BY JAMES HYMAS

The future of money market fund regulation

HYMAS

Money market funds (MMFs)—the biggest selling class of mutual funds in nine of the past 13-month periods—are decidedly an important part of the Canadian investment landscape. Assets held by MMFs totalled $73.1 billion at the end of May 2009, an increase of more than 50% since May 2007, according to the Investment Funds Institute of Canada.

When compared with the $503.7 billion in total liquid deposits in Canadian banks reported by the Bank of Canada for April 2009, MMFs form a significant portion of the Canadian economy, although not as important as they are in the U.S., where MMF assets of $4 trillion compare with bank deposits of $8.7 trillion.

In the U.S., MMF sales have been encouraged by the reserve requirements of the Federal Reserve. In order to minimize their mandatory reserve balances (which did not pay interest until very recently), many banks offer "sweep" programs to their depositors, whereby excess funds in chequing accounts are automatically used to purchase MMFs on an overnight basis.

In my essay published in the December 2007 edition of AER, *A Collateral Proposal*, I argued that:

› investors have a strong expectation of zero loss from MMF investments;

› banks would be forced, due to reputational concerns, to cover credit losses incurred in their MMFs;

› therefore, the credit risk of the commercial paper held by bank-sponsored MMFs should be included in their risk-weighted assets for capital ratio calculations.

Concern regarding reputational risk is not simply a reaction to the extreme events of the credit crunch. The implicit guarantee has been tested before: 15 near-failures of MMFs in 1993-94 cost sponsors around USD 600 million.

The effect of breaking the implicit guarantee was tested last September by Reserve Primary Fund, which announced it had "broken the buck" after writing off an investment of $785 million in commercial paper issued by Lehman.

Shocked at the sudden revelation that no investment is risk-free, investors placed MMF redemption orders totalling $169 billion in the two days following the announcement. After two weeks, bank-sponsored funds found their assets under management reduced by 30%. This posed a huge risk to the world financial system given that European banks are highly dependent upon U.S. MMFs as a buyer of their short-term USD paper. Extraordinary measures by central banks were required to limit the damage.

To avoid future crises, policymakers are now considering alternative methods of MMF regulation. Paul Volcker, chairman of the White House Economic Recovery Advisory Board, headed a group that concluded that because of the "dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk" two revisions to policy are required:

› MMFs seeking to offer bank-like services, such as maintenance of a stable NAV, should reorganize as special-purpose banks, with all the regulatory and capital implications that bank status implies; and

› other MMFs should not be permitted to use amortized cost pricing of their assets and would therefore carry a fluctuating NAV.

These proposals, endorsed by the Bank of England and currently being reviewed by the President's Working Group on Financial Markets, caused immediate howls of anguish. The president and CEO of the Investment Company Institute (ICI) warned, "If the recommendations are implemented, there will be no more money-market funds, period."

In order to protect their franchise, the ICI prepared a report that suggested credit risk in MMFs could be eliminated via increased box ticking. The proposals that apply to credit risk are:

› making it illegal to purchase "non-prime" commercial paper. These lower-grade credits are currently limited to 5% of investments, with a maximum of 1% exposure to a single name;

› requiring that all money market fund advisors establish a "new products" or similar

continued on page 7

INVESTMENTS

The future of money market fund regulation

continued from page 6

committee;

- encouraging money market funds and their advisors to follow best practices for determining minimal credit risks;
- retaining references to credit ratings in SEC rules as an important "floor" on investments; and
- requiring advisors of money market funds to designate and publicly disclose a minimum of three credit rating agencies that the advisor will monitor, to encourage credit rating agencies to compete for this designation by improving their ratings systems for short-term debt.

The emphasis on credit rating agencies in the ICI's proposals is simply an abnegation of the sponsor's role as trustee of the fund.

It should be very clear to all participants that the portfolio manager designated by the trustees is solely responsible for determining credit quality. He may take advice from his analytical support team, from the credit rating agencies, or even from his barber if he wants to, but he must not be permitted to delegate a shred of his responsibility for determining the suitability of investments.

Further, any revision of the SEC's rules must include the aim of providing a legal basis for the frustration of any attempts to encroach on his authority, such as is envisaged by the establishment of a "new products committee."

The ICI report's rebuttal to the Volcker proposals is simply laughable in its claim that imposing capital requirements on money market funds poses significant accounting and tax challenges and would provide little protection against the market-wide credit and liquidity events that can lead to widespread redemptions.

Somehow I feel an industry that touts its competence to manage $4 trillion in money market funds alone should be able to handle the unspecified accounting and tax challenges involved in adding to the 8,000+ banks currently operating in the United States. As for the protection against credit events: Credit events can happen anywhere, at any time.

However, on June 24 the SEC responded to a directive from the Treasury and released a set of rule changes titled Money Market Fund Reform, incorporating most of the ICI proposals. The approach to credit quality risk simply replaces the judgment of the portfolio manager with that of a committee, which includes the credit rating agencies.

Amusingly, the SEC has accepted the ICI's contention that requiring an MMF to designate, in advance, at least three credit rating agencies for determination of investment suitability "may promote competition among NRSROs to produce the most reliable ratings." Evidently, the SEC is not fully aware of events involving commercial mortgage-backed securities, the U.S. regulator of insurance companies (National Association of Insurance Commissioners, "NAIC") and the ratings agencies.

After S&P announced it was considering reducing its ratings for these securities en masse, there was an immediate move to have another agency, Realpoint, (which has a rosier outlook for the commercial mortgages) approved as a source of credit ratings by NAIC.

As Dr. Joseph Mason emphasizes, "The regulatory use of ratings thus has changed the constituency demanding a rating from free-market investors interested in a conservative opinion to regulated investors looking for an inflated one."

It's all very well to have box-ticking procedures in place that will absorb some blame for disasters; but ultimately nothing concentrates the mind like having your own money on the line. It should also be apparent that while the credit risk of any company might be extremely low, it's never zero.

The SEC's statement of allegations against Reserve Management Company and others claims that Reserve Primary's ability to maintain a stable NAV relied exclusively on the controlling shareholder's (the Bent family) ability and willingness to absorb losses.

The SEC alleges that the Bent family made assurances of such support to ratings agencies, unitholders and others, without any intention of doing so. The response of American MMF investors, and the worldwide repercussions that resulted from the lack of support for a single fund mean the current system of nods, winks and understandings is simply not good enough.

> **Canadian MMFs have seldom required sponsor support, but in August 2007 (following the ABCP collapse) National Bank announced it would acquire all the ABCP held through its mutual funds.**

Breaking the buck for an MMF is a strong indication that the financial system is already strained, since only the highest quality and largest companies are able to issue commercial paper in the first place.

The laissez-faire attitude toward MMF sponsors' credit guarantees may be contrasted with the demonization of AIG, which culminated with Senator Grassley's famous exhortation that AIG executives should "resign or go commit suicide" and the harassment of employees after AIG made contractual obligations of credit support (via Credit Default Swaps) that it couldn't back up.

In order to ensure that—unlike AIG—a willing sponsor will probably have the ability to bail out an MMF, explicit credit support should be accounted for when assessing the capital quality of the sponsor.

Currently the reputational risk is almost as trustworthy as a contract. The Bank for International Settlements has adopted, as a matter of policy, that supervisors must assess the degree of implicit support for MMFs, but have stopped short of including this off-balance-sheet implied credit guarantee as a factor when computing risk-weighted assets.

Canadian MMFs have seldom required sponsor support, but in August 2007 (following the ABCP collapse) National Bank announced it would acquire all the ABCP held through its mutual funds.

The National Bank Money Market Fund had about half its value invested in these instruments in March 2007. The total value of ABCP acquired by National Bank from various sources was $2.1 billion.

Since the provision of this credit support, National Bank has recognized $739 million in impairment charges while the cost of financing this position totalled $84 million.

National Bank's risk-weighted assets at the end of the third quarter of 2007 totalled about $51.2 billion; hence, the charge due to ABCP represented about 1.6% of risk-weighted assets. This is a manageable amount; the credit support and its effects may be described as a legitimately unexpected loss and it is the purpose of bank capital to absorb such unexpected losses.

National Bank is a relatively small player, but TD Asset Management was reported by BIS to have USD $22.6 billion in MMF assets as of August 31, 2008. TDAM provided support to its MMFs; they were not alone in this as about one-third of the top 100 U.S. MMFs received support of some kind throughout the depths of the crisis.

It is outrageous that unexpected losses to this degree arose from credit risks that are not recognized in the determination of the credit risk borne by a bank.

We may consider ourselves lucky that in Canada we have avoided the worst direct effects of the credit crunch; but we should be taking action to ensure that next time it won't be a matter of luck. Credit support must be made explicit and the credit risk inherent in this support should be incorporated in the calculation of the sponsor's risk-weighted assets. AER

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AT A GLANCE

continued from page 5

IIROC REOPENS TAUB PROCEEDINGS

IIROC has wasted little time in reopening its case against Stephen Taub after **a recent Ontario Court of appeal decision said it's OK for the regulator to penalize members who have left the industry.**

Taub, a former stockbroker, stalled enforcement action for more than four years, claiming IIROC has no legal means to pursue him.

IIROC vigorously appealed the decision, and won a reversal of the Divisional Court at the Ontario Court of Appeal at the end of August.

SEARCH: **TAUB**

GOLD PRICES WARRANT CAUTION

There are a number of reasons why you should invest in gold, but advisors need to be wary of the meteoric price of the metal, which could be the result of over-hype.

According to a recent report by Windsor-based Dan Hallett & Associates, gold investors need to be aware that much of the demand for gold is being driven by the financial markets rather than substantial shifts in supply and demand.

SEARCH: **gold**

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