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Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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The Changing Money Market Landscape: What Investors Need to Know

New Money Market Fund (MMF) rules are being implemented this coming October. The consequences of these changes may provide some opportunities for investors at the front end of the yield curve.

BACKGROUND

On September 16, 2008 the investment industry saw the first retail money market fund "break the buck." The Reserve Primary Fund held $785 million of Lehman Brothers Commercial Paper that was rendered worthless when Lehman filed for bankruptcy. Even though the holdings represented less than 1.5% of the fund, investors worried that other commercial paper issuers held within the fund might suffer the same fate. Redemptions continued and within 24 hours, the Reserve Fund's holdings were reduced significantly. Unable to satisfy redemption requests, the fund froze redemptions for 7 days and when those measures failed to stem the redemption tide, the fund was forced to halt operations and begin liquidation. In order to restore confidence in the market, the U.S. government launched the Temporary Guarantee Program for money market funds, which would guarantee investors a stable NAV of $1 per share on money market shares held as of September 19, 2008. While the SEC instituted regulatory rules around the 2008 financial crisis, on July 23, 2014 they issued final revisions to rules regulating the money market fund industry. Those rules will officially go in to effect on October 14, 2016.

NEW SEC RULES

Investor Types

The new rules redefine "retail" versus "institutional" prime and tax-exempt MMFs. Retail funds will be limited to ownership by individuals *(natural persons)* only. Any prime or tax-exempt MMF that does not meet the SEC's retail definition will be considered an Institutional Fund. Institutional funds, however, are open to any type of investor, including individuals.

The following tables illustrate the fund type definitions and new rules governing the use of floating NAVs, liquidity fees and redemption gates.

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Fund Types

Table 1. Money Market Mutual Fund Types

Money Market Mutual Fund Type	Instrument Types Typically Held
Treasury	U.S. Treasury securities, repurchase agreements collateralized by U.S. Treasury securities
Government	U.S. Treasury securities, other government securities and repurchase agreements collateralized by U.S. Treasury or other government securities
Municipal/Tax-Exempt	Tax-exempt securities issued by state and local governments and non-profit entities
Prime/General Purpose	Any eligible Money Market instrument as defined by SEC rule 2a-7, commercial paper, CDs, corporate notes, other debt instruments, as well as the government types listed above

Source: NEAM

Table 2. New Regulations (Effective October 14, 2016)

New Regulations	Rule
Floating NAV (Net Asset Value)	Institutional prime and institutional tax-exempt MMFs will be required to price and transact at a floating NAV based on the market value of the portfolio's underlying securities. The NAV will be priced out to 4 decimal places ($1.0000)
Liquidity Fee	If a fund's weekly liquid assets fall below **30%**, the fund's board can impose a 2% liquidity fee on redemptions. If a fund's weekly liquid assets fall below **10%**, the fund's board can impose a 1% liquidity fee on redemptions
Redemption Gate	If a fund's weekly liquid assets fall below 30%, the fund's board can suspend redemptions for up to 10 business days

Source: NEAM

Table 3. Summary of New Regulations as they Apply to Various Fund Types

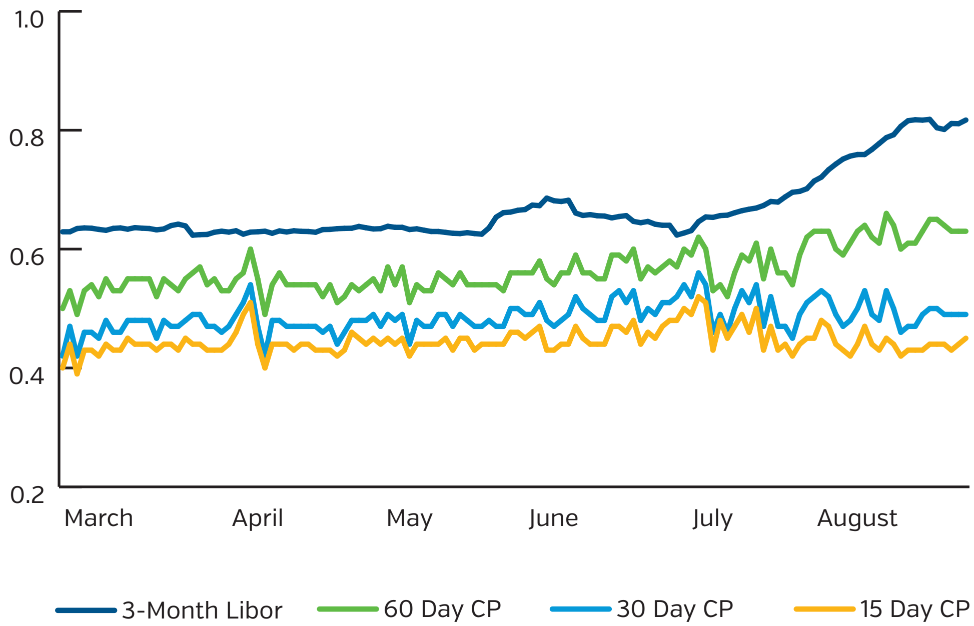
Fund Type	Net Asset Value (NAV)	Liquidity Fee	Redemption Gate
U.S. Treasury	Stable	No	No
Government	Stable	No	No
Retail Municipal/Tax-Exempt	Stable	Yes	Yes
Retail Prime/General Purpose	Stable	Yes	Yes
Institutional Municipal/Tax-Exempt	Floating	Yes	Yes
Institutional Prime/General Purpose	Floating	Yes	Yes

Source: NEAM

REACTION BY FUNDS THUS FAR

Significant outflows from Prime funds have occurred over the last several months in reaction to the upcoming rule change going into effect. The 4 week average outflow has been $23 billion but as of the week ending August 17, the outflows rose to $40 billion. Outflows will continue to put pressure on 3-month Libor as prime funds that have been large buyers of longer dater commercial paper shorten their weighted average maturities to improve their liquidity profile.

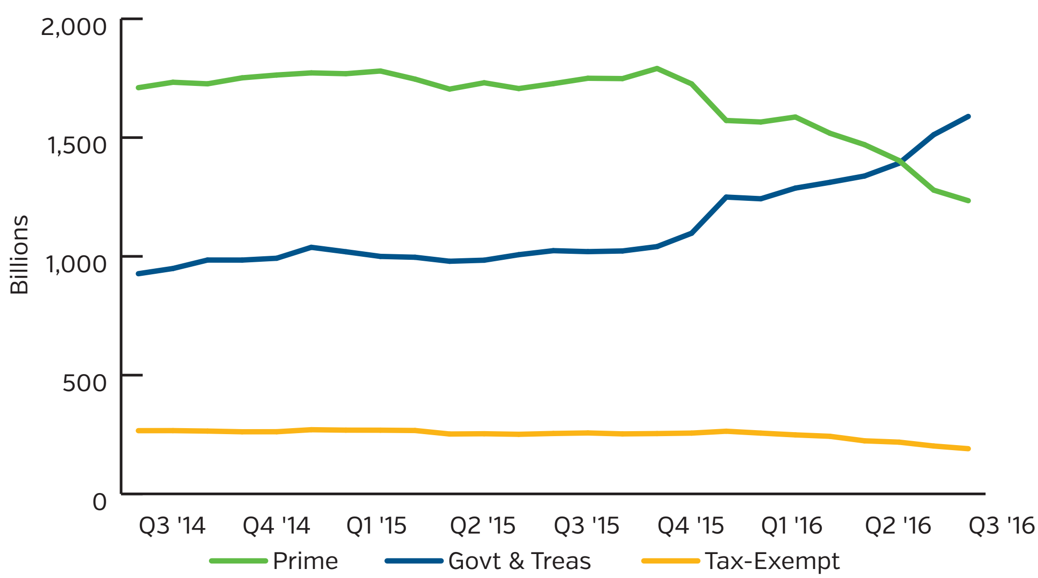
Chart 1. Commercial Paper vs. 3-Month Libor Rates



Source: Bloomberg

Since November 2015 through July 2016, Prime funds have decreased from $1.790 trillion to $1.234 trillion and government and Treasury funds have increased from $1.041 trillion to $1.589 trillion. We anticipate this trend will continue apace for the next several weeks.

Chart 2. Trend in Money Market Fund Assets, by Type of Fund



Source: SEC

KEY TAKEAWAYS

As inflows to Treasury and government funds continue to increase, we may see a squeeze on T-Bill rates as two things happen. First, there will be an ever increasing demand for short bills to satisfy the Treasury and government funds. Second, government regulation pertaining to the Treasury's debt ceiling (reinstated March 15, 2017) may force the Treasury to reduce its cash balances, causing downward pressure on yields across the bill curve.

- Wider spreads on non-government paper will continue to be driven by the reduction in demand for short-term instruments that prime and tax-exempt funds have typically purchased in this maturity range. The drop in demand should continue and lead to wider spreads for credit instruments versus government securities.
- Buying opportunities should emerge in various non-government sectors including municipal variable demand notes, bank CDs, commercial paper and corporate securities with maturities between 3 and 12-months.

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