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REFORMING MONEY MARKET FUNDS: A RESPONSE TO THE SQUAM LAKE GROUP

SUNDAY, MARCH 18, 2012 AT 09:34PM

The money markets are central to critical issues such as credit creation, systemic risk, and investor confidence. They function on a macro level to allocate globally short term credit, unsecured in the case of commercial paper, and secured in the case of repo.

Money market funds are defined in the Investment Company Act of 1940 Act and influenced by investor preferences as expressed within that regulatory framework. Historically and as a practical, functional necessity the money markets have been geared to the very lowest levels of perceived risk, which is to say very short term exposures (average maturities of 30- 45 days) to the very highest quality credits. Historically, one whiff of trouble … reputational, credit degradation, informational risk or whatever is not clear and simple… and you have investor flight, which is what happened to the TBTF’s (Too Big To Fail) in the Great Unpleasantness.

Today those same problems remain. Money funds today operate with no capital whatsoever. They are cash repositories and warehouse massive systemic risk: broadly put, short term, rolling AA- credit & liquidity risks ... sovereign, corporate & financial. And the nature of that risk has qualitatively changed for the worse over the last decade. Go price $ trillions of that quality and quantity of risk in the market today and see what it costs. Yet money market funds operate today with no capital whatsoever.

None.

The Squam Lake Group (SLG) in Reforming the Money Market Funds of Jan. 14, 2012, put forth a proposal to presumably stabilize and make the US money markets more durable. The Abstract is below:

> *The current stable-NAV model for prime money market funds exposes fund investors and systemically important borrowers to runs like those that occurred after the failure of Lehman in September 2008. This working paper, by the Squam Lake Group, argues that, to reduce this risk, funds should have either floating NAVs or buffers provided by their sponsors that can absorb losses up to a level to be set by regulators. We suggest alternative designs for such a buffer, as well as considerations that should be taken into account when determining its required size.*

We support their effort and thought we would supplement their comments with our own. The SLG proposal reduces to

1. Eliminate the $1.00 fixed unit of the money market fund. Make the NAV (Net Asset Value) float in accord with market rates (essentially a daily mark to market). This mechanic, so the thinking goes, should provide a timely market mechanism to clear trades in the event of any systemic credit and liquidity event; or
2. Keep the fixed $1.00 unit of the money market but with some capital the form of which is either a) subordinated claims or b) reserved, segregated assets subject to a call, either form in amount deemed adequate by regulators

First, team SLG got one big thing right:

> *"If money market fund managers believe that such guarantees [moral hazard] will be forthcoming in response to any systemic event, they will have*

> *incentives to take greater risks than is prudent from a systemic perspective."*

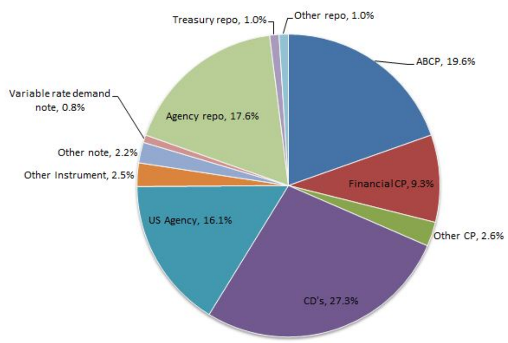
So here we are again. Having failed once, most funds have reloaded again. Hmmm, what is that song, *Who Let the Dogs Out?* This continuing regulatory failure evidences the limitations of an approach that relies on regulation for what it cannot provide.

Consider a recent Money Market Funds Aren't What You Think. Speaking of what investors don't know:

> *notwithstanding SEC actions since 2008, their [investor's] funds may not be fully safe. They don't know that as recently as last summer, the largest money funds averaged 45% of their investments in European bank paper, with one major player at just under 70%. They don't know that, were the investments to falter, half of the top 10 money-fund providers are not large and presumably well-capitalized banks but instead asset managers that don't have anything like banks' capital resources.*

> *Nor do money-fund investors know that the largest money-fund managers have been gaining share in the industry over time, therefore concentrating and potentially heightening the risk of a failure.*

Let's face it; money market funds warehouse risk: credit, liquidity, and to a lessor extend interest rate. We suggest you read a prospectus and look the portfolio. Here is a typical money market fund portfolio (more specifically, a major fund currently serving the retail market):



Look at the specific holdings of a different, much smaller money market fund. We actually suggest you look at the holdings of what you own.

- Risk free? No.
- Fully compliant? Yes.
- Distrubuted widely to retail investors? Yes.
- Any capital? No.

Where there is risk, there must be capital to support it. Would you feel comfortable with a bank operating without capital? That's where we are, or rather where our esteemed regulators have allowed us to be.

I think team SLG got two things wrong:

1) As the Great Unpleasantness demonstrated neither the regulators nor the rating agencies really ~~have a clue as to~~ know what levels of capital are necessary in 'normal' times let alone chaotic ones.

2) The form of variable unit pricing (i.e. daily mark to market) simply won't work in the markets when they need it to, that is, during a crisis. In theory it sounds good, but in practice, particularly in chaotic markets, it chafes against the hard reality of ***no bid = no bid.*** You probably can't price this stuff in a stressed, illiquid market… just when you need to.

Concentrated investor base

The structure and increasing concentrations of both the issuer & investor bases over time have greatly added to both the credit concentration & liquidity risk of the markets. For example, the top 10 or so investors in any commercial paper program [1], which we take as a proxy for the market in general, typically provide ~70% of the total volume for any particular issuer (the figures are somewhat dated, but close enough for our purposes). The aggregation of the industry, driven by Moore's Law and regulation, has concentrated the risks and reduced diversification. We'll talk about information risk a bit later.

Liquidity risk for issuers is liquidity risk for investors: large $, short fuses

Money market issuers (of commercial paper, euro commercial paper, CD's, ECD's and repo) sell paper (buy cash) every single day in the market. Consider that the average maturity of commercial paper is normally less than ~30 days with a hard skew to the short end. If you have a billion dollar book, half of it comes due in less than 15 days with a bunch due tomorrow. That's problematic because if you, the borrower, can't roll your funding today, you have geometrically increasing funding requirements for the next two weeks. A failure to fund one day essentially doubles in magnitude tomorrow and so on. It can go viral, exponentially, as it did before.

Recall that the top 10 investors in any commercial paper program typically provide ~ 60-80% of total volume, so if you lose one, you're hurting. Lose two, you're probably done. And we must remember that failure to pay when due is an event of default which triggers, typically, a boatload of cross defaults.

Of course, banks provide committed (putatively) back up facilities, hence a cash mechanic to aggregate & transmit failing risks and liquidity stress to the banks... you know, the same banks that recently had the same global liquidity failure in the Great Unpleasantness.

Real time rates of reaction: instantaneous credit decisions

Imagine a presentation by any large scale issuer of addressing its investors. The seating in the room is ordered so the size of exposure determines proximity to the door, such that the largest investor is seated closest to the door, and so on. The largest 2 or 3 investors ("Big Dogs") each carry about 10-15% of the program and are watching the presentation intently. All the other investors are watching the large investors. If one of the Big Dogs moves to the door, you have a stampede, in this case, a stampede of billions of dollars which spreads instantaneously to the CDS and overnight markets. It is done: ***no bid = no bid.*** Oops, it's time to draw on the banks, or if you're a bank, hit the Fed window.

If you get a lot of this behavior, you run out of timely liquidity. This is exactly what happened during the Great Unpleasantness to the TBTF institutions (including GE and GECC which was why it was deemed TBTF. Absolutely idiotic management, even stupider to bail them out, but we digress).

Regulations & fiduciary duties define credit parameters: primarily ministerial

The problem is an incorrect understanding (inferred by investors or *wrongly presumed by the regulators* operating in conjunction with the industry) that the risk is nil [2]. It is obviously not. As currently configured money market funds warehouse risk: credit, liquidity, and interest rate. They always have, but the market mechanics and risk footprint work differently now. The regulatory framework has not kept up. We leave our readers to research the association between industry interests and legislative initiatives over the past decade and a half.

Historically, in the good old days, committed back up lines of credit from stable banks were sufficient to mitigate any liquidity risk. Credit risk was statistical ether with loss ratios of near zero & easily absorbed by interest income, then actually a non- zero number. Things took longer to die then. Banks had measurable capital, greater liquidity, and less exposure to systemic risk. Credit issues in money markets were transferred to banks by back up credit lines for resolution. No problem, very orderly, one at a time, old style commercial banking. That model worked for a while and actually had capital, but when we increased the volumes by an order of magnitude, reduced capital by another order of magnitude, added Moore's Law to transaction & credit cycles, cross wired the exposures via credit derivatives… well, turn the blender on high... and blammo! The regulators and the rating agencies were behind the curve on each and every one of those factors.

The Great Unpleasantness presented a systemic failure of global liquidity. Bank liquidity and the commercial paper market started to fail and impact the money market funds. The US Treasury stepped up to prevent a complete liquidity failure.

Things have normalized now, but the money market regulations that took us there remain. Once again we have a widespread and incorrect perception that they are risk free or near risk free. Or alternatively (or rather, co-strategically?) there is an implicit expectation that the US Treasury will bail the money market funds out again. Thus, we manufacture moral hazard.

Rule 2(a)(7)

Most of the regulatory constraints derive from the Investment Company Act of 1940. Essentially, Rule 2(a)(7) defines the operational, credit & capital parameters of money funds. It failed. We encourage you give yourself a headache & read the provisions in whole, and you will see the nature of the problem. For all its complexity, it does nothing.

It defines the 'eligible' parameters of portfolios for Tier I funds (the large 'high quality' funds widely distributed); the role of rating agencies; and fiduciary duties of money fund managers. The simple story is that the requirements for Tier 1 funds are met if

- 95% of the stuff has any two of the highest ratings (A-1 or better, P-1, D-1, or F-1) from Moody's, Standard & Poor's, Duff & Phelps, Fitch and whomsoever else the SEC has dubbed a Nationally Recognized Statistical Rating Organization and
- the portfolio is within specified maturity parameters

We contend 2(a)(7) doesn't address real credit risk or liquidity parameters.

Structure of risk assessment

The largest investors have their own beady eyed credit analysts who crunch a lot of numbers and watch things. The good credit firms are very good (Vanguard comes to mind, probably the best in the business), and the mediocre ones are just shoveling paper and watching the guys near the door. Most mid to small institutional investors rely on the credit rating agencies and internal analysts of varying skill and likely trained by guess who? Yup, the rating agencies.

If we were to summarize casually the credit approval process: the file contains ratings, short & long term; proposed $ and maturity limits, the offering memo, maybe some detail on whatever committed back up lines of credit exist. The credit guys present the names to the directors for approval, and, they're done. We don't mean to be flippant: the good ones are very diligent and effective. The others are much less so.

Rule 2(a)(7) states:

> *General. The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by a Designated NRSRO) and that are at the time of Acquisition Eligible Securities.*

Understand that the Directors of funds are entitled to rely upon the recommendations of management and outside experts (including the rating agencies). If you've ever seen a commercial paper offering memo... well, they're Spartan at best.

Cost structure of the industry creates bias to risk

The current interest rate structure as created by the Fed has distorted the economics of the whole industry and has the unintended consequence of incenting the money market funds to increase their risk. This is not a good thing if you recall the analogy to a bank with no capital.

Here's a hypothetical, but reasonably accurate example of how it works today:

Interest Revenue: .12% [see cp rates here]

Net operating expenses: .20% [est. minimum cost for $100 bn size]

Fund operating loss: -.08%

Net to investors: .00% [most funds subsidize the operating losses]

Risk to add: .08% [risk you need to add to save your job/bonus]

The fund manager needs go buy .08% incremental yield just to break even… more to make money. That's huge in money market land, and there is only one way to get it: more risk. Those are the (reasonably) current economics and the incentives.

That means increased structured product, over rated companies, foreign banks, mysterious 'Other', products that warrant complexity premia, and poor quality sovereigns… all that can be bashed into 2(a)(7) parameters. And that's a lot, but it's all OK, it's 2(a)(7) compliant.

So to summarize we have

- return free risk of systemic scale
- a dysfunctional incentive for more risk,
- no supporting capital and
- a largely false public perception of risk promulgated under regulatory color of the SEC

So what to do? Let's define the problem by its components and work our way up.

1. It is impossible to eliminate risk in money market funds.
2. There is a false perception of risk embedded in money market funds that is promulgated by regulators and industry.
3. Regulators are unable to timely, accurately & uniformly define the real risk embedded in money market funds and therefore unable to define adequate capital levels necessary to support that risk.
4. There is a near instantaneous cycle time for both credit decisions & liquidity requirements on the buy and sell sides.

The fix: eliminate the defective regulatory & risk framework.

Kill 2(a)(7) in whole. Eliminate the SEC's requirement for ratings. Let the funds & investors decide what works for them. Force all, including the rating agencies, to compete on the basis of informational relevancy & risk effectiveness.

Hold investors & fiduciaries accountable for the risk of what they buy.

Force funds to compete in risk, liquidity, and yield space and with different methodologies. Eliminate the defective presumption that there is one 'correct' method of risk definition & management. There is simply no empirical data to support it and a bunch of train wrecks to evidence its failure.

Define the form of required capital, but let the market determine the level. As to form, we prefer subordinated (or "equity") tranches. It is real paid in capital and provides more robust protection to senior holders from both credit and liquidity risks. We suggest a continuous market for the tranches which would provide vital information and tactical flexibility in times of normalcy or stress. Flexibility in chaotic markets is key to effectively managing them. The ability to defer payment provides greater flexibility on whether to sell assets or to defer payment on the equity tranche; what to sell; when; and at what price. Not having to transact is one way to survive a liquidity crisis. Equity tranches provide better continuous information and a better shot at timely & complete payment to the senior holders in a stressed market.

The variable NAV model will likely suffer in illiquid or volatile markets. No bid is still no bid. And a bad bid impairs the entire value of the fund, not just the subordinated tranche. Retail investors will be informationally disadvantaged in the NAV model. If you are informationally disadvantaged in a stressed market ... well, it's not good. The equity tranche model will bring informational parity to the assessment & pricing of the problematic event.

Require full, public, and real time disclosure of all holdings; ratings, and capital levels of all money market funds.

Provide a safe harbor for individual investors. Provide or cause to be provided via banks or other distribution systems a US Treasury Money Market Fund, limited to $500,000 (or whatever) per US citizen available through banks and the Post Office to individuals. This would not be available to corporations, LLCs, partnerships, or other unincorporated business accounts. The big boys are on their own and accountable for their results. Walking the plank sharpens the mind.

Kill the public perception that there is an implied support for any money market fund. New message: no risk free solution: *caveat emptor*.

The equity tranche would be prepaid **cash capital** and function akin to a cash-collateralized credit default swap or a first loss policy for either liquidity or credit events. It would be priced by competitive market, presumably by a global herd of institutional, sophisticated **Beady Eyed Credit Geeks** from a variety of structured credit desks. It would provide protection, to a defined amount known to and priced by the markets. From the perspective of systemic risk it also has the virtue of finality: there is a defined end point which does not lead to the US Treasury. When you exhaust the capital, you're done. Investors (senior and subordinated) wear the risk they bought.

The Squam Lake proposal provides some historic data on capital draw downs. We propose letting the market price & allocate the appropriate level of capital as it deems necessary and would let investors, both senior & subordinated tranches, choose their risk.

Our proposal forces explicit recognition & management of credit & liquidity risk. It provides a self-correcting market and price based mechanic that can accommodate both credit & liquidity shocks to the extent investors are willing to pay for that protection. It can (and should) adjust to changing parameters of risk. We also provide a limited safe haven for retail investors while forcing institutional fiduciaries to take a focused approach to being responsible for the risk in which they invest and further forcing the money funds to compete on the basis of risk/return/liquidity space. The large institutional players will force a new discipline on the process. Risk focuses the mind & wallet. Focus on *faux* compliance does not.

Our current regulatory framework promulgates

- a public misperception of risk by retail investors
- a defective and inflexible risk management system that is driven by regulatory whimsy rather than by dynamic market forces, information, and new technologies, and
- greater concentrations of credit & liquidity risk, which is to say more TBTF

It needs to change.

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[1] We ignore the Tier II market (A-2/P-2) because it's pretty much DOA and not relevant. See general information on the commercial paper markets

[2] Ben Bernanke, ECB = riskless. Peter Orszag and Joseph Stiglitz, 2002, GSE = riskless. Geithner = 'no risk of downgrade'

This one needs some fine print, so here it goes:

Update on Tuesday, March 20, 2012 at 10:00AM by hb

Thank you for submitting a comment to the U.S. Securities and Exchange Commission. This auto-reply is your notification that we received your comment letter. The SEC generally will post comments on the SEC's Internet Website (http://www.sec.gov/). Comments will also be available for website viewing and printing in the SEC's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00pm. We reserve the right, but shall have no obligation, to review, to refuse to post or to remove any or all of your submission from www.sec.gov that is deemed to be inappropriate for publication, including, but not limited to, obscene language, personally identifiable information, copyrighted material and irrelevant content. Submissions that are not posted on the website but that contain relevant content generally will be retained in the comment file. We may redact personally identifiable information from submissions, but have no obligation to do so. You should submit only information that you wish to make available publicly. We generally post comments within 2 to 3 business days after we receive them electronically. Also, please review our privacy policy at http://www.sec.gov/privacy.htm.

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We appreciate your taking the time to communicate your thoughts on our proposed rules.

Sincerely,

Elizabeth M. Murphy

Secretary

U.S. Securities and Exchange Commission

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Reader Comments (2)

The SEC site for comments is here
http://www.sec.gov/comments/4-619/4-619.shtml
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Yes, this would be a variant of the Sigma Finance model.
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