The Financial Crisis of 2008 has left its mark on the capital markets and the economy, and money market mutual funds are one of those areas that were affected. One of the pieces of unfinished business following the financial crisis is improved regulation of money market mutual funds. It is widely believed that the collapse of the $62.5 billion Reserve Primary Fund in September 2008 triggered a wider run on money funds, which helped freeze global credit markets. Mary Shapiro, chairwoman of the SEC, has argued the funds’ stable share price encourages investors to flee at the first sign of trouble because it allows those who react quickly to sell their shares at $1 each even if the net asset value has dropped below that level. Her proposal would have given fund managers a choice of switching to a floating share price that reflected the market value of holdings, or establishing a capital buffer to protect against credit losses and redemption restrictions to discourage investor flight. However, last month three of the five commissioners, after heavy lobbying form the industry, told her they wouldn’t support her proposal, effectively derailing the initiative. With interest rates near historic lows, the rates of return on their investments in today’s investment environment are not high enough to cover the expenses of operating the money fund. So far, the industry has been successful lobbying to resist further regulation. This paper discusses current issues related to money market funds and the potential next step that we believe will be taken to further regulate money market mutual funds and what that implies for investors.

A Short History of Money Market Mutual Funds

Money market mutual funds, which were first introduced in 1971, are structured as registered investment companies under the Investment Act of 1940. Since they were originally offered outside of the banking industry, they did not fall under Regulation Q which fixed the rate that banks could pay on deposits. However, in 1983, the Garn-St. Germain Act permitted the establishment of bank money market accounts as FDIC-insured alternatives to money market mutual funds helping to stem the deposit outflows from the banks into money market funds. Since money market funds are separate pools of assets, they invest in securities which may include commercial paper, repurchase agreements, short-term bonds, bankers’ acceptances and certificates of deposit. As a result, during the high interest rate environment of the 1980’s, money market funds became a popular alternative investment for cash for investors since the yield was substantially higher than the regulated rate savers would earn in their bank savings account.

Today, money market funds have grown to $2.7 trillion and have become one of the pillars of the capital markets since they offer investors a diversified, professionally managed portfolio with daily liquidity. In addition, unlike most other financial instruments, money market funds seek to maintain a stable net asset value of $1 per share. However, as the structure of the capital markets has changed over the past decade, and the sheer size of the money market fund segment has grown relative to the overall capital markets, the form and role that money market funds play in the capital markets may be changing as well. Since the Federal Reserve’s monetary policies have forced short term interest rates near zero percent, investors in money market mutual funds are not earning the interest rates they have in prior decades.
During the Financial Crisis of 2008, the Reserve Primary Fund (one of the oldest money market mutual funds) Net Asset Value fell below the coveted $1.00 level after a large investment in Lehman Brothers commercial paper defaulted. There were many other funds that would have broken the buck if their parent companies hadn’t injected the capital that allowed the fund to maintain the one dollar NAV level.

As a result, the SEC passed rules in May, 2010, amending Rule 2-a-7 which further strengthened money market mutual funds. These amendments included shortening the weighted average maturity, lowering the single issuer limit, improving the overall credit quality, increasing the collateral requirements for repurchase agreements, and monthly disclosure of portfolio holdings. Through the turmoil in the markets last year as a result of the downgrade of the United States Treasury debt and the European financial crisis, no money market fund “broke the buck”.

The Dirty Secret of Your Money Market Fund

Money Market funds face two challenges: they are no longer profitable for the investment advisor and they are more difficult to manage given the limited universe of investable securities.

The investment manager of a money market fund charges an advisory fee for their service. Today, the investment advisor has to waive their fee in order to provide investors with a miniscule rate of return and maintain the $1 NAV. As an example, in 2007 Federated waived 0.17% of its fee on 0.65% of net expenses for the Federated Prime Money Market Fund. That year the total return for the fund was 4.78%. In 2011, they waived 0.32% of their fee and the total return of the fund for the year was zero.

One of the consequences of the massive Federal Reserve quantitative easing programs is that some of the money has found its way into money market mutual funds as a safe haven. The challenge that portfolio managers of money market funds have, given the growth in portfolio assets, is that there barely are enough good investments to buy that meet the investment criteria and provide a high enough yield to offset expenses of the fund. As money market funds have grown in size over the past ten years, the universe of investable assets in which they can invest has become more limited.

Histortically, money funds invested in money market instruments that provided liquidity for banks, finance companies and industrial companies. Today, with the consolidation in the banking industry, large banks lend directly to companies that historically borrowed in the commercial paper market. As a result, money market portfolios have higher exposures to the commercial paper issued by collateralized debt obligations and other structured securities, and less in commercial paper of industrial companies. As an example, the Federated Prime Reserve Fund Annual Report for 2011 shows roughly 25.8% invested in the commercial paper of structured securities including asset-backed and collateralized debt obligations. One of the cheaper investments for money market funds has been the commercial paper and certificates of deposit of European banks. However, over the past year, U.S. domestic money market funds have generally decreased investments in European banks. The U.S. money market fund industry has been a significant source of financing for European banks. This dynamic is summarized in our Investment Perspective – European Bank Leverage.
The Role of the Securities & Exchange Commission

This year, the Securities and Exchange Commission (SEC) attempted to push through additional rule changes for regulating money market mutual funds beyond what was imposed following the financial crisis. More specifically, the SEC considered additional reform with the objective of changing the structure of money market funds. The three concepts that were considered included allowing the net asset value to float, imposing a redemption holdback on investors withdrawing funds, and/or imposing capital requirements for the money market fund.

After delaying a vote on additional rule changes this summer, Mary Shapiro indicate last month that the SEC will no longer pursue these rule changes as a result of not gathering the internal support necessary. It is clear that mutual fund companies will not support any regulation that raises their costs to operate money market funds or puts any liability on them for investor protection.

We believe that there are two major problems with allowing money market mutual fund NAV’s to float. First, it represents a risk transfer from the mutual fund company to the consumer which is destabilizing to the capital markets. Second, the hidden costs to move to a floating rate money market fund are very high. Investors have come to rely on money market funds to earn a reasonable rate of return on their liquid cash. However, if there is no longer a guarantee of a $1.00 NAV, investors will find alternatives for their cash, resulting in disintermediation from money market funds to other products or bank deposits.

Regulations that require money market funds to abandon their stable $1.00 NAV will impose substantial costs on investors and funds whether the funds’ actual per-share values ever move or not. These costs include changes in software, accounting standards and reporting that would have to track gains and losses on cash balances. Currently, several state laws and investment policies bar governmental entities, nonprofit organizations, and businesses from investing cash in floating-value products, so those investors would have to retool their cash management systems. In addition, there is a no assurance that the Financial Accounting Standards Board (FASB) and Government Accounting Standards Board (GASB) would grant cash-equivalent status to floating-value money market funds, which means institutions would have to track and reflect any fluctuations in shares’ values on their books. As a result, individual and institutional investors would have to regard every money market fund transaction as a potentially taxable event, and funds would have to build reporting systems to track gains and losses.

In response to the initiative to allow the NAV of a money market fund to float, the Investment Company Institute (ICI) commissioned a survey through Treasury Strategies, Inc., to study the receptiveness of corporate treasurers, government and institutional investors to each of the SEC’ reform concepts. The report, Money Market Fund Regulations: The Voice of the Treasurer, concludes that the overwhelming majority of treasurers will either scale back their use of money market funds or discontinue use of them altogether if any of its SEC’s three concepts to change money market fund operations takes effect.
What Happens Next?

We believe the issue of money market mutual fund reform is not going to go away. Since Shapiro pulled the proposed rule changes from a vote this past week, we expect one of two things to happen. Either the SEC will draw up a new set of rules that will be more favorable to the mutual fund industry, or the issue will be taken up by the Financial Stability Oversight Counsel (FSOC). The FSOC is a result of the Dodd-Frank Act which includes representatives from the major financial services regulatory agencies. The FSOC could deem the largest money market mutual funds, which hold roughly 60% of the entire $2.5 trillion, as systemically important financial institutions. By the same token, the FSOC could deem the entire industry as systemically important and send the matter back to the SEC with instructions to regulate money market funds in a manner that would minimize their risk to the financial system, which is what Shapiro was trying to do in the first place.

As it relates to domestic money market funds and bank sweep accounts, we believe it is important to watch what is going on in Europe with respect to their €1.1 trillion cash fund market, which is similar to our bank sweep accounts. Similar to money market funds, cash funds are considered very safe and invest in high quality short term debt and bank deposits. Last week, the Financial Times reported that four European banks are talking with investors about passing on losses incurred after the European Central Bank cut in July. With short term interest rates on German and French government debt in negative territory, the banks are now looking to pass these negative yields on to investors. We expect the impact will ripple across the ocean and potentially affect the structure of U.S. money market funds.

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