ADVISORRESEARCH

A Collateral Proposal

Looking at money market funds as covered bonds

BY JAMES HYMAS

A sound banking system is essential to the functioning of a modern economy. Whether one is borrowing money to purchase a house or saving money for retirement, Canadians have become accustomed to the idea that a bank is a reliable institution that – for all the grumbling about high fees and poorly trained front-line staff – will honour its commitments promptly.

In Canada, we enjoy the benefits of a very strong banking system. According to the World Economic Forum's Global Competitiveness Report 2007-2008, Canada ranks second out of 131 nations in the category "Soundness of Banks." This stability has served the country well – and it has also served the banks well, as they have been able to translate their financial strength and the confidence with which they are viewed into marketing strength, dominating most aspects of the financial system as a whole, including money market mutual funds.

Money market funds are an integral part of the Canadian mutual fund landscape, with total assets of over $48 billion in September 2007. They have been touted "as a very competitive alternative to bank accounts," despite the fact that they do not (formally) have a CDIC guarantee. And, when the Canadian ABCP crisis hit, Rudy Luukko of Morningstar wrote: "For firms that did hold these securities in their funds, it was time for damage control. National Bank of Canada, and others including Fédération des caisses Desjardins and Industrial Alliance Insurance and Financial Services Inc., announced buybacks of their non-bank holdings to safeguard investors."

The view that this is a normal state of affairs is widely held. Gordon Pape has written: "While I do not expect any money market funds to incur material losses as a result of this situation (if need be, other sponsors will follow the lead of the National Bank)…" Many American institutions have bailed their MMFs out of suddenly dubious commercial paper.

These actions are merely a reaction to the expectations of retail investors. One seasoned investor wrote on a popular Internet discussion board: "If any Canadian bank broke the buck on one of its MMFs and walked away from it, I would sell all of my mutual funds, not just any MMF that I owned as well as my fundco stocks and never buy again. Reason: no bank/fundco is to be trusted. Although MMFs are not guaranteed, their history is such that they might as well be."

The banks and other sponsors are careful to include all the usual regulatory boilerplate in their prospectuses and advertisements: "Your investment in any mutual fund is not guaranteed. Unlike bank accounts or guaranteed investment certificates (GICs), mutual fund units are not covered by the Canada Deposit Insurance Corporation or any other government deposit insurer … the unit price of the fund may rise or fall, although we strive to maintain a constant $10 unit value."

But the public expects a guarantee of the money market funds, whether the banks intend to offer one or not. There may be no *de jure* support, but the actions of National Bank et al. have shown that *de facto* support is the order of the day.

Now let us turn to the concept of covered bonds. Covered bonds are unconditionally guaranteed by the issuing institution, but have specific collateral pledged against them – they may be thought of as old-fashioned "mortgage bonds." In June of this year, the federal bank regulator allowed the issuance of covered bonds by Canadian banks, to a limit of 4% of the total assets of the issuer, noting: "Covered bonds can improve funding diversification and lower costs. However, they also create a preferred class of depositors, reducing the residual level of assets available to be used to repay unsecured depositors (including the Canada Deposit Insurance Corporation) or other creditors in the event of insolvency, depending on the amount issued and the nature of credit enhancements."

Why would a bank issue covered bonds? An excellent reason may be found through consideration of the recent European issue by Royal Bank: after currency conversion, hedging and interest rate swaps are taken into consideration, they were able to borrow $2 billion dollars at a rate 25 basis points less than they would pay for deposit notes (which are, essentially, tradeable GICs for institutions).

As such, we can isolate some key points regarding covered bonds. The banks are giving certain sources of funding preferential claim on some assets, yet the banks are still exposed to the risk of these assets. The banks, however, earn income on these assets, allowing them to make a profit on the difference. I suggest that bank-sponsored Money Market Funds may be viewed in the same manner. The banks:

- Are giving MMF unitholders preferential claim on securities held by the MMF (if the bank should go bankrupt, unitholders will still own the assets)
- The banks are still exposed to the risk of these assets (since there are widely held and seemingly valid expectations that the bank will bail their MMFs out of investments that go wrong)
- Charge the unitholders a fee (money market management expense ratios in excess of 1% are considered entirely normal in Canada)
- And make a profit (it certainly does not cost 1% to run a billion-dollar money-market fund!)

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The point that the banks are exposed to the risks of investments made by its MMFs is critical, since risks assumed by the banks should be reflected in their Tier 1 Capital ratio. To derive this number, the bank's Tier 1 Capital is divided by its Risk Weighted Assets, where the former number is comprised of shareholders' equity and equity-like resources of the bank, while the latter is the sum of the loans the bank has made, weighted by its risk. A three-month Canadian treasury bill, for instance, has a risk weight of zero; credit card loans have a risk weight of 75%; a mortgage has a risk weight of 35%. Royal Bank, with a Tier 1 ratio of 9.3% as of July 31, 2007 seeks to maintain the ratio above 8%; Citigroup, the target of considerable scorn in the past few months, had a ratio of 7.32%.

The guidelines for the calculation of risk-weighted capital, from the Office of the Superintendent of Financial Institutions, states that commercial paper of the highest grade is assigned a risk weight of 20%. However, even the RBC Canadian T-Bill Fund held only slightly over half its assets in T-Bills; the rest was commercial paper. Therefore, we may assume – for the purposes of this calculation – that all the assets of the funds would be charged to risk-weighted assets at a rate of 20%.

We can then derive the result that the Tier 1 Capital Ratio, when calculated including their exposure to the credit risk of their Money Market Funds, should be stated as 9.2% rather than the reported 9.3%. Some may consider this to be a trivial change, but if Canada is to continue to enjoy the benefits of having an exceptionally strong and stable financial system, we must spare no effort to assess the risks the banks face in their operations and to ensure that they have adequate capital available to take these risks in a responsible manner.

Considerable resistance to such a change may be expected from the banks; after all, they will argue, even given the Money Market Fund bail-outs that have been executed this year, there is no contractual obligation to spend the money; if they are experiencing discomfort at the same time as the MMFs, they could simply walk away. However, as the opinions of the professional advisors show, such action would have an immediate and lasting effect on the fee income they earn from MMF operations. Credit quality is not just the Tier 1 ratio, a static evaluation of the balance sheet; credit quality also depends on continued strong earnings, which would be hurt were they to lose the MMF revenue. Should they not wish to have their Risk Weighted Assets affected by the assets held in their MMFs, there is an easy option available to them: T-Bills, as noted, have a zero risk weight for the purpose of this calculation.

So: let us have the bank regulators regard bank-sponsored money market funds in the same way in which their investors, and their investors' advisors, regard them: not as stand-alone investments, but as "covered bank deposits." The stability of the Canadian banking system will be enhanced by the change. There is a clear expectation that the banks will support their money market funds in times of trouble; recognizing this fact in advance and ensuring that the banks' capitalization reflects this potential will help ensure that the money will be available when required. AER

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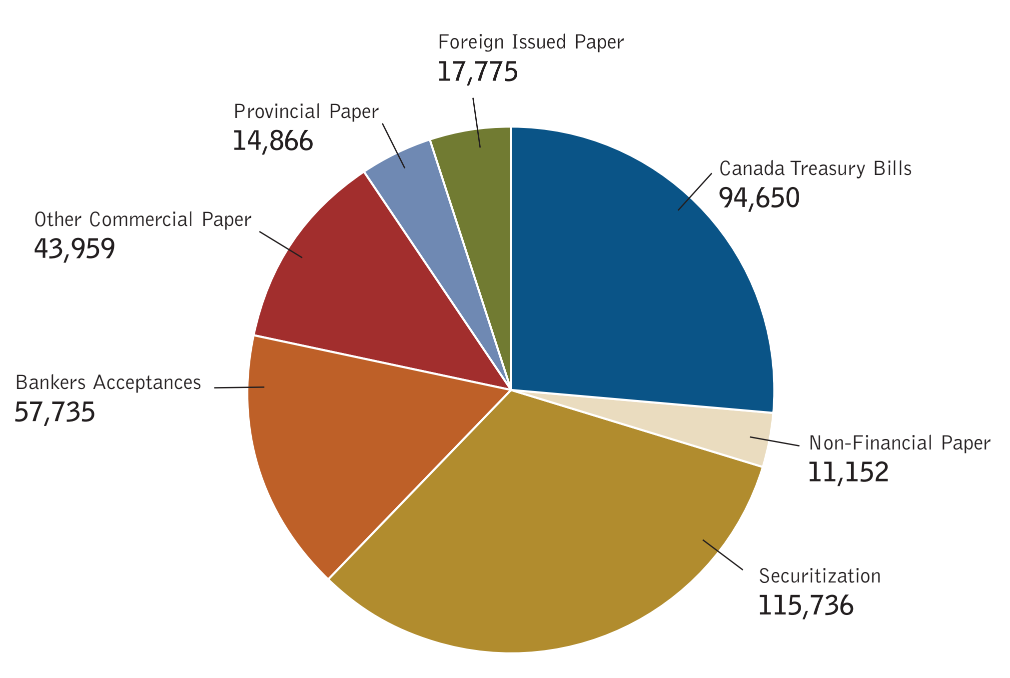
CANADIAN MONEY MARKEY, JULY 2007



Source: Bank of Canada Weekly Financial Statistics, September 28, 2007