfolio and monitor the liquidity profile of their core cash investments. They can, in effect, be as liquid as their risk profile dictates and are in a better position to reward managers that maintain the type of asset allocation and maturity schedule they require.

“Prior to the resolution of the US debt ceiling crisis on 2 August, US money market funds experienced the single largest weekly outflow since the Lehman bankruptcy. In the five days to 2 August, redemptions totaled about $133 billion, or 5% of net assets, and funds were able to meet these requests effectively without any large scale forced selling of securities. Furthermore, our rated funds’ portfolio mark-to-market values remained, on average, above or close to the $1.00 net asset value (NAV). This is credit positive for investors as it shows money market funds are better able to handle future market disruptions.”


11 2010 2a-7 Reform Options
HAD OPTION #9 BEEN IN PRACTICE IN 2007 AND 2008:

1. The Reserve Primary Fund may have been a smaller, lower risk fund – as it would not have the market incentives to incur greater risk for higher yield

2. MMF portfolios would have been much better diversified – as greater transparency into the funds would encourage fund managers to meet investor demands for higher diversification

3. Institutional investors would not have been forced to sell out of lower-risk MMFs – as they would have more visibility into underlying holdings

4. The MMFs and short-term marketplace would have been more liquid – the short-term market would have been less likely to seize

Individually these factors would have minimized the 2008 run on MMFs. Collectively, these factors should have eliminated it.

Draconian reforms are not the answer nor is merely agreeing to the 2010 SEC Rule 2a-7 amendments a complete solution to the problem. What is needed is an approach that leverages these 2010 reforms with technical ingenuity, business process, and wide-spread adoption to establish a self-policing set of best practices that can be applied across the entire industry.

Option #9 is the comprehensive solution that enables the corporate investor to drive the marketplace to a state of enhanced security and reduced credit and liquidity risk.

On President Obama’s direction, White House Chief of Staff William Daley has given new instructions to the cabinet. He has asked cabinet members to minimize regulatory costs, avoid imposing excessive regulatory burdens, and prioritize regulatory actions that promote economic growth and job creation. As the president has said, ‘We can make our economy stronger and more competitive, while meeting our fundamental responsibilities to one another. We will continue to eliminate unjustified regulatory costs—and thus to strengthen our economy.’

- Cass Sunstein
Administrator of the Office of Information and Regulatory Affairs: White House Office of Management and Budget,
Washington Is Eliminating Red Tape
Wall Street Journal (August 23, 2011)